Tuesday, 20 July 2021

RBA Board Meeting Minutes

RBA Likely to Hit Pause on QE Taper

- **At its July meeting the Reserve Bank (RBA) announced it will begin tapering bond purchases under its quantitative easing (QE) program from September. It also revealed it will keep yield curve control (YCC) pegged to the April 2024 bond. The cash rate was left unchanged.**
- **However, the minutes released earlier today need to be interpreted against a near-term deterioration in the economic outlook since the meeting. At that time, the NSW lockdown was expected to last only two weeks. We now expect the economy will contract 0.7% in the September quarter, cutting annual growth from nearly 5% towards the low 4s in 2021.**
- **Given these developments it seems increasingly likely that the RBA will opt to hold off tapering QE in September.**
- **The RBA announced it would reduce the rate of bond purchases from $5 billion to $4 billion per week because "economic outcomes had been materially better than earlier expected and the outlook had improved". This no longer holds true.**
- **Given the severity of the economic hit, another possibility is that the RBA actually lifts the rate of bond purchases to more than $5 billion per week in September.**
- **There was no fresh news on the path of the cash rate in the minutes with identical language to the statement following the meeting, noting the RBA's "central scenario" is that conditions for a cash rate hike won't be met until 2024.**
- **We still expect that the first cash rate hike will come in 2023, although acknowledge there is some risk this time frame could be pushed out if the lockdowns are dragged out. This is consistent with our expectation that activity will rebound rapidly once restrictions lift, and that the economy was in good shape heading into this period.**
- **However, the renewed outbreaks are a moving beast. We don't know how long the lockdowns will last or how harsh the measures will be, and as a result there is still substantial uncertainty over the extent of the economic hit. The response of the RBA will ultimately hinge upon how the lockdowns impacts jobs and inflation.**

The RBA Board had a big meeting on July 6. The main event was that the central bank announced it will begin tapering bond purchases under its QE program from September. It also revealed it will keep YCC pegged to the April 2024 bond rather than rolling to the next maturity of November 2024. The cash rate was left unchanged as expected.

Minutes from the meeting released earlier today provide more colour on the thinking underpinning these decisions. However, the minutes need to be interpreted keeping in mind that the near-term economic outlook has significantly deteriorated since the meeting.

Notably, at the time of the meeting, the New South Wales lockdown was expected to last only two weeks. Since then, restrictions in NSW have been extended and tightened, notably construction and non-essential retail have been shut down, and Victoria is also in lockdown. We now expect the economy will contract 0.7% in the September quarter, cutting annual growth from nearly 5% towards the low 4s in 2021.

Quantitative easing

Members agreed to reduce the rate of bond purchases from $5 billion to $4 billion per week because “economic outcomes had been materially better than earlier expected and the outlook had improved”. However, they also acknowledge an argument could be made to keep the purchases at $5 billion per week “given that economic outcomes were still well short of the Bank's goals for inflation and employment”.

As we expected, the RBA also moved to a flexible, open-ended QE model, rather than a fixed rate of purchases. This allows the RBA to increase or decrease the rate of bond purchases in the future, in line with the state of the economy at the time. It was noted, this was appropriate “given the high degree of uncertainty about the economic outlook”.

It seems increasingly likely that the RBA will invoke the flexibility clause of its new quantitative easing model and opt to hold off tapering purchases in September. It is likely this would be announced at the next meeting on 3 August. A decision on tapering would likely be deferred until the policy is reviewed in November.

Given the severity of the economic hit, another possibility is that the RBA actually lifts the rate of bond purchases to more than $5 billion per week following the conclusion of the current round of purchases in September. This would signal the Board is prepared to respond to changing economic conditions.

Yield curve control

The decision not to extend YCC was widely expected. YCC is designed to work alongside the cash rate by keeping shorter-term interest rates low. The RBA has stated YCC needs to expire before the cash rate will lift.

The minutes note the decision to not extend was underpinned by the “the faster-than-expected recovery in economic conditions over the course of 2021” because this had “widened the range of plausible scenarios” for the cash rate. To extend YCC to the November bond 2024 would imply the RBA did not intend to lift the cash rate until 2025 at the earliest, which is too far off given the strength of the recovery to date.

Cash rate

There was no fresh news on the path of the cash rate in the minutes. As we outlined following the Board meeting, the RBA has softened its commitment to the 2024 time frame. The minutes used identical language to the statement following the meeting, noting the RBA’s “central scenario” is that conditions for a cash rate hike won’t be met until 2024. Previously, the RBA said it was “unlikely” conditions for a rate hike would be met before 2024 “at the earliest”.

The growing economic hit from the lockdowns will weigh on employment and inflation, and in turn, could delay when the RBA lifts the cash rate. And we still don’t know how long the lockdowns will last and as such, how big the economic hit will be. However, at this stage, we still expect that the first cash rate hike will come in 2023, although acknowledge there is some risk this time frame could be pushed out if the lockdowns are dragged out.

Impact of lockdowns

The minutes flag that recent outbreaks and associated restrictions were likely to “weigh on consumption through the middle of the year”. However, the RBA remains upbeat about the outlook beyond the current disruption, consistent with our view.

Consumer spending is expected to rebound when lockdowns ease, supported by “highly accommodative policy settings, the strengthened balance sheets of many households and firms, and an increase in the pace of vaccinations”. The reference to balance sheets in a nod to the large saving buffers accumulated by households and businesses last year, which will provide support through this difficult period.

Our expectation for a rapid rebound in activity, which will partly offset some of the losses from lockdowns, is a key reason why we still expect the cash rate will be lifted in 2023.

It is also worth remembering that the economy was in good shape heading into this period. Last week, June data showed that the unemployment rate fell to 4.9%. This is the lowest level in 10 years. And economic activity was back at its pre-pandemic level in the March quarter.

The renew outbreaks and related restrictions are a moving beast. We still don’t know how long the lockdowns will last, or how harsh the measures will be, and as a result there is still substantial uncertainty over the extent of the economic hit. Encouragingly, the seven-day moving average of new locally acquired cases in NSW has edged lower over the past couple of days, which could be an early sign that daily case numbers have peaked. The response of the RBA will ultimately hinge upon how the lockdowns impact jobs and inflation.

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