Interest Rate Outlook

bank SA

Tuesday, 1 August 2023

RBA Board Meeting

RBA Makes it 3 Pauses in Last 5 Meetings

- **The Reserve Bank (RBA) Board left the cash rate unchanged at 4.10% today for the second straight month. The RBA has now paused in 3 of its last 5 meetings, including today's meeting, demonstrating that we are at or near the peak in the cash rate.**
- **Today's on-hold decision gives the RBA more time to better assess the full impact of the rate rises to date – 400 basis points or 4 percentage points since May of last year. Monetary policy does have long and variable lags.**
- **The decision to stay pat today begs the question is this it for the RBA? We favour no further rate rises from the RBA and 4.10% being the peak in the cash rate. However, we are cautious and cannot fully rule out further tightening. One of the key reasons is inflation remains elevated and we are still a long time from inflation returning to the target band.**
- **The RBA itself flags that "some further tightening may be needed". But decisions for the central bank have become acutely data dependant and we suspect the threshold for further tightening may be higher than where it has been.**
- **The pause gives the RBA the best chance of ensuring it doesn't overtighten and jeopardise a potential soft landing. Residential construction is going backwards. There is also strong evidence of consumption growth slowing significantly and in per capita terms, the consumer sector is already experiencing recessionary conditions.**

The Reserve Bank (RBA) left the cash rate on hold today at 4.10% for the second straight month. The RBA has now paused in 3 of its last 5 board meetings, which includes today's meeting. The greater frequency of pauses demonstrates that the RBA is assessing data very carefully month to month following 12 rate rises since May last year and a total of 400 basis points (or 4 percentage points) of tightening. Rate rises take time to fully flow through to economic activity and the lags can be variable. Now that we are seeing evidence that the economy is slowing, the RBA is assessing the impact of rate rises much more carefully.

As we flagged in our weekly, today's decision was a close call and there were shortened odds around another pause today in the wake of last week's inflation report. The recent inflation data showed a faster decline in the headline inflation rate than the RBA anticipated. This likely gave the RBA greater confidence that inflation will reach its target band.

Today, the RBA noted that it expects inflation to be within the target band at the end of 2025. In previous speeches, the Governor has flagged a reluctance to tolerate a later return to the top of the 2-3% target band by the middle of 2025. A specific reference to this timeframe wasn't included in today's statement. However, the August Statement of Monetary Policy will be published on

Friday and will confirm whether the RBA thinks this timeframe is still achievable.

This throws up a key uncertainty. The middle of 2025 is still about 2 years away, a long time in economics. It means this forecast carries considerable uncertainty and risk inflation doesn't reach this target in time. Goods disinflation is underway and will contribute to a further slowing in inflationary pressures. There are also some early signs that services inflation may be starting to taper, although it remains early days. Not unexpectedly perhaps then, the RBA draws a bow to the overseas experience and notes services inflation has been surprisingly persistent. The RBA calls out in the statement that the same experience could occur in Australia.

The RBA has not fully dismissed the possibility of another rate hike by stating in its final paragraph that "some further tightening may be needed." This means the bias for now is still to more tightening but given we know the RBA is in data-dependant mode, more tightening would only follow if the data printed in a way that requires the RBA to tap on the brakes again.

It means we cannot put our hands on our heart and be fully convinced the RBA is done hiking, especially with a 6 in front of headline annual inflation and a high 5 for underlying inflation. But we think the RBA is near or at a peak in the cash rate and we favour the current cash rate of 4.10% being the peak.

The RBA's higher threshold for more tightening comes alongside increasing evidence that economic activity is slowing, led by a weakening in consumer spending. Today's statement notes that "many households are experiencing a painful squeeze on their finances" and, in aggregate, consumption growth has "slowed substantially."

Strong population growth is insulating the extent of this slowdown. If we adjust consumer spending and consider it in per capita terms, a consumer recession has already arrived in Australia.

The RBA outlined the areas of the economy they are watching closely – in addition to household spending, they've highlighted the global economy, the labour market, and inflation.

In the global economy, major central banks also appear to be at the end of their tightening cycles or nearing the end of their tightening cycles.

On the labour market, unemployment remains near a historically low level, but this perhaps suggests the RBA may have success in engineering a return to the inflation target whilst keeping the economy on an even keel or in other words maintaining a low unemployment rate. The RBA's tone suggests they are less convinced of wage pressures adding to inflation. In fact, after removing a reference to well anchored inflation expectations last month, the RBA reinserted this reference, which noted that "medium-term inflation expectations have been consistent with the inflation target and it is important that this remains the case."

Finally, inflation measures are the biggest focus – both the monthly and quarterly measures. Inflation prints that suggest the RBA is not on a fast enough trajectory to target could lead the RBA to tighten again. Inflation in the period ahead may be trickier to forecast and interpret given the impact of electricity prices and the subsidies from some state governments to households and small businesses, as well as other policy measures such as increased childcare rebate and higher rental assistance payments.

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