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RBA Board Meeting Minutes

RBA Debates 25 vs 50 Basis Point Hike

- **The Reserve Bank hiked the cash rate 50 basis points to 0.85% in June. Today, the minutes from this meeting were released, the Governor delivered a speech 'Inflation and Monetary Policy', and the RBA also released the findings of its review of the yield curve target.**
- **The communications highlight the RBA's growing concerns over inflation, the risk that long-term inflation expectations shift above the 2-3% target band, and the risk of a material slowing in spending alongside price pressures, rate hikes and a slowing housing market.**
- **The minutes detail the Board considered hiking by 25 or 50 basis points at the June meeting. A 50-basis point hike was favoured given the level of interest rates was still very low, the jobs market is strong and inflationary pressures are elevated.**
- **On the other hand, moving 25 basis points would represent a "steady" approach in a time of heightened uncertainty.**
- **It is implied the RBA doesn't need to move in lockstep with central banks that have hiked by 50 or 75 basis points because the RBA meets more frequently.**
- **The RBA conceded the exit from the yield curve target on 3-year government bonds in November 2021 was "disorderly" and caused "reputational damage".**
- **The key uncertainties remain how fast, and how high, the cash rate peaks. The Governor underscored the RBA is "not on a pre-set path". Our central expectation remains that the RBA will hike 50 basis points in July. However, the arguments laid out in the minutes in favour of hiking in 25 basis point increments remain relevant.**
- **Markets are now split between a 25 and 50 basis point hike next month. Interbank futures markets are 85% priced for a 50 basis point hike in July and for a cash rate of 3.50% by the end of the year.**

The RBA hiked the cash rate 50 basis points to 0.85% in June, following a 25 basis point hike in May. Today, the minutes from the June meeting were released, the Governor delivered a speech titled 'Inflation and Monetary Policy' and the RBA also released the findings of its review of the yield curve target implemented in early 2020 and dropped in November last year.

Inflation fears

The minutes and the Governor's speech highlight the RBA's growing concern over inflation and "inflation psychology" in Australia.

The minutes note inflation has "increased significantly" owing to global and domestic factors, and flag the pressures have become more broad based. Plus, the outlook for inflation had been revised up alongside higher electricity, gas and petrol prices. The minutes explain firms have become more willing to pass on cost increases and employees are demanding higher wages alongside cost-of-living pressures.

The Governor has also noted growth in spending is “testing the ability of the economy to meet the demand for goods and services”, which is adding to inflation pressures. In particular, the Governor highlights that labour shortages are constraining the ability of many businesses to operate or expand.

While long-term inflation expectations remained in the 2-3% target band, there was a “risk that a sustained period of higher inflation could result in a shift up in expectations of inflation”. It is flagged that, if this materialises “returning inflation to the target would become more difficult and come at a higher cost in terms of lower levels of economic activity and employment”.

The Governor underscored that high inflation is damaging to the economy, and hurts “most those who are least well equipped to protect themselves”. In other words, cost-of-living pressures are hitting lower-income households the hardest.

However, the Governor doesn’t “see a recession on the horizon” given the strength of the labour market and household balance sheets, and the record high terms of trade.

The size of cash rate hikes

The minutes detail the Board considered hiking by 25 or 50 basis points at the June meeting.

The arguments laid out in favour of a 50 basis point hike were that the level of interest rates was still very low, given strength of the jobs market and elevated inflation. It was also noted there was a risk that higher inflation expectations become entrenched and that a 50 basis point hike in June would help mitigate this risk. It was acknowledged that a 50 basis point hike could add to “concerns that inflation was likely to stay high”, a nod to the idea that bigger hikes may signal the RBA is behind the curve.

The main argument for a 25 basis point hike was that this “represented a steady approach to withdrawing monetary policy stimulus and that this was appropriate in an uncertain environment”. The minutes flag the cash rate has typically increased in 25 basis points increments over the past two decades. And, if the cash rate was increased by 25 basis points at “each meeting over the remainder of 2022, the cash rate would be 2.1% by the end of the year”, which represents a “quite a rapid tightening”.

