Interest Rate Outlook

bankSA

Tuesday, 3 May 2022

Reserve Bank's Cash Rate Decision

"Houston, We Have Lift Off"

- **The waiting game is over. The Reserve Bank (RBA) delivered its first rate hike in 11½ years. It hiked the cash rate by 25 basis points to 0.35% and clearly signalled more rate hikes are on the way.**
- **In the press conference, the RBA Governor stressed that they "need to normalise interest rates" because emergency settings are no longer needed. Indeed, the economy is growing strongly, the labour market is tight and inflation pressures are elevated.**
- **The RBA significantly revised up its inflation forecasts and does not expect inflation to fall back into its 2-3% target band until 2024. This is amid RBA expectations that the unemployment rate will fall to 3.50% by early 2023.**
- **The RBA's economic forecasts are based on an assumption that interest rates increase to 2.50% by the end of next year, which the Governor considers to be a "more normal level" of interest rates. He also viewed a cash rate at the end of this year of 1.50–1.75% as plausible.**
- **We expect the RBA to follow up with a rate hike in June and take back the emergency rate cuts it delivered during the pandemic very quickly. We envisage 40 basis points is on the cards for June with further tightening over 2022 to take the cash rate to 1.75% by year's end.**

Today's Decision

The waiting game is over! Last week's set of very strong inflation numbers sealed the need for the RBA to stop its waiting game and begin a rate-hike cycle. Indeed, it's a milestone event, putting an end to the record low cash rate that has supported the economy through the pandemic. It's also the first rate hike in 11½ years and the first rate hike in an election campaign since 2007.

The move was larger than expected by financial markets. The consensus among economists was the RBA would start with 15 basis points, but in the event the RBA hiked by 25 basis points, to take the cash rate to 0.35%. We had flagged the risk of a possible bigger rate hike, but 15 basis points was also our core view.

Strong economic growth, the recent fall in the unemployment rate to its lowest level in almost 50 years and inflation running at its strongest pace in nearly 21 years meant the RBA could wait no longer. In the press conference, the Governor highlighted that "inflation has picked up more quickly, and to a higher level, than was expected and there is evidence that labour costs are increasing more quickly".

Indeed, March quarter's inflation outcomes were far stronger than the RBA's latest forecasts and outside of the range of economists' expectations. Headline inflation grew at its fastest in nearly 21 years and underlying at its quickest in 13 years. The heat in inflation, and inflation expectations being the highest in 10 years, likely determined that the RBA needed to start with a 25 basis points hike, rather than an expected 15 basis point hike.

The RBA also provided information on how it intends to manage its enlarged balance sheet following the bank's quantitative easing effort since the depths of the pandemic. Its balance sheet had tripled to around $640 billion. The RBA announced that it will not reinvest or sell the bonds from its bond-buying program, instead allowing the bonds to mature. The Governor indicated we can think of the balance sheet as being "on autopilot". This will place upward pressure on longer-term interest rates and is a form of monetary policy tightening.

Outlook for the Cash Rate

The Governor stressed they "need to normalise interest rates" because the economy doesn't "need these emergency settings any more". He also flagged in the questions session of his conference that interest rates could go to 2.50%, which would be "a more normal level" of interest rates. That represents another 215 basis points in hikes.

Sitting behind the RBA's fresh economic forecasts are assumptions that interest rates will increase to 1.50–1.75% at the end of the year and 2.50% by the end of next year. Whilst the Governor said rates at these levels could be considered reasonable, he also added that it would "depend on developments".

Inflation provides the north star for the RBA.

Alongside the lift in rates, the RBA unveiled revisions to its projections, including a major boost to its inflation forecast. The headline inflation forecast has been revised up to 6% for this year, from 3.75% previously. The Governor indicated inflation would only drop to the top of its band in 2024. That suggests inflation will be elevated for an extended time, leaving the RBA with little wiggle room and sealing the need for the RBA to keep hiking rates over the next 12-18 months.

Table: New RBA Forecasts as Suggested in Statement

Per cent, year-ended, previous forecasts in brackets*

	2022	**2023**	**2024**
GDP	4.25	2.00	-
	(4.25)	(2.00)	-
Unemployment rate	-	3.50 by early 2023	-
	(3.75)	(3.75)	-
Headline inflation	6.00	-	~3.00 by mid-2024
	(3.25)	(2.75)	-
Trimmed mean inflation	4.75	-	~3.00 by mid-2024
	(2.75)	(2.75)	-

* Blank forecasts were not specified in today's statement.

Source: RBA

On the question of the impact of rate hikes on economic growth, the Governor said there is a lot of positive momentum in the economy and he doesn't expect that to be lost by a small rise in the cash rate. This momentum includes a further decline in the unemployment rate to around 3½ per cent over the course of this year, which would be the lowest in 50 years. The RBA is also expecting

4.25% growth this year – a very solid pace. Our own forecasts are for 4.5% growth this year.

Interest-rate markets continue to price in aggressive tightening this year. Interest-rate markets were priced for a cash rate of 2.50% by the end of the year heading into the decision. This has moved to around 2.75% after the meeting.

The Governor was asked in his press conference whether other sized hikes were considered today, such as 15, 40 or 50 basis points. His response referenced the importance of getting “back to normal” and “back to business as usual”; he suggested 25 basis points was the right sized number for the hike at this meeting, the “standard” size.

The references to getting back to normal and standard sizes suggests next month the move could be 25 basis points in size again. But later in questions, the Governor also said he is “not on a pre-set path” and has not planned the future size of rate hikes. Data will be critical.

We favour June’s move being bigger than 25 basis points in size. Our central expectation is for a 40 basis point hike, taking the cash rate to 0.75% in June. Our view reflects the backdrop of strong inflationary pressures in the economy and expectations of rising wages growth. The Governor noted that around 40% of businesses from the RBA’s business liaison program are expecting wage increases of above 3%.

The RBA likely also wants to take back the 65 basis points of emergency rate cuts delivered during the pandemic quickly given emergency settings are no longer appropriate.

We continue to expect several more hikes over the remainder of the year, lifting the cash rate to 1.75% by the end of the year. Moreover, we expect a further two rate hikes in early 2023, taking the cash rate to 2.25% by mid 2023.

Besa Deda, Chief Economist
Ph: 0404 844 817

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