Bank of Melbourne

Tuesday, 2 July 2019

Reserve Bank Board Decision

Back-to-Back Rate Cuts & More Easing to Come

- **The Reserve Bank (RBA) delivered its second rate cut of 25 basis points this year today, taking the cash rate to a new record low of 1.00%.**
- **We expect at least one more rate cut from the RBA in coming months and there is a growing risk that a fourth rate cut will be needed if the unemployment rate does not improve sufficiently.**
- **Our central forecast remains for the RBA to pause for breath in August. We are still comfortable with this forecast, especially as the RBA inserted the words "if needed" when referring to adjusting future policy. These words hint at a possible pause by the central bank next month.**
- **Thereafter, every month is a live date for the RBA. Our favoured timing for the next move is November, but September becomes more likely if unemployment outcomes disappoint. The odds of a fourth rate cut to 0.50% this year would also shorten.**
- **Despite a backdrop of strong employment growth, the RBA stressed there has "been little inroad into the spare capacity in the labour market recently". More rate cuts are likely needed to achieve the required tightening in the labour market.**
- **The RBA has now also shone a brighter light on underemployment. as well as unemployment. Underemployment tends to be harder to bring down because it is stickier.**

The Reserve Bank (RBA) delivered its second rate cut of 25 basis points this year today, taking the cash rate to a new record low of 1.00%.The RBA cut rates just last month for the first time in nearly three years. The back-to-back rate cuts are the first time we have seen two rate cuts in succession since May-June of 2012.

A primary objective of this latest rate cut was to foster stronger employment growth so as to ensure inflation is more likely to be consistent with the inflation target over the medium-term.

More easing from the RBA is likely. We expect at least one more rate cut from the RBA in coming months and there is a risk that a fourth rate cut will be needed if the unemployment rate does not improve sufficiently.

Our central forecast is that they will pause for breath in August, as in the final sentence the RBA inserted the new words "if needed" after stating they would monitor developments in the labour market closely and adjust monetary. The insertion of these words suggests a possible pause for

August. Thereafter, every month is a live date.

Our favoured timing for the next rate cut is November, but the next cut could come as early as September if labour market outcomes disappoint and a fourth rate cut in this cycle would also become more likely.

On the outlook for the global economy, the RBA statement notes that the risks are “tilted to the downside” and that a slowdown in global trade has contributed to “slower growth” in Asia. The RBA displays more pessimism on the world outlook by describing the uncertainty from trade disputes as affecting investment rather than just investment intentions (as per its previous statement).

On the domestic economy, increased investment in infrastructure and a pick up in resources activity (due to higher commodity prices) is expected to prop up growth. However, the outlook for consumption continued to feature as a main source of domestic uncertainty for the RBA.

Employment remained firmly on the RBA’s radar in setting the cash rate. On employment, the RBA described growth as “strong”. Despite the firm employment outcomes, the RBA highlights there has “been little inroad into the spare capacity in the labour market recently”. The unemployment rate of 5.2% in May was up from the recent cyclical low of 4.9% in February.

Recent strong employment outcomes have contributed to a pick-up in wages growth in the private sector. However, the rate of wages growth remains very soft. The private sector measure of the wage price index has lifted from 1.8% annual growth in the December quarter of 2017 to 2.4% in the March quarter.

The RBA pointed out the Australian economy “can sustain lower rates of unemployment and underemployment”. In a speech last month the RBA Governor said full employment was closer to 4.5%. More rate cuts are likely needed to achieve the required tightening in the labour market.

The RBA in this statement suggested they are also now focussing on bringing down “underemployment” as well as unemployment. Reducing underemployment is harder, as it tends to be stickier.

Bringing down unemployment and underemployment is central to a lift in wages growth, and therefore, inflationary pressures. The inflation target band of 2-3% per annum remains the RBA’s north star. Inflationary pressures in today’s statement are described as “subdued” across much of the economy. Nevertheless, the RBA expects inflation to pick up and for underlying inflation to be around 2% in 2020 and a little higher after that. Our forecasts have inflation falling short of these RBA forecasts.

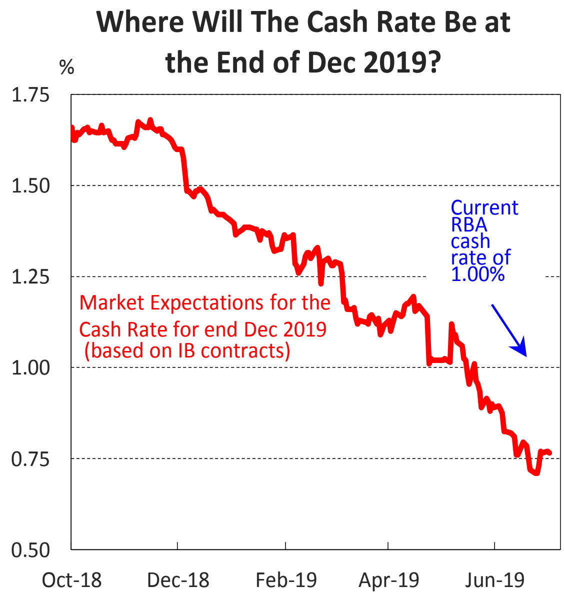
On the housing market, the central bank characterised conditions in most housing markets as “soft”, although conceded there are “some tentative signs that prices are stabilising in Sydney and Melbourne”. The recent improvement in auction clearance rates and dwelling prices in Sydney and Melbourne are encouraging, but the softening in dwelling prices elsewhere has broadened and deepened. Moreover, dwelling prices in Sydney and Melbourne are likely to hug around the bottom for some time.

The RBA notes that credit conditions “remain tight”, especially for small and medium-sized businesses. These tight credit conditions could constrain a lift in business spending, which would cap a recovery in economic activity.

The final sentence of the statement leaves open the possibility for more easing from the RBA. The last sentence says the Board will continue to monitor developments in the labour market closely and adjust monetary policy if needed. The RBA Governor takes to the podium tonight and more colour around future policy decisions could well be provided then.

The market reaction has been limited so far. The AUD/USD exchange rate dropped from 0.6978 to 0.6958 before recovering quickly to near 0.6985. Australian 3-year swap yields dropped 1 basis point, but also rose back up to be unchanged.

Interest-rate markets still view the terminal cash rate as 0.75% by the middle of next year. For August, interest-rate markets are attaching a probability of 24% to a rate cut whilst for September it is 39% and by November it is fully priced in.



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