CASH RATE OUTLOOK

RBA Board Meeting: No Change……Yet

Tuesday, 3 April 2012

- **Our core view remains that one more easing will be required before a period of cash rate stability occurs. The RBA has reiterated its openness to an easing of policy if demand conditions weaken materially. The unemployment and inflation figures due later this month will be carefully watched. Job losses and soft inflation numbers could well tip the scales at the May meeting of the board.**

Key Points made by the RBA

- **Reserve Bank of Australia (RBA) held its cash rate at 4.25%.**
- **The RBA has acknowledged that the economy is softer than it expected.**
- **The Board considers it prudent to wait for the March quarter inflation figures before considering a further step to ease monetary policy.**
- **The RBA acknowledges the risk for financial shocks emanating from Europe but it does not believe that Europe is heading for a deep downturn.**

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At its meeting today, the board of the Reserve Bank of Australia decided to leave the cash rate unchanged at 4.25 per cent. Below is the Governor's statement interspersed with our views.

RBA Statement: Recent information is consistent with the expectation that the world economy will grow at a below-trend pace this year, but does not suggest that a deep downturn is occurring. Several countries in Europe will record very weak outcomes, but the US economy is continuing a moderate expansion. Growth in China has moderated, as was intended, and is likely to remain at a more measured and sustainable pace in the future. Conditions around other parts of Asia softened in 2011, partly due to natural disasters, but are not showing signs of further deterioration. Some moderation in inflation has allowed policymakers in the region to ease monetary policies somewhat. Commodity prices declined for a few months last year and are noticeably off their peaks, but have been relatively stable for a while now, at quite high levels. Australia's terms of trade have peaked, though they remain high.

Our view: The bailout of Greece helped avert financial market and real economy chaos. That said, severe budget cuts will still occur across the nations of Europe and this will put downward pressure on economic growth. Interest rates are already low in Europe and there is little or no room for fiscal stimulus. The US has seen good signs of growth but it too faces fiscal contraction. The US debt ceiling has been lifted but policy makers seem intent on making spending cuts. In China, growth continues but not at the pace of several years ago. Activity in China and its slow structural change continues to provide opportunities not only in mining but in the delivery of services. Below-trend global growth and a global easing cycle gives the RBA room to cut rates if need be.

RBA Statement: Financial market sentiment has generally continued to improve in recent weeks and capital markets are supplying funding to corporations and well-rated banks. At the margin, wholesale funding costs are tending to decline, though they remain higher, relative to benchmark rates, than in mid 2011. But the task of putting European banks and sovereigns onto a sound footing for the longer term remains large and Europe will remain a potential source of adverse shocks for some time yet.

Our view: Following the Greek bailout, the premium for risk in wholesale markets has declined. At the same time, other funding costs remain under strong competitive pressure. The statement does not name Spain, Italy or Portugal as possible sources of shock but each has created some angst in markets in recent weeks.

RBA Statement: In Australia, growth in domestic demand ran at its fastest for four years in 2011, driven by private spending. Nonetheless the balance of recent information suggests that output growth was somewhat below trend over the year. There are differences in performance between sectors, and considerable structural change is occurring. Labour market conditions softened during 2011, though the rate of unemployment has been little changed for some time.

Our view: It is interesting to note that the RBA describes recent economic growth as 'somewhat below trend'. How large do they believe 'somewhat' to be? Recent figures for retail sales, building approvals, job growth and credit growth have all been weak. Keeping markets and the RBA on its toes are the impacts on income and inflation of the resources boom. The RBA has long argued that the nation's income has risen and will rise as resource projects are built and come on line. This boost to income has the potential to be inflationary and is at the heart of the RBA's reluctance to ease.

RBA Statement: Interest rates for borrowers remain close to their medium-term average. Credit growth remains modest. Housing prices have shown some signs of stabilising recently, after having declined for most of 2011, but generally the housing market remains soft. The exchange rate has remained high over recent months, even though the terms of trade have declined somewhat.

Our view: The RBA has again pointed to the terms of trade. Its tone implies that the weaker terms of trade might normally lead to a weaker currency. While the AUD has fallen from US$1.08 to around US$1.04 this is still relatively high. Without a boost to commodity prices it will be difficult for the AUD to gain ground from here. If there is further strength in the US economy we may well see the AUD edge a little lower – but not breaking parity – unless global growth slows significantly from here.

RBA Statement: In underlying terms, inflation was around 2½ per cent in 2011. CPI inflation was higher than that but will fall over the next quarter or two. It is currently expected that inflation will be in the 2–3 per cent range over the coming one to two years. This forecast abstracts from the effects of the carbon price and also embodies an assumption that productivity growth in the economy increases somewhat as a result of the structural change now occurring. At its next meeting, the Board will have the opportunity to reassess the outlook for inflation, taking into account not only data on demand and output but also forthcoming information on prices.

Our view: Future inflation remains the primary focus of the RBA. It has returned to centre stage now that European issues have subsided. Only if they believe that inflation will fall below their target zone will they be inclined to ease. Job losses, rising unemployment and soft retail spending will be the signals. The statement has highlighted the importance of the next set of inflation numbers.

RBA Statement: The Board eased monetary policy late in 2011. Since then, its judgement has been that, with growth expected to be close to trend, inflation close to target and lending rates close to average, the setting of monetary policy was appropriate. The Board's view was also that, were demand conditions to weaken materially, the inflation outlook would provide scope for easier monetary policy. At today's meeting, the Board judged the pace of output growth to be somewhat lower than earlier estimated, but also thought it prudent to see forthcoming key data on prices to reassess its outlook for inflation, before considering a further step to ease monetary policy.

Our view: The RBA acknowledges that the economy is weaker than it was expecting. The next inflation figure will be released on April 24^{th}. A reading of 0.7% or below would give the RBA comfort that inflation is well contained. Before that, we will see new unemployment figures where job losses of 15-20000 would highlight the weakness of the labour market. The scene may well be set for a rate cut in May – a position we have held for several months.

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