Tuesday, 19 May 2020

Reserve Bank Board Minutes

Low Rates Here to Stay

- **The Reserve Bank (RBA) left policy settings unchanged at its meeting earlier this month, including the cash rate of 0.25% and its target for the 3-year government bond yield at around 0.25%.**
- **The RBA board considers the package of monetary policy measures implemented in mid March to be "working broadly as expected".**
- **The minutes also confirmed the target of around 0.25% for the three-year government yield would be maintained until progress was made towards the Bank's goals of full employment and the inflation target. Further, it would also be appropriate to remove the yield target before the cash rate itself was raised.**
- **Low rates are here to stay for an extended time. We expect the 3-year government bond yield target to remain intact until 2022 and we do not expect the RBA to lift the cash rate before 2024.**
- **The minutes confirmed the RBA's forecasts for the economy, which were as previously outlined by the Governor a few weeks ago. The RBA continues to expect Australian GDP to contract by around 10% over the first half of 2020 with most of the contraction expected to occur in the June quarter.**

The Reserve Bank on March 19 deployed a wave of stimulus measures. Earlier this month, on May 5, the RBA had its second monthly board meeting since this stimulus was deployed. The minutes showed the board reaffirmed the elements of the policy package announced on March 19 and considered this policy package to be "working broadly as expected".

The minutes also confirmed the target of around 0.25% for the three-year government bond yield would be maintained until there was progress towards the RBA's goals of full employment and the inflation target, and that it would be appropriate to remove the yield target before the cash rate itself was raised.

The RBA repeated that it would also not increase the cash rate target until progress is made towards full employment and it is confident that inflation will be sustainably within the 2–3% target band.

Low rates are here to stay for an extended time. We expect the 3-year government bond yield target to remain intact until 2022 and we do not expect the RBA to lift the cash rate before 2024.

To assist with the smooth functioning of Australia's capital markets, the RBA broadened the collateral eligible for the Bank's domestic market operations to include debt issued by non-bank corporations with an investment grade credit rating. This was the one enhancement to the RBA's policy measures..

These minutes provide a more detailed discussion of the meeting but also follow the very detailed and comprehensive quarterly Statement on Monetary Policy. Therefore, the importance of these minutes to financial markets is diminished today.

Global Economy

Beginning with the global economy, the RBA board expects economies to begin to recover in the second half of this year, but they noted that "lingering concerns about the virus, including over possible renewed outbreaks" could continue to weigh on spending decisions.

In the major advanced economies, GDP was expected to contract from peak to trough by between 10-15% because of lockdowns and other restrictions on activity with much of the contraction likely in the June quarter.

The Chinese economy had contracted by almost 10% in the March quarter. While some parts of the economy had already begun to recover in the month of March as restrictions were eased, RBA board members noted that the improvement had been uneven.

Australian Economic Growth

The RBA board highlighted that the Australian economy had been severely affected by the imposition of measures to contain the outbreak of COVID-19. The RBA continues to expect Australian GDP to contract by around 10% over the first half of 2020 with most of the contraction to occur in the June quarter.

RBA board members noted that the nature of the contraction and the expected recovery was unprecedented because they were driven by public health measures, rather than induced by economic or financial factors.

Consumer Spending

The minutes referred to the strong, record gain in retail spending values in March, driven by households preparing for social distancing and potential supply-chain disruptions by stocking up on essential items, as well as goods related to exercise and working from home. However, it was flagged that estimates from retailers in the RBA's business liaison program point to a decline in retailing in April.

The RBA reiterated that it expects household consumption to fall by around 15% over the first half of this year. As restrictions are lifted, the effects of lower employment, incomes and wealth would become relatively more important for the consumption outlook.

Housing

On the housing outlook, turnover had been significantly reduced in the established housing market. Members noted that concerns that construction activity could be severely affected in the near term by supply-chain disruptions and health-related site closures had not been realised. However, contacts in the RBA liaison program had reported that demand for both new and established housing had fallen.

Lower incomes and confidence, as well as lower expected population growth, were expected to affect demand for new housing for an extended period.

