Friday, 6 August 2021

RBA Statement on Monetary Policy
Glass Half Full, Despite Lockdown Setback

- **Today the Reserve Bank (RBA) released updated forecasts, the first since the extended lockdown hit New South Wales. The Governor also appeared before Parliament for the central bank's semi-annual testimony.**
- **The RBA remains upbeat on the outlook, despite setbacks from the recent virus outbreaks.**
- **Beyond the short-term disruption, the RBA expects the overall level of economic activity to be higher and the unemployment rate to be lower than in the last set of forecasts from May 2021. This reflects strong momentum leading into the recent outbreaks.**
- **A contraction in economic activity of at least 1 per cent is expected in the September quarter. The RBA expects activity to recover strongly in the December quarter. GDP growth in 2021 is expected to reach 4 per cent, then 4¼ per cent in 2022 and 2½ per cent in 2023.**
- **The unemployment rate is forecast to reach 5 per cent by the end of the year, and touch 4¼ per cent in December 2022, around the RBA's estimate of full employment. It is then expected to fall to 4 per cent in December 2023.**
- **The RBA continued to emphasise that wage and price growth remains subdued. Wages growth is expected to reach 2¾ per cent by the end of 2023 and inflation is forecast to hit 2¼ per cent by December 2023, notably inside the 2–3 per cent target band.**
- **Despite the material deterioration in the near-term outlook, the RBA is sticking to its guns, going ahead with the tapering of bond purchases from September announced in July. The central bank also continued to emphasise they don't expect to lift the cash rate until 2024.**
- **Once restrictions ease, we are optimistic about the economic rebound, consistent with the RBA's views. But there are growing downside risks from recent lockdowns in other states and the ongoing rising trend in daily NSW infections. The situation is still evolving and near-term uncertainty remains heightened.**
- **We expect a faster fall in the unemployment rate and subsequently a stronger increase in inflation. On this basis, we still expect the first rate hike to come in the first half of 2023.**

The Reserve Bank (RBA) released its quarterly Statement on Monetary Policy earlier today. The Governor and other senior RBA representatives also appeared before the House of Representatives Standing Committee on Economics for the RBA's semi-annual parliamentary testimony. The Statement includes an updated set of forecasts, the first since the extended lockdown hit New South Wales and also extends the forecast horizon to the end of 2023 (previously to mid-2023).

Economic Growth

The RBA noted that the recent outbreaks of the Delta variant have disrupted the economic recovery. In fact, if it were not for the outbreak and subsequent lockdowns, the RBA would have noticeably upgraded its economic outlook.

Output Growth and Inflation Forecasts[a]

Per cent

	June 2021	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023
Year-ended						
GDP growth	9½	4	4½	4¼	2¾	2½
(previous)	(9¼)	(4¾)	(4)	(3½)	(3)	(n/a)
Unemployment rate[b]	5.2	5	4½	4¼	4¼	4
(previous)		(5)	(4¾)	(4½)	(4½)	(n/a)
CPI inflation	3.8	2½	1½	1¾	2	2¼
(previous)		(1¾)	(1¼)	(1½)	(2)	(n/a)
Trimmed mean inflation	1.6	1¾	1½	1¾	2	2¼
(previous)		(1½)	(1½)	(1¾)	(2)	(n/a)
Year-average						
	2020/21	**2021**	**2021/22**	**2022**	**2022/23**	**2023**
GDP growth	1¼	4¾	4½	5	4	2¾
(previous)	(1)	(5¼)	(5)	(4)	(3¼)	(n/a)

(a) Forecasts finalised on 4 August. Forecast assumptions (May *Statement* in parenthesis): TWI at 62 (64), A$ at US$0.74 (US$0.77), Brent crude oil price at US$70bbl (US$68bbl), population growth of 0.1 per cent over 2021, 0.4 per cent over 2022 and 1.2 per cent over 2023; cash rate in line with market pricing; and other elements of the Bank's monetary stimulus are in line with the announcement made following the August 2021 Board meeting. 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

As a result of the outbreaks, the RBA expects GDP to "contract noticeably" by at least 1 per cent in the September quarter. This is a significant downward revision from the previous expectation of quarterly growth of almost 1 per cent before the lockdowns. The decline is largely expected to come through reduced consumer spending, which tends to be most impacted by lockdowns. In his statement to Parliament, the Governor noted that consumption tends to decrease by around 15 per cent in areas subject to lockdowns. This is consistent with Victoria's (second extended) lockdown last year and our own views.

The economy is expected to bounce back after restrictions lift, consistent with past lockdowns. As a result, the RBA expects, some, but not all, of this decline to be recovered in the December quarter, if additional lockdowns remain limited. When pressed in the Q&A in Parliament the Governor noted that the RBA "can't rule out two quarter of negative GDP if the health situation deteriorates" but that it is quite unlikely at this stage.

The RBA also noted that "the need for extended lockdowns should diminish as vaccination coverage increases."

