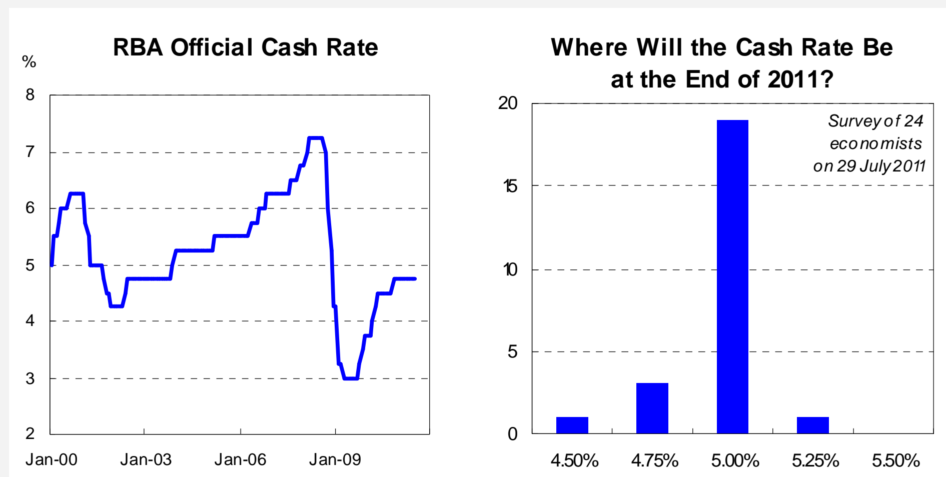
THE CASH RATE OUTLOOK

RBA Sits Pat

Tuesday, 2 August 2011

- The RBA left rates unchanged at 4.75%. Increased downside risks from the world economy, cautious households and the high exchange rate are balancing the income boost from the terms of trade and resources boom, allowing the RBA to sit pat.
- Uncertainty about how persistent the slower growth in the world economy will be appears to be a key pillar in today's RBA's decision.
- The RBA "remains concerned about the medium-term outlook" for inflation, suggesting that a tightening is not off the table. We expect that a tightening will only transpire this year if a re-acceleration of world growth occurs and households relinquish their shackles of caution.
- Our core view is that rates will stay steady for the remainder of this year because we think the downside risks around the world economy and consumer will be hard to shake in coming months.
- Attention now turns to Friday's Statement on Monetary Policy, which will contain updated forecasts. The RBA has again hinted at a downgrade of near term growth forecasts.



The Reserve Bank (RBA) left the cash rate unchanged at 4.75%, as widely expected. Rates have not changed since November last year.

The accompanying statement contained new information but the worries remained the same. One of the RBA's key worries that have likely contributed to it sitting on its hands today is the world economic outlook. While the world economy is still expanding, growth has slowed and the RBA is not clear "how persistent this slower growth will be". Our key trading partner, China, is not immune to the world slowdown, although the slowdown in China so far is characterised as "mild" by the RBA.

The multi-speed nature of the domestic economy remains intact; investment in the resources sector is "picking up strongly" but in other sectors "cautious behaviour by households and the high level of the exchange rate are having a noticeable dampening effect". The precautionary behaviour of households is keeping "some areas of demand weaker in the near term than earlier expected" by the RBA. This sentence from the RBA suggests that household consumption is perhaps softer than the RBA had previously thought.

In terms of overall growth as measured by GDP, growth this year is expected to be at about trend and be at trend or higher in the medium term. But the RBA continues to make these forecasts conditional on the world economy not deteriorating noticeably.

Further, the RBA has again hinted at a downgrade of its near term growth forecasts by flagging that a full recovery of flood-affected production now looks unlikely before early next year.

On inflation, the RBA "remains concerned about the medium-term outlook". That suggests that one cannot take off a tightening off the table within the next twelve months. Underlying inflation lifted in both the March quarter and June quarter by solid amounts of 0.9% on a quarterly basis. The annual underlying inflation rate for the June quarter moved to the top half of the RBA's 2-3% per annum target band and it looks set to have a '3' in front of it by the end of this year. A series of more benign quarterly outcomes could, however, see the underlying inflation rate fall back in the band for much of 2012.

We will get more guidance on Friday when the RBA's latest forecasts and detailed update on the economy is released within the Statement on Monetary Policy.

We expect that a tightening this year will only transpire if a re-acceleration of world growth occurs and households relinquish some of their caution. Our core view is that rates will stay steady for the remainder of this year because we think the risks around the world economy and consumer will be hard to shake this year. This is different from the median consensus view that rests with one rate hike before the end of this year (see chart on the front page).

The RBA notes that the exchange rate "is high" and is contributing to financial conditions being "tighter than normal". These tighter financial conditions are bearing down harder on the interest-rate sensitive sectors of the economy and on the non-mining trade-exposed sectors. The softness in these sectors is balancing the income boost from the high terms of trade and resources boom, allowing the RBA to sit pat. Last week, RBA Governor Stevens in a speech confronted the divergence between the resources boom and the cautious household. Stevens referred to the resources boom as the "biggest gift the global economy has handed Australia since the gold rush of the 1850s" but noted that households seem "for the moment, unhappy about that".

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