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Interest Rate Outlook

Tuesday, 20 September

RBA Board Meeting Minutes

The Inflation Fight Is On

- **In September, the Reserve Bank (RBA) Board raised the cash rate target by 50 basis points, taking the cash rate to 2.35% - the highest rate since January 2015.**
- **At 225 basis points, the cumulative tightening represents the most rapid increase in the cash rate over a five-meeting window since late 1994, which underscores the inflation challenge the RBA is taking on.**
- **Minutes released today revealed that the RBA Board discussed the merits of raising interest rates by either 25 basis points or 50 basis points. The decision to hike by 50 basis points was made because the cash rate was "still relatively low" and to safeguard against the dire economic impacts of high inflation.**
- **With the cash rate nearing the RBA's estimate of the "neutral rate" of "at least 2.5%" concerns around rates being "relatively low" could dissipate, possibly pointing to slow down in rate hikes to 25 basis points.**
- **Factors supporting a slowdown include that households and businesses are yet to feel the full impacts of the hikes. Additionally, the RBA was previously expecting a "slowdown in global growth" but is now of the view that the global economy has "deteriorated," particularly in "Europe and for interest-rate sensitive sectors in a number of economies."**
- **However, concerns around the dire economic impacts of high inflation and the shift in inflation psychology remain. The Minutes note that there are "pockets where labour costs were increasing briskly" and that consumers are willing to accept higher prices.**
- **The higher-than-expected US inflation read provides a stark reminder that there is a long way to go before we can confidently say inflation will decline to the RBA's target of 2-3%.**
- **It remains a close call between a 25 or 50 basis point move in October.**
- **However, given the balance of risks, it is our view that the Board will judge risks associated with high inflation as its main concern and err on the side of caution, increasing by 50 basis points. This would take the cash rate to 2.85%, above the RBA's estimated neutral rate.**
- **Interest-rate markets are currently pricing in a 75% chance that the RBA will increase the cash rate by 50 basis points in October, up from around 50% just a week ago.**
- **We continue to expect that the RBA will need to raise rates well into contractionary territory to return inflation back towards its 2-3% target band. This is likely to result in the cash rate increasing to above 3% by the end of 2022, with a peak in the mid-3s in early 2023.**

At its policy meeting earlier this month, the Reserve Bank (RBA) Board raised the cash rate target by 50 basis points. Today, the Minutes from the RBA's September Board meeting were released. The Minutes provide further insights into the September decision, along with some additional colour on the assessment of the global and domestic economic landscape.

More rate increases to come with the size and cumulative increase to be dictated by the data

The final paragraph of the Minutes notes that "the Board expects to increase interest rates further over the months ahead." What remains uncertain is the size of future increases and how far the RBA Board will need to go to be certain that inflation is on a path down to the target band of 2-3%.

The Minutes reiterate that the cash rate is not on a "pre-set path given the uncertainties surrounding the outlook for inflation" but will be "guided by the incoming data." Following the September RBA Board meeting our view was that it would be a close call as to whether the RBA Board will move by 25 or 50 basis points.

We still think it will be a close call. But we think that the needle has tilted towards a 50-basis-point hike in October.

On the one hand the RBA Governor has recently said that "at some point we'll obviously not need to be increasing rates by 50 basis points at each meeting, and we're getting closer to that point." That point appears to be when the cash rate reaches, or moves above, the "neutral rate" – that is where interest rates are neither acting as a brake on economic activity nor stimulating activity.

On the other hand, uncertainly remains on whether we are at that "point" yet. The RBA will be watching the data very closely, especially on inflation expectations. The RBA remains alert to the possibility of inflation expectations rising, which would make the task of taming inflation tougher.

Rising inflation expectations could materially increase the outlook for wages growth. The RBA inserted a new paragraph in this month's Minutes on wages, describing a pick up in wages growth from very low rates of recent years.

Inflation Psychology

Anchoring inflation expectations and steering the inflation psychology is key to getting inflation down. The Minutes note that "short-term measures of inflation expectations had declined modestly" based on the fall in international oil prices. The Minutes also note that longer term inflation expectations generally remained within the inflation target range.

The RBA had previously noted that if higher inflation expectations become entrenched in wage setting practices and businesses pass on price rises more readily, it will take longer for inflation to normalise and require more restrictive monetary policy.

Household Uncertainty

The key source of uncertainty continued to be the behaviour of household spending. Unlike previous tightening cycles, households have entered this cycle with over $250 billion in saving buffers which will help absorb some of the cash rate increases. Additionally, the labour market remains incredibly strong with the unemployment rate sitting around 50-year lows, at 3.5% in August. This tight labour market is translating into stronger wage pressures and "pockets where labour costs were increasing briskly".

On the other hand, higher inflation and higher interest rates are putting pressure on household budgets. Falling house prices means Australians are likely to scale back on spending given their wealth has taken a hit. This has seen consumer confidence entrenched in negative territory for some time. However, it has yet to translation into a slowdown in spending. The Board will be paying close attention to how these various factors balance out as it assesses the appropriate setting of monetary policy.

The Current Climate for Small Business Finance

Since the RBA Board last met, the RBA published a Bulletin article drawing on recent Small Business Finance Advisory Panel discussions. The RBA reported that economic conditions for small and medium enterprises (SMEs) have been strong since the second half of 2021. This has meant that labour shortages are biting with most participants reporting that it is challenging to attract and retain staff. On SME credit, the RBA noted that demand continued to be strong. In part this was due to record low interest rates and the narrowing of the spread between interest rates on loans for smaller businesses and those for larger businesses to be well below pre-pandemic levels. While credit growth remains high, economic uncertainty and higher interest rates could see an easing in credit growth.

Monetary Policy Outlook

Inflation is at its highest level since the early 1990's and the peak is still ahead of us. While global factors continue to explain much of the increase in inflation, domestic factors are now playing a more important role in putting upward pressure on prices. These factors include an incredibly strong labour market and capacity constraints in some sectors of the economy.

The RBA Board reiterated its commitment to doing what is necessary to ensure that inflation in Australia returns to target. Higher inflation expectations would lead to more elevated inflation and would necessitate higher interest rate. This is something RBA is monitoring closely.

Given the balance of risks, it is our view that the RBA Board will judge risks associated with high inflation as its main concern and err on the side of caution, increasing by 50 basis points in October. This would take the cash rate to 2.85%, above the RBA's estimated neutral rate.

Regardless of the October decision, we continue to expect that the RBA will need to raise rates well into contractionary territory to return inflation back towards its 2-3% target band over time. This is likely to result in the cash rate increasing to above 3% by the end of 2022, with a peak in the mid-3s in early 2023.

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