BULLETIN

3 June 2022

We expect the RBA Board will take the right decision and lift the cash rate by 0.4% next week

The Reserve Bank Board meets on June 7 next week.

Immediately following the Board's decision to raise the cash rate by 25 basis points on May 3 we argued that the correct policy decision for June 7 would be to raise the cash rate by a further 40 basis points.

By lifting the cash rate by 40 basis points from 0.35% to 0.75% the Board would be fully unwinding the emergency rate cuts we saw in 2020 during the Covid crisis.

Clearly that emergency has passed and there is no justification to maintain an extreme emergency policy stance.

We believe that the Board will make that correct decision next week.

Most analysts have and continue to predict a move of 25 basis points, partly in response to the Governor's press conference which he conducted following the decision on May 3.

He referred to going back to a "business as usual" policy process which he implied was movements of 25 basis points at the meetings.

But the Minutes of the meeting provided further insight into that statement.

The Minutes noted that the Board considered three policy options for the cash rate.

The 15 basis points option which was favoured by most analysts (including Westpac) and the market, was dismissed by the Board because policy settings were already "very stimulatory"; further rate rises would be required; and a 15 basis point increase would be inconsistent with the historical practice of changing the cash rate in increments of at least 25 basis points.

The Minutes pointed out that the case for 40 basis points "could be made given the upside risks to inflation and the current very low level of interest rates." That case remained open without any real argument against it, although "given the Board meets monthly, it would have the opportunity to review the setting of interest rates again within a relatively short period of time".

That second comment could be interpreted in two ways – no need to adopt big moves given the frequency of meetings or the decision to do "40" could be deferred to next month.

The lack of a clear argument against the 40 in May and the fact that they refer to the level of rates being "very stimulatory" supports doing more than 25 and thereby signalling the Board's commitment to achieving its inflation objectives and managing inflationary expectations.

Assistant Governor Kent emphasised at a recent Kanga News Conference (May 16) that it was the level of rates that mattered the most not the change- consistent with the comment in the minutes "current very low level of interest rates."

At his press conference the Governor referred to "business as usual".

That may have been interpreted as "25 basis point movements." However, the minutes refer to the " historical practice of changing the cash rate in increments of AT LEAST 25 basis points" (my emphasis).

I think it is reasonable to assess the Governor's "business as usual" comments as being in line with that observation and not restricting " business as usual" to 25 basis point moves.

Another key argument supporting the likely 40 basis point policy is the description of the actions of other central banks in the minutes. "Several central banks in advanced economies had indicated that they were seeking to return policy rates to a neutral setting QUICKLY (my emphasis) and may increase policy rates further thereafter."

Since that Board meeting we have seen the FOMC lift the federal funds rate by 50 basis points to 0.875%; the Bank of Canada lift its benchmark rate by 50 basis points to 1.75%; the RBNZ lift the official cash rate by 50 basis points to 2.0%; and each bank indicated that further significant increases can be expected.

All these central banks started their cycles with a 25 basis point move followed immediately (FOMC; BOC) by 50 basis points while RBNZ moved to 50's after two moves of 25 basis points.

Larger increases at the early stages of the tightening are good policy. Better to move decisively in the early stages of the cycle when it is clear rates are well below neutral than later in the cycle when there is a risk that policy moves too quickly into contractionary territory .

An early decisive move also sends a clear signal that the Bank is committed to its inflation objective and impacts inflationary expectations in the community.

The RBA has been slow to recognise that Australia has a formidable inflation challenge.

It is not appropriate to only compare Australia's CURRENT inflation rate with other countries. Inflation forecasts are just as important.

In that regard note that the RBA's current forecast for inflation by end 2022 is 4.6% (trimmed mean) and 5.9% (headline) compared to the FOMC's forecast by end 2022 (core PCE) of 4.1% and 4.3% (PCE).

Recent developments around energy prices and rents are likely to see the RBA lifting its current forecasts for inflation, although we will not see a formal update until November.

Since the May Board Meeting there have been a number of significant developments which further emphasise the need to be decisive.

Inflation

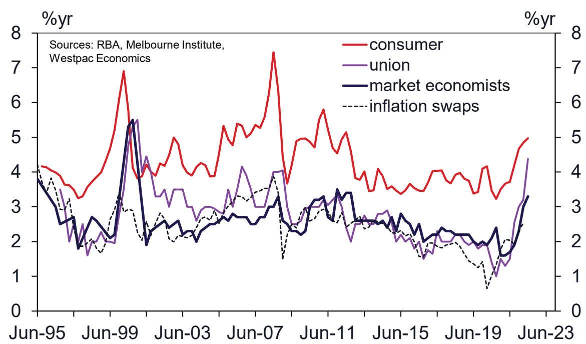
The March quarter national accounts confirmed the inflation surge we saw in the March quarter CPI report.

The most appropriate measure of domestic price pressures- the domestic final demand implicit deflator – rose by 1.4% in the quarter – the fastest increase since the introduction of the Goods and Services Tax in 2001.

Inflationary expectations are rising quickly. The latest inflation expectations measure from the Melbourne Institute , which is followed very closely by the RBA, (Figure 1) showed that expectations of the trade unions, in particular, lifted from 3.2% to 4.3% over the last three months and are up from just 1.5% a year ago.

Figrue: 1

Short term inflation expectation – over 1 year



Employment

The April jobs report showed a fall in the unemployment rate from 4.0% to a 48 year low of 3.9% while the underemployment rate fell by 0.2% to 6.1% (the lowest level since 2008).

There were "only" 4,000 more jobs added in April but hours worked surged by 1.3% with 88,400 part time jobs being replaced by 92,400 full time jobs as workers increased their hours and "progressed" from part time to full time.

Wages

There was some market disappointment that the increase in the WPI printed 0.7% compared with market expectations of 0.8%.

Annual growth was 2.4% compared to expectations of 2.5%.

RBA now assesses the pulse of wages growth using other measures as noted in the Minutes, "more timely evidence from liaison and business surveys indicated that labour costs were rising in a tight labour market and a further pick-up was likely over the period ahead."

We also saw some interesting evidence from the WPI report that the average increase of those who received a wage increase was 3.4%, up from 2.8% in the December quarter and the fastest increase since 2013.

We also saw the "compensation per hour" data from the national accounts – the best measure of the wage pulse in the accounts, given that other measures can be affected by hours worked.

This series lifted by 2.7% for the quarter to be up by 4.9% for the year, compared with a 2% annual growth rate in the December quarter.

Conclusion

The best policy for the RBA Board will be to raise the cash rate by 40 basis points at the June Board meeting next week.

The RBA is well "behind the curve"; has seen further threatening evidence around inflation and inflationary expectations since the last meeting and needs to make a clear statement that like most developed nations Australia is facing a formidable inflation challenge which needs a stronger early response than the minimum 25 basis point gesture.

Although the Board meets more frequently than other central banks the need for a decisive move when rates are extremely stimulatory and there is a clear need to manage inflationary expectations makes a strong case for a 40 basis point decision.

Taking back the emergency cuts in 2020 would be a very important symbol of the Bank's clear intentions to address the inflation challenge.

The arguments set out above would also be consistent with a 50 basis point move. However given that the Board actively considered 40 basis points at the May meeting we think it is much more likely that the 40 basis point option will be taken.

Bill Evans, Chief Economist

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