Tuesday, 19 July 2022

RBA Board Meeting Minutes

50bps Hike As Rates Still Below Neutral

- **The Reserve Bank (RBA) hiked the cash rate by 50 basis points in July, to 1.35%.**
- **The cash rate has increased by 125 basis points in three meetings, from a record low of 0.10%. These hikes represent the fastest pace of tightening in a three-month window since 1994, when the RBA tightened by 200 basis points in the three months to December 1994.**
- **As was the case in June, the board considered raising rates by 25 or 50 basis points. However, the minutes do not make a case for a 25-basis-point hike and noted that "members agreed that arguments for raising interest rates by 50 basis points were stronger."**
- **The RBA is closely monitoring inflation expectations as "members viewed it as important that inflation expectations remained well anchored and that the period of higher inflation be temporary".**
- **The minutes note that the cash rate was "well below the lower range of estimates of the nominal neutral rate" and that "further increases in interest rates will be needed to return inflation to the target over time".**
- **Next week's inflation report is expected to show that inflationary pressures continued to heat up in the June quarter. We expect an annual headline inflation rate starting with a '6'.**
- **We expect the RBA to increase the cash rate by 50 basis points in August. However, we wouldn't fully rule out a larger 75-basis-point hike if the inflation numbers surprised significantly to the upside.**

The RBA hiked the cash rate by 50 basis points in July, to 1.35%. This followed interest rate hikes of 25 and 50 basis points in May and June, respectively. The cash rate has increased by 125 basis points in three meetings, from a record low of 0.10%. The recent hikes represent the fastest pace of tightening in a three-month window since 1994, when the RBA tightened by 200 basis points in the three months to December 1994.

Today, the minutes from the July meeting were released.

The size of cash rate hikes

As was the case in June, the board considered raising rates by 25 or 50 basis points. However, the minutes do not make a case for a 25-basis-point hike and noted that "members agreed that arguments for raising interest rates by 50 basis points were stronger."

The minutes flagged that "the level of interest rates was still very low for an economy with a tight labour market and facing a period of higher inflation". Despite rapid tightening over the past three meetings, at the current level of 1.35%, the cash rate remains stimulatory. As such, it is sensible for the RBA to increase rates quickly and move them towards a more neutral setting.

The pace cash rate hikes also have an impact on inflation expectations. It is important for the RBA to manage household and market inflation expectations and reduce the risk that expectations become unanchored due to this elevated period of inflation.

This was recognised in the minutes, which noted that should medium term inflation expectations increase, “the task of returning inflation to the target would be more difficult and would come at a higher cost in terms of activity and employment.” It was also noted that “members viewed it as important that inflation expectations remained well anchored and that the period of higher inflation be temporary”.

While short term inflation expectations are currently elevated, the minutes note that longer term inflation expectations remain well-anchored. For example, market inflation expectations, as estimated by breakeven rates from 5-year inflation-indexed bonds, remain within the RBA’s 2-3% band. The need to manage inflation expectations was a likely argument in favour of increasing rates by a more aggressive 50 basis points, as this helps signal to households and market participants that the RBA is serious in its task of getting inflation back within the 2-3% band over time.

Neutral interest rate

Today’s minutes included a section on the Board’s discussion regarding the neutral policy rate. The neutral policy rate is like coasting in a car. It is the rate which is neither stepping on the accelerator nor stepping on the brake of the economy.

The level of the current cash rate relative to the estimated neutral interest rate is an important consideration for whether monetary policy settings are expansionary or contractionary and is something that is contemplated by central banks when setting monetary policy.

The minutes note that understanding the level of the neutral interest rate is challenging in practice. The neutral interest rate is a concept that cannot be observed. Rather, it must be estimated. And the range of estimates of the neutral rate is wide.

The minutes did not provide an estimate of what the RBA considers to be the neutral interest rate. However, Deputy Governor, Michele Bullock, noted in the Q&A to a speech today that the latest RBA estimates of the real neutral rate, published in 2017, were between 0.50%-1.50%. To move from the real rate to the nominal rate, inflation expectations need to be added. Note that the cash rate is expressed in nominal terms.

