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Reserve Bank – Cash Rate Outlook

Deeper Rate Cuts & Other Stimulus Looms Larger

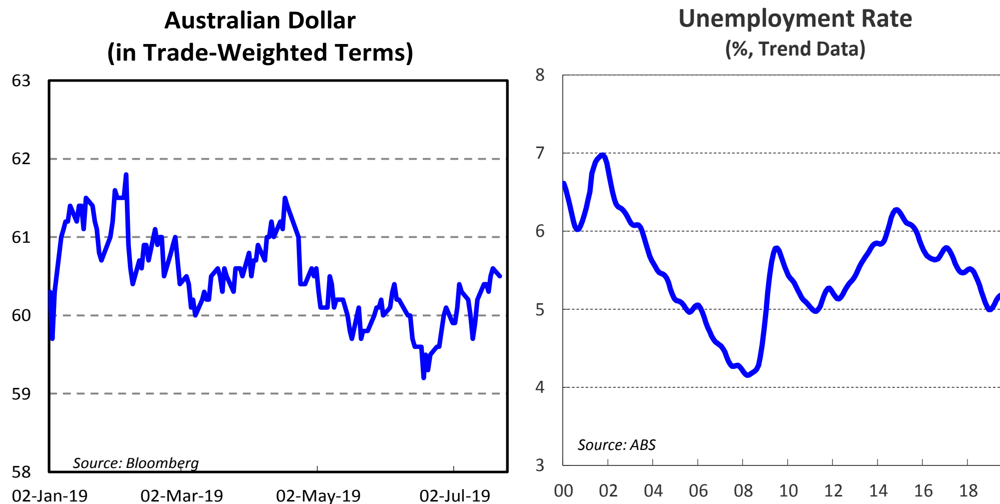
- **Last week, jobs data revealed jobs growth might be finally catching up to the weaker momentum in the domestic economy.**
- **In recent weeks, it has also become clear that looser monetary policy has not had the desired effect on the Australian dollar. One of the factors weighing on the US dollar and propping up the AUD is widely-held expectations the US Federal Reserve is set to embark on its own rate-cutting cycle.**
- **The rate cuts from the Federal Reserve are likely to be in response to a more fragile outlook for US business investment and the world economy. A wave of protectionism still threatens to grip the world further and add further damage to world-growth prospects.**
- **The shape of the domestic labour market and the fragile nature of global trade and the world economy makes us increasingly concerned about the outlook for the Australian economy.**
- **The Reserve Bank's next Statement on Monetary Policy is likely to reveal downgrades to the 2019 growth forecast and to the 2019 and 2020 underlying inflation forecasts.**
- **Our forecast for some time has been to expect three rate cuts from the RBA this year. We have also been flagging the growing risk of a fourth rate cut in this cycle to take the cash rate to 0.50%.**
- **Recent data suggests to us that the risk of the cash rate falling to 0.5% is now sufficiently high for us to shift our RBA rate view to accommodate a fourth rate cut in this cycle.**
- **If the RBA were to take the cash rate to 0.50%, it could be more successful if it were accompanied or followed by a supportive package designed to enhance the effectiveness of rate cuts. Evidence from the experience of other economies, such as the UK, underscores our view.**
- **We now expect the RBA to cut two more times (rather than once more). We see the most likely timing as October (previously November), followed by February next year, but stress that each meeting is live. Indeed, a rate cut as soon as September cannot be ruled out.**
- **We also think there is some prospect the RBA will deliver a package of supportive policies as, or after, the RBA lowers the cash rate from 0.75% to 0.50%.**

The Reserve Bank (RBA) delivered its second rate cut of 25 basis points earlier this month, taking the cash rate to a new record low of 1.00%. These back-to-back rate cuts are the first time we

have seen two rate cuts in succession since May-June of 2012.

A primary objective of these rate cuts were to foster stronger employment growth so as to ensure inflation is more likely to be consistent with the RBA's inflation target over the medium-term. The RBA Governor has previously highlighted that the unemployment should and can be lower and highlighted a desired unemployment rate of 4.5%.

Last week, we received an update on conditions in the jobs market and it was looking less favourable. The unemployment rate stayed sticky at 5.2% in June and jobs growth was weak in the month (+0.5k), suggesting the trend in jobs was possibly finally catching up to the weaker momentum in the economy.



