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RBA Board Meeting Minutes

Growth Concerns Weigh On RBA Board

- **In October, the Reserve Bank (RBA) Board raised the cash rate by 25 basis points, to 2.60% - the highest rate since July 2013.**
- **The decision to increase the cash rate by 25 rather than 50 basis points took financial markets and many economists by surprise. Interest-rate markets had around an 80% probability of a 50-basis-point hike immediately prior to the meeting.**
- **The arguments between a 25 or 50 basis point increase were “finely balanced”.**
- **The arguments for a 25 basis point hike “rested on the risks to global and domestic growth, and the potential for inflation to subside quickly”. It was noted that “external inflationary pressures might ease quickly given that the global outlook had deteriorated” and the “full effects of higher interest rates were yet to be felt”.**
- **Some arguments for a 50 basis point move included the current elevated inflationary environment and risks to inflation expectations; upside risks due to a tight labour market, rising rents and high energy costs; and the risk that wages increase more quickly than expected.**
- **Growth concerns and uncertainty over the impact of hikes to date led to the Board taking a more cautious approach in October. This is at odds with the messaging from other key central banks. Their focus has been on getting inflation down, even if it comes at a cost to the real economy.**
- **The RBA is still eager to engineer a soft landing. However, this is not without its risks. If upside risks to inflation materialised, “it would be costly to re-establish low inflation” and rates would need to remain higher for longer. If the RBA achieves a soft landing it will be championed as premier economic mangers. Only time will tell.**
- **We expect further cash rate hikes to control elevated inflationary pressures. This is likely to come in the form of further 25 basis point moves, rather than a re-acceleration to 50 basis points. We expect the cash rate to peak in the mid-3s in the first half of 2023.**

At its policy meeting earlier this month, the Reserve Bank (RBA) Board raised the cash rate by 25 basis points. Today, the Minutes from the RBA’s October Board meeting were released.

The decision to increase the cash rate by 25 basis points in October rather than 50 basis points took financial markets and many economists by surprise. We had always held that the choice between the two would be a close call, however, we felt that the needle had swung towards a 50-basis-point hike at the October meeting. Financial markets were in agreement. Interest-rate

markets had around an 80% probability of a 50-basis-point hike immediately prior to the meeting.

Following the decision to raise rates by 25 basis points, there were large movements in bond yields and equity markets rose. The Westpac-Melbourne Institute of consumer sentiment showed that confidence among households surveyed after the surprise 25 basis point hike was substantially higher than among those households surveyed prior to the move, when 50 basis points was the overwhelming expectation.

The Minutes provide further insights into the October decision, along with some additional colour on the assessment of the global and domestic economic landscape.

25 basis point vs 50 basis point move "finely balanced"

The final section of the Minutes outlined the arguments the Board considered in its decision to raise by 25 basis points. It is noted that the final decision was "finely balanced", however, the Board ultimately chose 25 basis points as being the most appropriate size of the hike.

Arguments for a 50 basis point hike

The arguments for hiking by 50 basis points included:

- The current elevated inflationary environment and risks to inflation expectations
- Inflation pressures having proven to be more persistent than previously expected
- Upside inflation risks due to the tight labour market, and rising rents and energy costs
- The risk of wages growth increasing more quickly than expected
- Risks to inflation expectations and financial market movements if "the community came to question the Board's resolve to reduce inflation"
- The cash rate not yet being at "an exceptionally high level"
- Consumption being resilient despite the increases to date

Arguments for a 25 basis point hike

On the other side of the ledger, the Minutes note that the arguments for a 25 basis point hike "rested on the risks to global and domestic growth, and the potential for inflation to subside quickly".

This potential for inflation to subside more quickly than expected was noted again later in the Minutes: "External inflationary pressures might ease quickly given that the global outlook had deteriorated".

Additionally, other points the Board considered in favour of slowing the pace of hikes included:

- The rapid rise in the cash rate to date and that the full effects had not yet been felt
- Wages growth continuing to be consistent with inflation returning towards the target band
- Being cautious and assessing the impacts of the hikes to date in an uncertain environment
- Drawing out hikes helping to maintain public attention on the Board's resolve to return inflation to target
- The RBA meeting more frequently than other central banks

Growth concerns and rapid pace of increases so far outweighed other arguments

Despite the arguments outlined for a 50-basis-point hike, the risks to the global and domestic

growth outlook were front of mind for the Board. A more cautious approach was taken given the rapid increases to date and the uncertainty of the final impact these hikes will have on households.

