# ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 9TH JULY 2021

## Summary


- The RBA is in the process of gradually unwinding its 'unconventional' policies;
- Providing the economy remains strong they should be finished that process within 12-18 months;
- Financial markets are pricing the first rate hike for H2 2022;
- That looks early given what the RBA says it is trying to achieve;
- But the strength of the economy and supply constraints will see rates move sooner than what is currently suggested by the RBA (H1 2023).


The Australian economy has bounced back more sharply than anyone expected. Partly that has been a result of the (generally) good health outcomes. It has reflected the massive fiscal stimulus that the federal and all state governments are still pumping into the economy. The RBA has played its part.

Following the July meeting the RBA took its next (gradual) step in unwinding its 'unconventional' (QE, yield curve control, term funding facility) monetary policy support for the economy. We can expect further gradual unwinding of those unconventional measures providing the economy continues to power ahead (which is very likely). Those 'unconventional' programs are likely to finish in 12-18 months' time.

Only once the 'unconventional' programs are finished will interest rates be changed. Financial markets are speculating that the first rate hike could be as early as the second half of next year. That looks early given what inflation outcomes the RBA is saying it is trying to achieve. But my view on the timing of the first move (H1 2023) is earlier than the RBA's current view.

## Term Funding Facility – Gone but not forgotten

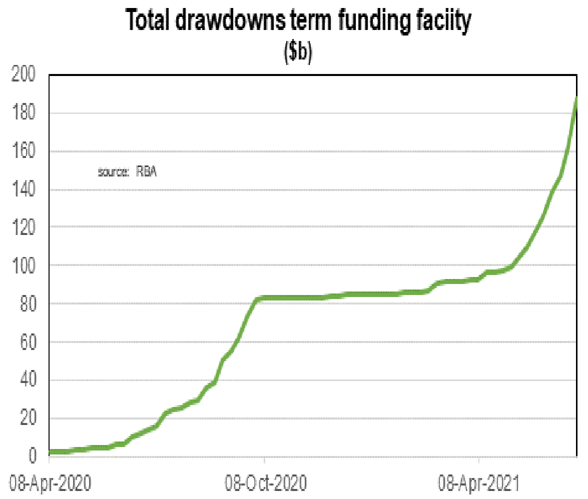
Since COVID in early 2020, the RBA has provided support to the economy in four ways. First, was the Term Funding Facility (TFF) (essentially the RBA providing cheap funding to banks for a term of 3 years). That program provided a number of benefits. It ensured that cheap funding was widely available. The reduction in banks borrowing from financial markets provided space for non-banks to borrow at cheaper rates. The RBA also structured the TFF to incentivise lending to SME's (who are typically more reliant on bank lending than large firms).

In May the RBA announced that the TFF would finish at the end of June. In a bit under two years' time banks will need to start replacing the funding borrowed from the RBA (banks first started borrowing from the RBA in the first half of 2020).

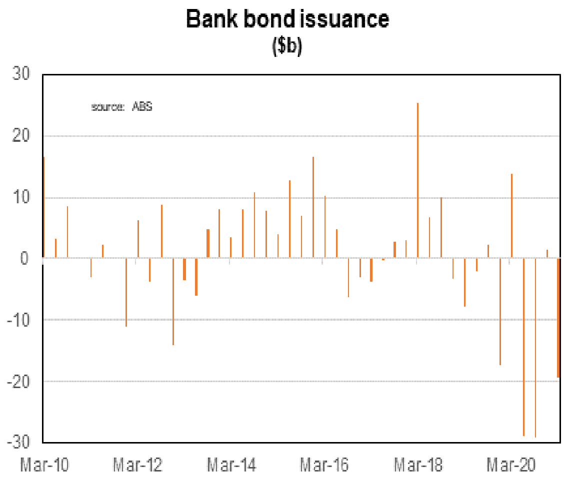
In time banks will need to meet new funding requirements from other financial market sources. How long that will be and how much they will need will depend upon the strength of bank deposit and credit growth. Last year deposit growth was very strong and credit growth was modest. But that has changed this year. Housing credit has growth started to pickup and finance approvals indicate that a further rise in growth is virtually certain over the next few months. Business credit growth is also (more gradually) increasing.

