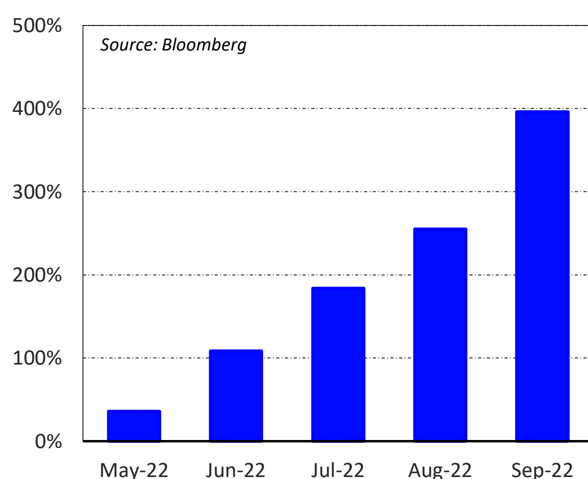
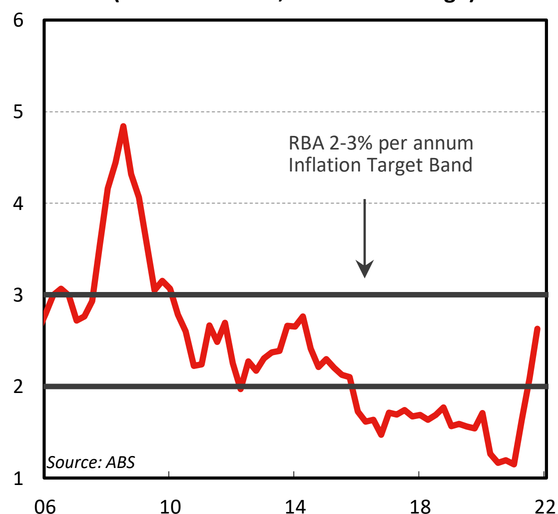
Tuesday, 1 February 2022

RBA Board Meeting

Rate Hikes - Only a Matter of Time

- **The Reserve Bank (RBA) scrapped quantitative easing and left the cash rate unchanged at 0.10 per cent. These decisions met widely-held expectations.**
- **The RBA explained the decision to drop the program reflected the progress towards employment and inflation goals, as well as other central banks bringing forward the conclusion of their bond-buying programs.**
- **The RBA has sharply revised up its inflation forecast and moved its unemployment forecasts lower to sub 4 per cent, laying the groundwork for rate hikes later this year.**
- **The RBA now expects underlying inflation it to hit 3¼ per cent "over the coming quarters" – notably above its target band. The forecast for 2023 was also revised up. If these forecasts materialise, it is hard to imagine the RBA waiting until 2023 to hike the cash rate.**
- **But the RBA flagged that "ceasing purchases under the bond purchase program does not imply a near-term increase in interest rates". This is an important sentence. It suggests a rate hike is not imminent next month or the month after, but the RBA will wish to wait to see more data.**
- **On the RBA's fresh forecasts, unemployment will be pushing under full employment. It remains only a matter of time before wage pressures mount and a rate hike is sealed. We expect a rate-hike cycle to start in August with a rate rise of 15 basis points, taking the cash rate to 0.25 per cent. Subsequent hikes will return to 25 basis point intervals.**





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Quantitative Easing (QE)

The bond-buying program (also known as quantitative easing) supported the economy by putting downwards pressure on long-end bond yields. It was the last remaining unconventional policy measure implemented in response to the pandemic. The other measures – namely the term funding facility and yield curve control – wrapped up last year.

The RBA began tapering the program in September, reducing the weekly purchase rate from $5 billion to $4 billion and announced it would review the program at this month’s meeting.

Governor Lowe had previously outlined three options for the program: (1) tapering purchases further and concluding the program in May, (2) tapering purchases further and reviewing the program again in May or (3) ceasing purchases altogether in February. Lowe said the option they choose would “depend upon the news”.

Since then, headline inflation printed at 3.5 per cent over the year to the December quarter – above the RBA’s 2-3 per cent target band. Underlying inflation was also strong at 2.6 per cent – above the mid-point of the band and its highest level since 2014. Added to that, the unemployment rate came in at 4.2 per cent in December, its lowest level since 2008.

Separately, the Federal Reserve has accelerated its exit from its own quantitative easing program. And many other central banks have ended, or will soon end, their bond purchase programs. This gives the RBA more room to pullback support faster without driving upwards pressure on the Australian dollar.

