Friday, 5 November 2021

RBA Statement on Monetary Policy

RBA Upbeat, Except on Inflation

- **There were major shifts from the Reserve Bank (RBA) this week which lay the groundwork for earlier rate hikes. The Statement on Monetary Policy (SoMP) was released today, including fresh forecasts projecting a strong rebound from the recent setbacks.**
- **GDP is expected to contract by around 2½ per cent in the September quarter. But a rapid recovery is already underway. GDP growth is expected to land at 3 per cent over 2021 and 5½ per cent over 2022, before normalising to 2½ per cent over 2023.**
- **Jobs are set to recover quickly over the coming months. The RBA has the unemployment rate hitting 4¾ per cent for the end of this year and heading to 4 per cent by the end of 2023. The unemployment rate has not been consistently sub-4 per cent since the 1970s.**
- **However, the RBA continued to emphasise it expects wages and inflation will only pick up gradually. The RBA expects underlying inflation will reach 2¼ per cent by the end of this year and hold at that level until the end of 2023, when it is forecast to tick up to 2½ per cent.**
- **The RBA's moves to drop the yield curve target and adjust its forward guidance are sensible given the recovery has far exceeded expectations. However, the central bank is pushing back against hikes in 2022, which are currently expected by the market.**
- **Some may argue that the RBA's inflation forecasts are too subdued in the context of global supply chain disruptions and elevated energy prices. Indeed, we expect inflation will pick up faster but remain comfortable with our long-held view that the tightening cycle will commence in early 2023, although would not rule out the possibility of a move sooner.**

The RBA released its quarterly Statement on Monetary Policy (SoMP) this morning. The statement includes an updated set of forecasts which shed more light on the RBA's expectations for the economy's rebound following the setbacks from the Delta outbreak.

There were major shifts in the policy outlook at Tuesday's meeting. The RBA abandoned its yield curve target of 0.10% and dumped its forward guidance that rates would not be raised until 2024. These are significant shifts which pave the way for earlier rate hikes.

Economic Growth

The RBA acknowledged that the setback from the Delta outbreak was significant, and that the impact was very uneven, concentrated in "contact-intensive industries in the south-eastern part of the country". Accordingly, the RBA expects GDP contracted "around 2½ per cent" in the September quarter.

However, with high vaccination rates and restrictions easing, the economy is recovering rapidly.

GDP growth for 2021 was revised down 1 percentage point to 3 per cent (the RBA had forecast 4¾ per cent growth before the Delta outbreak). However, GDP growth over 2022 was revised up to 5½ per cent, reflecting the strong rebound expected next year, led by a rapid recovery in consumer spending. In addition, dwelling investment has also turned around after it was temporarily hindered by restrictions on construction. Business investment is also expected to pick up, resuming the recovery that was underway ahead of the Delta outbreak. In 2023, GDP growth is expected to return to 2½ per cent which is closer to pre-pandemic averages.

Output Growth and Inflation Forecasts[(a)]

Per cent

	Year-ended					
	June 2021	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023
GDP growth	9.6	3	4	5½	3¼	2½
(previous)	(9½)	(4)	(4½)	(4¼)	(2¾)	(2½)
Unemployment rate[(b)]	5.1	4¾	4½	4¼	4	4
(previous)		(5)	(4½)	(4¼)	(4¼)	(4)
CPI inflation	3.8	3¼	2¾	2¼	2¼	2½
(previous)		(2½)	(1½)	(1¾)	(2)	(2¼)
Trimmed mean inflation	1.6	2¼	2¼	2¼	2¼	2½
(previous)		(1¾)	(1½)	(1¾)	(2)	(2¼)
	Year-average					
	2020/21	**2021**	**2021/22**	**2022**	**2022/23**	**2023**
GDP growth	1.4	4¼	3¼	5	5	3
(previous)	(1¼)	(4¾)	(4½)	(5)	(4)	(2¾)

