

RBA preview: Currency comments to drive reaction

From a rates perspective, there is little need for Australia's central bank to do anything on Tuesday. The only cause of concern may be the AUD and the Bank might want to walk back from its relaxed stance on currency's strength. A simple (RBNZ-style) acknowledgement that it is posing a threat to the recovery may be enough to trigger a mild negative AUD reaction



The RBA looks comfortable with its current stance

[This speech by Reserve Bank of Australia's Deputy Governor, Guy Debelle, from 30 June](#) makes for nice background reading and is a nice summary of all the measures the RBA has put in place during this pandemic, and how successful they have been.

Whether this is intended to convey a message ahead of this week's rate meeting on 7 July is less clear, but if it is, then the message is a fairly clear one - nothing needed now, and maybe not for some time.

The following extract from Debelle's concluding remarks captures the essence of the RBA meeting

this week:

"The cause of the decline this time is much different from those in the past. Many of the imbalances that exacerbated declines in previous downturns are not present this time. But it is still quite likely that this decline will have a long-lived impact that will require considerable policy support for quite some time to come. While much of that support is likely to be on the fiscal side, the Bank will maintain current policies to keep borrowing costs low and credit available, and stands ready to do more as circumstances warrant".

In other words, it's all good now, but it is possible that conditions change, and then anything goes.

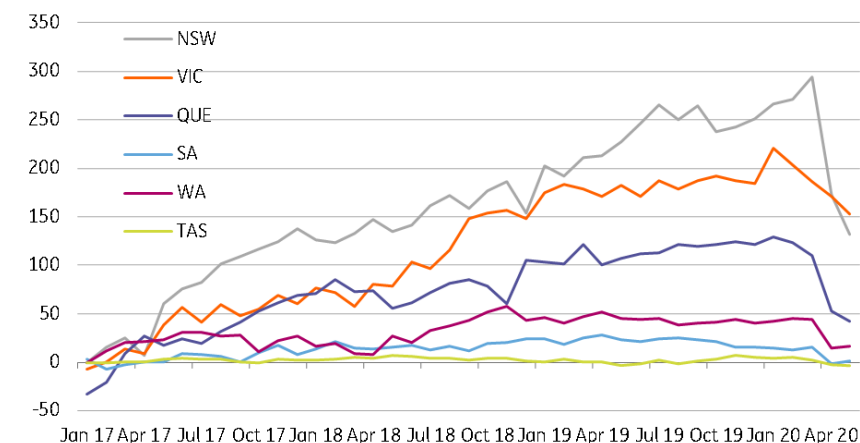
As the chart below shows, recent labour market figures show that the worst of the declines may have passed, and indeed in some states, employment began to creep tentatively higher again in May. More of this is likely in June everywhere except in Victoria, where restrictions remain in place.

The main concern for the central bank and the Australian government may be the strength of the Australian dollar, and it is possible that the upcoming rate meeting looks to talk up some of the possible downside risks to the economy and policy choices to keep the AUD from moving too much higher, though global market sentiment and appetite for the AUD and Australia's commodity exports could shortly turn for the worse if Covid-19 flare-ups in the US and elsewhere do not begin to turn back down again.

The Aussie dollar has been trading in the 0.68/0.70, following the stall in global market sentiment as indications of global recovery are being offset by second Covid-19 waves. As rightly pointed out by governor Lowe, there is no evidence that the AUD is overvalued - our in-house BEER estimates show an undervaluation of around 10%. However, the current global recessionary environment would surely warrant a much wider risk premium embedded into a quintessentially pro-cyclical currency such as AUD.

The role of a weaker AUD as a shock-absorber for the Australian economy is non-negligible, and the fact that neighbouring Reserve Bank of New Zealand is directly addressing a strong NZD as a hindrance to economic recovery is a case in point.

Cumulative employment growth - Australian states



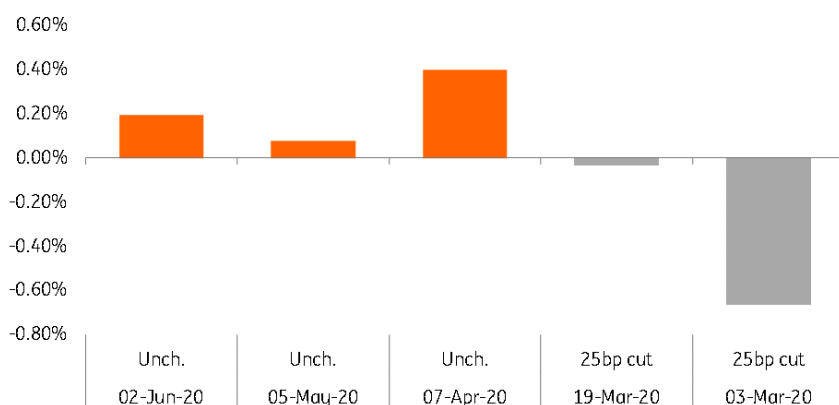
Source: CEIC

AUS state employment growth

AUD reaction function depends on any currency comment

AUD has not faced very high volatility around the latest RBA meeting. The chart below analyses the impact on AUD/USD of the latest five RBA rate announcements: the AUD posted gains (although very marginal in May) in past three meetings, when rates were kept unchanged.

Performance of AUD/USD one hour after the RBA rate announcement



Source: ING, Bloomberg

This time, markets are likely pricing in very little surprise potential - as discussed above, the RBA appears to be comfortable with its current policy measures.

We suspect that most of the AUD reaction will be driven by whether and how the RBA will address the currency situation as there is a chance that Governor Lowe may want to implicitly walk back from the message that the RBA is quite relaxed about the current AUD levels.

If no mention of the currency is made and (as widely expected) there is no change in the policy stance/rhetoric, we expect a balanced or mildly positive impact on AUD.

If the AUD strength is mentioned, we think this would probably look similar to what the

RBNZ did: acknowledging that currency strength poses an obstacle to the economic recovery, but not going as far as hinting at any measures to counter more appreciation. In this case, we expect a negative impact on AUD, although relatively limited in size, in line with the reaction after the last few meetings.

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