Deposit growth is slowing. The household saving ratio in the March quarter was a still high 11.6%. That ratio will fall in coming quarters although consumers' have not yet shown the intention to aggressively run down their 'saving mountain' built up last year. Business saving will also decline as firms partially fund their higher capex spending by running down their deposits.

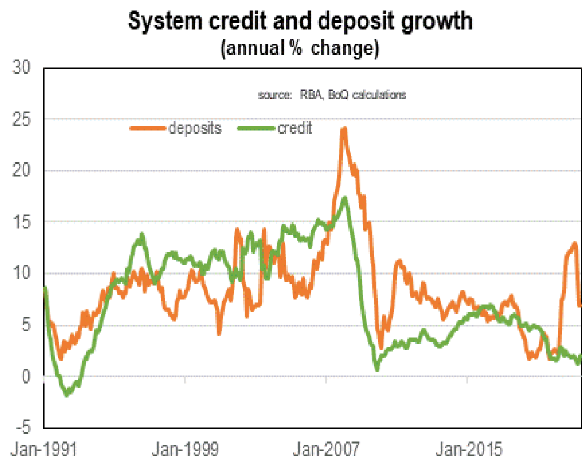
**Banks have made ample use of the TFF.**



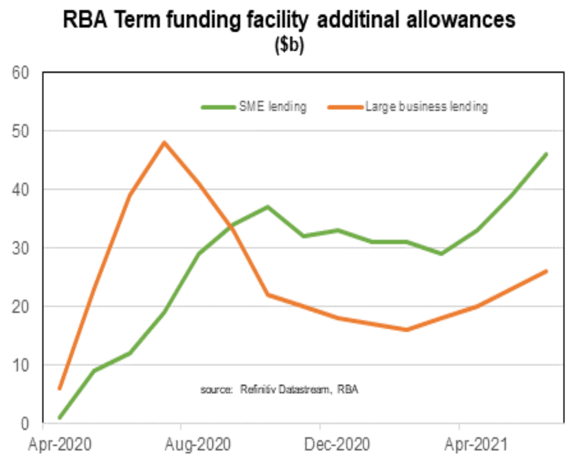

**This allowed them to reduce borrowing from financial markets.**




**Deposit growth was very strong last year, credit growth was modest.**




**The structure of the TFF incentivised lending to SME's.**




## Yield curve control – Setting the Market

A second policy the RBA has used to support the economy has been through yield curve control (YCC). This policy is when the RBA sets the price (yield) for more parts of the interest rate curve than just the cash rate. Central banks used to regularly do YCC in the days before financial market deregulation. The RBA has implemented YCC only at the short end of the yield curve (the Bank of Japan YCC policy is set for both 3- and 10-year interest rates).

The reason why the RBA implemented a YCC policy was to ensure interest rates would be low for short-dated borrowing (where most of the borrowing is done in Australia). Practically they aimed to keep 3-year government bond yields in line with the cash rate. The reason why Federal Government bond yields were chosen is that they are the benchmark for all other borrowing done in the financial system. The three-year part of the curve was initially chosen last year as it was the RBA's view that the cash rate would be unchanged 'for at least three years'.

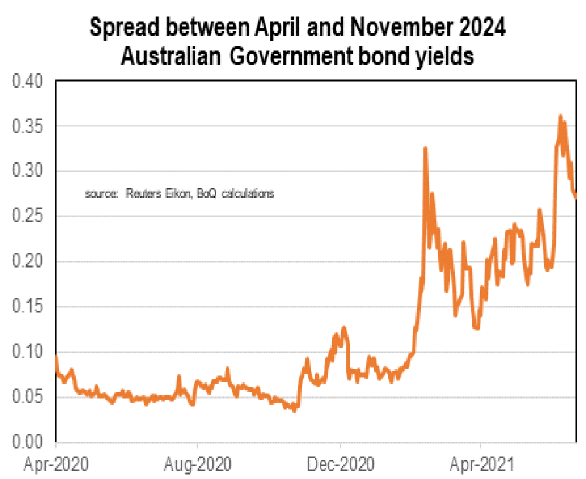
At their February 2021 meeting the RBA changed their view that the cash rate would be kept unchanged for 'at least three years' to highlighting a particular year (cash rates would not change until 2024 at the earliest). In my view the naming of an actual year was the first step of the RBA of unwinding the YCC policy (others' may disagree). But when that decision was take it was really only a small step as the first half of 2024 was at least three years away.

