WESTERN AUSTRALIAN
TREASURY CORPORATION

Economic Analysis — RBA Monetary Policy Decision May 2022

At its meeting today, the Reserve Bank of Australia (RBA) decided:

- **to increase** the cash rate target by 25 basis points to 0.35%,
- **to increase** the interest rate on the Exchange Settlement balances by 25 basis points to 0.25%,
- **not to reinvest** the proceeds of maturing government bonds in its portfolio, but also not to sell government bonds at this stage.

The decision not to roll over the maturing government bonds will result in a decline in RBA's balance sheet (quantitative tightening). The start of quantitative tightening will be in mid-July 2022, when the first of bonds held by the RBA mature (around A$2.2b).

Justification of the Decision

The RBA Board judged that this was the right time to begin to withdraw some of its monetary policy support because:

- the Australian economy has proven resilient, particularly with respect to the labour market; the RBA expects that the unemployment rate will decline to 3.5% by early 2023, while GDP is expected to grow 4.25% in 2022 and 2.0% in 2023,
- inflation has moved up more quickly and to a higher level than previously expected; the RBA forecasts that in 2022 headline inflation will reach around 6.0% and the trimmed mean around 4.75%, before moderating to around 3.0% by mid-2024.

However, the RBA underlined that there is a great deal of uncertainty about the economic outlook.

The RBA has previously identified higher wages growth as integral to maintaining inflation sustainably within the target band and said that its business liaison suggests wages growth is picking up. An increasing number of companies are reporting that they are having to pay higher wages to attract and retain staff, given the combination of a tight labour market and rising costs of living.

The above evidence was timely enough to give the RBA confidence to proceed with the move, ahead of the wage price index release for Q1 scheduled for 18 May.

Forward Guidance

In his post-meeting statement, the RBA Governor said that the Board is committed to do whatever is necessary to ensure that inflation returns to target over time.

He stressed this will require further increases in the interest rates and the RBA will continue to closely monitor the incoming information in determining the timing and scale of interest rate hikes.

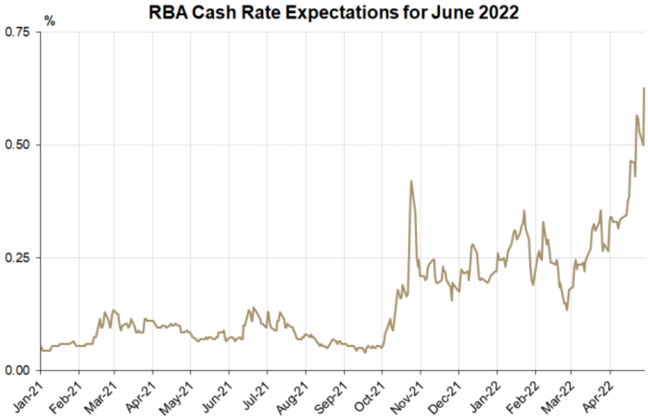
Market Impact

While a cash rate increase was widely expected by the market participants, its scale was surprising as the commentators had been expecting rather a 15bps hike to 0.25%. Given this, there was a slight increase in market interest rates and appreciation of the Australian dollar following the decision.

3-year Commonwealth bond yields rose to 2.971% from 2.884%. 10-year yields rose from 3.286% to 3.308%.

The Australian dollar initially appreciated from US$0.7088 to US$0.7142 and is US$0.7127 at the time of writing.

The probability of a 0.40bps hike to 0.75% in June rose to around 80% after the May decision.



Comment

With its May decision, the RBA took a large U-turn in its monetary policy. It came after a less than hawkish statement in April, which suggested that a hike will come in the coming months, rather than the next month. Given the emphasis on wage growth present in RBA communication since late 2020, it seemed reasonable to expect that the RBA would abstain at until the official Q1 wage price index.

This is not to say that monetary policy tightening was unjustified at the May meeting, or even earlier. Inflation is well and truly above the RBA's target, while economic conditions are favourable and the labour market is tight. The RBA stressed today the rise in inflation, while largely reflecting global factors, is increasingly supported by domestic capacity constraints.

Market expectations for future rate increases are quite stretched, with markets pricing in a rise to 3.5% in early 2023. However, we expect that the RBA will be forced to stop lifting rates significantly lower than that, constrained by a high level of private debt.

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