Tuesday, 15 February 2022

RBA Board Meeting Minutes

RBA Prepared to be Patient

- **The minutes from the meeting, released earlier today, reiterated recent messaging from the Reserve Bank (RBA). And we have certainly heard plenty from the central bank in the past few weeks.**
- **The RBA's forecasts point to an upbeat view of the economic outlook. While inflation pressures heat up, the RBA continues to underscore "patience" due to uncertainty over the path of wages.**
- **So, what will trigger a rate hike? Well, on several recent occasions, the Governor has actively avoided providing specific guidance. This reflects uncertainty over the outlook, especially with respect to supply disruptions and the behaviour of wages with unemployment at historic lows.**
- **That said, some clues can be gleaned from Friday's parliamentary testimony. The Governor said it would be good to see "another couple of CPIs". The next readings are due in April and July, suggesting August is the earliest window for a rate hike.**
- **This window relies on economic outcomes matching the RBA's forecasts; 2021 has shown the RBA underestimated the resilience of the economy.**
- **The Board will decide how quickly to run down the balance sheet in May, with the central considerations being the "state of the economy" and the inflation and employment outlook.**
- **While there are uncertainties over how economic conditions will play out over the coming year, the case for rates hikes has grown materially. We continue to expect the rate hike cycle will kick off with a 15 basis point move in August although there is a growing risk of an earlier move.**
- **We see the earliest live window as June, when there will have been two more wages prints, since inertia in wages appears to be a primary concern for the RBA. Indeed, interest-rate markets are fully priced for a rate hike in June.**

The RBA dropped its quantitative easing program at its 1 February meeting, as widely expected, and has acknowledged that rate hikes later in 2022 are "plausible".

The minutes from the meeting, released earlier today, reiterated the messaging from the RBA we have heard over recent weeks. And certainly, we have heard plenty from the central bank. There has been a speech from the Governor and fresh forecasts in the quarterly Statement on Monetary Policy. Plus, last week was the RBA's semi-annual parliamentary testimony, where the central bankers are quizzed by politicians on their thinking.

So, taking all this into consideration, we have outlined the key messages.

How is the economy tracking?

The RBA reiterated in the minutes the economy was in good shape in the lead up to the Omicron outbreak, and that the new variant will likely have less of an impact on the economy than earlier waves. The surge in cases will weigh on growth in the March quarter. The adjustment to growth will primarily occur through hours worked, rather than employment. Timely measures of consumption suggest spending has been “relatively resilient”.

The minutes note the labour market has recovered much faster than expected, with unemployment at its lowest level in more than a decade and labour force participation around historic highs. However, while wages have picked up – as measured by the wage price index – they are only around the “subdued” rates from before the pandemic. The central bank has acknowledged, however, that broader measures of employee earning have picked up more significantly. This is consistent with an increase in bonus payments, a pick up in job turnover, and more work at overtime rates.

Meanwhile, there was an upswing in business investment ahead of the Delta outbreak, supported by “tax incentives, strong corporate balance sheets and the broader recovery in demand conditions”. However, it was noted that the RBA’s liaison program suggested supply disruptions, including material and labour shortages, and planning bottlenecks, could slow some projects.

What does the RBA expect looking ahead?

The RBA’s forecasts point to an upbeat view of the outlook. GDP is forecast to grow by 4.25% in 2022 and the unemployment rate is expected to fall below 4.0% later in 2022 – a level not sustained since the 1970s.

But the RBA has continued to emphasise there is a lot of uncertainty over how conditions will evolve, particularly with respect to inflation and wages. And this is why the RBA continues to underscore “patience” while inflation pressures heat up and markets are fully pricing in hikes as soon as June.

The RBA expects near-term price pressures will be boosted by supply-chain disruptions flowing through to the cost of building materials and retail goods. But later in 2022, the RBA projects these pressures will broaden, including via a pickup in labour costs (i.e. wages). However, the central bank has flagged the persistence of price pressures stemming from supply-chain disruptions remains unclear. Plus, there is also uncertainty over how quickly global consumption patterns will normalise, which will eventually take some of the heat out of goods inflation.

The other sticking point is wages. The RBA only expects a gradual pick up in wages but notes there is uncertainty over the behaviour of wages as with the unemployment rate around historical lows and the reopening of international borders.

What will trigger a rate hike?

Economists and markets are pouring over every word that comes out of the RBA to try to determine what exactly will satisfy the RBA Board that inflation is “sustainably” in the target bands and, hence, justify a rate hike. This is also referred to as the RBA’s reaction function.

But the RBA has deliberately been more ambiguous about its reaction function than usual. In fact, on several recent occasions, the Governor has actively avoided providing specific guidance on what will trigger a rate hike.

The RBA’s reluctance is due to heightened uncertainty over how the economy will evolve as they

navigate these unchartered waters. It is perhaps also likely because the RBA does not want to get locked into any particular course of action.

That said, a few important nuggets were dropped at the parliamentary testimony on Friday:

- The Governor said it would be good to see "another couple of CPIs [consumer price indices]" before hiking the cash rate, which is consistent with earlier guidance he has provided. The next readings will be released in April and July. It suggests the earliest window for a rate hike is August. However, this assumes that data will print in the way the RBA expects. In 2021, the RBA underestimated the resilience of the Australian economy; GDP, inflation and wages growth were above the RBA's forecasts and unemployment below.
- Assistant Governor Luci Ellis explained the RBA estimates an unemployment rate around the "high 3s to low 4s" is consistent with full employment. However, she emphasised there is considerable uncertainty around these estimates. The takeaway remains that with the unemployment rate at 4.2%, and heading lower, the labour market is already at, or approaching, full employment.
- Lastly, it was acknowledged that the RBA is monitoring broader measures of wages than the wage price index. These broader measures – which include bonuses and overtime payments – typically respond more quickly to the tightness in the labour market than the wage price index, the typical measure the RBA tracks closely. This suggests the RBA could be satisfied sooner that wages growth has picked up sufficiently.

The recent communications from the RBA have reinforced our expectation that the RBA will kick off the hiking cycle with a 15 basis point move in August, followed by another 25 basis points later in the year. The RBA can comfortably tick-off its goal of full employment, meaning the timing of the first hike will depend on CPI and wages. If inflation and wages evolve in line with the RBA's forecasts, August is the most likely window for the first move.

Another consideration for monetary policy, which has been overshadowed by cash rate speculation, is how quickly the RBA runs down its balance sheet. While the bond purchase program has ceased, the RBA will need to decide how to reinvest maturing bonds. The RBA can let the balance sheet shrink by not reinvesting maturing bonds. This will put upwards pressure on Australian dollar and mortgage rates. The minutes flag the Board will decide on reinvestment in May, with the central considerations being the "state of the economy" and the inflation and employment outlook.

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