Bank of Melbourne

Tuesday, 2 November 2021

RBA Board Meeting

RBA Paves the Way for Earlier Rate Hikes

- **The Reserve Bank (RBA) abandoned its yield curve target of 0.10% and dumped its forward guidance that rates would not be raised until 2024. These are significant shifts which pave the way for earlier rate hikes from the RBA.**
- **The RBA's forecasts point to the first rate hike in 2023, but the central bank has left itself wiggle room to adjust to evolving circumstances.**
- **We remain comfortable with our view that the hiking cycle will commence in early 2023. But we also think the risk of a late 2022 move is higher than it was a few months ago.**
- **Ahead of the meeting, financial markets had aggressive tightening priced in for 2022; almost 4 rate hikes were fully priced in. The Governor pushed back against the notion of rate hikes in 2022, describing market pricing as an "overreaction" to recent inflation data. He said he "still struggles" with scenarios for rate rises in 2022.**
- **Markets were arguably expecting today's changes after the RBA stopped defending the yield curve target last week, allowing the yield on the April 2024 target bond to rise significantly above the 0.10% target.**
- **The RBA remains committed to not raising the cash rate until actual inflation is sustainably within the 2-3% target range. However, the RBA dropped its language around the economy not meeting this condition until 2024.**
- **The central bank upgraded its growth and inflation forecasts for 2022, setting up the economic framework for rate hikes before 2024. Forecasts for wages growth were also revised higher to 3% for 2023. The 3% rate is a key threshold; it's a rate that policymakers believe wages need to grow at to help ensure inflation is sustainably in the target band.**
- **The Governor stressed that the RBA is prepared to be "patient", suggesting 2023 remains the most likely timing for the first rate hike.**

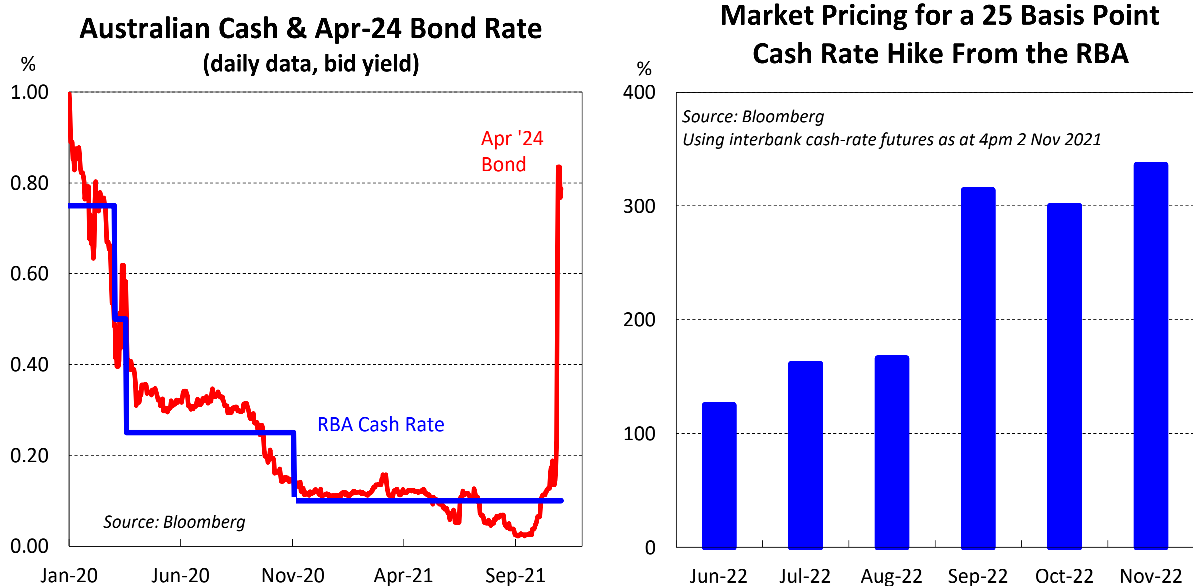
The Reserve Bank has dropped its yield curve control (YCC) program and its 2024 forward guidance. A stronger-than-expected uplift in inflation was a primary catalyst for the RBA's decision. Last week, data showed underlying inflation rose to 2.1% and into the RBA's 2-3% per annum target band for the first time in nearly 6 years.

The RBA sent a very clear signal last week that it could drop this program after not defending the target when the April 2024 bond yield rose well above its 0.10% target.

