Interest Rate Outlook

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RBA Board Meeting

The Inflation Fight Is On

- **The Reserve Bank's fight against inflation continued with another rate hike of 50 basis points delivered today to take the cash rate to 2.35% - the highest rate since January 2015.**
- **The RBA has taken a two-pronged approach to fighting inflation – raising rates and talking tough on its commitment to quell inflation.**
- **The RBA has made it clear that fighting inflation is its number one commitment and has flagged that more rate rises are on the way.**
- **The statement implied that today's increase takes the cash rate near estimates of the "neutral" level, perhaps suggesting the size of future rate hikes will step down to 25 basis points. But this is no done deal. Much will depend on how the data evolves.**
- **One piece of data the RBA will be eyeing closely is inflation expectations. The RBA is staying alert to any signs of inflation expectations accelerating, which would make the task of taming inflation tougher.**
- **Rising inflation expectations could materially increase the outlook for wages growth. The RBA flagged that labour costs are increasing briskly in pockets with unemployment at a 50-year low and more than one job vacancy per unemployed person.**
- **Fighting inflation comes with a trade-off to growth. But the RBA sees inflation as the bigger evil. We do not expect rate hikes to end until the RBA has compelling evidence that inflation is decelerating. This commitment is fanning fears of a recession.**
- **We remain comfortable with our view that the RBA will hike again in October and take the cash rate to 3.10% by the end of this year. Markets have almost 3.25% priced in by year's end.**

The Reserve Bank's fight against inflation continued with another rate hike of 50 basis points delivered today to take the cash rate to 2.35% - the highest rate since January 2015.

The RBA has taken a two-pronged approach to fighting inflation – raising rates and talking tough on its commitment to quell inflation.

The RBA has now tightened by a total of 225 basis points since it began this rate-hiking cycle in early May –the most tightening in a 5-month window since late 1994, which underscores the inflation challenge the RBA is taking on.

Inflation was running at an annual rate of 6.1% in the June quarter and is headed to nearly 8% in the final quarter of this year on the RBA's own forecasts. Price pressures of this magnitude mean that getting inflation down will not be easy.

Not surprisingly, the RBA has signalled more rate increases are on the way. The final paragraph of its statement highlights "the Board expects to increase interest rates further over the months ahead". The question boils down to how much more tightening can we expect.

The current cash rate appears to have neared "neutral" with the RBA no longer describing rate rises as further steps in normalising policy. The neutral rate is the rate that is not acting as a brake on economic activity and that is not stimulating conditions.

The suggestion that the cash rate is nearing neutral suggests the RBA could choose to scale back the size of tightening from 50 basis point steps to 25 basis point steps. However, this is by no means a done deal and, in fact, is likely to be a close call.

The RBA will be watching the data very closely, especially on inflation expectations. The RBA remains alert to the possibility of inflation expectations rising, which would make the task of taming inflation tougher. Inflation expectations over the medium term are currently well anchored, but this has the potential to change.

Rising inflation expectations could materially increase the outlook for wages growth. The RBA inserted a new paragraph this month on wages, describing a pick up in wages growth from very low rates of recent years. It highlighted there are pockets where labour costs are "increasing briskly".

The very tight labour market and the upstream price pressures, means the RBA board will watch how labour costs evolve and the price-setting behaviour of firms in the period ahead. The feedback from our business customers suggests they are still feeling the pressure to lift prices to the end consumer.

Fighting inflation comes with a trade-off to growth. But the RBA sees inflation as the bigger evil. The trade-off in fighting inflation is one that involves balancing an economic outlook hampered by growing costs and labour shortages against the vulnerability of heavily indebted households.

One of the major sources of uncertainty is the behaviour of household spending. Consumer confidence has fallen, house prices are declining and the "full effects of higher interest rates (are) yet to be felt in mortgage payments". But people are finding jobs, hours worked are growing, wages growth is rising and many households continue to build up financial buffers.

The trade-off means fears are fanning that the resolve to slow inflation will result in a recession. These recession risks are more pronounced in the US and Europe. Our core view is that a soft landing will materialise in Australia, but the higher the RBA takes the cash rate to slow inflation, the greater the risk of a hard landing.

As long as inflation remains the top priority, we do not expect the rate-hike cycle to end until the RBA has compelling evidence - a series of data releases - showing decelerating inflation. At that point, the RBA would likely pivot toward a more balanced dual focus of growth and inflation.

We remain comfortable with our view that the RBA will hike again in October and take the cash rate to 3.10% by the end of this year. Markets have almost 3.25% priced in by year's end. A cash rate of 2.85% - near the top end of the neutral zone – seems a done deal. Whether our forecast is accurate and how much further the RBA takes the cash rate above 2.85% will depend heavily on the data and on the actions of other major central banks around the world.

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