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RBA Board Meeting Minutes

Upside Risks & Strong Arguments For Hike

- **In May, the Reserve Bank (RBA) Board surprised financial markets and most economists by hiking rates by 25 basis points. This followed a pause at the April meeting and took the cash rate to 3.85% – the highest since April 2012.**
- **Like in April, the RBA considered two options, a 25-basis-point hike or a pause. The minutes appear slightly more hawkish than recent meetings and demonstrate that the RBA remains concerned about the rapid pace of inflation. The minutes note that potential risks leave the RBA's gradual path back to the inflation target with "little room for upside surprises".**
- **There were several arguments for a hike, including potential upside risks to inflation and inflation expectations amid an elongated return to target, the persistence of services inflation overseas and the risk we have the same experience, upward pressure on rents amid record population growth and low vacancy rates, and ongoing strength in the labour market which is putting pressure on services inflation.**
- **Weak productivity growth was another risk. The RBA's forecasts were "predicated on productivity growth returning to around the modest pace recorded prior to the pandemic". However, if this didn't happen, "growth in unit labour costs would be uncomfortably fast".**
- **Asset prices and their impacts on inflation, such as rising dwelling prices and a weak AUD, were discussed. The Board acknowledged that the April pause "was likely to have contributed" to this, while also noting that "several factors had contributed". Recent data suggests dwelling prices have continued to rise, despite the May hike.**
- **Arguments for a pause included inflation having peaked in the December quarter and being on the way down, risks inflation may slow faster than expected, weak consumption and expectations for further softness, and the long and variable lags in monetary policy which will see aggregate mortgage payments continue to rise even without further increases in the cash rate.**
- **Our central view is that we have reached the peak in this cycle at a cash rate of 3.85% and the next move will be a cut. We are anticipating rate cuts to materialise in 2024. However, risks remain skewed to the upside with inflation still well above the target band, so we cannot fully rule out further tightening this year.**
- **Separately, today's monthly Westpac-Melbourne Institute consumer sentiment release showed that sentiment has been dented further by the May rate hike. Consumer sentiment fell to 7.9% in May, to 79.0.**

At its May policy meeting the RBA Board surprised financial markets and most economists by hiking rates by 25 basis points – to 3.85%. This took the cumulative amount of tightening in this cycle to 375 basis points. Today, the minutes from that meeting were released, providing further

insights into the RBA's policy deliberations and guidance for future meetings.

Options considered by the RBA Board

The Board considered two options for monetary policy, a 25-basis-point hike, or a pause, as it did in April. The reasons laid out in favour of each option were similar to those discussed at the April meeting. However, the outcome was different and the arguments for a hike won out on the day.

25 basis point hike

The arguments supporting a hike built on those from previous meetings. However, additional arguments were added, and the emphasis appears to have shifted to a more concerned tone.

Importantly, the Board placed greater emphasis on potential upside risks to inflation. It acknowledged that its current gradual path of inflation only returning to the top of the 2-3% band by mid 2025 leaves "little room for upside surprises" as "inflation would have been above the target for around four years by that time".

Such a gradual return to target raises the risk that inflation expectations will become unanchored, and the minutes again noted this risk. These comments suggest there is some concern around the slow return to target and that the Board would likely tighten monetary policy further in response to any signs that this path may be threatened.

Asset price developments were discussed. In particular, the depreciation of the AUD and dwelling prices rebounding. The Board acknowledged that the April pause "was likely to have contributed" to this, while also noting that "several factors had contributed". These factors need to be considered "when assessing the outlook for activity and inflation", despite the RBA not explicitly targeting asset prices. Notwithstanding the May hike, daily CoreLogic data suggests that dwelling prices have continued to rise. If this continues, dwelling prices are likely to be considered again in future meetings.

The Board discussed potential upside risks to inflation and rising rents were a key risk. Record population growth is adding to rental demand amid record low vacancy rates and a subdued supply response, amplified by ongoing delays in dwelling construction. This combination is likely to lead to continued upward pressure on rents.

Another factor was the 'stickiness' of services inflation overseas and the risk we have the same experience. Indeed, Australia has largely lagged other developed countries during this cycle. For example, the goods disinflation process that has been well-underway in the US for over six months has only materialised recently here. Therefore, it is possible that we are not so different and may face similar challenges as other countries in getting services inflation down.

Key to services inflation is the pace of wages growth. Here, the minutes point to weak productivity growth being another upside risk to inflation. RBA inflation forecasts were "predicated on productivity growth returning to around the modest pace recorded prior to the pandemic". However, the Governor has noted on several occasions that productivity growth has yet to rebound to these levels. The minutes flag that if productivity growth didn't return to pre-pandemic levels, "growth in unit labour costs would be uncomfortably fast". This suggests that wages growth may not need to grow at the same pace as overseas for the RBA to become concerned about its impact on inflation, particularly if productivity growth remains weak.

On the economic front, data received between the April and May meetings confirmed the labour market remained tight and services inflation was high in the March quarter and persistent overseas. Additionally, an easing in banking stresses was noted.

Pause

The arguments supporting a pause included that inflation had peaked in the December quarter and was on its way down. Risks to inflation remain two-sided and the Board noted that there was a “possibility that inflation could return to the centre of the inflation target band earlier than forecast” if goods inflation slowed more rapidly than expected.

Current wages growth was considered consistent with the target band, on the caveat that productivity growth picked up, and liaison pointed to stabilising wages pressures.

Consumption was expected to be weak going forward and there were downside risks to this outlook. In particular, per capita consumption was expected to fall over the year ahead amid record population growth. Indeed, as we outlined in our note on Friday, 5 May, the most recent forecasts from the Statement of Monetary Policy showed the RBA expects a per capita recession and expects both per capita consumption and per capita GDP to remain below their pre-COVID levels (as of December quarter 2019) until the end of 2024.

Aggregate mortgage repayments will also continue to increase, even without a further increase in the cash rate, as the large pool of fixed-rate mortgages roll off onto higher rates. Finally, the long and variable lags of monetary policy were another argument supporting a pause.

Monetary policy outlook

Mechanically, the higher rates go, the closer we get to the peak. Our central view is that we have reached the peak in this cycle at a cash rate of 3.85% and the next move will be a cut. We are anticipating rate cuts to materialise in 2024. However, risks remain skewed to the upside with inflation still well above the target band, so we cannot fully rule out further tightening this year.

The risks are skewed to the upside and the RBA will need to remain vigilant going forward. There are growing concerns that inflation may be sticker than previously thought amid a continued strong labour market and record population growth. The May minutes suggest the Board is live to these risks and will continue to closely monitor upcoming data. Tomorrow’s March quarter Wage Price Index and Thursday’s April Labour Force data releases are important to watch in this regard.

The 2023-24 Budget was another key piece in the inflation puzzle. The centrepiece cost-of-living package will provide vulnerable households with some support. This is welcomed. Some elements of the package will lower the measured rate of the consumer price index as they represent subsidies from the government. However, when the economy is pushing up against capacity constraints, additional spending adds to risks that inflation may take longer to subside and that the cash rate may need to be higher for longer.

Financial market pricing has also been creeping higher over recent days and markets now price 11 basis points of hikes by September, compared with less than 6 basis points on Friday. This suggests around a 44% chance of another hike by the September meeting.

As always, economic data will be important to monitor over coming weeks and months.

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