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Economic Analysis RBA Monetary Policy Decision August 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 target to 1.85%,
- the interest rate on Exchange Settlement balances to 1.75%.

The decision to deliver a third consecutive 50bps hike was in line with market expectations. The cash rate target is now 175bps higher than before the start of the tightening cycle in May.

A separate dataset shows that RBA's bond holdings shrank by A$2.6b to the still large A$353.1b in July as, in line with the quantitative tightening policy, the proceeds from the maturity of the Commonwealth bond on 15 July were not reinvested.

Justification of the Decision

Another 50bps interest rate hike is a continuation of normalisation of monetary policy in Australia. The post-meeting statement stressed the RBA's determination in bringing inflation down to the 2-3% target range. However, the Governor also highlighted the importance of not derailing the economy in the process.

Governor Lowe again stressed that inflation is elevated, not only due to global factors but also, because of domestic pressures from strong demand, supply disruptions and the tight labour market. He highlighted signs of rising wages in business surveys and the RBA's liaison program.

The RBA inflation forecasts were revised significantly upwards, as expected. According to the new central projection path, inflation will reach 7.75% in 2022, before falling back to slightly above 4.0% in 2023 and around 3.0% in 2024. This means inflation will likely remain above the RBA's target range for much of the next two years.

At the same time, the RBA revised GDP growth forecasts downwards, to 3.75% for 2022 and just 1.75% in each of the following two years. The RBA expects further declines in the unemployment rate in the months ahead. However, slower growth is forecast to push the unemployment rate up to around 4.0% by the end of 2024.

The post-meeting statement again pointed to uncertainties around the projection's central path. These include various global risks and, domestically, the reaction of Australian households to higher costs of living and interest rates. Governor Lowe again stressed that labour market conditions are strong and households have built up significant buffers throughout the pandemic, but pledged to track developments in the household sector.

Forward Guidance

Governor Lowe indicated that the sharp pace of interest rate increases has provided the RBA with flexibility going forward and that, while monetary policy normalisation will continue, the RBA Board is not "on a pre-set path". The size and timing of future rate hikes continue to be dependent on the incoming data, mainly the outlook for inflation and the labour market.

Market Impact

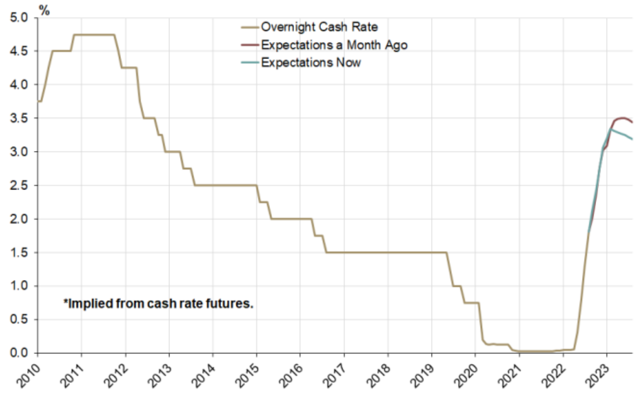
A 50bps hike was expected by the market participants and almost fully priced in. However, it again seemed that some market participants had expected a larger hike or more hawkish tone in the post-meeting statement.

The Australian dollar depreciated from US$0.7014 to a little above US$0.6959 at the time of writing.

3-year Commonwealth bond yields dropped from 2.77% to 2.69%, while 10-year yields fell from 3.05% to 3.00%.

Futures market pricing for another 50bps hike to 1.85% in August is currently above 50%. Cash rate expectations have declined somewhat for 2023, with the terminal rate at around 3.25% rather than the 3.50% now expected.

RBA Historical and Expected Cash Rate*



Comment

The RBA continues its swift monetary policy normalisation, with the 175bps hikes and the first modest monthly shrinkage in the balance sheet now past us. The task is increasingly challenging, with domestic inflation expected to climb further and the economic growth outlook becoming more clouded.

The post-meeting statement is quite nuanced and opens a door to a pause in the hiking cycle sometime later this year, which would allow for a preliminary assessment of the impacts and spillovers from higher interest rates.

While cash rate expectations have eased over the past few weeks, the markets are still pricing in a 3.25% cash rate for early 2023. This would be the highest cash rate in a decade and well and truly in restrictive territory.

2 AUGUST 2022

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