It was noted that while some central banks had hiked their policy rates in 50 basis point increments, these central banks also meet less frequently than the RBA. This implies that perhaps the RBA does not need to move in lockstep with other central banks.

However, the Fed last week moving by 75 basis points means that if the RBA drops back to 25 basis-point-sized hikes, there is likely to be downward pressure on the Australian dollar, which could fan inflationary pressures via imported goods.

The risk of a material slowdown in consumer spending also appears to be a concern for the Board, as they considered the “evolving risks to household consumption, including how households would adjust their spending in response to higher prices and interest rates, and the impact of higher interest rates on the housing market”. The RBA continues to expect “strong household consumption growth over the remainder of the year”.

We would flag there is a risk that momentum in spending growth slows later this year, as the cash rate moves higher and share prices and dwelling prices remain under downward pressure.

Review of the yield target

This morning the RBA released a review of its yield target on 3-year government bonds. This is an unusual event.

The yield curve target was 25 basis points when introduced in March 2020, before it was reduced to 10 basis points in November 2020 and then discontinued in November 2021.

The policy was closely linked to the RBA's forward guidance that the cash rate was unlikely to increase until 2024, which clearly did not materialise. It is explained the policy was introduced as insurance against "catastrophic downside risks" in the "dark days of the pandemic".

The RBA acknowledges as the economic outcomes turned out better-than-feared, the yield target was "not well suited to respond". The central bank concedes the policy caused "reputational damage". The RBA recognises the way the target ended was "disorderly" and was associated with volatility and "some dislocation" in bond markets.

The RBA has also committed to undertaking reviews of its bond purchase program and approach to forward guidance.

It should be noted, these internal reviews are separate to the long-standing calls for a comprehensive external review of the central bank. Reports suggest Treasurer Jim Chalmers will appoint an independent panel to review the RBA. The scope of the review is unclear, although there have been calls for a wide-ranging assessment, including of the 2-3% inflation target, the composition of the Board, the frequency of meetings and the transparency of the central bank's communications.

Monetary Policy Outlook

Today's communications from the Reserve Bank reinforce that the central bank is set to continue aggressively hiking the cash rate. The Governor has emphasised the "Board is committed to doing what is necessary to ensure that inflation returns to the 2 to 3 per cent target range over time".

The key uncertainties remain how fast, and how high, the cash rate peaks. The Governor underscored that the central bank is "not on a pre-set path" and will be "guided by incoming data and the Board's assessment of the outlook for inflation and the labour market".

It was added that the Board will pay "close attention to developments in the global economy, the evolution of labour costs and how household spending is responding to higher interest rates". This points to the fact that the evolution of the Ukraine war, China's COVID restrictions, wages and consumer spending will all be important considerations.

Our central expectation remains that the cash rate will be hiked 50 basis points in July. The RBA is clearly concerned about upside risks to inflation, and that long-run inflation expectations will shift up. A 50 basis point hike in July will help to mitigate this risk. The recent 75 basis point hike from the US Federal Reserve will also add to pressure on the RBA to hike faster.

However, the arguments laid out in the minutes in favour of a 25 basis point hike in June, also still apply in July. If the cash rate is hiked 25 basis points at every meeting until the end of the year, this would still represent a considerable tightening. This would be a more "steady" approach in an environment of elevated uncertainty, but could mean the currency will depreciate against the US dollar and induce higher imported inflation.

Markets are now split between a 25 and 50 basis point hike next month. Interbank futures markets are 85% priced for a 50 basis point hike in July, down from 100% yesterday. And the cash rate is priced to hit around 3.50% by the end of 2022, compared to 3.75% yesterday. However, we expect the high level of household debt will ultimately limit how far the Reserve Bank can lift the cash rate and markets are too aggressively priced.

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