RESERVE BANK OF AUSTRALIA

Speech

Today's Monetary Policy Decision

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Governor

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Good afternoon and welcome to today's briefing.

The Reserve Bank Board met this morning by videoconference. At that meeting, we agreed on policy measures that will provide ongoing and important support to the Australian economy as it continues its recovery. In particular we decided to:

- retain the April 2024 bond as the bond for the yield target and retain the target of 10 basis points
- continue purchasing government bonds after the completion of the current bond purchase program in early September. We will purchase $4 billion of bonds a week until at least mid November
- maintain the cash rate target at 10 basis points and the interest rate on Exchange Settlement balances of zero per cent.

The Reserve Bank Board is committed to achieving the goals of full employment and inflation consistent with the target. Our strategy is to do what we reasonably can with monetary policy to achieve low unemployment and a rate of inflation that is sustainably in the 2 to 3 per cent target range. Today's decisions, together with those we have taken previously, have us on a path to achieving those objectives.

Today's decisions are taken against the backdrop of an economy that has bounced back earlier and stronger than expected. The Australian economy is on a positive path. Output is now above its pre-pandemic level and more Australians have a job than they did before the pandemic. The unemployment rate has returned to its pre-pandemic level, underemployment has declined and job vacancies are at a high level. So we are in a much better position than we thought we would be in.

The recent outbreaks of the virus and lockdowns will affect the strength of the recovery in the near term. But Australia's experience has been that once an outbreak is contained and restrictions are eased, the economy bounces back quickly. Recent events have, however, reminded us again that it is difficult to predict the future. It is possible that we will experience further setbacks and we need to be prepared for this. But it is also possible that we experience further positive surprises for the economy; over most of this year we have had a run of better-than-expected data and this could continue.

On the nominal side of the economy, we have not seen the same upside surprises in wages and prices that we have experienced in jobs and output. Both aggregate wage growth and underlying inflation remain subdued and we expect this to remain the case for some time yet. One issue we are watching carefully, though, is how the balance of supply and demand in the labour market is being affected by the closure of our international borders. There have been increased reports of labour shortages in parts of the country and a step-up in wage increases for some occupations. Even so, wage increases for most Australians are still modest and the expected pick-up in overall wages growth is still forecast to be only gradual.

This is the background against which we made our decisions today. I would now like to turn to the specifics.

First **the yield target**.

The 3-year yield target was introduced in March last year during an exceptional period. It has served its purpose of lowering funding costs in Australia and reinforcing the Board's forward guidance about the cash rate. In my view, it has been a successful monetary policy measure.

At the time the target was introduced, the Board judged that the probability of the cash rate increasing over the subsequent 3 years – that was, until early 2023 – was extremely low. In March last year there were credible predictions that Australia's health system could be overwhelmed and it was difficult to envisage scenarios in which interest rates would increase before early 2023. The Board recognised that the pandemic was going to be a major drag on the economy and that the recovery would require an extended period of very low interest rates, especially given the already low rate of inflation. In these circumstances, the Board adopted a target for the yield on the 3-year government bond, which at the time had a maturity date of April 2023.

Now, 16 months on, the maturity date for the 3-year bond has moved to April 2024 and it will soon move to November 2024. The Board has once again considered the likelihood of an increase in the cash rate target over a 3-year window, which now extends out to November 2024.

The situation today is quite different from that in March last year; we are no longer looking over a cliff but instead transitioning from recovery to expansion. This improvement has widened the range of plausible scenarios for the cash rate. Our central scenario continues to be that the condition for an increase in the cash rate will not be met until 2024. But there are alternative plausible scenarios as well. This means that probabilities have shifted and the decision to adjust the approach to the yield target reflects this shift in probabilities.

In particular, the Board has decided to maintain the April 2024 bond as the target bond, rather than extend the horizon to the bond with a maturity date of November 2024. This means that, as time passes, the maturity of the yield target will naturally decline. The Board remains committed to the target of 10 basis points, which is the same rate as the target for the cash rate. As has been the case since the target was introduced, we stand ready to operate in the market to support the target if that is necessary.

I would now like to turn to the **bond purchase program**.

This program has lowered risk-free yields across the yield curve in Australia, thereby lowering funding costs for all borrowers. In turn, this has contributed to a lower exchange rate than otherwise, freed up cash flows for households and businesses, and strengthened balance sheets by supporting asset values. The bond purchases have also led to portfolio rebalancing by investors and this too has supported the prices of other assets. It is through these channels that our bond purchases have supported the economic recovery in Australia.