The Board noted that "monetary policy operated with a lag and there was a risk that household spending might adjust by more than expected" and that "the full effects of higher interest rates were yet to be felt in mortgage payments".

Housing market risks a factor

The Board is acutely aware of the risks to the housing market of the rapid pace of increases in interest rates to date and the flow-on effects this may have on the broader economy. The Minutes noted that "the increases in the cash rate were close to the interest rate buffer applied when many current borrowers took out their loans".

Remember, to support financial stability, banks and other lenders are required to assess borrowers at rates that are above prevailing market rates. This is to ensure borrowers can continue to meet mortgage repayments if interest rates rise. This buffer was increased to 3 percentage points, from 2.5 percentage points, by the banking regulator in October 2021. With 250 basis points of increases, the cash rate hikes to date are equal to the minimum buffer size that prevailed prior to October 2021.

Household debt levels in Australia are among the highest in the world and have increased significantly over recent decades. This means that Australian households are more sensitive to rate hikes compared with other households around the world, and more so than in the past.

Additionally, Australian households are relatively more exposed to movements in the short-term policy rate than in other countries. Variable rate mortgages are standard in Australia. While many households took up low fixed rate offers during the pandemic and this increased the share of fixed-rate loans to around 35%, around two thirds of these will expire by the end of 2023.

In contrast, in many other economies, interest rates are fixed for a period of five years or more. For example, around 90% of mortgages in the US are fixed for 30 years. This means that it takes more time for interest rate increases to be felt by households. This is one of the key reasons why we expect interest rates to be increased to a higher level in the US than in Australia.

The housing market has been one of the first areas of the economy to feel the impacts of higher interest rates. After an incredible increase in prices during the COVID-19 pandemic, dwelling prices have been falling since May and these falls have broadened and deepened across the country.

Rapid falls in dwelling prices can lead to indebted households cutting their consumption. The RBA emphasised this in the Minutes, noting that "previous episodes of lower housing prices and turnover had seen a large effect on consumer spending, in part through the wealth channel of transmission."

Wages breakout viewed as less likely in Australia

Another key argument outlined for scaling back the pace of hikes centred on the Australian labour market and the risks of wages increasing by more than expected.

The RBA has noted on several occasions that wage pressures in Australia are not as significant compared with other countries. The Minutes also noted that the current pace of wages growth "had not reached levels that would be inconsistent with the inflation target".

While upward pressure on wages exists given the tightness of the labour market and wages are expected to increase over the period ahead, the RBA does not appear too concerned that this will

lead to a wage-price spiral. The Minutes noted that “institutional features of the Australian labour market also made a sharp rise in wages less likely than in other economies”.

Monetary Policy Outlook

Growth concerns and uncertainty over the impact of hikes to date have factored into the RBA’s decision making and led to the Board taking a more cautious approach in October.

However, this approach is not without risks.

One of the key reasons for scaling back the pace of hikes in October was around the potential for inflation to decline more quickly than expected. This approach creates a risk that inflation continues to increase and the credibility of the RBA’s resolve in fighting inflation is undermined. The RBA has previously been at pains to outline the importance of inflation expectations remaining well anchored. The Minutes of the October meeting suggest that the pendulum is starting to swing towards the Board placing greater emphasis on growth and other aspects of the economy.

Additionally, one of the arguments in favour of a 25 basis point move was that a slower pace of hikes would keep the “public attention focussed for a longer period on the Board’s resolve to return inflation to target”. This statement is at odds with communication from other central banks, where they have been maintaining or accelerating, rather than decelerating, the pace of hikes to show the public that they are serious about the inflation threat.

We continue to expect further increases in the cash rate to control elevated inflationary pressures. This is likely to come in the form of further 25 basis point moves, rather than a re-acceleration to 50 basis point hikes. We expect the cash rate to peak in the mid-3s in the first half of 2023.

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