Tuesday, 6 October 2020

Reserve Bank Policy Outlook

The RBA Holds Fire for Now

- **The Reserve Bank (RBA) held policy settings steady today ahead of the Federal Budget tonight, as we anticipated. We do not expect the RBA to hold fire for long. A package of stimulus measures is likely to be deployed next month on Melbourne Cup day.**
- **We expect these measures to include cutting the cash rate by 15 basis points to 0.10% and cutting the 3-year bond yield target from 'around' 0.25% to 'around' 0.10%. The RBA's reference to market pricing in today's statement suggests a favouring of this approach.**
- **Stimulus next month is also likely to include cuts to the rate for new borrowings from the RBA's term funding facility by authorised deposit institutions (ADIs) and a reduction on the rate paid on exchange settlement balances held with the RBA.**
- **In addition, we anticipate the RBA will engage in a large-scale asset program (LSAP) of buying government bonds beyond maturities of three years (i.e. four to ten years).**
- **The idea behind these measures is to lower borrowing rates and underpin the supply of credit to households and businesses, thereby bolstering the economic recovery.**
- **The RBA reiterated a recovery is under way in most of Australia and that it will be "bumpy and uneven" and "some time before the level of output returns to its end 2019 level".**
- **A stronger recovery would help in bringing the unemployment rate down. The jobs market was a key theme in today's statement and is expected to be a focus in tonight's Federal Budget. The RBA "views addressing the high rate of unemployment as an important national priority".**
- **It now expects the unemployment rate to "peak at a lower rate than earlier expected", which was 10% by the end of this year. But the RBA anticipates unemployment and underemployment to remain "high" for an "extended period".**
- **This national priority of bringing the unemployment rate down assures us of further stimulus from the RBA before too long, especially as the RBA board "continues to consider how additional monetary easing could support jobs as the economy opens up further".**

The Reserve Bank (RBA) board met today and left policy settings unchanged. But the RBA will not hold fire for long.

On 23 September, we flagged the strong likelihood of the RBA deploying more stimulus in coming months, following a key speech by the RBA Deputy Governor. On 26 September we indicated the RBA would wait until its November board meeting to fire off more stimulus and not divert attention from the Federal Budget.

Today's accompanying statement leaves us comfortable with this view. We anticipate the RBA will deploy more easing on November 3, also Melbourne Cup day. This should include a 15 basis point cut to the cash rate to 0.10%, as well as a 15 basis point cut to the 3-year government bond yield target to 0.10%.

The RBA notes that over the last few weeks, 3-year bond yields have fallen to around 18 basis points, as markets price in some probability of further monetary policy easing. This sentence suggests the RBA is implicitly endorsing market pricing around the outlook for the cash rate and 3-year bond yield.

The package of RBA stimulus next month is also likely to include a cut to the rate for new borrowings from the RBA's term funding facility rate accessed by authorised deposit institutions (ADIs) and a reduction on the rate paid on exchange settlement balances held with the RBA. In addition, we anticipate the RBA will engage in a large-scale asset program (LSAP) of buying government bonds beyond maturities of three years (i.e. four to ten years)

The idea behind these measures is to lower borrowing rates in the economy and underpin the supply of credit to households and businesses, thereby bolstering the economic recovery.

The RBA board reiterated that a recovery is under way in most of Australia. It follows a smaller-than-expected decline of 7% in GDP in the June quarter. It also continues to anticipate the economic recovery to be "bumpy and uneven" and "some time before the level of output returns to its end 2019 level".

A stronger recovery would help bring the unemployment rate down. The jobs market was a key theme in today's statement and will be a focus in tonight's Federal Budget. Indeed, the RBA board "views addressing the high rate of unemployment as an important national priority".

The RBA now expects the unemployment rate to "peak at a lower rate than earlier expected". This remark suggests the RBA no longer expects the unemployment rate to peak at 10% by the end of this year. The new forecast peak will be revealed by the RBA next month. We expect there will also be revisions to the RBA's growth forecasts due to the change in the unemployment forecasts.

Our own forecast is for the unemployment rate to peak at 8% early next year. We also expect the unemployment rate will only gradually come back down towards 5%. The RBA board see unemployment and underemployment as remaining "high" for an "extended period", despite the downward revision in the peak unemployment rate.

This national priority of bringing the unemployment rate down assures us of further stimulus from the RBA before too long. These expectations are cemented in the final sentence of the statement where the Board notes it "continues to consider how additional monetary easing could support jobs as the economy opens up further".

With the twin goals of bring down the unemployment rate towards full employment and pushing inflation up sustainably within 2-3 per cent target band, the RBA needs to deliver more stimulus and this stimulus will likely come as soon as next month.

Finally, the RBA could be eyeing the Australian dollar (AUD) closely because it noted it "remains just a little below its peak of the past couple of years". Given the pace of economic activity has dropped down a few gears compared with the pace over the past couple of years, the level of the AUD must be causing some beads of sweat to break out on the foreheads of RBA policymakers. A LSAP together with these other stimulus measures next month could help limit the rise in the AUD.

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