The second $100 billion tranche of purchases will be completed in early September. We will continue to purchase bonds after this date, providing ongoing support to the Australian economy. We will continue do so in the current 80/20 spilt between Australian Government Securities and the securities issued by the states and territories. These purchases will be at the rate of $4 billion a week, rather than the $5 billion a week under the current program.

The Board will next review the rate of purchases at its November meeting. Its decision to do so, rather than lock in this volume of purchases for a longer period, reflects the balance of 2 considerations.

The first is the benefit of being able to respond in a timely way to the flow of economic news. In a world characterised by a high degree of uncertainty, there is benefit from not being locked into a particular path for an extended period.

The second is that our guidance about future bond purchases helps with market pricing. The more information the market has about these purchases, the more efficiently they can be reflected in market prices.

The Board's judgement is that reviewing the situation in November strikes the right balance. It allows the possibility of a timely recalibration of the Bank's bond purchases in either direction. And it also provides as much guidance about future bond purchases as we reasonably can in an uncertain world. We are not locked into any particular path and bond purchases could be scaled up again if economic conditions warrant.

As I have discussed on previous occasions, the reviews of our bond purchases take into account: the effectiveness of the bond purchases to date; the decisions of other central banks; and, most importantly, progress towards our goals for inflation and employment. We will use this same framework in our future reviews.

We will continue buying bonds until there is further material progress towards the goals for full employment and inflation. We want to see clear evidence that the stronger economy is translating into a pick-up in aggregate wage growth and a lift in inflation towards the target. We will also be reviewing the ongoing rate of purchases in light of our forecasts for future progress towards our goals. So both the outcomes and the forecasts are important here.

Today's announcement reflects this decision-making framework.

We are still well short of our goals for full employment and inflation, and this means that a continuation of monetary support through bond purchases is appropriate.

At the same time, though, the economy is on a better path than we had earlier expected and the outlook has improved. We have responded to this improved situation by adjusting the weekly purchases from $5 billion to $4 billion.

The additional bond purchases that we announced today provide an ongoing important source of support to the Australian economy. I want to emphasise that the step-down from $5 billion to $4 billion does not represent a withdrawal of support by the RBA. The evidence is that central bank bond purchases have their impact through the total stock of bonds purchased, not the flow of those purchases. By mid November, our cumulative purchases under the bond purchase program will have amounted to $237 billion. We will hold a little more than 30 per cent of Australian government bonds on issue and 15 per cent of state and territory bonds. This represents a substantial and ongoing degree of support to the Australian economy. The adjustment in the rate of weekly purchases does not change this.

The final part of today's decision was to maintain the **cash rate target at 10 basis points** and the interest rate on exchange settlement balances at zero per cent.

The Board does not intend to increase the cash rate until inflation is sustainably within the 2 to 3 per cent range. It is not enough for inflation to be forecast in this range. We want to see results before we change interest rates. Any increase in the cash rate will take place after bond purchases have ended.

For inflation to be sustainably in the 2 to 3 per cent range, it is likely that wages growth will need to exceed 3 per cent. That is on the basis that labour productivity continues to increase and that the labour share of national income remains broadly steady. The current rate of wage growth is materially less than 3 per cent and we expect it will be a few years still before it increases back above 3 per cent. Further progress on reducing unemployment and underemployment will be needed to get there.

I want to make it clear that this focus on wages does not mean we have a target for wages growth or that wages growth necessarily has to have cleared a specific benchmark before we adjust interest rates. The condition for a lift in the cash rate relates to inflation, not wages. It is clear that inflation can increase for reasons unrelated to wages and there will be another example of this in the June quarter, when CPI inflation spikes to 3½ per cent. Yet even so, history teaches that sustained changes to the inflation rate are accompanied by sustained changes in growth in labour costs. So, over time, these 2 go together.

When the RBA staff last prepared a full set of forecasts in May, the central forecast was for growth in the Wage Price Index to pick up, but to do so only gradually. For inflation, the central forecast was for it to just reach 2 per cent by mid 2023. This is the basis of our guidance that we do not expect the cash rate to be increased until 2024 at the earliest.

I want to re-emphasise the point that the condition for an increase in the cash rate depends upon the data, not the date; it is based on inflation outcomes, not the calendar. The central scenario remains that the condition for a lift in the cash rate will not be met until 2024.

Let me conclude.

The Australian economy has bounced back earlier and stronger than expected. More Australians have jobs today than they did before the pandemic. This is good news. Even so, we are still well short of our goals of full employment and inflation consistent with the target. The RBA is committed to achieving these goals. Today's decisions maintain the supportive monetary conditions that are needed to do this.

Thank you for listening. I am happy to answer your questions.