Economic Analysis RBA Monetary Policy Decision July 2022

At its meeting today, the Reserve Bank of Australia (RBA) decided to lift its interest rates by 50 basis points, increasing:

- the cash rate to 1.35%,
- the interest rate on Exchange Settlement balances to 1.25%.

The decision was in line with the market expectations.

Justification of the Decision

The second consecutive 50bps interest rate increase is another step in the withdrawal of the monetary policy support introduced during the pandemic. In the post-meeting statement, which echoed that from June, RBA Governor Philip Lowe drew particular attention to:

- still high inflation, both in Australia and globally,
- the role of domestic factors, including strong demand, and increased inflation pressures,
- evidence from the Bank's liaison program and business surveys that the tight labour market is putting upward pressure on wages growth.

Governor Lowe stressed that inflation in Australia is lower than "many other countries", with global factors responsible for much of the increase. However, he added that the rise in inflation was partly due to domestic factors, particularly the tight labour market, capacity constraints and the recurring floods over east. On a positive note, medium-term inflation expectations remain well anchored, according to the RBA.

Looking ahead, the RBA expects that inflation will peak later this year, before declining towards the 2-3% target band next year.

While Governor Lowe emphasised that the Australian economy is resilient, there are two major sources of uncertainty.

The first one is the behaviour of households amid the pressure from higher prices, higher interest rates and lower house prices over east, though the risk is partly mitigated by improvement of household balance sheets during the pandemic (on aggregate).

The second source of uncertainty is obviously the global outlook, also clouded by the impact of higher prices and interest rates, as well as the zero COVID policy in China.

Forward Guidance

With reference to the future decisions, Governor Lowe said that the Board expects to continue monetary policy normalisation in the coming months. The size and timing of future rate hikes will be dependent on the incoming data, as well as the outlook for inflation and the labour market. Governor Lowe reiterated the RBA's commitment to doing what is necessary to ensure that inflation returns to the target band over time.

Market Impact

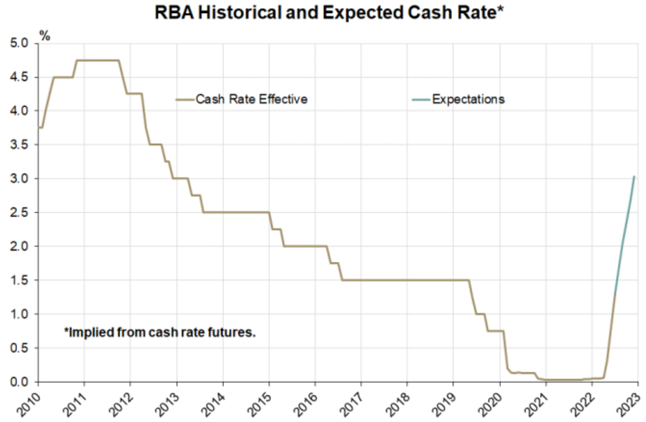
As a 50bps hike was expected by the market participants and almost fully priced in, the market reaction was quite calm. It seems that some market participants had expected a larger hike, which would have been at odds with recent RBA communication.

The Australian dollar depreciated from US$0.6880 to a little above US$0.6850 immediately after the decision.

3-year Commonwealth bond yields have declined 3bps to 3.07%, while 10-year yields fell 5bps to 3.56%.

Futures market pricing for another 50bps hike to 1.85% in August is currently 77%. The market is pricing in a cash rate of 3.00% by the end of 2022.

RBA Historical and Expected Cash Rate*



Comment

The RBA continues its swift monetary policy normalisation. While being somewhat of a late starter compared to some other central banks, the 125 basis points of interest rate hikes since May is the fastest pace of RBA tightening over a three-month period since 1994.

The RBA's task remains challenging going forward. Despite the increasing role of domestic demand pressure, much of the upward pressure on inflation continues to be driven by supply shocks. Unless they are resolved, the RBA might have trouble bringing inflation back toward its target without triggering a bigger than anticipated slowdown or even a contraction, possibly at least partly driven by financial stress among highly indebted Australian households.

The markets are currently pricing in a 3.0% cash rate by the end of the year and a peak at around 3.50% in the first half of next year. This would be the highest cash rate in a decade and well and truly in restrictive territory.

The cash rate expectations have eased over the past few weeks, due to concerns over global growth and comments by the RBA Governor, who continues to say he expects the cash rate to be taken to a neutral level of 2.50% or just slightly higher.

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