MNI RBA Review - December 2020

Meeting Date: Tuesday December 1 2020

Statement Release Time: 03:30 GMT/14:30 AEDT

Link To Statement: https://www.rba.gov.au/media-releases/2020/mr-20-32.html

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MNI POV (Point Of View): Looking To 2021

Markets were quick to look through the final RBA meeting of 2020, although the decision and accompanying statement weren't expected to provide much, coming hot on the heels of the Bank's latest round of monetary easing.

The guidance passage was a cut & paste from the previous statement, while the Bank's language surrounding its ACGB purchase scheme and impact on the AUD was very matter of fact and had been outlined previously.

Elsewhere, the tone surrounding the local and global economies was still cautious, even with Australia escaping the worst-case scenario given its relative success in employing its COVID-19 mitigation measures.

The RBA flagged the broader risk backdrop as the driver behind the recent bid in AUD/USD (which is of course well documented/flagged in our preview), which shows that the RBA is comfortable with the recent movements in that particular cross, which are fundamentally driven. The fact that the RBA's AUD TWI measure sits a little further away from its YtD peak will also afford the RBA greater breathing room on that front.

It was also keen to reiterate the need for an appropriate monetary-fiscal policy mix. All in all, it was a very vanilla affair, with little of note to go off. Now we move to the Governor's appearance in Canberra tomorrow.

As we turn the page into 2021, the strength of the rebound of the Australian economy will be one of the key drivers that will determine just how nimble the Bank will have to be, whether that be re: the enforcement of its 3-Year yield target or the ultimate size/extension of its ACGB purchase scheme. Relative central bank policy will also be key in shaping matters on those fronts, as will the velocity of any potential hazardous market moves.

RBA December 1 2020 Meeting Statement

At its meeting today, the Board decided to maintain the current policy settings, including the targets of 10 basis points for the cash rate and the yield on 3-year Australian Government bonds, as well as the parameters of the Term Funding Facility and the government bond purchase program.

Globally, the news has been mixed recently. On the one hand, infection rates have risen sharply in Europe and the United States and the recoveries in these economies have lost momentum. On the other hand, there has been positive news on the vaccine front, which should support the recovery of the global economy. The recovery is also dependent on ongoing support from both fiscal and monetary policy. Hours worked in most countries remain noticeably below pre-pandemic levels and inflation is low and below central bank targets.

Financial conditions remain accommodative around the world, with bond yields near historically low levels. The positive news on vaccines has boosted equity markets, lowered risk premiums and supported further increases in some commodity prices. The improvement in risk sentiment has also been associated with a depreciation of the US dollar and an appreciation of the Australian dollar.

In Australia, the economic recovery is under way and recent data have generally been better than expected. This is good news, but the recovery is still expected to be uneven and drawn out and it remains dependent on significant policy support. In the RBA's central scenario, it will not be until the end of 2021 that the level of GDP reaches the level attained at the end of 2019. In the central scenario, GDP is expected to grow by around 5 per cent next year and 4 per cent over 2022.

Employment growth was again strong in October, although the unemployment rate increased to 7 per cent as more people rejoined the workforce. A further rise in the unemployment rate is still expected, as businesses restructure in response to the pandemic and more people rejoin the workforce. The unemployment rate is forecast to decline next year, but only slowly and still to be around 6 per cent at the end of 2022.

The extended period of high unemployment and excess capacity is expected to result in subdued increases in wages and prices over coming years. In the September quarter, the Wage Price Index increased by just 0.1 per cent, to be 1.4 per cent higher over the year. In underlying terms, inflation is forecast to be 1 per cent in 2021 and 1½ per cent in 2022.

The Board views addressing the high rate of unemployment as an important national priority. Its policy decisions over recent months will help here. These decisions are complementary to the significant steps taken by Australian governments to support jobs and economic growth.

The Bank's policy response has lowered interest rates across the yield curve, which will assist the recovery by: lowering financing costs for borrowers; contributing to a lower exchange rate than otherwise; and supporting asset prices and balance sheets. The Term Funding Facility is also supporting the supply of credit to businesses. To date, authorised deposit-taking institutions have drawn down $84 billion under this facility and have access to a further $105 billion. Over the past month, the Bank has bought $19 billion of government bonds under the bond purchase program and a further $5 billion of Australian government securities in support of the 3-year yield target. Since the start of this year, the RBA's balance sheet has increased by around $130 billion.