The decision taken at the July meeting though was a bigger step. The RBA indicated that it would not move the fixing of the yield curve any further from the first half of 2024. In effect they are allowing the YCC to gradually 'decay'.

The reason why the RBA changed its YCC policy was the strength of the domestic economy and the actions of global central banks. The Norwegian central bank is talking about raising their cash rate in the second half of this year. Financial markets are pricing in a higher cash rate in New Zealand next year. Some members on the Federal Reserve Board also think that their cash rate may need to rise sometime next year. All of this means it would have been hard for the RBA to justify saying the cash rate will remain unchanged any longer than the first half of 2024. Indeed, financial markets already think that the cash rate will need to rise well before early 2024.

If the economic momentum remains strong (as I expect) there is a good chance that next year the RBA will stop its YCC policy. By then the economy will be strong enough to not need the RBA setting any other interest rate other than the cash rate. And by then a cash rate increase is likely to be well and truly on the radar screen. The RBA would also be happy to stop YCC as they would prefer that interest rates other than the cash rate be set by demand and supply conditions in the financial markets.

**Financial markets had long expected the RBA not to extend their YCC policy at the July meeting.**




**The improvement in the economy has seen financial markets expected US rate hikes next year.**

## Quantitative Easing – the biggest balance sheet in town

A third policy the RBA implemented was the buying of longer bonds with an aim of driving down longer term interest rates (known as quantitative easing, or QE)[1]. The bonds that the RBA bought for QE reasons were federal and state government debt. Buying that debt helps drive down interest rates for other borrowers' as investors would have had to buy other bonds. RBA research indicated that for the bonds that they were targeting (5- to 10-years) yields were 0.3 percentage points lower than they would have been without QE (I agree).

Perhaps even more important has been the high likelihood that QE has helped dampen the exchange rate. Many 'fundamental' models suggest that the $A should currently be trading higher than 80c (higher commodity prices, current account surplus, strong economy). One reason it is not is likely QE.

The RBA began their QE program in November 2020 when they announced they would purchase $5b bonds each week, for a total purchase of $100b. In February this year the program was extended by another $100b, with the RBA still buying about $5b per week.

In their most recent announcement the RBA indicated that they would buy $4b per week from September (when the current program of $100b is due to end), but with no targeted total amount. The lack of a target provides the RBA with flexibility to either increase or reduce the total amount of purchases made. The RBA said that they will review the pace of their weekly purchases in November, taking into account a range of factors including what other central banks are doing (most notably the US) and how the international and domestic economy is performing (notably the inflation and wages growth). The RBA has indicated that it will stop QE before they change interest rates.

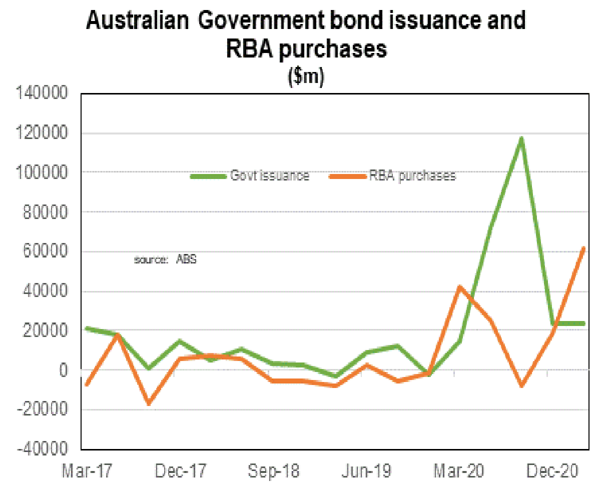
Given the strength of the economy I believe the RBA will gradually reduce its bond buying in a series of moves until it ends the QE program next year. Most likely that will mean that every three months it will reduce the pace of its weekly purchases by $1b (so in November it will announce its weekly purchases will fall from $4b to $3b).