(a) Forecasts finalised on 3 November. The forecasts are conditioned on a path for the cash rate broadly in line with recent market pricing and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the November 2021 Board meeting. Other forecast assumptions (August *Statement* in parenthesis): TWI at 62 (62), A$ at US$0.74 (US$0.74), and Brent crude oil price at US$80bbl (US$70bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Budget. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter

Source: RBA

The RBA underscored that there is still considerable uncertainty over the outlook. They note that GDP growth may rebound more strongly if household spending increases by more than expected, particularly as sentiment is boosted by better health outcomes and high vaccination rates. Meanwhile, lingering uncertainty could result in ongoing near-term precautionary saving. Bad news on the health front, like the emergence of a new variant or diminishing vaccine efficacy, could also result in a worse outcome for economic activity.

Labour Market

Forwarding looking indicators point to a strong recovery in the jobs market over the coming months. Indeed, the RBA has revised down its unemployment forecast to 4¾ per cent for the end of this year, with jobs back at their pre-Delta levels. The unemployment rate is forecast to head to 4% by the end of 2023. The unemployment rate forecasts for 2022 and end-2023 were left unchanged, reflecting that the Delta outbreak is not expected to have a lasting impact on the jobs market. These projections represent very strong conditions in the labour market. In fact, the last time the unemployment rate was consistently sub-4 per cent in Australia was the in 1970s.

We continue to hear reports of labour shortages in certain industries. These shortages are placing upward pressure on wages in isolated cases. However, this has not yet flowed through into broad-based increase in wages growth.

Despite the tight labour market, the RBA still expects the pick up in wages growth to be gradual. Wages growth is forecast to hit 2¼ per cent by the year of this year (unchanged from the August SoMP) and reach 3 per cent at the end of 2023 (up from 2¾ per cent previously). Importantly, the RBA has flagged it believes around 3 per cent is the level of wages growth needed to drive underlying inflation sustainably into the target band. Wages growth has not had a 3-handle since 2013.

Inflation

The RBA conceded that inflation has picked up faster than it anticipated. The forecasts for trimmed mean inflation – which strips out volatile price movements and is a key focus for the RBA – were revised up accordingly. The RBA expects the metric will reach 2¼ per cent by the end of this year (up from 1¾ per cent). Interestingly, the RBA has forecast inflation will hold at that level until the end of 2023 when it is forecast to tick up to 2½ per cent.

The RBA also presents upside and downside scenarios. In the upside scenario, the unemployment declines to around 3¼ per cent and trimmed mean inflation rises to a little above 3 per cent by the end of 2023. Such conditions would clearly suggest a rate hike is necessary by 2023, if not sooner.

Monetary Policy Outlook

The RBA has appropriately dropped its guidance that the cash rate will not be raised until 2024, setting up for an earlier hike. However, the central bank has pushed back against the notion of hikes in 2022 and stressed they are prepared to be “patient”. The market is pricing the first rate hike around the middle of next year.

The SoMP waters down previous language to flag the first rate hike “could” come in 2024 while acknowledging there are “plausible scenarios” where a cash rate increase in 2023 could be warranted.

Some would argue that the RBA’s inflation forecasts are too subdued, particularly in the context of global supply chain disruptions, which are unlikely to abate for the next 12 months, and elevated energy prices. There is a risk that some of this ‘temporary’ uplift in inflationary pressures becomes permanent. Indeed, it is a bold assumption that underlying inflation effectively will not increase between now and the end of 2023. We expect trimmed mean inflation will be approaching the upper end of the 2–3% target band by the end of 2022.

All this considered, we remain comfortable with our long-held view that the tightening cycle will commence in early 2023, although would not rule out the possibility of an earlier move.

Matthew Bunny, Economist
Ph: (02) 8254 0023

Contact Listing

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

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

Senior Economist
Jarek Kowcza
jarek.kowcza@bankofmelbourne.com.au
0481 476 436

Associate Economist
Jameson Coombs
jameson.coombs@bankofmelbourne.com.au
0401 102 789