Stronger employment growth is necessary to help bolster wages growth and lift consumer spending. The downturn in dwelling prices is a key factor having a negative wealth effect on consumer spending. House prices rose last month for the first time in nearly two years in Sydney and Melbourne. Auction clearance rates also continue to rise in these cities. However, volumes are low and until the Spring selling season commences, we cannot fully be convinced we are on the cusp of a recovery. At best, dwelling prices in these capital cities are bottoming where they might remain for an extended time.

The stabilisation in dwelling prices in Sydney and Melbourne reflects the fact that rate cuts are having some impact. But while rate cuts might be working, they are not fully effective. Indeed, nowhere is this more evident than with the currency. The Australian dollar is not playing its usual "automatic stabiliser" role in stimulating economic activity in the wake of looser monetary policy. The Australian dollar in trade-weighted terms has appreciated since the first rate cut on June 4 and since the second rate cut on July 2, by around 0.2% and 0.8%, respectively. One of the factors weighing on the US dollar and, therefore, underpinning demand for the AUD is widely-held expectations the US Federal Reserve is set to embark on its own rate-cutting cycle (later this month).

The rate cuts from the Federal Reserve are likely to be in response to a more fragile outlook for US business investment and the world economy. Overnight, the International Monetary Fund (IMF) published its periodic world economic outlook and downgraded its world-growth forecasts for the third time this year.

Trade tensions are fostering uncertainty among businesses and consumers and contributing to a more vulnerable world outlook, despite some recent progress at the G20. A wave of protectionism threatens to grip the world further; the World Trade Organisation (WTO) Appellate body that rules

on trade disputes has seven members. But the US Trump administration has been vetoing the appointment of new members to replace mandatory retirements. Only three members remain – the minimum for hearing an appeal over a trade dispute. The terms of two of those three will expire on December 10 this year, making the Appellate Body inoperable. It will mean then for the first time since WWII the world will not have a rules-based trading system.

The fragile nature of global trade and the world economy together with the weaker jobs outlook makes us increasingly concerned about the outlook for the domestic economy.

The RBA's next Statement on Monetary Policy is released on August 9. We expect their 2019 growth forecast to be downgraded (from 2.75% to 2.50%) and for their underlying inflation (trimmed mean) forecasts to be cut in both 2019 and 2020 (from 1.75% to 1.50% and 2.00% to 1.75%, respectively). If our expectations prove correct, inflation returning to the RBA's 2-3% per annum target band will take longer.

Our forecast for some time has been three rate cuts from the RBA this year and we have been flagging the growing risk of a fourth rate cut in this cycle to take the cash rate to 0.50%. Recent data suggests to us that the risk of the cash rate falling to 0.5% is now sufficiently high for us to shift our RBA rate view to accommodate a fourth rate cut in this cycle.

In terms of timing, we expect the RBA to pause in August and then move in September or October (previously our call was November). Much will depend on how the data evolves if they next cut in September or October. The national accounts data is published on September 4, so the RBA might choose to wait and cut in October in order to assess the growth figures. However, September will be a live date and a very close call.

We then expect the RBA to cut in February next year by another 25 basis points, taking the cash rate to 0.50% in February, which will likely also be the terminal rate.

For the fourth rate cut in this cycle, which would take the cash rate to 0.50%, we believe it could be more successful if the RBA accompanied the rate cut with supportive policies to enhance the effectiveness of rate cuts. These policies (or package) might include a term funding scheme, which was an element of the UK stimulus package in 2016. Term funding is just one option. Other options might be pursued. Evidence from the experience of other economies, suggests at these lower rates of interest rates, monetary policy becomes less effective due to structural impediments facing commercial banks.

Corporate bond and government bond purchases are what formed the quantitative-easing policy in the United States, when the US Federal Reserve responded to weak economic activity caused by the global financial crisis.

At a forum yesterday, RBA Assistant Governor Christopher Kent said that it is "very unlikely" the RBA would adopt a QE-style approach. Therefore, alternative stimulus policies might be more likely, although not in the near term. These alternative policies would need to be chosen so as to best suit the Australian financial system.

In summary, we expect more rate cuts from the RBA; we now expect the RBA to cut two more times (rather than once more). We see the most likely timing as September/October, followed by February next year, but stress that each meeting is a live date. We also think there is some risk the RBA will deliver a package of supportive policies as, or after, the RBA lowers the cash rate from 0.75% to 0.50%.

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