Interest Rate Outlook

bankSA

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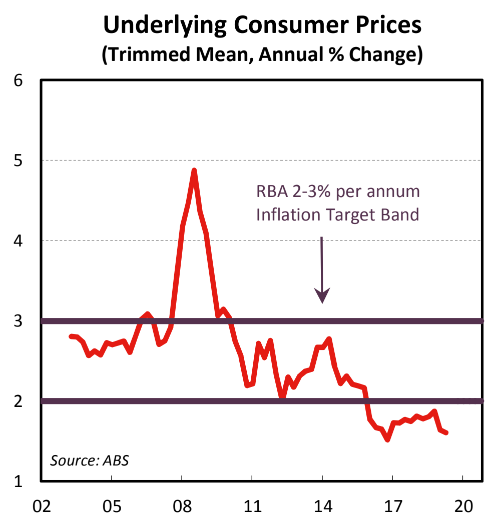
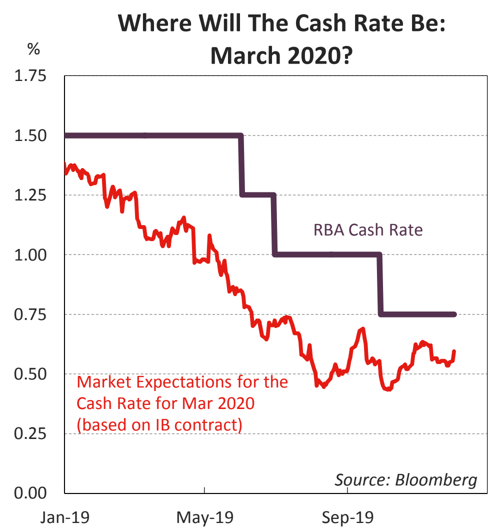
RBA Cash Rate Outlook

Biding Time

- **Financial markets and economists, including ourselves, attached a very low probability of the Reserve Bank (RBA) cutting rates today and we were not wrong. The RBA left the cash rate unchanged at 0.75%, after last cutting the cash rate in October.**
- **The RBA's accompanying statement made it clear the RBA is biding its time due to the "long and variable lags in the transmission of monetary policy".**
- **Our view is that come February next year, another rate cut will be needed, and another one again in June, taking the cash rate to the effective lower bound of 0.25%.**
- **It would be a challenge to achieve the RBA's forecasts for economic growth, underlying inflation, wages growth and unemployment in the timeframe they've provided, setting up the scenario for more rate cuts next year.**
- **The overall tone of today's statement is more positive. The RBA is more optimistic on the global economy, on financial market sentiment and on established housing markets. However, the exception is the tone on the labour market.**
- **The RBA omitted from the previous statement its characterisation that employment has continued to grow strongly, perhaps highlighting that they are less assured about jobs growth continuing.**
- **The RBA Governor gave an insightful keynote speech last week on unconventional policies. We view the messages from that speech and today's RBA statement as supportive of our forecast for more easing next year. The possibility of QE also remains, although the threshold is high and the RBA will be hoping two more rate cuts will be enough.**





Financial markets and economists, including ourselves, attached a very low probability of the Reserve Bank (RBA) cutting rates today and we were not wrong. The RBA left the cash rate unchanged at 0.75%, after last cutting the cash rate in October (and before that in June and July).

The RBA's accompanying statement made it clear the RBA is biding its time due to the "long and variable lags in the transmission of monetary policy". That is, the RBA is allowing time for the three rate cuts this year to work their way fully through the economy before determining if more easing is needed. Our view is that come February next year, another rate cut will be needed, and another one again in June, taking the cash rate to the effective lower bound of 0.25%.

It would be a challenge to achieve the RBA's forecasts for economic growth, underlying inflation, wages growth and unemployment in the timeframe they've provided, setting up the scenario for more rate cuts next year.

Whilst the inflation rate is the RBA's "north star", it is clear that the labour market is the "big dipper". The RBA board in its final sentence of its statement said it will continue to monitor developments, "including in the labour market", and is "prepared to ease monetary policy further if needed".

There were only a few changes to the statement and some of these changes were subtle.

The overall tone of today's statement is more positive. For example, on the global economy, the statement says that risks to the global economy remain tilted to the downside, but "some of these risks have lessened recently". On financial market sentiment, the statement articulates that it has "continued to improve". On further signs of a turnaround in established housing markets, especially in Sydney and Melbourne, the board notes "prices in some other markets have also increased recently".

However, it is on the domestic labour-market front that one can argue the tone has not improved. In its previous board statement published on 5 November, the RBA noted: "Employment has continued to grow strongly and has been matched by strong growth in labour supply, with labour force participation at a record high". However, this month this sentence was omitted and the rest of the paragraph on employment remained mostly unchanged. The latest jobs data revealed a loss of 19,000 jobs in October, which is the first fall since May 2018, and potentially the start of jobs growth catching up to weaker economic activity nationally.

The RBA Governor, Phillip Lowe, gave a keynote speech last week to the Australian Business Economists' Association (ABE) which was centred on unconventional policies. It was a very insightful speech in which Lowe made a number of critical observations.

Firstly, low interest rates are not a temporary phenomenon and are likely to be with us for some time.

Second, the effective lower bound for the cash rate is 0.25%.

Thirdly, quantitative easing becomes an option to be considered "at a cash rate of 0.25% and not before that". Further, the threshold for undertaking QE in Australia has not been reached and is not expected to be reached "in the near future". Lowe also added that it is a bigger step to engage in money-financed asset purchases by the central bank than it is to cut interest rates.

The most likely form quantitative easing would take is the purchase of Commonwealth government bonds and the intention would be to lower the risk-free interest rates along the yield curve, which then helps lower all other interest rates in the economy. The risk-free rate also affects all asset prices.

The Governor did not rule out the inclusion of bonds issued by State governments in a QE program.

Lowe also said negative interest rates are “extraordinarily unlikely” and there is “no appetite” to undertake the outright purchases of private assets as part of QE.

To get to the point of needing QE, the economy would need to be moving “persistently” away from its inflation and full employment targets. That is, an accumulation of evidence that the RBA was unlikely to achieve its objectives would be needed. Lowe hoped that if the Australian economy arrived at the point of needing QE that all arms of policy would be working.

The RBA has for some time considered full employment to be at an unemployment rate of 4.5%, but during the question-and-answer session that followed the speech, Lowe suggested it may need to go lower for longer in order for wage pressures to be generated. Whilst jobs growth has been strong, incomes growth has not been. Further, jobs growth has been firm, but it has been met by strong rises in labour supply (reflected in a rising participation rate) and labour supply is very difficult to forecast.

Lowe stressed that conventional monetary policy is still working in Australia and we see evidence of this in the exchange rate, in asset prices and in the boost to aggregate household disposable income.

RBA Deputy Governor Debelle also recently took to the podium. Debelle said the RBA’s liaison program suggested 80% of all businesses expected “stable” wages growth in the coming year. Moreover, just 10% were tipping stronger growth while the remaining 10% believed it might slow. It was the lowest proportion of firms expecting higher wages in 20 years of survey work by the RBA. Debelle added that “the more wages growth is entrenched in the 2s, the more likely it is that a sustained period of labour market tightness will be necessary to move away from that”.

We view the messages from these speeches and today’s RBA statement as supportive of our forecast for two more rate cuts next year. The possibility of QE also remains, although the threshold is high and the RBA will be hoping two more rate cuts will be enough.

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