Tuesday, 6 July 2021

RBA Board Meeting

Tapering Starts Amid Subtle Shift in Tone

- **The Reserve Bank (RBA) left the cash rate unchanged at 0.10%, as expected.**
- **The RBA also made decisions on two other key policies, which support low borrowing rates in the economy and keep the Australian dollar lower than otherwise would be the case.**
- **The RBA will reduce the rate of bond purchases under its quantitative easing program to $4 billion a week, from $5 billion per week, when the current round of purchases ends in early September.**
- **The strength of the economic recovery is behind the decision to taper the rate of bond purchases. But the program will still be extended beyond the current tranche since inflation remains short of the RBA's target and unemployment is not yet at full employment.**
- **The RBA will review this program again at its November meeting. We expect the RBA to continue its bond-buying program beyond mid November at a reduced rate.**
- **As widely expected, the RBA decided to leave the yield curve target pegged to the April 2024 bond, instead of rolling to the next maturity at November 2024.**
- **The RBA made a subtle tweak to its forward guidance that strengthens the case for a rate hike before 2024. Previously, the RBA said it was "unlikely" conditions for a rate hike would be met before 2024 "at the earliest". Today, it said the "central scenario" is that these conditions won't be met until 2024.**
- **This shift reinforces our expectation that the first cash rate hike will come in 2023.**
- **The communication around housing was mostly unchanged, but the Governor noted specific macroprudential tools which could be utilised. These include lifting interest serviceability buffers and applying portfolio-wide loan-to-value ratio and debt-to-income restrictions.**
- **The RBA was upbeat on the ability of the economy to bounce back quickly from lockdowns.**

Today, the RBA left the cash rate unchanged, left the yield-curve control program unchanged and pegged to the April 2024 bond but announced a slowing in the pace of its bond-buying program from early September. The language of the RBA board statement and the RBA Governor's press conference remained dovish but the tweaks were subtly tilted towards a more hawkish tone. In particular, the RBA watered down its language around not raising the cash rate before 2024.

Quantitative easing

Today's major policy change was the tapering of the RBA's bond-buying program from early September. The program involves the RBA buying government bonds of maturities between 5 and

10 years. It is currently in its second phase, which is due to end in early September, purchasing $5 billion per week over six months, totalling $100 billion. It is one of the unconventional policies used by the RBA to keep lending rates low in the economy. It is also helping to keep the Australian dollar lower than otherwise would be the case.

From early September, it will buy bonds at the rate of $4 billion a week until at least mid November. The tapering is in response to the strong economic recovery and improved outlook.

The tapering is not a withdrawal of support because it is the stock of bonds purchased that matters rather than the flow. By mid November, the RBA's cumulative purchases under the bond purchase program will have risen to $237 billion. The adjustment in the rate of weekly purchases does not change this.

At its November 2 meeting, we expect the RBA to decide to continue its bond-buying program, but at a further reduced rate. We are anticipating the bond-buying program to run until the middle of 2022 because the RBA will still be short of achieving its targets.

Yield curve control

Another other unconventional policy the RBA has implemented is yield-curve control (YCC). YCC involves the RBA buying and selling bonds to keep the 3-year government bond yield at around 0.10%. It is currently tied to the April 2024 bond.

The RBA today announced today it is leaving YCC pegged to this bond maturity. It chose not to extend to the next maturity at November 2024.

This decision matched our expectations, as an extension to November 2024 would suggest that the RBA would not start raising the cash rate until 2025 at the earliest, which is inconsistent with the robust economic conditions in the economy. Retaining April 2024 means that, as time passes, the maturity of the yield target will naturally decline.

In the Q&A the Governor provided clarity on what would happen to YCC if the first cash rate hike is before 2024. He reiterated that YCC is designed to reinforce expectations for the path of cash rate. This implies if the cash rate increases before 2024, the RBA will abandon the yield curve target before its current expiration in April 2024.

