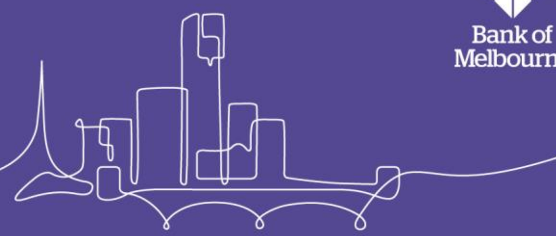

Tuesday, 20 June 2023

RBA Board Meeting Minutes

Battling to Anchor Expectations

- **The Reserve Bank (RBA) hiked the cash rate by 25-basis points in June, taking the cash rate to 4.10%. After the RBA's April pause, we flagged potential risks of inflation expectations becoming unanchored, which, if realised, would require more hikes later in the cycle.**
- **The minutes suggest that this risk may be starting to materialise. Back-to-back rate hikes from the RBA in May and June plus guidance of more to come suggest the RBA Board is worried about inflation expectations.**
- **Inflation expectations are important because they shape how households and businesses behave and it is this behaviour which ultimately determines economic outcomes, including wages growth and inflation.**
- **The Board judged that risks to inflation expectations, higher than expected growth in award wages, a slower-than-expected moderation in goods inflation and pressures in the energy and rental markets "had shifted the balance of risks on inflation to the upside".**
- **The Board noted that persistently high inflation "would make it more difficult to keep the economy on the narrow path". The risk of a hard landing is rising given the RBA is hiking into an economy that is "already quite weak". This could see the "economy slowing and unemployment rising by more than expected" given the lags in monetary policy.**
- **Managing the upside risks to inflation will likely come at the cost of the RBA veering off the narrow path. This does not necessarily entail a recession (although the risks have certainly increased), but instead that a more significant slowdown in the labour market is now likely required to ensure expectations remain anchored and that inflation returns to target.**
- **On balance, we think that more hikes will be required. We are expecting two more 25-basis point rate hikes taking the cash rate to 4.60%.**

The Reserve Bank (RBA) hiked the cash rate by 25-basis points at its June meeting, taking the cash rate to 4.10% - the highest since April 2012. The minutes from that meeting were released today and provide some further insight into the decision and the outlook for interest rates.

A pause from the RBA in April accompanied by dovish messaging from the Board prompted expectations that the RBA was at or near the end of its hiking cycle. This was supported by the Board's objective to "take somewhat longer to return to target" inflation to "preserve as many of the gains in employment as possible".

At the time we flagged that this approach risked inflation expectations becoming unanchored, which, if realised, would require more hikes than otherwise later in the cycle. It now appears that this risk may have been partly realised and that back-to-back hikes in May and June plus guidance of more to come is a sign that the RBA is worried about inflation expectations and battling to keep

them under wraps.

Inflation expectations are important because they shape how households and businesses behave and it is this behaviour which ultimately determines economic outcomes, including wages, prices and inflation.

Upside Inflation Risks

The minutes point to some potential changes in behaviour which may be interpreted as a sign that inflation expectations are beginning to shift. In particular, "members observed that some firms were indexing their prices, either implicitly or directly, to past inflation". Additionally, the Board expressed concerns about the "possibility of indexation of wages to past high inflation" following the recent Fair Work Commission's minimum and award wage determination of 5.75%.

The Board noted that "it was understandable that the lowest paid workers would be compensated for high inflation, but that it would be concerning if wages across a broad range of jobs were to become implicitly indexed to high inflation." If wages growth is implicitly linked to past rates of inflation, elevated inflation will persist going forward – a lesson we learnt during the 1970s where high inflation triggered by the OPEC oil price shock persisted due to the indexation of wages.

The minutes note that these developments, alongside a slower-than-expected moderation in goods inflation and pressures in the energy and rental markets "had shifted the balance of risks on inflation to the upside".

In particular, the RBA assessed that there had "not been as clear a moderation in goods price inflation in Australia as there had been in some other countries", casting some doubt over the expected disinflationary pulse. Additionally, rising retail electricity prices and surging rents posed another significant unknown. These risks are skewed to the upside given the delayed flow-through of wholesale electricity prices to retail customers and surging population growth accompanied by a dwelling construction downturn.

The minutes also noted the importance of productivity in ensuring current wages growth remains sustainable, pointing to upside risks to this dynamic given the overseas experience.

Downside Risks

The RBA did still consider a rate pause and listed several downside risks to inflation and the economy which were considered.

The most notable risk lies with the "economy slowing more sharply than expected". It was discussed that consumption growth, the engine room of the economy, was "already quite weak", "especially in per capita terms". The Board also noted that liaison with retailers suggested that conditions had softened further in the June quarter.

Moreover, "lags in the transmission of monetary policy" and "the large number of fixed rate loans scheduled to expire" meant that there would be further tightening in financial conditions even without additional rate hikes. This posed a risk "of the economy slowing and unemployment rising by more than expected".

However, the Board did suggest that developments in the housing market, including rising dwelling values and a stabilisation in loan approvals, could mean "financial conditions may not have been as tight as they had previously judged".

The minutes also considered some downside risks to inflation, including that commodity prices and the cost of international shipping had "fallen quite significantly", that wages growth could undershoot the RBA's forecasts and that productivity growth may prove stronger than expected.

The downside risks to economic growth and the labour market, if realised, would also pose a downside risk to inflation outcomes.

In the event, the Board judged that, despite both sets of arguments being "finely balanced", the case to raise the cash rate "was a stronger one" and was required to "provide greater confidence that inflation would return to target".

RBA 'Pivots'… Again

The RBA has reignited its hiking cycle to protect against the evolving balance of risks. In doing so, the RBA has 'pivoted' yet again – this time in the other direction. The pivot will likely come at the cost of the RBA veering off the narrow path. This does not necessarily entail a recession (although the risks have certainly increased), but instead that a more significant slowdown in the labour market is now likely required to ensure expectations remain anchored and that inflation returns to target.

The inserted disclaimer "acknowledging the considerable uncertainty regarding the outlook for household spending and the financial stresses facing households" appears an initial step towards the RBA eventually abandoning its "narrow path" rhetoric. This is likely to be replaced by a comment more similar to that of the US Federal Reserve, that the RBA will do what is necessary to bring inflation down, even if that comes at the expense of a weaker economy – which appears to more readily reflect the realities.

Outlook

The question is whether the RBA has done enough? Or is more tightening required to restore the credible commitment to price stability that is necessary to keep expectations anchored?

On balance, we think that more hikes will be required. As long as progress on inflation remains slow, large upside risks to inflation expectations will persist. And the evidence to date suggests more work needs to be done to achieve the desired progress on inflation.

We are, therefore, expecting an additional two 25-basis point rate hikes taking the cash rate to 4.60%. We anticipate the timing of these hikes will be consecutive increases in July and August.

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