Last Melbourne Cup, the Reserve Bank (RBA) cut the target on the 3-year government bond from around 0.25% to 0.10%. The targeting of this bond was part of its yield curve control (YCC)

program. One year later, and the RBA has abandoned the target.

The YCC program and the previous guidance from the RBA that the cash rate would not lift until 2024 were inextricably linked. Dropping the target, therefore, is consistent with the shift in forward guidance.



The RBA's use of language in its final paragraph confirms the change in guidance. The RBA remains committed to not raising the cash rate until is sustainably within the 2-3% target range. However, the RBA dropped its language around its "central scenario", which outlined that the economy would not meet this condition before 2024. Instead, the RBA now says that "this is likely to take some time".

The RBA says the Board is "prepared to be patient", with the central forecast for underlying inflation to be no higher than 2½ per cent at the end of 2023 and for only a gradual increase in wages growth. It leaves us comfortable with our long-held house view that the RBA will start hiking in early 2023.

Ahead of the meeting, interest rate markets had priced in aggressive tightening for next year, starting in June 2022. Financial markets had four rate hikes fully priced in, but after today's meeting it has been wound back to three. Last week, markets had nearly four rate hikes priced in, but this pricing has wound back after the meeting today.

The RBA pushed back hard against the notion rate hikes in 2022 in the statement and accompanying press conference. The Governor explicitly stated "the latest data and forecasts do not warrant an increase in the cash rate in 2022" in his press conference following the meeting. He added that market pricing for 2022 is an "overreaction" to recent inflation data and he "still struggles" with scenarios that would warrant rate rises in 2022.

Lowe also said that the decade decline in wages growth is unlikely to be reversed in a few months because factors that have kept wages down in Australia are pretty strong.

We do not think multiple rate hikes in 2022 are realistic and that market pricing has overshot. Lowe presented two plausible scenarios in the questions session in the press conference. He said it is still plausible that the first rate hike might not happen before April 2024 but it's also plausible that the first rate hike will occur in 2023.

We see some risk of a rate hike late in 2022, but it would rely on faster than expected progress on

inflation and employment. Data over the coming months will be important.

The Governor outlined that he expects pressures from supply-chain disruptions will start to ease over the next six months alongside the rebalancing in consumption back towards services, and away from goods, as economies around the world reopen. While he underscored there was still considerable uncertainty over this time horizon, it arguably remains an optimistic assumption.

In the press conference, the Governor explained the RBA is not lifting rates as quickly as some other countries because inflation is not picking up as quickly. He highlighted that wages growth remains much lower in Australia than some other countries (for example, wages growth remains below 2% in Australia but is at nearly 5% in the US). He also flagged that Australia has not been subject to the same energy price pressures as other parts of the world, noting the utility prices have been subdued or even declined in Australia, while they have skyrocketed in other countries.

Implicit in the RBA's decision is the stronger growth and inflation forecasts that now underscore the RBA's economic outlook. There will be a full set of forecasts published on Friday in the RBA's quarterly Statement on Monetary Policy (SoMP). But, the RBA provided us with an entrée today.

GDP growth for 2021 was revised lower, reflecting the impact of lockdowns in NSW and Victoria. However, critically, growth and inflation forecasts were upgraded for 2022, setting up the framework for rate hikes before 2024. Taking into account these tweaks, GDP will be higher at the end of 2022 than in the previous forecasts.

Unemployment forecasts were left unchanged. The RBA has previously indicated that full employment is in the low 4s, so the unemployment forecasts are consistent with a labour market tightening towards full employment.

Forecasts for wages growth were revised higher to 3% in 2023. The 3% rate is a key threshold; it is a rate that the RBA believes wages needs to grow at to help ensure inflation is sustainably in the target band. Lowe in the press conference stressed that wages growth does need to be "materially higher" for inflation to be sustained in the target band.

These new forecasts point to the first rate hike taking place in 2023. However, the RBA has left itself wiggle room to adjust to evolving circumstances, sensibly opting not to lock in when it expects the cash rate will increase.

The RBA has emphasised is prepared to be patient. This patience leaves us comfortable with our view that the first rate hike will likely be delivered in early 2023.

RBA Output and Inflation Forecasts

	Year Ended		
	Dec-21	**Dec-22**	**Dec-23**
GDP growth	3.00	5.50	2.50
(previous)	(4.00)	(4.25)	(2.50)
Unemployment rate		4.25	4.00
(previous)		(4.25)	(4.00)
Underlying inflation	2.25	2.25	2.50
(previous)	(1.75)	(1.75)	(2.25)
Wages inflation		2.50	3.00
(previous)		(2.50)	(2.75)

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The Detail

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