We think that the nominal neutral interest rate is currently towards 2.00%. Household debt levels are more elevated in Australia than historically. As a result, rate hikes are expected to have a larger impact on households than in previous tightening cycles. This supports our view of a neutral interest rate that is likely lower than in the past.

The minutes made three key points regarding the neutral interest rate.

Firstly, the level of the cash rate at the time of the July meeting (0.85%) was “well below the lower range of estimates of the nominal neutral rate”. As a result, the cash rate remained in expansionary territory and the Board noted that “further increases in interest rates will be needed to return inflation to the target over time”.

Secondly, inflation expectations are one input into the estimate of the neutral rate. This implies that if inflation expectations become unanchored, the RBA would need to increase interest rates more aggressively to bring inflation back to within the 2-3% band.

Finally, the framework provided a “general guide” only and “any specific estimates need to be treated with caution”.

Evolving risks

In an environment of elevated debt levels, hikes in the cash rate are likely to have a greater impact on households than in previous hiking cycles.

Consumer sentiment data has shown that consumers are becoming increasingly downbeat. Consumer sentiment has declined for eight consecutive months and is approaching levels seen during previous crises, such as the beginning of the COVID-19 pandemic, the GFC, and the 1990’s recession.

However, despite the fall in consumer sentiment, the minutes noted that recent spending data remains positive. Additionally, the minutes noted several factors supporting household incomes, including savings buffers accumulated by many households, stronger income growth, an elevated household saving ratio, and the increase in household wealth alongside the run-up in dwelling prices over much of 2020 and 2021.

Additionally, the economy remains strong. The minutes noted that “growth had been supported by household and business balance sheets that are generally in good shape, an upswing in business investment and the large pipeline of construction work to be completed.”

However, the impact of rate hikes on the housing sector is an important consideration for monetary policy and the minutes also noted that the RBA will monitor household spending as it increases interest rates.

Monetary Policy Outlook

The minutes from the July Board meeting reinforce the view that the RBA will continue increasing the cash rate to manage inflationary pressures in the economy.

While international supply-side factors, such as the war in Ukraine and China’s zero-COVID policy are contributing to inflationary pressures, domestic factors also play a role. The economy continues to grow, demand remains strong, the labour market is incredibly tight, and capacity constraints are impacting some sectors. These factors are all contributing to elevated inflationary pressures. Additionally, members noted that “domestic inflationary pressures, including those outside of the labour market, continued to build.”

Increases in the cash rate will place downward pressure on demand in the economy and establish a better balance between supply and demand. The RBA agreed that the level of cash rate remained well below the estimated level of the neutral rate and was therefore still expansionary. This requires further increases in the cash rate to normalise monetary policy settings.

As with previous communication, the minutes noted that “The Board remains committed to doing what is necessary to ensure that inflation in Australia returns to the target over time.”

However, the RBA will “continue to be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market, including the risks to the outlook.”

In thinking about the incoming data since the July meeting, the latest labour force survey showed that the jobs market continued its amazing run of strength. 88.4k jobs were added in June and the unemployment rate fell to 3.5%, its lowest level since August 1974! The participation rate also increased to a new record high of 66.8% and more Australians than ever before were in a job.

The tight labour market is expected to contribute to an acceleration in wages growth and the RBA noted that "around 60 per cent of private sector firms in the Bank's liaison program had reported that they expect wages growth to pick up over the coming year".

Next week, the June quarter inflation report will provide further evidence of the inflationary pressures facing the economy. This will be key in determining the size of the August hike. The report is expected to show that inflationary pressures continued to heat up in the June quarter. We expect an annual headline inflation rate starting with a '6'.

The strong jobs data and an expected acceleration in inflation support the view that a continued rapid removal of monetary policy stimulus and a shift towards more a neutral level of the cash rate is warranted in August.

We expect the RBA to increase the cash rate by 50 basis points in August. This would move the cash rate to 1.85%.

However, while our base case remains for a 50-basis-point move, we wouldn't fully rule out a larger 75-basis-point hike if the inflation numbers surprised significantly to the upside.

Jarek Kowcza, Senior Economist
Ph: 0481 476 436

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
(02) 8254 3251

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
0481 476 436

Associate Economist
Jameson Coombs
jameson.coombs@stgeorge.com.au
0401 102 789