Given the outlook for both employment and inflation, monetary and fiscal support will be required for some time. For its part, the Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. Given the outlook, the Board is not expecting to increase the cash rate for at least 3 years. The Board will keep the size of the bond purchase program under review, particularly in light of the evolving outlook for jobs and inflation. The Board is prepared to do more if necessary.

MNI Policy Team Review: RBA Holds Rates But Says More QE Possible

By Lachlan Colquhoun

MNI (Sydney) - The Reserve Bank of Australia said Tuesday it remains prepared to expand its quantitative easing program based on the outlook for jobs and inflation although it left policy settings unchanged, citing the recovery underway.

In its statement, the central bank said it is keeping the size of its bond purchase program "under review, particularly in light of the evolving outlook for jobs and inflation."

"The Board is prepared to do more if necessary," the statement said.

As widely expected, the RBA left official rates unchanged at the record low of 0.10% at its final meeting for 2020 and confirmed other policy settings, such as its yield control program for the benchmark three-year Australian government bond and the AUD100 billion QE program for longer dated bonds.

WAGES

The RBA has a dual mandate to address employment and inflation, but has increasingly focused on employment as Australia fell into recession this year for the first time in more than 25 years.

Tuesday's statement presented employment as a precursor to any increase in inflation, which at 0.7% is well outside the 2-3% target.

Wage growth needs to be "materially higher" and significant gain in employment is needed before inflation could begin to move towards the target, the RBA said, before repeating its guidance that rates would not rise for three years.

The central bank cut rates and announced the QE program in November.

Sell-Side Analyst Views

ANZ: The final paragraph of the RBA's final statement for 2020 was unchanged from that in November. Critically, "monetary and fiscal support will be required for some time. For its part, the Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range." For practical purposes this requires "a return to a tight labour market." Given the current outlook "the Board is not expecting to increase the cash rate for at least 3 years". The bond purchase program remains under review, with the Board "prepared to do more if necessary." We think this will happen in 2021, with an extension of QE beyond its current end date. This could be announced as early as the RBA Board's February meeting.

- One part of the economy that didn't rate a mention was the housing market. We suspect the RBA is quite happy to see the turn in sentiment and recovery in prices, given what it means for household spending and, indeed, inflation. Given our expectations for housing in 2021 we doubt it will be long before it does feature in RBA commentary. Initially as a source of good news, but perhaps with more concern about financial stability implications as the end of 2021 approaches.
- For now, we think the RBA will have been very happy that 2020 may be drawing to a close without any further surprises. There are four weeks to go, however!

Barclays: The RBA continues to say that it views "addressing the high rate of unemployment as an important national priority" and expects recent policy steps to help in this regard. While the labour market conditionality for maintaining the highly accommodative policy settings has changed from "progress towards full employment" to "significant gains in employment and a return to a tight labour market", we think the message remains the same. However, the unemployment rate is expected to increase in the near term as the labour force increases and businesses adjust decisions in response to the post-pandemic economic outlook.

- The RBA flagged that recent better-than-expected data has shown that activity levels are improving, but cautioned that it will take time for the economy to recoup all losses. The uneven and drawn out recovery will be dependent on policy support. According to the bank's base case, the economy will reach December 2019 levels of GDP only in 2022.
- The bank maintained that the size of the bond purchase program will be flexible, contingent on " the evolving outlook for jobs and inflation". The guidance remains that it is "prepared to do more if necessary." That compares with its commentary from before the November meeting that it was considering "how additional monetary easing could support jobs." The RBA board for now does not seem to be worried about the increase in house prices or the strength of the currency, but is maintaining its focus on the labour market.
- While the bank forecasts that both unemployment and inflation rates will remain away from their respective targets for some time, we think it has provided sufficient monetary support for the economy's return to growth. Besides the extremely low cash rate and 3yr bond yields, the bank's Term Funding Facility has AUD105bn for authorized deposit-taking institutions to draw on at the rate of 0.10% till June 2021.
- The bank has enough ammunition to lower longer term yields as well as reduce pressure on the currency under its current bond purchase target: AUD19bn of bonds have been bought over the last month and the bank still has space to buy AUD81bn (~4% of GDP) of securities with maturities in the 5-10 year space till May 2021. The bond purchases to maintain the 3y AGB target yield are over and above the planned AUD100bn. The bank has purchased AUD5bn over the last month to maintain the 3y target.
- As such, the RBA is unlikely announce any further major policy changes before May 2021, in our view, unless there is a resurgence of COVID-19 in Australia. If further easing is required, the RBA could purchase more bonds, as long as it does not affect market functioning. However, we do not expect the bank to cut the cash rate further. The RBA's view is that it has "gone as far as it makes sense" on interest rates and negative interest rates are "extraordinarily unlikely." RBA Governor Philip Lowe's appearance before the House of Representatives Standing Committee on Economics tomorrow, and a speech on 7 December, will likely continue to highlight the same message.