The announcement at the July meeting was a bit of a surprise. While most analysts expected that no target amount would be announced, most thought that the weekly pace of $5b would be maintained. On the announcement of lower weekly purchases there was a modest rise in financial market interest rates. Some of the rise in interest rates was retraced when in subsequent statements the RBA Governor indicated that the first cash rate increase might be longer than current financial market thinking.

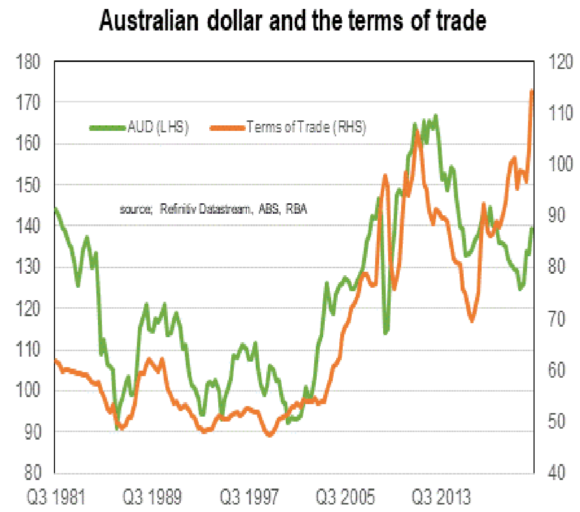
The RBA believes that over the next year it will own Government debt equivalent to 30-35% GDP. They think owning this amount of debt should continue to have a dampening impact on longer-term interest rates. But the RBA has also given a clear signal that it will be doing less buying. And that means that over time it will own a smaller proportion of Government bonds. And that means the impact of QE on interest rates will decline over time.

[1] The RBA also bought bonds to reduce financial market volatility and to support the YCC policy.

**In the March quarter the RBA actually bought more bonds than the Federal Government issued.**




**RBA bond buying has kept the AUD lower than would be suggested by its 'fundamental' factors.**




## Interest rate outlook

All of these 'unconventional' policies have reduced interest rates on financial markets and helped the economy. But the biggest driver of interest rates along the yield curve (and the AUD) is the outlook for the cash rate.

The RBA still thinks that it's economic and inflation forecasts means that it will not need to change the cash rate until 2024. But whereas before it thought that would not happen until 2024 'at the earliest' now they acknowledge not changing interest rates until 2024 is their 'central case scenario'. Given that the economy has surprised the RBA (and everyone) the clear risk is that the RBA will need to change the cash rate earlier.

As is their way financial markets have already moved to that view. They have priced the first move in H2 2022, with (at the time of writing) at least 5 moves by end 2024. In a recent Reuters survey only one economist expected a move in 2022, although the majority though at least one quarter percentage point cash rate rise likely in 2023.

To me current financial market pricing looks aggressive. The RBA has made it very clear that it has changed the triggers for how they determine interest rates (their 'reaction function' in the jargon). It is no longer an inflation forecasting framework but an actual inflation (and wages) outcome framework. And there must be certainty that inflation (and wages) will be hitting the RBA's targets (above 2% inflation, above 3% wages growth). In a question and answer session, the RBA Governor indicated that meant there would need to be several quarters where inflation needed to be above 2%. And that does not mean 2.1%.

As always the inflation outlook will depend the economic outlook. But as the RBA Governor acknowledged, also important is how long the supply problems currently hitting the economy last. One of the important supply problem is that many firms' are struggling to get good workers. The answer to that question will partially depend upon how long international borders remain closed. Another supply problem is the lack of suitable materials (such as computer chips to build cars).

Estimates vary between 9-18 months as to how long it will take the global supply chain to get back to full capacity.

Even with relatively optimistic assumptions, it is hard to see how inflation will sustainably be above 2% until at the second half of next year at the earliest. And then we will need to see several more quarters to confirm that inflation will remain there. This is the reason I think the first move is likely to be in the first half of 2023.

