Tuesday, 21 February 2023

RBA Board Meeting Minutes

New Year, Renewed Focus for the RBA

- **In February, the Reserve Bank (RBA) hiked the cash rate by 25-basis points, taking the policy rate to 3.35% - it's highest level since September 2012.**
- **It wasn't the decision which captured the attention of markets and economists, it was the policy statement. The statement provided clear guidance that at least two more rate hikes are on the horizon and subtle changes to the RBA's rhetoric.**
- **Today, the minutes revealed that the RBA is more concerned about the upside risks to inflation and has elevated its focus on controlling inflation. The objective of 'keeping the economy on an even keel' now appears to be secondary.**
- **An improvement in the global outlook and "a pattern of incoming prices and wages data exceeding expectations" largely explain the RBA's renewed aggression to tackle inflation.**
- **The RBA Board considered a 25 or 50 basis point hike in February, quashing some expectations for a pause. Ultimately, the Board concluded that the case to hike by 25-basis points was more compelling as interest rates had already increased substantially and the monthly frequency of meetings provided scope to react to future uncertainties.**
- **In the December meeting, the RBA considered a pause, flagging the long and variable lags in monetary policy as a key argument in favour of this option. However, the February minutes make little effort to highlight this argument.**
- **The February meeting marked a substantial change in the RBA's characterisation of where the inflation risks lie and their resolve to prevent any upside risks from being realised. This further supports our expectation that the cash rate will peak at 3.85% in this cycle.**

At its February policy meeting, the RBA hiked the cash rate by 25-basis points, taking the policy rate to 3.35% - it's highest level since September 2012. However, it wasn't the decision which captured the attention of markets and economists, it was the policy statement.

The most compelling feature of the statement was the RBA's guidance that at least two more rate hikes are on the horizon. However, there were also more subtle changes to the RBA's rhetoric which illustrate their assessment of how economic conditions are evolving.

Today, the minutes from that meeting were released providing some further insight into the Board's discussion and what prompted the RBA's change in tone.

Immediately, the minutes from the February meeting read more hawkish. In particular, the RBA included more caveats on the potential trajectory of the economy and balanced both upside and downside risks. In comparison, the discussion in previous meetings focused more on the downside risks to domestic growth and inflation, including the long and variable lags in monetary policy and the risk of overtightening.

This suggests that the RBA is more concerned about the upside risks to inflation and has somewhat subordinated the objective of 'keeping the economy on an even keel', although this remains a key focus. Supporting this concern, the minutes acknowledge the global outlook had improved following more resilience in the US and Europe and the reopening of China. The repercussion being that the RBA can no longer rely on a pronounced slowdown in global growth to do some of the heavy lifting in bringing inflation down.

However, the RBA appears more concerned by "a pattern of incoming prices and wages data exceeding expectations". Specifically, this is referring to the December quarter inflation report and the September quarter wage price index (WPI). Together, these changes largely explain the RBA's renewed aggression to tackle inflation.

Options considered by the RBA Board

The Board considered a narrower set of options in the February meeting, a 25 or 50 basis point hike, quashing some expectations for an impending pause in tightening. In not considering the option to pause, the RBA elevated their focus on fighting inflation and skewed the odds towards a higher peak in the cash rate.

The arguments in favour of 50-basis point hike included the risk that inflation is more persistent, sighting hotter than expected price and wages data and the risk that inflation expectation become unanchored. In particular, the RBA flagged that these risks grow the longer inflation remains elevated. Additionally, the RBA considered the "significant costs" incurred by the economy if inflation were to remain persistently high.

In considering a 25-basis point hike, the RBA noted that inflation is expected to have reached a peak in the December quarter and is forecast to return to target over the forecast horizon. It was added that the outlook for consumption was softening as households are facing tighter budgets and real incomes are being eroded. Finally, the RBA highlighted that there were an increasingly large number of uncertainties surrounding the outlook.

Ultimately, the Board concluded that the case to hike by 25-basis points was larger, citing that the monthly frequency of the RBA's meetings provided the scope to assess the uncertainties and react if needed. Additionally, there was less need to move by 50-basis points given interest rates had already increased substantially.

In the December meeting, the RBA had considered a pause, flagging the long and variable lags in monetary policy and the uncertain impacts of such rapid tightening on the economy as key arguments in favour of this option. However, the February minutes make little effort to highlight these arguments, even when discussing a 25-basis point hike. Instead, the RBA underscores that household savings buffers in Australia are relatively large compared to other developed economies, providing upside risk to demand. This is a material change in thinking.

Forward guidance

A prominent inclusion of the February policy statement was the RBA's forward guidance that "the Board expects that further increases in interest rates will be needed over the months ahead". Crucially, this implies that there are likely to be at least two more rate hikes left in this cycle.

This guidance is consistent with the RBA's renewed appreciation for the upside risks to inflation and elevated focus on containing inflationary pressures. However, the minutes also provide some further detail on the formulation of this guidance.

In particular, the RBA notes that its economic forecasts were prepared on the assumption that the cash rate will peak at 3.75%. Subsequently, a cash rate of at least this level will be required to ensure the “current period of high inflation is only temporary”, based on the RBA’s own forecast profile. It is important to note that the cash rate assumption is derived from a combination of market implied rates and economist forecasts at the time and is not the RBA’s own forecast for the peak in the cash rate. Market pricing and economist forecasts have since been revised higher following the February meeting.

Monetary Policy Outlook

The February policy meeting marked a substantial change in the RBA’s characterisation of where the inflation risks lie and their resolve to prevent any upside risks from being realised. The Bank’s more aggressive forward guidance and narrower consideration of a 25 or 50 basis point hike are testament to this.

The discussion from the RBA’s February meeting further supports our expectation that the cash rate will peak at 3.85% in this cycle.

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