Cash rate

The RBA left the cash rate unchanged at 0.10%, as widely anticipated. The RBA made subtle tweaks to its forward guidance that strengthens the case for a rate hike before 2024. The final paragraph of the statement reiterated that the cash rate would not increase until actual inflation is sustainably within the 2-3% target range. But today the RBA also said the "central scenario" is that this condition would not be met before 2024. The June statement said it was "unlikely" until 2024 "at the earliest". By dropping references to "unlikely" and "at the earliest" and tying it to a central scenario, the RBA has weakened its commitment to the 2024 timeframe. The Governor reinforced this underlying message in his press conference by saying "the condition for an increase in the cash rate depends upon the data, not the date".

The change in forward guidance reflects the RBA laying the groundwork for a cash rate hike sooner than 2024. We continue to expect the RBA to start a rate hike cycle in early 2023. However, we cannot entirely rule out the RBA starting in late 2022; much will depend on how economic data evolves, especially labour market data.

A key focus for the RBA remains the labour market. The language around the health of the labour market in today's statement was strengthened. The RBA acknowledged that "more firms are reporting shortages of labour, particularly in areas affected by the closure of Australia's international borders." But the statement also stressed that inflation and wage "outcomes" remain subdued. This is a slight nuance from its June statement where it noted that wage "pressures" were subdued. This shift is likely a nod to the loud reports of labour shortages we are hearing from across the economy, which have, so far, failed to meaningfully materialise in the wages data.

The RBA again emphasised that "while a pick-up in inflation and wages growth is expected, it is likely to be only gradual and modest." Although, perhaps reflecting the stronger-than-expected outcomes over recent months, the Bank lifted its forecast for June quarter headline inflation to 3.5%, up from 3.25% in the May Statement on Monetary Policy. However, the RBA continued to state that the uptick would be transitory, and the forecasts for trimmed mean inflation were left unchanged at 1.5% in 2021 and 2.0% in mid 2023.

Conditions for a cash rate hike

The Governor provided more clarity on the conditions needed to lift the cash rate in the press conference.

Firstly, the Governor noted that to consider inflation "sustainably" in the target band, they would need to see inflation above 2% for a number of quarters. According to our inflation forecasts, this is still consistent with a cash rate hike in early 2023.

Second, the Governor explained the RBA's thinking on wages growth. He emphasised the RBA does not "have a target for wages growth" and the condition for a lift in the cash rate relates to inflation, not wages. However, Lowe still said for inflation to be sustainably in the 2-3% range, it is likely that wages growth will need to exceed 3%.

Third, the Governor said there is uncertainty around the rate of full employment but said unemployment rate would likely need to be "in the low 4s for some time". Previously the RBA had stated it considered full employment to be around the "high 3s to low 4s". This means, we will hit the RBA's definition of full employment slightly sooner than previously anticipated, further reinforcing our view that the first cash rate hike will take place in 2023.

Housing

The communication around housing was mostly unchanged. The RBA reiterated that it will continue to monitor trends in borrowing, particularly lending standards.

In the press conference, the Governor provided further guidance on the conditions that need to exist before intervention in the property market was warranted and the types of macroprudential tools that the Council of Financial Regulators may consider. Lowe noted that the Council will consider lending standards and the sustainability of trends in household credit growth. It would become concerned if housing credit and household debt were to grow at significantly higher rates than household income. Potential macroprudential tools which could be used by regulators include increasing interest serviceability buffers and applying portfolio-wide loan-to-value ratio and debt-to-income restrictions.

Impact of lockdowns

On the current lockdowns across much of the country, the RBA noted that "recent outbreaks of the virus and lockdowns will affect the strength of the recovery in the near term. But Australia's experience has been that once an outbreak is contained and restrictions are eased, the economy bounces back quickly." This is consistent with our view on the NSW lockdown. We expect the lockdown to knock at least 0.2 percentage points off GDP growth in the September quarter, although this figure could be larger if the lockdown is dragged out. The longer the lockdown, the greater the impact on consumer and business confidence, and the economy.

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
(02) 8254 3251

Economist
Matthew Bunny
matthew.bunny@stgeorge.com.au
(02) 8254 0023

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
(02) 8254 3251

Economist
Sonali Patel
sonali.patel@stgeorge.com.au
(02) 8254 0030