February 18, 2022

**Australian labor market withstands Omicron as policymakers gear for multi-decade low unemployment**

- **AUD:** Australia’s labor market performs marginally better than expected in January in spite of the spread of the Omicron variant through the population. The unemployment rate remains at a 13.5 year low of 4.2% and employment increases by 12.9k, exceeding the market’s flat consensus expectation. Instead, the brunt of the COVID impact is borne by hours worked, which fall by 8.8%, the largest decline since the initial pandemic wave in April 2020 and results in a rise in the underemployment rate from 6.9% to 7.0%. Following the employment report, the Australian Treasury joins the RBA in not seeking to potentially snuff-out the reduction in unemployment that could come from a premature rise in official interest rates by suggesting that the NAIRU (natural rate of unemployment) could be lower than historical estimates, which also aligns with the RBA’s view. The comments from the Federal Treasury Secretary yesterday and comments in the last few weeks from the RBA Governor show an alignment in the desire of policy makers to get the unemployment rate lower and test the boundary of NAIRU. With the Treasury Secretary on the Board of the RBA, Citi analysts warn against underestimating the resolve of Australia’s most senior monetary and fiscal policy bureaucrats in driving the unemployment rate sustainably lower before joining other AE central banks in tightening policy rates.

- **AUD:** Citi analysts also suggest that the desire for a structurally lower Australian unemployment rate is now an unofficial goal of policy. This is already something of a tenet of Governor Lowe’s stewardship of the RBA and that of some other senior RBA staff members. The Federal Treasury Secretary’s comments yesterday on wages, productivity and inflation also appear to favor policy makers testing the limits of how far lower the unemployment rate can go with respect to inflation and investors should not underestimate recent comments from the RBA Governor and Federal Treasury Secretary on this issue, even though they are at odds with market pricing for an earlier start to hiking the cash rate target.

- **AUD:** Following the positive surprises to the labor market across Q4 and now at the start of 2022, Citi analysts expect domestic demand to accelerate in 2022, which will likely see the unemployment rate decline further. Consequently, the team lower their Australian unemployment rate forecast to 3.7% by the end of 2022, and to 3.5% by the end of 2023, which is consistent with levels of full-employment. Moreover, the encouraged worker effect and the return of skilled migration will likely see the participation rate rise further to 66.7% by the end of 2022.
Revisiting the Bank of Japan outlook

- **JPY**: Citi analysts believe – (1) negative interest rates policy (NIRP- negative interest rate policy) and yield curve control (YCC) will stay in their current form for the remainder of BoJ Governor Kuroda’s term to April 2023, and (2) the new governor who takes over in April 2023 will likely give instructions for a second comprehensive assessment and, when the results appear that summer, the BoJ will likely abandon NIRP and shorten the YCC target to 5 from 10Yr JGBs. Speaking in December 2021, Governor Kuroda indicated that he wants to see Japanese wages rising around 3% to help achieve the 2% price stability goal and Japanese economic growth/labor productivity growth of just over 1%. However, a 3% wage hike looks extremely unlikely in the near future. If the BoJ waits for a clear step up in wage growth and related realization of 2% inflation, it would need to maintain its accommodative policy stance for longer than envisaged.

- **JPY**: But the next governor is unlikely to leave policy untouched — Will it be possible to maintain the status quo without making any changes to the current policy framework? Citi analysts don’t think so. Issues with current policy accommodation are likely already emerging in the form of – (1) impact on bank profits, (2) impact on Japanese pension and insurance finances from excessive flattening in the yield curve, and (3) reduced bond market liquidity and volatility. It would seem natural to address these issues with fresh faces. More authoritative forward guidance — given changes in policy, Citi analysts think forward guidance would probably be amplified at the same time of the next governor with a clear explanation that – (1) abandoning NIRP to enhance sustainability in monetary easing is entirely different from a rate hike to lift the policy rate into positive territory, and (2) a clear increase in inflation is required for a shift to a positive policy rate.

- **JPY**: Currently, the BoJ is paying 0.10% interest to financial institutions that have strengthened their business foundations under the Special Deposit Facility to Enhance the Resilience of the Regional Financial System, which was introduced in November 2020. The payments will basically be made through FY2023. Since the system will be terminated in FY2024, 2023-2024 would seem a good time for an NIRP rethink. With regard to YCC, the BoJ has long argued that short- and medium-term interest rates exercise the greatest influence on economic activity, and that impact lessens further out (September 2016 comprehensive assessment). This would imply that shortening the YCC target to a five-year tenor would likely be a natural step.

- **JPY**: In the coming months under Governor Kuroda’s leadership of the BoJ, Citi analysts also do not rule out the BoJ taking action to stave off yen depreciation, given a dollar surge that has sparked political concern over imported inflation. That said, BoJ comments make it unlikely that it would abandon NIRP, or reduce its YCC target, to stem yen weakness. In this scenario, the team assigns a comparatively high likelihood to extension of the 10Yr JGB yield band (perhaps to ±0.35% from the current ±0.25%) to guide interest rates higher.
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