Monday, 7 June 2021

A Turning Point in RBA Policy

This week is quieter on the data front after a bumper week which showed the Australian economy continued its remarkable recovery through the March quarter. Economic activity is now back at its pre-pandemic level after a sharp V-shaped recovery.

Last week, the Reserve Bank (RBA) left its policy settings unchanged, as widely expected. We are approaching a crucial juncture for RBA policy. At its July meeting, the central bank will decide whether to extend yield curve control (YCC) and quantitative easing (QE).

Alongside the record low cash rate of 0.10%, these measures have supported the flow of cheap credit to households and businesses and put downward pressure on the Australian dollar, in turn boosting economic activity. These policies have helped keep more people in jobs and more businesses afloat.

We now expect the RBA will not roll the 0.1% target on the 3-year government under YCC to the November 2024 bond. The RBA is currently targeting the April 2024 bond. This follows last week's national accounts data which revealed another stronger-than-expected print for GDP. Indeed, the recovery in Australia's GDP has consistently exceeded the expectations of policymakers and economists.

We also expect QE will be extended in the form of an open-ended $5 billion per week purchase program after the conclusion of the second tranche with $100 billion in bond purchases.

The RBA continues to reiterate that a rate hike before 2024 is unlikely. However, with economic data continuing to print on the high side of expectations we do not rule out a move in 2023. Consumer spending has been robust and has led the recovery. Importantly, the outlook for business investment has also improved significantly.

So, what else is underpinning our thinking on YCC?

Previously, we argued that the RBA would roll its YCC target to the November 2024 bond because its forecasts were not consistent with the conditions necessary to increase the cash rate in the first half of 2024. The RBA has specified it will need to see unemployment rate around the 'high 3s to low 4s', wages growth consistently above 3% and inflation sustainably back in its 2-3% target range to hike the cash rate.

In May, Deputy Governor Guy Debelle stated that three years is a reasonable horizon over which the Board has 'some confidence' about economic forecasts. In other words, we cannot accurately forecast economic activity for 2025. Indeed, a mere 18 months ago, the coronavirus was barely on the international radar.

New information from last week suggests a decision to extend YCC to November 2024 would imply the RBA has a view on the economy in 2025, which as explained, the RBA believes is too far out to accurately forecast. On this basis, the RBA would not make a decision to extend YCC to November 2024 at its July meeting.

The expiry of this program will put upwards pressure on the 3-year bond yield, which has been held down by the RBA's 0.1% target.

And what about QE?

Our previous view was that the RBA would announce another $100 billion round of bond purchases, followed by a fourth and final tranche with $50 billion in bond purchases. However, we had recently flagged that the run of strong economic data, both domestically and offshore, meant that the probability of another $100 billion extension was not as high as it was a few months ago.

We now know that the RBA will hold a press conference after the July meeting. This is unusual for the RBA and an important signal. Historically, the RBA has utilised press conferences to mark a significant change in policy. The RBA last held a press conference in November 2020, when the cash rate was cut to 0.1% and QE was introduced. At the February Board meeting, when the RBA announced it would conduct another (second) tranche of QE, worth $100 billion, there was no press conference.

One option the RBA may choose to adopt and, one we have sympathy for, is to introduce some flexibility to the QE program. This would be similar to the US Federal Reserve Open Market Committee (FOMC) model, under which the central bank purchases US$120 billion in bonds per month.

We now expect the RBA will move to a $5 billion per week program, consistent with the current rate of bond purchases.

Such a model would provide the RBA with flexibility: it could monitor the actions of the FOMC and economic data while avoiding implying a tapering in bond purchases. The RBA has emphasised an important factor in determining the future of the QE program is the actions of other central banks, namely the FOMC. The minutes of the last FOMC meeting noted that some Fed members are open to discussing the scaling back of the Fed's bond purchases "at some point". The FOMC could begin tapering before the middle of next year or even as early as late 2021.

If the RBA were to begin tapering bond purchases before the FOMC, it could put upwards pressure on long-end bond yields, and in turn, on the Australian dollar. The RBA believes QE has held the Australian dollar by up to 5% lower than otherwise and reduced the long-end bond rate by around 30 basis points.

Navigating the exit from QE will be a tricky exercise for the RBA – there are lot of moving parts to consider. It is the first time in history the RBA has had a QE program, so it is swimming in uncharted waters in terms of how and when to roll it back. The RBA would welcome some wiggle room to watch how FOMC policy and the ongoing recovery in the Australian economy play out. A flexible QE program will provide this wiggle room.

Any tapering will likely be gradual and modest and well telegraphed by the RBA. Tapering QE would place upward pressure on bond and swap rates, and subsequently, upward pressure on lending rates.

Now turning to the data coming out this week: we will get a read on consumer sentiment for June and business confidence in May.

In May, consumer sentiment fell to 113.1 from 118.8, although remained very elevated at its second highest level since April 2010. We expect consumer sentiment in June will be dented by the 14-day snap lockdown in Victoria. However, over the longer term, other factors are likely to remain very supportive of consumer confidence: house prices are booming, the share market is at record high and the labour market is continuing to recover.

In April, business conditions and confidence both hit fresh highs, pointing to ongoing jobs growth and a continued recovery in business investment. The May numbers are the first survey after the Federal Budget. While it remains to be seen how long these measures will hold out at record highs, we expect business conditions will continue to be supported by low interest rates and generous government tax incentives. Encouragingly, last week we saw that business investment surged 3.6% in the March quarter, building off a recovery that started in the December quarter of 2020.

We are at an important turning point in the economic recovery where the conversation has shifted to the withdrawal of policy support. While any exit from policy support will be very gradual, the fact that it is already on the table for discussion is a testament to Australia's remarkable recovery to date.

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Forecasts

		2021		2022			
End Period:	**Close (4 June)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.10
90 Day BBSW, %	0.03	0.07	0.09	0.10	0.10	0.10	0.10
3 Year Swap, %	0.36	0.40	0.45	0.60	0.80	0.90	1.00
10 Year Bond, %	1.69	1.95	2.10	2.20	2.30	2.40	2.50
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond, %	1.62	1.85	2.00	2.10	2.20	2.30	2.40
USD Exchange Rates:							
AUD-USD	0.7657	0.80	0.82	0.85	0.85	0.85	0.85
USD-JPY	110.26	109	110	111	111	111	110
EUR-USD	1.2114	1.21	1.23	1.25	1.26	1.27	1.27
GBP-USD	1.4092	1.40	1.41	1.41	1.41	1.42	1.42
NZD-USD	0.7145	0.73	0.74	0.76	0.76	0.76	0.76
AUD Exchange Rates:							
AUD-USD	0.7657	0.80	0.82	0.85	0.85	0.85	0.85
AUD-EUR	0.6365	0.66	0.67	0.68	0.67	0.67	0.67
AUD-JPY	84.8	87.2	90.2	94.4	94.4	94.4	93.5
AUD-GBP	0.5467	0.57	0.58	0.60	0.60	0.60	0.60
AUD-NZD	1.0717	1.10	1.11	1.12	1.12	1.12	1.12

	2019	**2020**	**2021 (f)**	**2022 (f)**
GDP, %	2.1	-1.0	4.8	3.2
CPI (Headline), %	1.8	0.9	2.2	1.8
CPI (Trimmed mean), %	1.5	1.2	1.5	1.6
Unemployment Rate, %	5.2	6.8	5.0	4.7
Wages Growth, %	2.2	1.4	2.2	2.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

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