CBA: The Governor's post meeting Statement struck the right tone between recognising that the Australian economic data "have generally been better than expected" whilst acknowledging that, "the recovery is still expected to be uneven and drawn out". The RBA will be pleased that the domestic recovery is occurring faster than they expected. And that, "employment growth was again strong in October". But they need to retain a dovish stance and keep the door ajar for more policy easing so that they do not put any undue upward pressure on the Australian dollar.

- The RBA has embarked on a fixed quantity government bond purchase program, as well as its other easing measures from its November meeting to contribute to a "lower exchange rate than otherwise". It is therefore essential that at this stage the RBA does not let too much optimism creep into their communication as it would have an unwanted impact on the Australian dollar. Retaining the line from the November Board meeting that, "the Board is prepared to do more if necessary" was required today to keep the Australian dollar from appreciating at 2.30pm, especially as the AUD has already been appreciating due to improved risk sentiment.
- The RBA Governor noted that, "there has been positive news on the vaccine front". Here we note that the RBA's central scenario for the economy does not presuppose the introduction of a vaccine. Indeed both the upside and downside scenarios contained in the November Statement on Monetary Policy (SMP) do not presuppose the introduction of a vaccine. So the positive news on the vaccine front is a clear upside risk to their forecasts.
- For RBA watchers the focus quickly shifts to tomorrow's appearance by Governor Lowe before the House of Representatives Standing Committee on Economics. Given home prices are now rising and new lending has accelerated the Governor may be asked specifically about dwelling prices and financial stability in the context of monetary policy. Rising asset prices are part of the transmission mechanism of monetary policy. And to that end we think that rising dwelling prices in 2021 are unlikely to feed into the monetary policy debate because the RBA primarily sees financial stability related to the housing market through the lens of credit and leverage.
- We have an optimistic view on the economic outlook and think that the Australian economy will be on a sufficiently entrenched path of improvement by the middle of next year that the RBA will need to either remove or increase the target yield on the 3 year Australia Commonwealth Government Bond (ACGB). For as long as the target on the 3 year ACGB sits at the same level as the cash rate the RBA is implying that the cash rate will remain on hold for the next three years. The middle of next year is still some time away, but it is worth considering now how these dynamics are likely to play out given our views on the outlook for the Australian economy.

J.P.Morgan: At today's meeting the RBA maintained policy settings from the November package, and the concluding guidance paragraph. To be confident their job is done, the Board needs to see "materially higher" wage growth, "significant gains" in employment, and a return to a "tight" labour market. Inflation needs to be "sustainably within" the target band. This carries on the guidance change from November, pivoting away from forecast inflation, to delivered inflation (i.e., an even higher bar) to justify turning away from accommodation. Given these inputs, the board is not expecting to raise the cash rate for "at least three years". The board will keep the size of the purchase program "under review ...in line of the evolving outlook for jobs and inflation."

- Recent local news has been positive, so at a stretch the "under review" language could therefore be read say the A$100bn program size could be trimmed if outcomes were good enough. But given the thresholds that need to be hit on inflation and employment, it seems very unlikely a sufficient gap can be closed within the remaining five months of the program. At today's decision, the board reaffirmed the parameters of the November purchase program (including the program size of A$100bn) and concluded that the Board is "prepared to do more if necessary."
- In the description of the economy, the Governor notes data have been "better than expected", but the recovery is nevertheless likely to be uneven and require ongoing "significant" policy support. The staff still expects a further rise in unemployment from here, as lagged firm restructuring outweighs recovering labour supply (presumably, the now-fading government support induces the lagged employment response). The statement also provides a brief round-up of actions taken and how earlier commitments are rolling out: the cumulative allocation under the TFF operations is worth A$189bn, and the bank has so far bought A$24bn of government and semi-government paper under the new purchase program.
- For markets, we continue to see the RBA's pivot to quantity-targeting as a material change relative to the framework that held through most of 2020. Unlike the crisis management period where front-end yield targeting and local deleveraging were propagating quite uniformly across the curve, the RBA is now easing in an improving economic backdrop, and absorbing more than 100% of planned net supply from the AOFM through April. This should impose significant influence on local curve shape, particularly on a cross-market and asset swap basis. Further, QE will achieve much greater pass-through to reserves, and so to front-end funding conditions than seen to date in 2020, now that Treasury cash balances are no longer accruing at the RBA. We expect surplus ESAs to breach A$200bn, and 1M-3M FX-OIS to test new lows.

