Economic Analysis RBA Monetary Policy Decision Aug 2023

At its meeting today, the Reserve Bank of Australia (RBA) decided to keep interest rates on hold. The cash rate target remains at 4.10% and the interest rate on Exchange Settlement balances at 4.00%.

Cash rate futures had priced in around a 75% probability of no change. However, the majority of commercial bank economists had expected a 25bps hike.

Justification of the Decision

In the post-meeting statement, RBA Governor Philip Lowe justified the decision citing:

- substantial monetary policy tightening to date,
- incoming data being consistent with inflation returning to the 2-3% target range,
- uncertainty surrounding the economic outlook.

On the first point, Governor Lowe repeated that interest rates had increased by 400bps in this cycle, in an effort to work towards a 'more sustainable balance between supply and demand', but again stressed that monetary policy operates with a lag.

On the second point, Governor Lowe underscored that:

- inflation has declined, led by slower growth in goods prices, and is forecast to be back in the 2-3% target range by the end of 2025,
- economic growth is subdued, with 'weak' increases in both consumption and dwelling investment,
- while labour market conditions remain 'very tight', they have 'eased a little', and
- wages growth is still consistent with the inflation target, provided productivity growth accelerates.

On the third point, the RBA Governor citied risks to the inflation projection path, most notably:

- services price inflation is 'brisk' and, similarly to other advanced economies, could also remain persistent in Australia,
- private consumption outlook is uncertain due to the uneven distribution of the effects of tightening across households, with some benefiting from rising house prices, savings buffers and higher interest income.

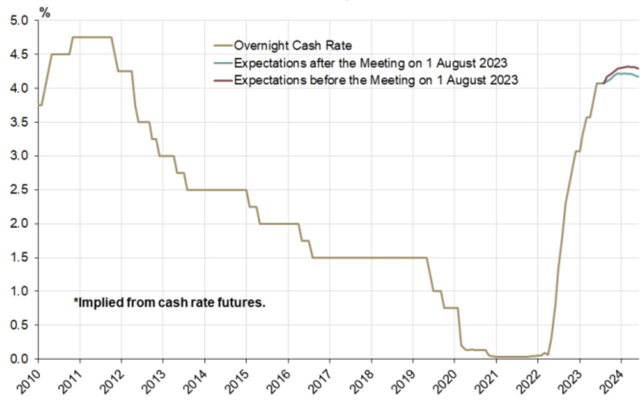
Governor Lowe stressed that inflation is still 'too high', with 'brisk' growth in prices for some services. He underscored that future decisions would remain data-dependent, focussing on the global economic outlook, household spending, inflation and labour market conditions.

Market Impact

The RBA's decision to keep the interest rates on hold was a surprise to some market participants. As a result of this, there was some reaction in the financial markets:

- 3-year Commonwealth bond yields dropped from 3.86% to 3.75% after the decision,
- 10-year yields fell from 4.03% to 3.97%,
- the AUD/USD ebbed from $0.6693 to $0.6655,
- the ASX 200, which was trading at 7,433 just ahead of the decision, closed at 7,451.

RBA Historical and Expected Cash Rate*



Comment

The RBA's decision to pause was expected by a lot of traders, particularly after the recent downside surprise to the Q2 inflation figures and June retail trade data.

It was taken despite renewed strength in the housing market, caused by ongoing solid demand and structural undersupply.

The majority of commercial bank economists were expecting a renewed 25bps hike, given that labour market conditions remained strong, inflation is still well above the RBA's target range and services price inflation picked up in Q2. However, it appears that the RBA is increasingly confident that, absent of materialisation of upside risks, inflation will return to the 2-3% target range over the medium term.

In the post meeting statement, Governor Lowe continued to stress that the RBA Board remain 'resolute' in their determination to bring down inflation. However, no more cash rate increases are fully priced for this cycle, with the peak at around 4.25% implied both from the futures and overnight index swaps.

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