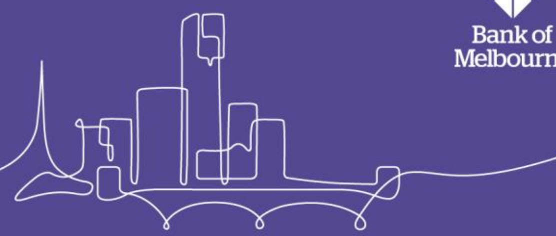
Interest rate outlook

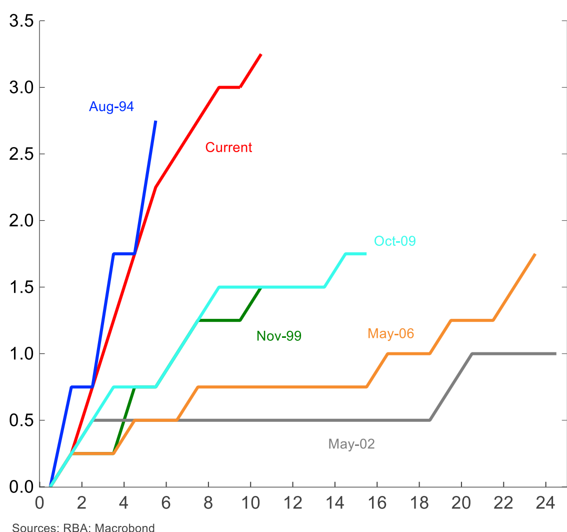


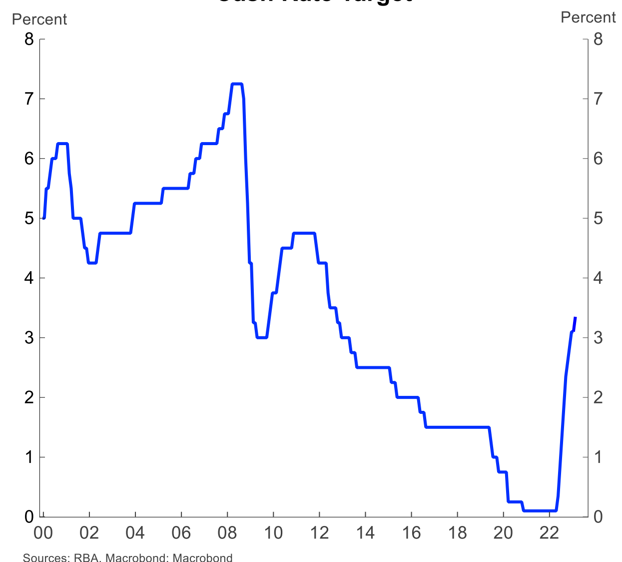
Tuesday, 7 February 2023

RBA Board Meeting

RBA Gives Green Light on Further Hikes

- **The Reserve Bank (RBA) kicked off 2023 with another hike of 25 basis points, taking the cash rate to 3.35% – the highest since September 2012.**
- **The tone of the statement was arguably more hawkish than December. The language was stronger around the RBA's resolve to bring inflation back to the target. In fact, the statement all but confirmed that more interest rate increases are on the horizon.**
- **The key final paragraph included the statement: "The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary".**
- **Importantly, this referred to "further increases" and not "a further increase" or similar. This implies that there are likely to be two more hikes left in this cycle, if not more.**
- **The RBA is getting closer to a cash rate peak, but there is still some way to go. The RBA has signalled that underlying inflationary pressures are likely to remain elevated. Further rate hikes will be required to ensure that inflation expectations remain well anchored, and that inflation is brought back towards the 2-3% target band over time.**
- **Our view has been that the cash rate would peak at 3.85% in this cycle. Today's move and accompanying changes to the statement provide further support to this view.**





The Reserve Bank (RBA) kicked off 2023 with another hike of 25 basis points, taking the cash rate to 3.35%. This is the highest rate since September 2012. This is also the ninth consecutive RBA Board meeting where the cash rate has increased, taking the cumulative tightening to 325 basis points since May 2022. This is the most tightening of any cycle since inflation targeting began in the early 1990s.

Going into the meeting, the Board was faced with the highest headline inflation rate since 1990. Crucially, underlying inflation, as measured by the trimmed mean, came in at 6.9% over the year to the December quarter – above the RBA's 6.5% forecast.

Additionally, the global economic environment was looking slightly less pessimistic, as a rapid reopening in China, a milder-than-expected European winter and lower energy prices, and a still strong US labour market reduced some of the uncertainty around global growth expectations.

Beyond that, key domestic economic data showed a mixed picture, demonstrating a slowing, but still robust domestic economy.

Taking these factors into account, the RBA was left with little choice but to increase rates further.

Importantly, the tone of the statement was arguably more hawkish than December. The language was stronger around the RBA's resolve to bring inflation back to the target. In fact, the statement all but confirmed that more interest rate increases are on the horizon.

The key final paragraph included the statement: "The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary".

This is a slight change from the December version: "The Board expects to increase interest rates further over the period ahead, but it is not on a pre-set course".