NAB: The RBA's December Board Meeting was expected to pretty much be a non-event given the RBA had made a substantial number of policy announcements in November. Markets were not disappointed with policy and forward guidance unchanged.

- One surprise that might have been seen was the slight downplaying of the recent run of data that has surprised sharply to the upside, with a continued emphasis on the recovery being "uneven and drawn out" with the unemployment only expected to decline "slowly". The substantial recovery in job advertising in recent months though is one potential signal that suggests unemployment may fall a bit more quickly than expected – we'll be watching eagerly to see if this signal is confirmed in next week's NAB Business Survey (which to be clear, we have not seen as yet). Note the Board does not meet in January with the next meeting in February providing a further detailed review of the Bank's forecasts. While the Bank acknowledged the positive associated with recent vaccine news, the Board continues to state it "is not expecting to increase the cash rate for at least 3 years", having previously tied any increase in the cash rate to actual inflation being sustainably within the 2-3% target band. A sustained lift in inflation will require a tight labour market and wages growth to be "materially higher than it is currently".
- One area currently under debate for markets is the $100bn QE program which expires in five months. Markets are likely to speculate over whether the program will be continued, tapered or even stopped. That debate will likely be closely tied to the trajectory for the unemployment rate as it should. Not surprisingly, the RBA did not broach the subject today, noting that "the Board will keep the size of the bond purchase program under review, particularly in light of the evolving outlook for jobs and inflation" but equally stating that the Board is prepared to do more. Markets will be listening closely to any clues from Governor Lowe in his Parliamentary Testimony tomorrow, though its unlikely he will signal anything just one month into the program and with the unemployment rate still at 7%.

RBC: There was very little new news in today's short post RBA meeting statement. Having delivered additional easing last month as it began its A$100bn QE program, we suspect the RBA is starting to wind down after an historic year of policy action and happy to monitor developments as it settles into its new QE program. As per tradition, there is no meeting in January over the summer, with the board next convening on 2 Feb. An updated set of forecasts will be delivered at the 5 Feb Statement on Monetary Policy with Governor Lowe set to deliver his Semi Annual Testimony on Monetary Policy shortly thereafter.

- There was little reference to recent key developments – vaccine progress, the further opening up of State borders and stronger currency – in today's statement. We suspect we will hear more on these more topical issues tomorrow when the Governor appears before the House Economics Committee. He is likely to err cautiously optimistic as we close out 2020 with activity and labour market data strengthening, restrictions easing further, and confidence high.
- Despite all of that, the key final paragraph continues to highlight the challenges for the RBA. A "tight labour market", "materially higher" wages and "sustainably" within target inflation are the goals and "The Board is prepared to do more if necessary." to ensure this. Even with emerging upside to 2021, this looks to be several years down the track and policy will remain suitably accommodative.

Westpac: Over the course of the next few months, as we move to the next Board meeting on February 2 the Board may need to significantly review its forecasts.

- Taking the RBA's unemployment rate forecasts at face value there is clear scope for more policy support. The RBA sees its role as complementary to fiscal policy – "monetary and fiscal support will be required for some time" and "the Board is not expecting to increase the cash rate for at least three years". The decision to peg the three year target bond rate at the cash rate is the strongest form of forward guidance - much bolder than we see from other central banks that engage in forward guidance. On the face value of the RBA's current forecasts, Westpac's view that the RBA will be required to adjust the target rate on the three year bond around mid-2022, seems reasonable but the risks around the forecasts will see significant market speculation around this issue through 2021.
- In the near term the Governor's confirmation that "The Board will keep the bond purchase program under review, particularly in light of the evolving outlook for jobs and inflation … is prepared to do more if necessary". raises the real prospect that the $100 billion program, which is targeted to be completed by June, will be extended. That decision would certainly be consistent with the timing that Westpac currently envisages for the adjustment of the yield curve control policy.

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- Whereas 2021 might appear to be an uneventful year from the perspective of the cash rate the introduction of the RBA's other policy tools raises a range of uncertainties about the policy mix. All of these uncertainties will have significant implications for markets; the yield curve; and ultimately the economy.

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