Business Spending

The minutes also discussed how businesses were grappling with deteriorating economic conditions and low confidence about future demand. Indeed, many liaison contacts of the RBA had reported that they were taking steps to preserve cash flow, including deferring non-essential investment. Non-mining business investment was therefore expected to decline significantly.

The board also discussed possible changes in the pattern of activity after the recovery and how it would impact investment. Examples included the potential for significant changes in demand for office space if more people worked from home on a regular basis, and a continuing shift of retail activity away from bricks-and-mortar stores if retailers expand their online operations.

Jobs

This meeting preceded the official labour force survey data for April published last week. The RBA's preferred gauge of the health of the labour market in this crisis is the total hours worked measure. The RBA notes that some of the labour market adjustment had occurred through lower average hours worked by those remaining in employment rather than through job losses. Information from the business liaison program suggested that many firms had asked staff to take paid leave or work shorter hours. These weak labour market conditions were in turn expected to result in slower wages growth; wage freezes were likely to become more common, and there had already been isolated reports in liaison of wage cuts.

The RBA still anticipates the peak-to-trough decline in total hours worked to be around 20%, which is expected to be larger than the decline in output, partly because many of the most-affected activities were highly labour-intensive. The RBA forecasts the unemployment rate to peak at around 10% in this June quarter.

Inflation

On inflation, COVID-19 is expected to have a very large effect on prices in the June quarter. Headline CPI was expected to fall by around 2¼% in the June quarter, driven by the decline in petrol prices and the removal of childcare fees.

Recovery Scenarios

The RBA board noted that beyond the first half of 2020, the outlook for the domestic economy would depend on how long restrictions on economic activity were in place and how long uncertainty and diminished confidence weighed on the spending, hiring and investment plans of households and businesses. Given these uncertainties, members considered three plausible scenarios for the outlook.

The baseline scenario assumed that the process of relaxing social-distancing measures would continue over coming months, but that restrictions on large gatherings and national border controls would remain in place until towards the end of the year. Under the baseline scenario, the economy was expected to begin recovering gradually over the second half of 2020. However, the level of output was expected to remain lower – and the unemployment rate higher – at the end of the forecast period than had been projected in February.

More optimistic and pessimistic scenarios were also considered but the RBA appears to remain comfortable with its baseline scenario.

In the various scenarios for the Australian economy considered, the labour market was expected to have ongoing spare capacity and inflation to be below 2% over the following few years.

Financial Markets

The functioning of financial markets had improved over the prior month, although conditions had not completely normalised. Credit markets had progressively opened to more firms and long-term bond yields remained at historically low levels.

RBA members noted that, in response to the large amount of liquidity in the banking system, Exchange Settlement balances held by banks were high, reducing banks' need to borrow from each other in the overnight market. Consequently, the cash rate had drifted a little lower to be around 14 basis points (or 0.14%), where market participants expected it to remain for some time.

The package of monetary policy measures had also contributed to a further decline in bank funding costs.

Financial Stability

The board considered the resilience of Australian households in the current downturn. They noted around one-third of households with mortgages had prepayment buffers of three years or more. But a smaller share had no mortgage prepayment buffer and these households were more susceptible to financial stress. Housing loan arrears were likely to increase, but the extent would depend on the severity of the economic contraction and the associated increase in unemployment. Loan payment deferrals would reduce the increase in arrears rates for at least the following six months.

Members discussed vulnerabilities associated with commercial property, particularly for office and retail property. A large amount of new office space was expected to be completed in Sydney and Melbourne in 2020. Members noted that demand was not expected to keep pace with stronger supply in the near term and therefore it was likely that vacancy rates would rise and office rents would fall. Rising vacancies and reduced rent would be likely to lead to lower valuations, which would pose challenges for leveraged property investors and developers. Retail property was already experiencing rising vacancies and falling capital values prior to the current downturn. The effect of the social distancing measures on retail businesses was likely to exacerbate these problems.

Besa Deda, Chief Economist
Ph: 02-8254-3251

Contact Listing

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

Senior Economist
Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898

Economist
Nelson Aston
nelson.aston@bankofmelbourne.com.au
(02) 8254 1316