Bank of Melbourne

Tuesday, 4 May 2021

Reserve Bank Board Meeting

Inflation Set to Touch 2% Sooner

- **The Reserve Bank delivered no surprises today, leaving policy settings unchanged. It reiterated it does not anticipate lifting the cash rate before 2024 because it does not expect actual inflation to be sustainably within its 2–3 per cent target band before then.**
- **However, the RBA made a tweak to its language to acknowledge the slight possibility of a rate hike before 2024. In earlier statements, the RBA said "it did not expect" conditions to be met to hike the cash rate before 2024. In today's statement, the RBA said it was "unlikely" this would be until 2024.**
- **The RBA also now expects underlying inflation to hit 2 per cent in mid-2023, sooner than previously anticipated.**
- **The stronger inflationary pressures tie in with the stronger growth trajectory the RBA has outlined. GDP growth is now forecast to be 4¾ per cent over 2021, well above trend and up from 3½ per cent expected previously. Growth for 2022 is unchanged at 3½ per cent.**
- **The faster pace of growth is set to help hasten the jobs recovery. The RBA has revised down its unemployment forecasts. It now expects an unemployment rate of 5 per cent by the end of this year and 4½ per cent at the end for 2022.**
- **This has not changed our view that the cash rate will not be lifted before 2024.**
- **For bond markets, the July board meeting will be an important date. The RBA has drawn a line in the sand and said it will decide at this meeting if it will direct its yield-curve control (YCC) target from the April 2024 bond to November 2024 (the next maturity). We are expecting the shift to November to materialise.**
- **And in a widely expected move, the RBA said the Term Funding Facility will not be extended. It will expire on 30 June 2021.**
- **The RBA was mum on housing risks, choosing to roll out similar remarks to April. Today's data showed investor lending grew at the fastest clip in nearly 18 years, which is sure to have regulators monitoring housing even more closely.**

The Reserve Bank (RBA) delivered no surprises today, leaving policy settings unchanged. It also continued to suggest it does not anticipate lifting the cash rate before 2024 because it does not anticipate actual inflation to be sustainably within its 2–3 per cent target band before this date.

But the RBA now expects underlying inflation to hit 2 per cent in mid-2023! This timing is earlier than previously flagged. Previously, the RBA's forecasts extended only to mid-2023 and underlying inflation only reached as high as 1¾ per cent in mid-2023. Forecasts will be extended in the RBA's

Statement on Monetary Policy slated for release this Friday.

The RBA has stressed it will not raise the cash rate until actual inflation is sustainably in the RBA's inflation target band of 2–3 per cent. For inflation to be sustainably in the band, it needs to be there for a time and for this to occur, the jobs market will need to be tight enough to produce the sort of wages pressures that can put inflation where the RBA wants it to be.

Whilst it is several years away, we economists are preoccupied with when the RBA might start raising the cash rate from the current record low of 0.10 per cent. This new, revised inflation forecast for mid 2023 throws up the possibility that a rate hike might occur sooner than previously expected.

Indeed, the RBA made a tweak to its language to acknowledge the slight possibility of a rate hike before 2024. In the past the RBA had said it 'did not expect' conditions to be met to hike the cash rate until 2024 at the earliest because it does not anticipate actual inflation to be sustainably within its 2–3% target band before this date. The statement today said it was 'unlikely' this would be until 2024. This has not changed our view that the cash rate will not be lifted before 2024.

The stronger inflationary pressures tie in with the stronger economic recovery trajectory the RBA has outlined. GDP growth is now expected to be 4¾ per cent over 2021, well above trend and upgraded from 3½ per cent previously. Growth for 2022 is unchanged at 3½ per cent.

The faster pace of growth is set to help hasten a faster jobs recovery. The recovery in jobs has also been stronger than what policymakers anticipated throughout this pandemic; the latest data showed a drop in the unemployment rate to 5.6% in March. Accordingly, the RBA has revised down its unemployment forecasts. It now expects an unemployment rate of 5 per cent by the end of this year, which is down from the previous estimate of 6 per cent. At the end of 2022, the RBA has an unemployment rate slated at 4½ per cent, down from 5½ per cent previously. The RBA has stated it expects the unemployment rate will need to be in the 'high 3s or low 4s' to generate enough wage growth to sustainably lift inflation into the target band.

One of the fresh bits of information in today's RBA board statement was particularly important for bond market. The RBA has drawn a line in the sand and said it will decide at this meeting if it will direct its yield-curve control (YCC) program from the April 2024 bond to November 2024 (the next maturity). The YCC program designed to keep the three-year government bond yield at around 0.10%. Our view for some time has been that the RBA will shift to the November 2024 bond and the RBA noting that it will make the decision in July seems to suggest a shift will occur. Why? Well, the RBA did not take the opportunity today to water down such a shift instead choosing to highlight that a decision is coming.

Another new piece of information was that the Term Funding Facility (TFF) would not be extended beyond its expiry on 30 June 2021. This facility has provided cheap cost of funding to authorised deposit institutions. The expiry of this facility may lead to a modest lift in three-year swap yields.

Two areas that were eyed for fresh remarks from the RBA board were around housing and the currency. But the RBA rolled out similar remarks to April's statement. On housing, the RBA repeated that it will be monitoring trends in housing borrowing carefully and it is important that lending standards are maintained. The RBA made no mention of the pick up coming through now in investor lending. Indeed, investor lending rose 12.7% in March – the fastest monthly clip in nearly 18 years! We do not rule out the possibility of a tightening in macroprudential policy next year to take some heat out of the market. On the Aussie dollar, the RBA reran the remark that it "remains in the upper end of the range of recent years".

All eyes now turn to the Federal Budget next week. We expect a deficit of $155 billion, which is better than the government's estimate of nearly $198 billion in December 2020. A stronger

economic recovery has helped underpin an improvement in the bottom line. This firmer economic recovery includes a faster rebound in jobs growth and resilience in spending by households. As a result, the government has received more tax revenue and spent less on income support payments than expected. Soaring iron ore prices and prices for other exports have also helped drive an improvement in the bottom line.

In 2021/22, we anticipate the deficit will narrow to $84bn. But large deficits are still likely to be a feature over the next few years.

Job creation will likely remain a priority in next week's Federal Budget. There will be patience around budget repair. The name of the game needs to be around ensuring the current recovery is sustained and the best way to do this is for the government to keep its foot on the accelerator.

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

Contact Listing

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

Economist
Matthew Bunny
matthew.bunny@bankofmelbourne.com.au
(02) 8254 0023

The Detail

The information contained in this report ("the Information") is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom Bank of Melbourne has a contract to supply Information, the supply of the Information is made under that contract and Bank of Melbourne's agreed terms of supply apply. Bank of Melbourne does not represent or guarantee that the Information is accurate or free from errors or omissions and Bank of Melbourne disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to Bank of Melbourne products and details are available. Bank of Melbourne or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. Bank of Melbourne owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of Bank of Melbourne.

Any unauthorised use or dissemination is prohibited. Neither Bank of Melbourne- A Division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ACL 233714, nor any of Westpac's subsidiaries or affiliates shall be liable for the message if altered, changed or falsified.