The important point is that the statement referred to "further increases" and not "a further increase" or words to that effect. This implies that there are likely to be two more hikes left in this cycle, if not more.

This was a significant outcome of this meeting and appears to push back against expectations held by some that perhaps a pause was on the horizon sooner rather than later.

Additionally, the statement dropped the phrase "but is not on a pre-set course". This change is arguably also more hawkish than previously.

Other Key Changes

The statement acknowledged that we have likely moved passed the peak in inflation, noting that price pressures are "moderating in response to lower energy prices, the resolution of supply-chain problems and the tightening of monetary policy". However, this did not undermine the Board's focus on fighting "very high" inflation. The statement subtly elevated the importance of the damages of inflation, while the goal of "keeping the economy on an even keel" was somewhat subordinated.

When discussing the outlook for household spending, the statement for the first time recognised that the impact on households from rate hikes is diverse. The commentary noted that "some households have substantial savings buffers, but others are experiencing a painful squeeze on their budgets". This was flagged as a key source of uncertainty around "the timing and extent of the expected slowdown in household spending". A nod to recent house price declines was also a new addition to the statement, which suggested that declining house prices are likely to pressure household balance sheets and help cool demand, via a negative wealth effect.

The statement also noted that the strong rebound in services spending as pent-up demand was unleashed following extended lockdown has “largely run its course” and that “tighter financial conditions will constrain spending more broadly”. The December quarter National Accounts (due 1 March) will provide important confirmation of whether the post-COVID rebound has run its course and partial spending data over coming months will also be monitored closely.

The statement’s characterisation of the global economic environment was also upgraded. This perhaps reflects the recent improvement in expectations for the performance of the global economy. Previously, the statement had highlighted the deteriorating outlook for the global economy, and it seemed as though the RBA expected this weakness to help do some of the heavy lifting for its own inflation fight. However, today’s statement appeared more balanced on the global outlook.

Updated Forecasts

The RBA will be releasing its latest set of forecasts in the February Statement on Monetary Policy, due Friday. As is common ahead of the release of this statement, the Board provided some insights into forecasts for key economic variables.

The main takeaway is that the RBA’s central forecasts are little changed from that published in November. Inflation is still expected to gradually decline over 2023 and beyond. The central forecast is for inflation to slow to 4¾ per cent in 2023 and fall to “around 3 per cent” by mid-2025. This implies that the RBA doesn’t expect inflation to get back to the 2-3% target band until mid-2025, at the earliest.

The economy is still expected to slow to around 1½ per cent in 2023 and 2024. The labour market remains tight but is expected to slow in line with a deterioration in economic growth. The RBA forecast the unemployment rate to increase to 3¾ per cent by the end of 2023 and 4½ per cent by mid-2025.

RBA Economic Forecasts:

	Dec 2023	**Dec 2024**	**Jun 2025***
GDP, y/y%	1½	1½	
Consumer Price Index, y/y%	4¾	3¼	~3
Unemployment, %	3¾	4¼	4½

*2025 forecasts included in February Monetary Policy Decision to be formally released in the Statement on Monetary Policy

Outlook

While the peak in domestic inflation was likely seen in the December quarter, the RBA has further work to do to sustainably return inflation towards the 2-3% target band.

What does this mean for the future path of monetary policy?

Our long-held view has been that the cash rate would be lifted to a peak of 3.85% in this cycle. This included an expected hike at this meeting and another in March, before the RBA would pause in April to assess the impact of the hikes to date. Our final expected hike in the cycle was pencilled in for May, after the Board had the benefit of assessing the March quarter inflation report.

Today’s move and accompanying changes to the statement provide further support to this view. The wording of the statement implies at least another two hikes. It is consistent with our long-held view of a peak at 3.85%.

However, the Board continued to emphasise that it will be guided by the data. Key factors the Board will be watching closely include “developments in the global economy, trends in household

spending and the outlook for inflation and the labour market."

Looking forward over the next few months, there will be a range of important domestic data releases which will help to guide the Board's decision-making process. These include:

- The December quarter Wage Price Index (22 Feb) – providing insights into how the tight labour market is translating into wages growth across the economy.
- The December quarter National Accounts (1 Mar) – providing comprehensive insights into the performance of the Australian economy over the December quarter. The evolution of household consumption will be a key area to watch, particularly as the partial data provided by the retail sales release only covers around a third of household spending.
- And the monthly Labour Force releases and quarterly Consumer Price Index data (March quarter CPI on 26 April). The monthly CPI also warrants monitoring.

Internationally, hiking cycles by the major central banks in the US, Eurozone, and the UK are nearing their peaks. However, further hikes are likely to be necessary, as has been emphasised by each respective central bank.

The situation in Australia is similar. The RBA is getting closer to a cash rate peak, but there is still some way to go. The RBA has signalled that underlying inflationary pressures are likely to remain elevated. Further rate hikes will be required to ensure that inflation expectations remain well anchored, and that inflation is brought back towards the 2-3% target band over time.

We continue to expect a further two hikes, to a peak of 3.85%.

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The Detail

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