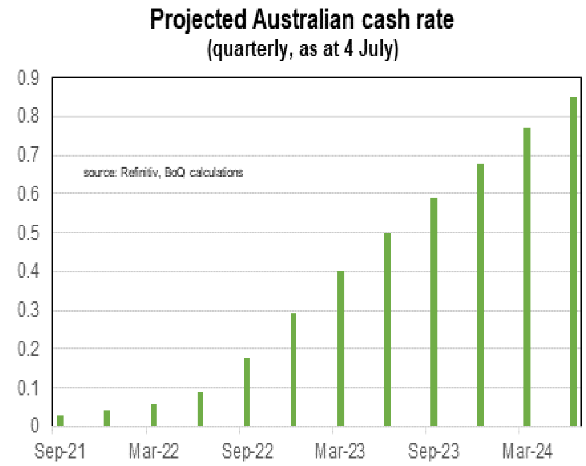
Once the first move happens the next obvious question to ask is how high interest rates may go. A number of financial market participants believe that the cash rate peak in this cycle will be a bit over 1%. This is based on the view that high levels of household debt would make it difficult to raise interest rates much further.

Maybe. But this thinking might be underestimating the RBA's desire to ensure that household disposable income growth is clearly stronger than it was in pre-COVID times. It is also underestimating their desire to ensure that inflation will sustainably higher than it averaged in the pre-COVID decade (around 2%). Fiscal policy has been used a lot more aggressively by Federal and State Governments' than it has in the past. And there are signs that global productivity growth is rising (which should be boosted further by strong capex spending).

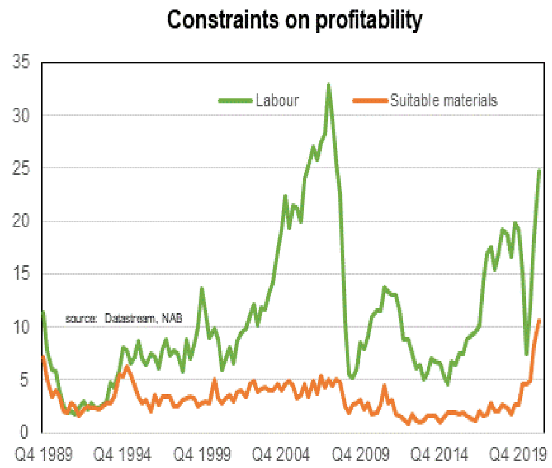
Financial markets are currently pricing a 2-2.25% peak in the cash rate. In the years pre-COVID the RBA thought that an 'average' cash rate would be 3-3.5%. In the long term the RBA figure may still be correct. But financial markets are unlikely to expect that the cash rate in Australia will hit 3% in a world where the cash rate is expected to be negative in Europe for at least the next five years. For now I think the answer is somewhere between financial market pricing and the RBA's previous thinking.

The other question is how quick the cash rate will rise once the RBA decides to start raising interest rates. The RBA has made it clear that it will not increase interest rates until they are confident that their inflation target will be hit. That means that actual inflation will need to be within its 2-3% target band before the first move. But that the means that one you decide to move the rate hike process might be quick. And certainly quicker than financial markets pricing of about half percentage point rate rise each year from late 2022.

**Financial markets are expecting the first rate hike next year.**

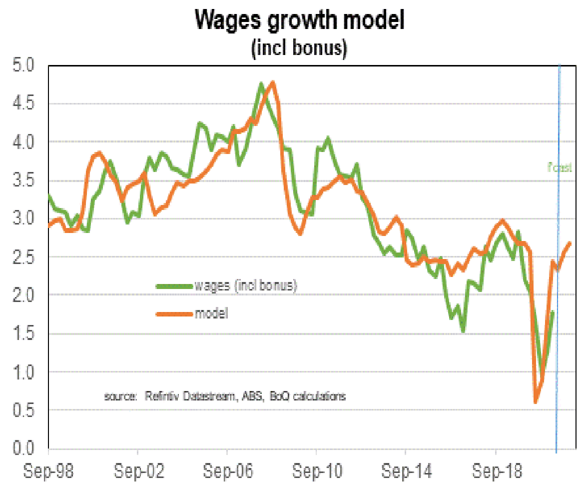



**A big part of the inflation puzzle is how long the supply shortages will last.**




**The unemployment rate will almost certainly decline further.**


**Strong demand and low worker supply is likely to lead to higher wages growth.**




We live in interesting times.

Regards,

**Peter Munckton**
**Chief Economist**
**Bank of Queensland**