Speech

Today's Monetary Policy Decision

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Good afternoon and thank you for joining this webinar.

The Reserve Bank Board met this morning. At our meeting we agreed to:

1. maintain the target for the cash rate at 10 basis points
2. continue to purchase government bonds at the rate of $4 billion per week until mid February 2022, with a further review to be undertaken then
3. discontinue the target for the yield on the April 2024 bond.

I would like to take this opportunity to explain these decisions – particularly the decision to discontinue the yield target – and to answer your questions.

I would like to start with some background and our updated forecasts.

The Australian economy is now growing again, after the recovery from the pandemic was interrupted by the Delta outbreak. GDP is expected to record a solid gain in the December quarter, following the sharp contraction in the September quarter. And by the middle of next year, GDP is expected to be back on its pre-Delta path. Our central scenario is for the economy to grow by around 5½ per cent over 2022 and by around 2½ per cent over 2023.

At the outset of the pandemic, economic policy, including monetary policy, set out to build a bridge to the other side. That other side is now clearly in sight. As restrictions are eased, spending is expected to pick up relatively quickly as people seek a return to a more normal way of life. The rapid increase in vaccination rates has been critical in getting us to this point. More broadly, the support provided by both monetary and fiscal policy means that the Australian economy is well placed to resume its expansion.

The resilience of the economy continues to be evident in the labour market. A strong bounce-back in hours worked is now under way, after a sharp fall during the lockdowns. The unemployment rate is expected to trend lower over the next couple of years. Our central scenario is for the unemployment rate to reach 4¼ per cent by the end of next year, and 4 per cent by the end of 2023. This would be a welcome development. Australia has not experienced a sustained period of unemployment at levels this low since the early 1970s.

Inflation, in underlying terms, remains low in Australia, at 2.1 per cent. Inflation is, however, a little higher than it has been over recent years. This increase largely reflects higher oil prices in global markets, higher prices for residential construction and strained global supply chains. Looking forward, we are expecting a further, but gradual, increase in underlying inflation. Our central forecast is for underlying inflation of 2¼ per cent in 2022 and 2½ per cent in 2023.

While these forecasts for inflation are higher than our previous forecasts, we are not expecting the surge in inflation that has been experienced in some other countries. The situation in Australia is different. We have not seen the same fall in labour force participation as experienced elsewhere, and the impact of other supply disruptions, including in energy markets, is less evident in our CPI.

It is also relevant that the starting points for inflation and wages growth are lower in Australia than in many other countries. In addition, our business liaison suggests that wage growth remains modest, although there are some hotspots. Wages growth is expected to pick up as the labour market tightens, but this pick-up is expected to be gradual.

So that is the economic backdrop against which today's decision was made.

I will now turn to the yield target.

The yield target was introduced in the exceptional days of March 2020. It was part of a package of monetary policy measures designed to help build that bridge that I spoke about before. That package has been effective and it is one of the reasons that the Australian economy is now well placed to recover from the pandemic.

The yield target had two motivations.

The first was to directly anchor the short end of the yield curve so that funding costs were low across the economy. In the exceptional circumstances of the time, we judged that the most efficient way of anchoring the curve was to target a risk-free yield further out along the curve than the cash rate.

The second motivation was to reinforce the Board's forward guidance that the cash rate was very unlikely to be increased for three years, which at the time ran until March 2023.

On both counts, the yield target has been effective and has supported the recovery of the Australian economy. But its effectiveness as a monetary policy tool declined as expectations about future interest rates shifted due to the run of data and the forecast progress towards our goals.

At the time the yield target was introduced, the Board assigned a very low probability to an increase in the cash rate over the three-year horizon of the target – which at the time aligned with the

maturity date of the April 2023 bond. Indeed, the central scenario was that the cash rate would need to be held steady beyond that date and the likelihood of an earlier increase in the cash rate was considered to be very low.

Today, more than a year and a half on, the balance of probabilities is a little different. Given our forecasts, it is still entirely plausible that the first increase in the cash rate will not be before the maturity of the current target bond – that is, the bond with a maturity date of April 2024. But it is now also plausible that a lift in the cash rate could be appropriate in 2023.

In our central scenario, underlying inflation reaches the midpoint of the 2 to 3 per cent range only in late 2023. Having underlying inflation reach the midpoint of the target range for the first time in seven years does not, by itself, warrant an increase in the cash rate. It is also relevant that wages growth at the end of 2023 is expected to be running at 3 per cent. While this is higher than it is now, it is still below the average over the two decades to 2015. This expected configuration of inflation and wages growth allows the Board to be patient in considering a lift in interest rates.