Our own expectation is that the national economy will contract by a more significant 2.2 per cent in the September quarter, before rebounding strongly in the December quarter as restrictions lift.

The RBA expects growth of 4 per cent in 2021 (down from 4¾ per cent due to the Delta outbreak and associated lockdowns), 4¼ per cent in 2022 (up from 3½ per cent as the economy bounces back), and 2½ per cent in 2023.

Looking further into the future, the RBA expects the overall level of economic activity to be higher than previously anticipated. This reflects both stronger-than-expected growth leading into the lockdowns and a strong recovery, in addition to expectations of stronger private investment and public demand in the future.

Labour Market

The labour market has so far recovered much faster than the RBA had expected. Job vacancies are elevated, and some firms are reporting difficulty in finding the right labour. The unemployment rate fell to 4.9 per cent in June, the lowest level in 10 years. The RBA had not expected the unemployment rate to fall to these levels until late 2021.

The current lockdowns will result in some job losses in the coming months. The RBA expects the unemployment rate to increase as a result.

However, it was also noted that “most of the adjustment in the labour market is likely to be through declines in hours worked and participation, rather than in job losses.” This is consistent with previous lockdowns and with our expectations. Government support programs, notably NSW’s JobSaver wage subsidy will help to reduce job losses.

The RBA did also note that “the longer the lockdowns continue, however, the more likely it is that jobs are lost.”

The RBA expects the labour market to recover once restrictions are lifted, driving momentum through the end of 2021 and into the first half of 2022.

The RBA forecasts an unemployment rate of 5 per cent in December 2021 (unchanged from its previous estimate), 4 ¼ per cent in December 2022 (down from 4½ per cent), and 4 per cent in December 2023.

Inflation

The RBA continued to highlight that wages growth and inflation remain subdued despite the faster than expected rebound in the labour market and economic growth, a sentiment which was echoed in the Governor’s remarks to Parliament this morning. It is noted that there are reports of labour shortages in parts of the economy and a related increase in wages for some occupations but that “wage increases for most Australians are still modest”.

However, the RBA still bumped up its inflation and wages forecasts a little.

Wages are expected to grow by 2¼ per cent over 2021 (up from 1¾ per cent), 2½ per cent over 2022 (up from 2¼ per cent) and 2¾ per cent over 2023.

Trimmed mean inflation – the RBA’s preferred measure of inflation – is expected to reach 2¼ per cent by December 2023, notably inside the 2–3 per cent target band. The near-term forecast for trimmed mean inflation was pushed up a little, from 1½ to 1¾ per cent for December 2021, but the remainder of the profile was unchanged.

The RBA also presents upside and downside scenarios alongside its baseline forecasts. It is worth noting, that since the onset of the pandemic, the recovery has consistently outperformed the RBA’s baseline forecasts. In the RBA’s upside scenario, trimmed mean inflation reaches 2¾ per cent by the end of 2023 – in this instance, it is difficult to envisage the RBA waiting until 2024 to hike the cash rate.

Monetary Policy Outlook

Despite the material deterioration in the near-term outlook, the RBA is sticking to its guns. As outlined following the Board meeting earlier this week, the RBA intends to go ahead with its plan to reduce bond purchases to $4 billion per week from September. The RBA also continued to emphasise its “central scenario” is that the cash rate will not increase until 2024.

The central bank surprised us and the market this week by opting not to defer the tapering of bond purchases in the face of a contraction in economic activity in the third quarter. The Governor provided some colour on this decision in his speech, noting that any additional bond purchases now would have their maximum effect next year, and a very small effect right now when the support is needed most. It was flagged that fiscal policy was the most appropriate tool to respond to the “temporary and localised hit to income”.

However, the Governor still left the door open for bond purchases to adjust, noting the RBA is prepared to respond to further bad news on the virus front if it impacts the “outlook for the economy over the year ahead”. This suggests the RBA does not want to be dragged into adjusting monetary policy every time new lockdowns are imposed, given the economy usually rebounds quickly, and monetary policy has a lagged impact on the economy.

The near-term outlook is clouded with uncertainty and virus developments are still evolving. A contraction in the September quarter is a given at this stage. But the extent of the economic impact will depend on how long the NSW lockdown lasts and whether there are lengthy lockdowns elsewhere in the country. There are growing downside risks from recent lockdowns in other states and the ongoing rising trend in daily NSW infections.

Once restrictions ease, we are optimistic about the rebound in the economy, consistent with the RBA’s views. However, we have forecast a faster fall in the unemployment rate and subsequently a stronger increase in inflation. We expect that trimmed mean inflation will reach the mid 2s by the end of 2022. And on this basis, we still expect the first rate hike to come in 2023.

Matthew Bunny, Economist &
Jarek Kowcza, Senior 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

Economist
Sonali Patel
sonali.patel@bankofmelbourne.com.au
(02) 8254 0030