Tuesday, 2 June 2020

Reserve Bank Board Meeting
Downturn May Not Be as Bad as Feared

- **Things are usually not as bad as first feared and it seems that the economy is no exception. The key take out from the Reserve Bank (RBA)'s statement today was that "it is possible that the depth of the downturn will be less than earlier expected".**
- **Indeed, the decline in the rate of infections has been significant and some restrictions have been eased earlier than previously thought likely.**
- **The RBA adds that there are signs that hours worked stabilised in early May and there has been a pick-up in some forms of consumer spending.**
- **But the central bank is quick to underscore that the outlook, including the nature and speed of the expected recovery, "remains highly uncertain and the pandemic is likely to have long-lasting effects on the economy". This is as true as ever, especially given the nature of the shock to the economy.**
- **The RBA did not change any policy settings today, including its forward-guidance messaging. We can continue to expect low rates to be here for a long time. There will be no hike to the cash rate for at least three years, possibly longer.**
- **The RBA's yield target or quantitative easing is also likely to be around for an extended time. The RBA noted that its purchases of bonds have virtually ceased; since the last Board meeting in April, the RBA has purchased government bonds on only one occasion. But Australia's central bank stands ready to increase its purchases of bonds if needed.**
- **Debate around negative interest rate policy (NIRP) has reared its head again in Australia over the past week. The RBA was silent on this policy in today's statement. In the past, RBA rhetoric has strongly pointed to a lack of enthusiasm for adopting NIRP. A NIRP is at the bottom of the RBA's toolkit, but it is still in there, and will be pulled out only if economic conditions warrant its use.**

Things are usually not as bad as first feared and it seems that the economy is no exception. The key take out from the Reserve Bank's statement today was that "it is possible that the depth of the downturn will be less than earlier expected". Indeed, the decline in the rate of infections has been significant and some restrictions have been eased earlier than previously thought likely. The Reserve Bank adds that there are signs that hours worked stabilised in early May and there has been a pick-up in some forms of consumer spending.

Tomorrow, the national accounts data will be published for the March quarter. The gross domestic product (GDP) measures will reveal the pace or lack thereof of economic growth in the March quarter. We are expecting a contraction of 0.4% in the quarter, but there is some small possibility of a positive outcome; such an outcome was not even imaginable let alone a possibility two to three months ago. The deeper economic downturn will be in this current June quarter and that data will not be made available until early September; by this time, the economic recovery is likely to have progressed further.

However, the RBA is quick to underscore that the outlook, including the nature and speed of the expected recovery, "remains highly uncertain and the pandemic is likely to have long-lasting effects on the economy". This is as true as ever. Given the nature of this significant health shock to the economy, forecasts are subject to greater variability than usual. In the period ahead, the RBA rightly points out "that much will depend on the confidence that people and businesses have about the health situation and their own finances". The economy is reopening but it is not necessarily a V-shaped recovery. Without a commercial vaccine and/or anti-virals it is difficult to imagine an outlook that does not involve some social distancing and ongoing changes to business models.

The RBA did not change any policy settings today. The cash rate remains at a record low of 0.25%. The RBA's target for the 3-year government bond yield of around 0.25% remains unchanged. Its term facility is intact for banks to access. Forward guidance is also the same; that is, the RBA does not intend to increase the cash rate until progress is being made towards full employment and it is confident that inflation will be sustainably within its target band of 2-3% per annum.

The rate of unemployment consistent with full employment is around 4.5%. The current rate of unemployment is 6.2% and headed higher. The underlying (trimmed mean) inflation rate is 1.8% and headed lower. Therefore, we can expect the RBA to not move the cash rate up for at least three years, possibly longer (as previously flagged by the Governor). Low rates are here to stay in the economy for a long time.

Quantitative easing is also likely to be around for an extended time. Today the RBA noted that its purchases of bonds have virtually ceased; since the last Board meeting in April, the RBA has purchased government bonds on only one occasion. But Australia's central bank stands ready to increase its purchases of bonds if needed.

Debate around negative interest rate policy (NIRP) has reared its head again in Australia in recent days. The RBA was silent on this policy in today's statement. In the past, RBA rhetoric has strongly suggested a lack of enthusiasm for adopting NIRP. Our opinion on NIRP remains unchanged. NIRP is in the RBA's toolkit. It is at the bottom of the toolkit, but it is still in there, and will be pulled out only if economic conditions warrant its use. We suspect the RBA would enhance its quantitative easing program or extend it before implementing NIRP.

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