Australia: Reserve Bank hikes and says job not done

The Reserve Bank of Australia has hiked a further 25bp taking the cash rate to 3.35% - there is no suggestion that rates are close to the peak or that they will fall any time soon

Governor of the Reserve Bank of Australia, Philip Lowe

3.35%

Cash rate target

+25bp

As expected

Hawkish statement

In addition to hiking rates a further 25bp to 3.35%, the Reserve Bank of Australia (RBA) engaged in a spot of forward guidance in the statement that accompanied today's decision on rates. There are two key comments in this statement that leave us thinking that we were right to revise our cash rate target forecast to 4.1% recently, up from 3.6% previously, which was roughly where the market consensus lay before this meeting.

The first of these comments reflects the path the RBA sees for inflation, which is for only a very slow decline. "*The central forecast is for CPI inflation to decline to 4¾ per cent this year and to around 3 per cent by mid-2025".*

The second comment is "*The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary*".

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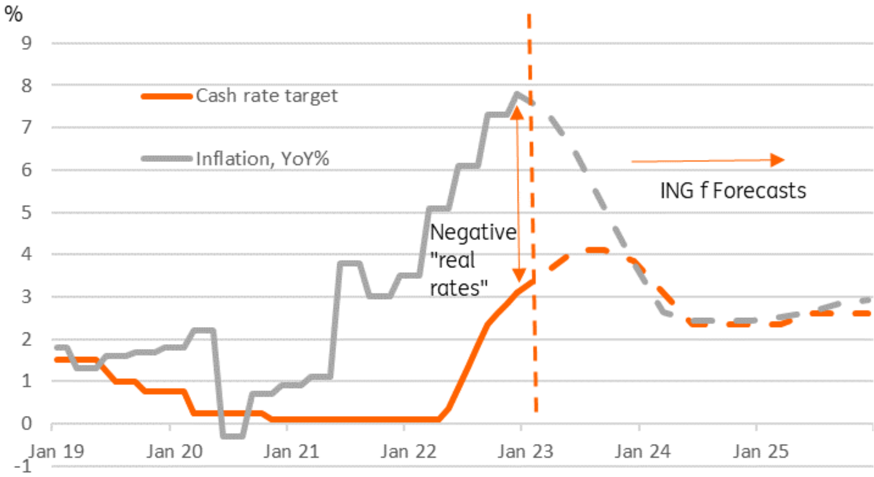
>
> Philip Lowe, Governor, Reserve Bank of Australia

Australian rates and inflation forecasts (ING)



Source: CEIC, ING

Caution - forward guidance!

The RBA's inflation forecasts and their implication that rates will rise more and stay higher for longer are magnitudes different to our own forecasts (see chart) and also the prevailing market view before this meeting. In contrast, we believe that headline inflation will be back below 3% by the first quarter of 2024. So how can we be so far at odds with the RBA's outlook?

The answer probably lies in the concept of "forward guidance". By stating that, in its view, inflation will stay high for a protracted period, the RBA is undermining any thoughts of easing later this year or early next. This will lift longer-term bond yields and short-term rate expectations. It will give the AUD a boost too. All of these things tighten financial conditions and will make it easier to bring inflation down.

However, we may want to remind ourselves of the RBA's track record here. Even as Australian inflation was taking off, the RBA's guidance was that rates would not be raised from their cycle low of 0.1% until at least 2024. Well, that obviously didn't happen. Nor did wage growth need to exceed 3% for inflation to return sustainably to its target range on the way up.

But then forward guidance does not have to be accurate to work. Indeed, if it does work, then it probably won't be accurate as credible guidance will help bring about a quicker adjustment of inflation.

In short, we don't need to believe the RBA's forecasts and statements or adjust our forecasts to match them. We just need to be aware of their intentions. It is a very different approach to that taken by the US Federal Reserve's Chair, Jerome Powell. He recently expressed no interest in short-term market reactions to the Fed's meetings and statements.

For Australian markets, the near term is likely to see some more support for the AUD from higher rate expectations, though it would only take a soft inflation report or some weak employment data for holes to start appearing in the RBA's assertions.

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