July 6, 2021

Reserve Bank of Australia Adjusts Its Policy Kit

- **The Australian central bank extended its bond purchase program by two months, but pared down the amount of bond purchases.**
- **The central bank retained the April 2024 bond as the key bond for its yield targeting, and maintained the target at 0.10%. The benchmark interest rate was also left unchanged at 0.10%.**

At today's monetary policy meeting, the Reserve Bank of Australia (RBA) made three key decisions. First, it announced a two-month extension to its bond buying program after the current program concludes in September; however, the central bank tapered the bond purchase amount from AUD 5 billion a week to AUD 4 billion. Second, the RBA decided to retain the April 2024 government bond as the key bond for its yield targeting, instead of switching to the November 2024 maturity. Third, the central bank left the benchmark interest rate unchanged at 0.1% (chart 1). As the yield-target was also kept at 0.1%, the RBA signals that the policy rate will remain unchanged at the current level until early 2024.

We assess that the RBA's decision, which was in line with our expectation, is a balancing act between remaining committed to supportive monetary conditions and acknowledging stronger-than-expected economic recovery dynamics. The Australian economy has returned to pre-pandemic levels, both in terms of output and employment. The RBA expects the strong momentum to continue, which justifies a cautious adjustment to the ultra-accommodative monetary policy backdrop. At the same time, the recent surge in COVID-19 infections and slow vaccination progress in Australia highlight downside risks to the economic outlook, warranting a commitment by policymakers to maintain supportive monetary conditions in the near and medium-term. The added flexibility of the RBA's program—i.e. having the next review of the asset purchase program by mid-November—will allow the policymakers to respond to the evolving economic environment in a timely manner.

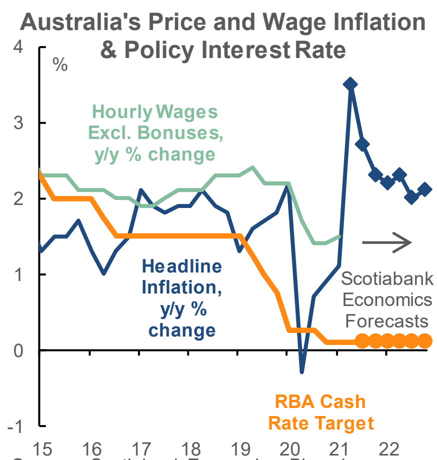
Governor Philip Lowe underlined the RBA's commitment to reaching full employment and inflation that is consistent with the 2–3% y/y target. Australia's labor market continues its strong recovery (chart 2). Spare capacity has decreased faster than expected; the jobless rate has dropped to pre-pandemic levels and employment gains have been broad-based across part-time and full-time categories. While some sectors are reporting labour shortages, wage inflation has yet to accelerate, keeping a lid on demand-driven price pressures. Nevertheless, closed international borders prevent access to the global labour pool, which is expected to put some upward pressure on wages over the coming months. Even so, Governor Lowe pointed out that the labour market ought to tighten further with wage gains reaching 3% y/y before inflation can sustainably remain within the RBA's target. The central bank does not expect the employment and inflation goals to be met before 2024.

We expect Australia's headline inflation to reach 3.5% y/y in Q2 on the back of year-ago base effects. While the pickup is forecast to be temporary, inflation will likely remain consistent with the 2–3% target through the foreseeable future as the economy's spare capacity diminishes. While we do not expect runaway inflation, we believe that the RBA is overly dovish in its assessment of Australia's inflation trajectory. Therefore, we highlight the risk of a shift in the RBA's tone over the coming quarters. Indeed, during today's press conference Governor Lowe stated that it is likely that the RBA will be revising its forecasts upward in the near future.

CONTACTS

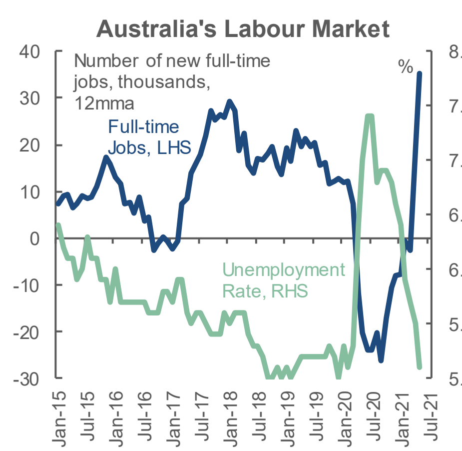
Tuuli McCully, Head of Asia-Pacific Economics
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.