It is also possible that the global inflation shock is more persistent than currently expected and that this is transmitted to Australia. There is also uncertainty as to how wages growth responds to the unemployment rate being near 4 per cent for an extended period. We have little historical experience to guide us and there is also the question of the impact on labour supply of the opening of the international border. Given this, it is possible that faster-than-expected progress continues to be made towards achieving the inflation target. The recovery of the economy and the recent inflation data have increased the probability of this. If this faster progress were to be sustained, there would be a case to lift the cash rate before 2024.

It is, of course, also possible that we experience yet another setback that throws the economy off course and delays progress towards our goals. One source of such a shock would be a new strain of the virus or a decline in vaccine effectiveness. In this case, the cash rate would need to remain at its current level for longer than otherwise.

At its meeting this morning, the Board considered these various possibilities and their implications for the yield target.

One option discussed was to continue with the target on the basis that it remained consistent with our central forecasts for the economy.

A second option considered was to lift the target yield or change the maturity of the target bond. However, this would not have been consistent with the Board's view that the yield target was an appropriate tool during an exceptional period, but not one to be used on an ongoing basis.

The third option considered was to discontinue the target on the basis of the shift in the distribution of possible outcomes for the cash rate that I just spoke about.

The Board decided on this third option.

I want to make it clear that this decision does not reflect a view that the cash rate will be increased before 2024. As I have discussed, there is genuine uncertainty as to the timing of future adjustments

in the cash rate. Given the information we currently have to hand, it is still entirely possible that the cash rate will remain at its current level until 2024. But it is also possible that an earlier move will be appropriate. Given this, the Board judged that there were more costs than benefits in seeking to anchor the yield on the April 2024 bond at 10 basis points.

Given the progress towards our goals and the revised outlook, the Board judged that it was no longer sustainable to maintain the target of 10 basis points. The Board took into account the fact that the shift in the distribution of possible outcomes was being reflected in other term interest rates in Australia. If we had sought to pin the yield on the April 2024 bond at 10 basis points in the face of these developments, we would have ended up holding all the freely tradable bonds in the bond line, so that trading in that bond would cease. This would have further diminished the usefulness of the target.

I recognise that the past few days have been turbulent ones in the bond market. Our decision to stand out of the market in the days between the release of the CPI and the Board meeting did result in uncertainty as to our policy and affected market pricing and liquidity. We faced a difficult choice over those days: stand out of the market until the Board had an opportunity to review the latest data and forecasts in a matter of a few days; or enter a thin market in an effort to defend a target that was losing credibility for the reasons I have spoken about. I thought the better approach was for the Board to review the situation and decide whether or not to confirm or discontinue the target.

I would now like to turn to a broader point and that is the nature of the RBA's forward guidance. As I have stressed on previous occasions, our forward guidance is based on the state of the economy, not the calendar. Our focus has been on returning inflation sustainably to the 2 to 3 per cent range and doing what we reasonably can to reach full employment. These are our goals and it is progress on these fronts that will continue to determine decisions about the cash rate. These decisions are not driven by the calendar.

We have, though, supplemented this state-based guidance with a reference to our forecasts and the calendar. We have done this to provide the community with our expected time frame and the factors that will influence that time frame. This in no way has constituted a promise that the cash rate would remain unchanged to any particular date. Rather, at the time of each policy statement we provided our best expectation of the timing of when the cash rate might change, recognising that expected timing can change.

While on the issue of timing, the latest data and forecasts do not warrant an increase in the cash rate in 2022. I recognise that some other central banks are raising rates, but our situation is different. The Board will not increase the cash rate until inflation is sustainably in the target range. We are prepared to look through spikes in the inflation rate, as we have done with headline CPI inflation this year. For inflation to be sustainably in the target range, wages growth will have to be materially higher than it is now. This is likely to take time. The Board is prepared to be patient.

Finally, in terms of the bond purchase program, we will be including the April 2024 bond in our regular auctions from next week. We will also continue with the program at the current rate of purchases until February, when we will review it again. That review will be based on the same three

considerations as previous reviews: (i) the actions of other central banks; (ii) how our bond market is functioning; and (iii) most importantly, the actual and expected progress towards our goals for inflation and unemployment.

Thank you. I am here to answer your questions.

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