Considering all these factors, dropping QE was widely expected. The next question is when the central bank will begin shrinking its balance sheet. The statement noted the board will consider this issue in May. Since the start of the pandemic, the RBA’s balance sheet has more than tripled to $640 billion. Moving forward, the RBA will need to decide how quickly to let the balance sheet shrink. The RBA will control the pace of the run-off by reinvesting the proceeds of future bond maturities. The faster the reduction in the balance sheet, the more upward pressure on long-end bonds.

Forecasts

The statement previewed sweeping revisions to the RBA’s forecasts, the complete set of which will be released in the Statement of Monetary Policy (SoMP) on Friday. The RBA’s last forecasts were

released in November. Since then, there has been a string of stronger-than-expected economic data, and of course, widespread disruptions from Omicron.

The biggest shift was in the forecast for underlying inflation, which the RBA expects will break above the upper end of the target range. The RBA expects it to hit 3¼ per cent “over the coming quarters”. In November, the RBA expected underlying inflation to hit 2¼ per cent at the end of 2021 and remain there until the June quarter of 2023. The forecast for 2023 was also revised up, albeit more modestly, to 2¾ per cent (previously 2½ per cent). If these forecasts materialise, it is hard to imagine the RBA waiting until 2023 to hike the cash rate.

The RBA trimmed its GDP forecast for 2022 to 4¼ per cent, previously 5½ per cent, alongside the hit to the economy from the surge in cases. But the statement underscored that the outbreak has “not derailed the recovery” and that spending is expected to lift as case numbers decline, consistent with our views. The forecast for 2023 was lowered to 2 per cent, from 2½ per cent.

Table: RBA Forecasts

(% ch over year to Dec unless otherwise stated, Nov forecasts in brackets)

	2022	2023
GDP	4.25	2.0
	(5.5)	(2.5)
Underlying Inflation	3.25 over coming quarters	2.75
	(2.25)	(2.5)
Unemployment Rate	<4.0 later this year	3.75
	(4.25)	(4.0)

Source: RBA

The statement also noted the labour market has continued to recover strongly, with the unemployment rate projected to “fall below 4 per cent later in the year”. Previously, the RBA forecast the unemployment rate to reach 4¼ per cent by the end of the year. The statement notes that hours worked are expected to decline sharply in January alongside the Omicron surge but that high job vacancies point to a resumption in employment growth in the period ahead.

Relatedly, the RBA expects the wages growth will pick up later this year as the labour market tightens, but the statement did not include a forecast. The statement continued to emphasise there is uncertainty over the path of wages growth as the unemployment rate approaches historical lows.

Monetary Policy

Today’s statement provides important insights into the RBA’s thinking around the economy and an update to key forecasts on inflation, growth, and unemployment. The upgrade to the inflation profile is consistent with the first increase in the cash rate occurring in 2022. We previously outlined we expect the RBA to increase the cash rate by 15 basis point in August 2022, before a further 25 basis point hike in late 2022. We expect further tightening in 2023, with a peak in the cash rate of 1.75 per cent occurring beyond 2023.

The RBA has been slowly walking back from previous public statements which indicated that the cash rate was not expected to increase until 2024. While, in late 2021, the Governor pushed back against the prospect of a rate hike in 2022, the dial has now clearly shifted. Given the upgrade to the inflation profile, an increase in the cash rate in 2022 appears to be the most likely outcome.

In its statement, the RBA allowed for some wiggle room regarding future interest rate moves,

emphasising that it is “prepared to be patient as it monitors how the various factors affecting inflation in Australia evolve.”

The RBA also noted that while inflation has picked up, “it is too early to conclude that it is sustainably within the target band.” Supply-chain disruptions continue to impact the Australian economy and the RBA will want to see further evidence of how these disruptions are impacting domestic inflation before increasing the cash rate.

The outlook for wages growth remains a key variable of interest for the bank, as it expects that wages growth will need to increase to sustain inflation within the target band. On wages, the RBA noted that “it is likely to be some time yet before aggregate wages growth is at a rate consistent with inflation being sustainably at target.” But with the unemployment forecast to push under full employment, it is only a matter of time before wage pressures mount and a rate hike is sealed.

Tomorrow, the RBA Governor will be giving a speech on ‘The Year Ahead’ and the bank’s full updated forecasts will be published in the Statement of Monetary Policy on Friday. Both will be closely watched by economists for further insights in the RBA’s thinking around inflation and the future path of monetary policy.

Contact Listing

Chief Economist
Besa Deda
dedab@banksa.com.au
(02) 8254 3251

Economist
Matthew Bunny
matthew.bunny@banksa.com.au
(02) 8254 0023

Senior Economist
Jarek Kowcza
jarek.kowcza@banksa.com.au
0481 476 436

Associate Economist
Jameson Coombs
jameson.coombs@banksa.com.au
0401 102 789

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