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Minutes of the August RBA Board Meeting

The Optimism of Uncertainty

- **The minutes from the last Reserve Bank (RBA) Board meeting on August 1 contained no jack-in-the-box moments. Since the last meeting, the Statement on Monetary Policy has been released and the RBA Governor has given testimony to the House of Representatives. Both have provided us with a strong guide as to what to expect from today's minutes.**
- **RBA Governor Lowe on Friday suggested that market expectations that the next move in the cash rate is up seems "reasonable". Nothing in today's minutes altered this tone.**
- **However, there are a number of uncertainties and worries for the RBA. High on the RBA's worry list now is the value of the exchange rate. The RBA's forecasts for output growth and inflation remain reliant on the assumption of no change in the Australian dollar exchange rate. The appreciation of the local currency then means there is greater variability around achieving these forecasts.**
- **Sliding down the RBA's worry list is the labour market. The RBA seemed more positive about the outlook for the labour market and dropped the labour market as an area warranting careful monitoring.**
- **Not budging from the worry list was the housing market. The RBA notes in the minutes that there are signs that conditions in Sydney and Melbourne housing markets had "eased somewhat", but that housing price growth in these two cities "had remained relatively strong".**
- **On the global economy, the RBA appears upbeat on the outlook, by noting economic conditions had "strengthened" and the improvement in the global economy had "broadened beyond international trade".**
- **In our view, the areas deserving close watching by the RBA – the exchange rate, wages growth, housing market and household balance sheets – leave us reluctant to change our long-held view that the RBA will keep the cash rate steady into 2018.**
- **While the RBA is likely to keep the cash rate steady, Australian bond and swap rates are still likely to grind higher over this time period, as higher US bond and swap rates drag our rates higher.**

The minutes from the last Reserve Bank (RBA) Board meeting on August 1 contained no jack-in-the-box moments. Since the last meeting, the Statement on Monetary Policy has been released and the RBA Governor has given testimony to the House of Representatives. Both have provided us with a strong guide as to what to expect from today's minutes.

One of the ongoing developments since the last meeting has been the short odds attached to a rate hike in the coming year by financial markets. Indeed, the RBA Governor himself on Friday acknowledged that the "current market pricing implies a greater probability of a rate rise than a rate reduction" and that he thinks "they are reasonable assumptions", which he "doesn't want to dissuade". The tone of today's minutes seems consistent with this recent rhetoric from the RBA, despite the uncertainties plaguing the RBA.

Output growth is expected by the RBA to reach around 3% in year-ended terms during 2018 and 2019, which was modestly higher than estimates of potential growth. Underlying inflation was expected to be close to 2% in the second half of this year and to edge higher over the subsequent two years.

High on the RBA's worry list now is the value of the exchange rate. This concern is not surprising when we consider the Australian dollar has risen nearly 4% in trade-weighted terms and by 9% against the US dollar since the end of last year. The RBA in these minutes notes that its forecasts for output growth and inflation were largely unchanged from three months earlier. However, the RBA notes that these forecasts were "conditioned on the assumption of no change in the Australian dollar exchange rate during the forecast period". The RBA highlights that this assumption is a "source of uncertainty". The appreciation in exchange rate acts to dampen economic growth and inflationary pressures. We expect the Australian dollar has limited room to fall, so the RBA is likely to retain its concerns over the exchange rate.

The outlook for domestic economic growth also relies on a pick up later in the forecast period in investment spending by non-mining businesses. This has been a missing ingredient for some time in the economic growth story. The RBA notes that "businesses had continued to report above-average conditions and many members noted that many of the conditions that might typically be associated with stronger growth in investment were in place".

Sliding down the RBA's worry list is the labour market. The RBA seemed more positive about the outlook for the labour market. In these minutes, the housing market and household balance sheets were determined as areas "warranting careful monitoring". The labour market no longer received a monitoring mention, as it did in the July board meeting minutes.

The RBA expects further employment growth and the degree of spare capacity in the labour market to decline gradually. The RBA, however, remains uncertain about the effect any decline in spare capacity in the labour market would have on wage inflation. Wages and price inflation has not increased as much as expected in other economies around the world that are already close to full employment. The RBA says that this then raises the possibility that low inflation in Australia might persist longer than forecast. Tomorrow's update on wages will be closely watched as a result.

It is no surprise the housing market remains high on the "careful monitoring" list. The RBA notes in the minutes that there are signs that conditions in Sydney and Melbourne housing markets had "eased somewhat", but that housing price growth in these two cities "had remained relatively strong". According to the latest CoreLogic data for house prices, Sydney and Melbourne dwelling prices grew by 12.4% and 15.4% in July, respectively, and accelerated from the annual rate of growth in June.

On the global economy, the RBA appears upbeat on the outlook, by noting economic conditions had "strengthened" and the improvement in the global economy had "broadened beyond international trade". In discussing global growth, the RBA highlighted that it remained "unclear how [Chinese] authorities would negotiate the difficult trade-off between growth and the build-up of leverage in the Chinese economy".

In our view, the areas deserving close watching by the RBA – the exchange rate, wages growth, housing market and household balance sheets – leave us reluctant to change our long-held view that the RBA will keep the cash rate steady into 2018. While the RBA is likely to keep the cash rate steady, bond and swap rates are still likely to grind higher over this time period, as higher US bond and swap rates drag our rates higher.

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