# BULLETIN

19 September 2022

# RBA to raise the cash rate by 50 bp's on October 4

We have long argued that the Reserve Bank Board should slow the pace of rate increases once it reaches its assessment of neutral. That is particularly because of the 'treacherous lags' that will have built up as the inevitable result of such a sharp rate increase in rates, from 0.1% back in May.

The Governor has certainly indicated that intention, both in the speech to the Australian Business Economists on September 8 and in the Parliamentary hearing last Friday.

Our view had been that the scaling back to a slower pace of tightening could begin from the October meeting, with the cash rate having reached the 'neutral zone' at 2.35%.

However there has always been some uncertainty as to whether a starting point of 2.35% would be too far below the Governor's assessment of neutral.

We know that he has argued in the past that the 'real' neutral is at least zero, implying a 2.5% nominal rate given longer term inflation expectations. That is above the 2.35% starting point for the October meeting.

Whether he wants to start the scale-back at a rate below his assessment of neutral or begin when rates are much nearer his estimate of neutral will be influenced by his assessment of the risks on inflation, the labour market and the economy in general.

There were significant remarks in the Parliamentary hearing on Friday that suggest he will err on the side of a higher rate before deciding to scale back the pace of tightening.

We now expect the Governor to decide to push the rate more clearly into his best estimate of the contractionary zone before scaling back the pace of increases.

**That suggests that he will push the rate to 2.85% with a 50bp increase at the October Board meeting.**

Some comments at the House of Representatives Standing Committee on Economics hearing that resonated were:

- **On the risks:**
  - "… the general inflation psychology appears to be shifting; it is easier for firms to put their prices up, and the public is more accepting of this."
  - "… it is important that we avoid a cycle where higher inflation leads to higher wages and inflation running high."
  - Comment: he seems very unnerved about the risks of inflationary expectations getting away from him.
- **On the language:**
  - "We're CLOSER to a normal setting now, which means the case for large adjustments has diminished."
  - "… AT SOME POINT we'll obviously not need to be increasing rates by 50 basis points at each meeting, and we're GETTING CLOSER to that point.
  - "… we're getting to that range that you'd think is normal but probably still on the low side."
  - Comment: we are getting CLOSER but we are not there yet.
- **On the economy:**
  - "… recent data suggests that spending has remained resilient so far."
  - "… it's incredibly difficult to hire workers."
  - "… retail spending was again pretty firm."
  - "… spending in the economy is pretty strong."
  - Comment: chose to emphasise his assessment that the economy remains strong

Those comments on the timing of the point at which the Board moves to a slower pace appear to be more cautious than we saw from the Governor's Statement following the September Board meeting.

This could be significantly explained by the events in global markets following the US inflation report released on September 13.

As a result of that report and the hawkish language from Fed Chair Powell at Jackson Hole, we lifted our forecast for the terminal federal funds rate from 3.375% to 4.125%, including a 75bp move at the September 20-21 FOMC meeting.

While the Governor makes the point consistently that the Fed has a more urgent inflation challenge than the RBA due to much faster wage growth, he will take notice of such a sharp reassessment of the outlook for US interest rates and interest rates globally.

That relates to not only the near-term outlook but the assessment of higher global rates in general.

As such we have also raised the terminal rate from 3.35% to 3.6%.

Raising the terminal rate by 25bps compared to the 75bp increase in the federal funds rate still acknowledges Australia's higher sensitivity to the central bank's policy instrument.

Recall that the key reason why the RBA reluctantly adopted QE in 2020 was maintaining competitiveness in the AUD. The Governor would be concerned that such a sharp widening of the expected yield differential with global rates will have implications for a weaker AUD complicating the inflation challenge.

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We have not changed our post October profile with increments shifting down to 25bp as emphasised in the comments above.

Having comfortably exceeded the neutral target it seems likely that he would then deliver on the guidance to slow the pace.

But unlike most analysts we continue to expect that the tightening cycle will continue for November, December and February.

The November and February increases will be in response to ongoing evidence of sustained inflation pressures in the September and December inflation reports.

Clear evidence of the expected slowdown in inflation will not be apparent until late February, allowing the RBA to go on hold in March on evidence that growth is slowing and that inflation and rates have also peaked in the US.

We have already sharply marked down own our growth forecast for 2022 to 1%, to incorporate the previous terminal rate forecast of 3.35%.

That 1% growth rate (and the associated 1.2 ppt increase in the unemployment rate in 2023) now has some downside risks but, for now, given the current momentum in the economy we have decided not to mark 2023 growth down any further.

We also note that since we forecast the 1% growth rate in 2023 we have revised down our 2022 growth rate from 4.4% to 3.4% meaning that the level of GDP by end 2023 will be considerably lower than we had expected when we first made the 1% growth forecast.

Readers may see that 3.6% terminal rate as 'over-tightening' but our view is that the growth rate required to achieve the objective of wringing inflation out of the system is consistent with the 3.6%.

Given these extreme circumstances around the build up of inflationary pressures central banks will take the policy of 'least regret'. Which will be to err on the side of containing inflation at the potential cost of growth in the near term.

**Bill Evans, Chief Economist**

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