Tuesday, 4 July 2023

RBA Board Meeting
'Upside Risks' Go Missing In Action

- **The Reserve Bank (RBA) Board left the cash rate unchanged at 4.10%, following twelve rate increases since May last year. However, the Governor's statement suggests that the pause may be short lived with the statement saying more tightening "may be required," and today's pause providing more time to assess the economy.**
- **<u>Changes to the statement provide clues on the outlook for policy. There were plenty of changes.</u> A key change was the recognition that the rapid increase in interest rates is having the intended impact on demand.**
- **<u>The hit to demand is expected to be significant enough that the reference to the economy remaining on an "even keel" was dropped for the very first time this cycle and replaced with the economy is expected "to grow as inflation returns to the target range, but the path to achieving this balance is a narrow one".</u>**
- **One interpretation of this change is that the RBA will do whatever it takes to get inflation down even if it leads to a sharp downturn. This is the approach followed by other central banks in the US and New Zealand and points to further hikes.**
- **Another interpretation is that the RBA believes it is at risk of going too far and if it goes further, it may overshoot and do serious harm to the labour market. This interpretation is supported by the removal of a key paragraph outlining the upside risks to services inflation from wages growth.**
- **Data since the last RBA Board meeting suggests that these risks remain – wages growth in enterprise agreements continue to pick up. The Fair Work Commission's 5.75% increase for award wages and the aged care wage decision, which provides a 15% wage boost, started from 1 July. This makes the RBA's messaging difficult to interpret.**
- **Given the RBA's recent shifts in messaging, we don't yet believe there is enough evidence to materially change our expectation for the peak in the cash rate. We retain the expectation of two further hikes, with the next hike occurring in August. However, we stress that there are risks around the final hike – in terms of materialising and/or timing. The RBA will release an updated set of forecasts before the August Board meeting which should provide more clarity.**

The Reserve Bank (RBA) left the cash rate on hold today at 4.10% and has left the door open for more hikes down the track.

The decision was always going to be a line-ball call. Indeed, a survey of 27 economists were evenly split on the decision. The surprise, therefore, did not come from the decision itself but from the contents of the Board's statement, which looked decidedly different to the last meeting.

In particular, the Board dropped a key paragraph outlining the upside risks to inflation which previously included services price inflation, growth in unit labour costs and subdued productivity growth. Recall, these factors were key to the decision to hike in June. Given there has been no material change in the data It's hard to believe that these upside inflation risks have dissipated in the space of one month.

The key paragraph was replaced with new commentary centred on the size of the tightening in the cash rate to date. The Board noted that "higher interest rates are working to establish a more sustainable balance between supply and demand in the economy and will continue to do so". Given this progress and the "uncertainty surrounding the economic outlook" the Board decided to keep rates on hold to "provide some time to assess the impact of interest rates to date". In other words, the Board has replaced the upside risks which were a centrepiece to June's decision with the familiar focus on the long and variable lags of policy. This suggests the Board has made a new assessment of the balance of risks and is behaving more cautiously to avoid the risk of overtightening.

This is affirmed by the other major change in the statement, whereby the Board dropped its reference to "keeping the economy on an even keel" and navigating a "soft landing". This can be interpreted in one of two ways.

First, that the RBA has adjusted the weightings of its dual mandate and is now willing to do what is necessary to bring inflation back down, even at the cost of a weaker labour market. This would suggest that despite a pause this month, the RBA still believes it has work left to do.

The second interpretation is that the RBA has not lost sight of its goal of preserving the gains in the labour market but has instead come to realise that taking the cash rate much higher will put that goal in severe jeopardy. In the circumstances, the RBA must tread lightly moving forward to make sure it doesn't push the economy off the narrow path.

Despite there being no clear catalyst for the RBA's shift in view, based on the guidance in the statement we prefer the second interpretation. But given the RBA's mixed shifts in messaging, we don't yet believe there is enough evidence to materially change our expectation for the ultimate peak in the cash rate.

We, therefore, retain the expectation of two further hikes, coming consecutively in August and September. However, we stress that there are risks that the final hike in September does not materialise or even materialises at a later time. This is based on our expectation that the incoming economic data will weaken significantly by that stage, giving the RBA enough comfort to remain on hold.

Pat Bustamante, Senior Economist
+61 468 571 786

Jameson Coombs, Economist
+61 401 102 789

Contact Listing

Chief Economist
Besa Deda
dedab@banksa.com.au
+61 404 844 817

Senior Economist
Jarek Kowcza
jarek.kowcza@banksa.com.au
+61 481 476 436

Senior Economist
Pat Bustamante
pat.bustamante@banksa.com.au
+61 468 571 786

Economist
Jameson Coombs
jameson.coombs@banksa.com.au
+61 401 102 789