Interest Rate Outlook

Tuesday, 18 February 2020

RBA Minutes of the February Meeting

Uncertainty Grips the RBA

- **The Reserve Bank (RBA) met on February 4 and kept the cash rate at a record low of 0.75%.**
- **The clear theme in the minutes was the uncertain times facing RBA policymakers. On the global economy, trade tensions could re-escalate and the novel coronavirus had emerged as a new downside risk. On the domestic front, the forecast recovery in consumption was less certain.**
- **Despite these ongoing and fresh uncertainties, the RBA continues to expect economic growth to return to trend this year and grow above trend in 2021.**
- **The RBA acknowledged COVID-19 was still evolving and it was too early to determine the extent to which growth in China would be affected or the nature of international spillovers.**
- **The projected improvement in the GDP profile for the Australian economy over the second half of this year and through 2021 partly rests on household consumption increasing gradually, but it is also the "key uncertainty" for the outlook.**
- **Consumers are grappling with slow growth in incomes and have been directing more income to saving and reducing their debt. A recovery in housing prices should help consumption, but the RBA warns it is too soon to see a response and it is unclear for how long the period of balance sheet adjustment will continue.**
- **In reviewing the cash-rate settings, the minutes again underscored the RBA was "prepared to ease monetary policy further if needed".**
- **However, these minutes suggested the RBA has tempered its bias to ease. In particular, the RBA discussed the case for cutting, which is primarily to speed up the progress towards the Bank's goals and make it more assured in the face of current uncertainties. And it debated the case for not cutting. A further reduction in interest rates could encourage additional borrowing at a time when housing was in a strong upturn.**
- **We still see the risk of more easing later this year from the central bank, but it may now also depend more critically on how deep and long-lasting international developments are.**

The Reserve Bank (RBA) board met on February 4 and left the cash rate unchanged at a record low of 0.75%. The minutes of this meeting were published earlier today.

The clear theme in the minutes was the uncertain times facing RBA policymakers. On the global economy, trade tensions could re-escalate and the novel coronavirus had emerged as a new downside risk. On the domestic front, the forecast recovery in consumption was less certain.

Despite these ongoing and fresh uncertainties, the RBA continues to expect growth to return to trend this year and grow above trend in 2021. The RBA reiterated its growth forecasts, published in the recent Statement on Monetary Policy. Growth for this year and next year is slated for 2.75% and 3.0%, respectively. These forecasts are in our opinion too optimistic and will be a challenge to achieve. In comparison, our own forecasts for growth are 1.9% this year, followed by 2.7% next year.

The RBA conceded economic growth was likely to be weaker in the near term compared with their expectations three months ago, partly due to the impact of the bushfires and the COVID-19 outbreak.

The RBA in its minutes also explored the situation with COVID-19. It noted COVID-19 was still evolving and it was too early to determine the extent to which growth in China would be affected or the nature of international spillovers. The RBA further added that previous outbreaks of new viruses had significant but short-lived negative effects on growth in the economies at the centre of the outbreak, but it was difficult to know how representative these earlier episodes are. The indirect effects on activity from the bushfires and the COVID-19 outbreak were also "difficult to assess".

Compared with SARS in 2003, China now accounts for a much larger share of the global economy and is more closely integrated, including with Australia.

COVID-19 is a downside risk to the global economy. Throughout last year, US-China trade tensions were a key downside risk to the world outlook. The progress in addressing the US-China trade and technology disputes had alleviated an important downside risk to global growth, but the RBA pointed out that the nature of the "phase one" deal and the potential for tensions to re-escalate meant the risk had not been eliminated.

The projected improvement in the GDP profile for the Australian economy over the second half of this year and through 2021 relies on an increase in mining investment and a turnaround in dwelling investment. Growth in household consumption was also expected to increase gradually, but this expectation appears plagued by uncertainty. Indeed, the RBA continued to characterise the forecast recovery in consumption as the "key uncertainty" for the outlook.

Consumers are grappling with slow growth in incomes and recent data has revealed that consumers are directing more income to saving and reducing their debt. The RBA's forecast for a gradual pick up in consumption rests on moderate growth in household disposable income and the recovery in housing prices. But the RBA warned it was too soon to see the response of the rebound in housing prices in household spending. And, moreover, it was unclear for how long the period of balance sheet adjustment would continue.

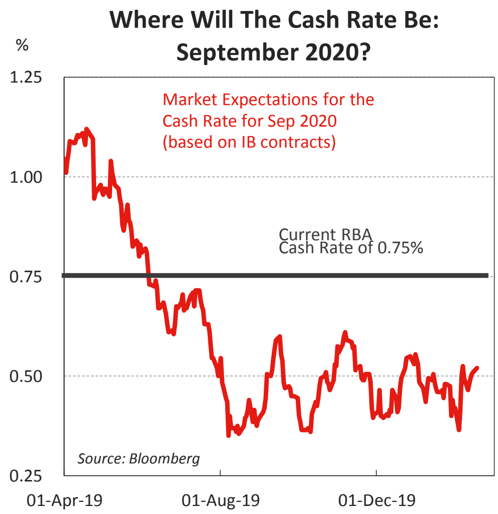
On housing, leading indicators suggested a recovery in dwelling investment is in sight for the end of this year. Contacts in the RBA's business liaison program had reported an increase in sales of new homes and greenfield land in recent months.

The RBA's business liaison program also indicated that mining investment was passing through a trough. Non-mining investment was expected to be subdued in the near term, but then to rise modestly, consistent with the expected pick up in domestic activity.

Whilst the RBA has left its growth forecasts unchanged recently, the same brush was not applied to the labour market. The minutes note the RBA's forecast of employment growth had been revised downwards for the first half of 2020, but the unemployment rate was expected to stay in the 5-5.25% range for some time. A decline to around 4.75% in 2021 was also flagged.

Meanwhile, inflationary pressures remain subdued. The risks around the soggy wage and price inflation forecasts were evenly balanced.

In reviewing the cash-rate settings, the minutes again underscored the RBA was "prepared to ease monetary policy further if needed". However, these minutes suggested the RBA was more torn with keeping a bias to ease. In particular, the RBA discussed the case for cutting, which is primarily to speed up the progress towards the Bank's goals and make it more assured in the face of current uncertainties. And it debated the case for not cutting. A further reduction in interest rates could encourage additional borrowing at a time when housing was in a strong upturn.



We still see the risk of more easing later this year from the central bank, but it may now also depend more critically on how deep and long-lasting international developments are.

Interest-rate markets are currently fully pricing one more rate cut from the RBA this year, of 25 basis points.

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