Bank of Melbourne

Tuesday, 3 August 2021

RBA Board Meeting
Sticking to the Game Plan

- **The Reserve Bank (RBA) stuck to its game plan. It will commence tapering of its bond-buying program in September, as announced last month.**
- **This surprised the market, including us. The RBA was widely expected to defer tapering given a contraction in economic activity is likely for the current September quarter.**
- **The RBA highlights that this program is "flexible", leaving the door open for a change of mind. With the number of daily infections yet to peak in New South Wales, leaving the door open is sensible.**
- **The RBA predicated this decision on the assumption the economy will bounce back quickly. But the near-term outlook is marred by uncertainty and depends critically on the evolution of the health situation and vaccine rollout.**
- **The RBA is also sticking to its game plan of not expecting to lift the cash rate before 2024. We are not convinced and still anticipate the first rate hike to arrive in the first half of 2023.**
- **Ahead of this Friday's quarterly Statement on Monetary Policy, the RBA has also revised its key forecasts. Growth has been revised up a smidgen next year to above 4 per cent - a solid pace. The unemployment rate has been revised down to 4¼ per cent by end next year.**
- **Forecasts have been extended to 2023. Growth in 2023 is expected to be slightly below trend and the unemployment rate forecast to breach what the RBA Governor has previously outlined as full employment.**
- **A notable change to this month's statement is the RBA expects the pick up in wages growth and underlying inflation to be "only gradual", no longer "gradual and modest". Perhaps this is a subtle concession to the possibility of stronger inflationary pressures and a slight hint that a rate hike before 2024 is not inconceivable for the RBA.**
- **What is clear is that the RBA views the disruption from the current outbreak as temporary and a resumption in robust growth is anticipated.**
- **Whether the RBA is able to keep to its plan depends critically on the containment the virus, a high share of the population being vaccinated by the end of the year and international borders gradually reopening from the middle of 2022.**

The Reserve Bank (RBA) is sticking to its game plan. It was widely anticipated that the RBA would delay the tapering of its bond-buying program – which is slated to start in September. The virus outbreak in Sydney and the disruption to economic expansion caused by the lockdown in New South Wales was expected to push out the tapering.

As announced last month, tapering will start in September when the RBA will reduce the rate of bond purchases from $5 billion per week to $4 billion per week. The RBA sticking to these plans suggests the central bank is looking through the disruption from the virus and perhaps hinting it is not expecting the disruption to last much beyond the September quarter.

The tapering of the bond-buying program are the first baby steps towards an eventual tightening of traditional monetary policy i.e. raising the cash rate.

In sticking to this game plan, the RBA has stressed their already highly accommodative policies in place. Moreover, the economic recovery has been much stronger than expected to date, and there was considerable momentum in the economy prior to the latest outbreak.

The RBA's bond-buying program is "flexible". This flexibility means the door is open to a delay in tapering if economic conditions warrant a delay. But right now, the RBA does not believe this is the case.

The RBA also stuck to its mantra that it does not expect actual inflation to be sustainably within the 2 to 3 per cent target range before 2024, suggesting the first rate hike will not happen before this time. We are still expecting the first rate hike in the first half of 2023. The RBA's revisions to its forecasts, especially for the jobs market, add to the case for a rate hike to occur before 2024.

The RBA concedes GDP is likely to decline in this September quarter, which also matches our own expectations. However, the RBA notes that once outbreaks are contained, the experience to date is that the "economy bounces back quickly".

The RBA previewed some of its updated forecasts ahead of this Friday's quarterly Statement on Monetary Policy (SoMP). The RBA's central scenario is for the economy to grow by a little over 4 per cent over 2022 and by around 2½ per cent over 2023.

The contraction forecast for the September quarter suggests a downgrade to growth in 2021 and the forecast of "a little over" 4 per cent for 2022 suggests a modest upgrade for next year. However, unusually the RBA has not provided a 2021 forecast in today's statement.

In Friday's SoMP, the forecast horizon will also now extend to the end of 2023. A GDP growth rate of 2½ per cent over 2023 suggests the RBA is expecting momentum to slow to a bit below trend the year after next.

The RBA's forecasts critically depend on a significant share of the population being vaccinated by the end of this year and a gradual opening up of the international border from the middle of 2022.

The RBA also provided an update on inflation and unemployment forecasts.

For underlying inflation, 1¾ per cent in 2022 is outlined, followed by 2¼ per cent for 2023.

The forecast for unemployment for 2022 has shifted down, from 4½ per cent to 4¼ per cent. For 2023, unemployment is expected to end the year at 4 per cent, from 4¼ per cent at the end of 2022. The RBA Governor has recently said the unemployment rate consistent with full employment is the low 4s. This implies the RBA expects we will hit full employment at the end of next year.

The RBA explains that some increase in the unemployment rate is expected in the near term due to the current lockdowns, but most of the adjustment in the labour market is likely to take place through a reduction in hours worked and in participation.

The RBA highlights that one source of uncertainty is the behaviour of wages and prices at the low levels of forecast unemployment, including because it is some decades since Australia has sustained an unemployment rate around 4 per cent.

Emphasising the uncertainty around this relationship gives the RBA some wiggle room to revise its forecasts in line with the faster-than-expected recovery while maintaining its position that it doesn't expect to hike the cash rate before 2024.

When we hit full employment will be critical for when wage pressures, and hence inflation pressures, start to build more materially. Currently the bank's forecasts suggest we will hit full employment in late 2022, which arguably suggests a 2024 hike will be too late.

What has stood out is that the RBA no longer expects the pickup in wages growth and underlying inflation to be "gradual and modest". The description of "modest" contained in last month's statement has been dropped, which is perhaps some acknowledgement that the uplift in wage and price inflation might be quicker than what the RBA previously expected. Perhaps it is also a subtle concession to the possibility of stronger inflationary pressures and a slight hint that a rate hike before 2024 is not inconceivable.

What is clear is that the RBA views the disruption from the current outbreak as temporary and a resumption in robust growth is anticipated. Uncertainty abounds – from the health situation and vaccination rollout – but assuming all progresses well on this front, the RBA could be looking to continue to unwind its non-traditional forms of policy before the start of a rate-hike cycle in 2023.

Whether the RBA is able to keep to its plan depends critically on the containment of the virus, a high share of the population being vaccinated by the end of the year and international borders gradually reopening from the middle of 2022.

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