Floods will have no impact on interest rates

Reserve Bank Board meeting

- **The Reserve Bank Board has left the cash rate at 4.75 per cent at its first meeting for 2011. The next meeting is on March 1 2011.**
- **The Reserve Bank Board provided a relatively long accompanying statement, paying particular attention to the floods. In short, the RBA says that the floods won't impact interest rate settings: *"The focus of monetary policy will remain on medium-term prospects for economic activity and inflation."***

What does it all mean?

- The Reserve Bank has reassured borrowers that it will look through the impact of the floods on activity and prices. In short the floods have no immediate implications for interest rate settings. And in light of that commitment, the Reserve Bank has returned to wait and see mode – content to monitor developments month after month.
- The Reserve Bank can afford to stay on the interest rate sidelines for a few months. Key sectors of the economy are going backwards, like manufacturing, services and construction. Inflation is lower than the Reserve Bank had previously expected and the outlook is mixed. Retailers are still slashing prices, the higher Aussie dollar is pushing down prices of imported goods but the floods will lead to higher fruit and vegetable prices.
- The high terms of trade, or injection of income into Australia, has been at the forefront of Reserve Bank concerns. But the current softness of the economy shows why those concerns have been overdone. If all cylinders were firing together, then there would be solid grounds for concern. But sectors like home building and consumer spending have significant multiplier effects, meaning that weak activity can quickly trump any strength in mining or engineering.
- Economists are still firmly of the belief that rates are going higher over 2011. But financial markets have different ideas. The overnight indexed swap rate is pricing in the small chance of a rate cut in the next two months while a 25 basis point rate hike is not fully factored in to market pricing over 2011.
- We think that investors should still be working on the assumption that rates will be higher at the end of the year. In the second half of the year we expect that Queensland rebuilding work will be fully underway. At the same time the domestic job market will be tightening, consumers will start spending again while the global economy will be motoring at a near 4.5 per cent annual rate. So the cash rate may be closer to 5.50 per cent at year end rather than the current rate of 4.75 per cent.
- In terms of the floods, the RBA notes: *"In setting monetary policy the Bank will, as on past occasions where natural disasters have occurred, look through the estimated effects of these short-term events on activity and prices."* And further: *"The Bank's preliminary assessment is that the net additional demand from rebuilding is unlikely to have a major impact on the medium-term outlook for inflation."*

Interest rate decision and past cycles

- The Reserve Bank Board has left the cash rate at 4.75 per cent. In October 2009 the cash rate stood at a 49-year low of 3.00 per cent. But then the RBA embarked on a process to remove the emergency stimulus, lifting the cash rate by a quarter of a percent in October, November and December 2009, and then in March, April, and May 2010 and following it up with a move in November.
- In the last rate-cutting cycle the cash rate fell to a low of 4.25 percent in December 2001. In the two previous rate-cutting cycles, the cash rate fell to lows of 4.75 per cent.
- In response to funding pressures, banks have been forced to lift rates above the cash rate over the last year. As a result, the Reserve Bank now looks more closely at the variable housing rate to gauge how close rates are to

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"normal". Currently the average bank variable housing rate stands at 7.80 per cent, well above the long-term average or "normal" rate of 7.15 per cent.

- The Reserve Bank remains relaxed and comfortable, believing that employment growth will slow over coming months and that inflation will remain under control.

Comparing the two most recent statements

- The statement from the December meeting is on the left; the statement from today's February 2011 meeting is on the right. Emphasis has been added to significant changes in wording in the recent statement.

MEDIA RELEASE

No: 2010-30
Date: 7 December 2010
Embargo: For Immediate Release

**STATEMENT BY GLENN STEVENS, GOVERNOR
MONETARY POLICY**

At its meeting today, the Board decided to leave the cash rate unchanged at 4.75 per cent.

Since the previous Board meeting, concerns about the creditworthiness of a number of European governments have again become the main focus of financial markets, with a marked rise in sovereign bond spreads for some euro-area countries and an increase in volatility. At the same time, recent data suggest that the Chinese and Indian economies have continued to grow strongly and price pressures, particularly for food, have picked up in China as well as a number of other economies in Asia. Modest growth is continuing in the United States.

For Australia, the terms of trade are at their highest level since the early 1950s, and national income is growing strongly as a result. Recent information indicates that, as had been expected, **private investment is beginning to pick up** in response to high levels of commodity prices. In the household sector thus far**, there continues to be a degree of caution in spending and borrowing, which has led to a noticeable increase in the saving rate**. Asset values have generally been little changed over recent months and overall credit growth remains quite subdued, notwithstanding evidence of some greater willingness to lend.

Employment growth has been very strong over the past year, though some leading indicators **suggest a more moderate pace of expansion in the period ahead**. After the significant decline last year, growth in wages has picked up somewhat, as had been expected. Some further increase is likely over the coming year.

The exchange rate has risen significantly this year, reflecting the high level of commodity prices and the respective outlooks for monetary policy in Australia and the major countries. This will assist, at the margin, in containing pressure on inflation over the period ahead. **Over the next few quarters, inflation is expected to be little changed,** though it is likely to increase somewhat over the medium term if the economy grows as expected.

Following the Board's decision last month to lift the cash rate, and the subsequent increases by financial institutions, lending rates in the economy are now a little above average. The Board views this setting of monetary policy as appropriate for the economic outlook.

MEDIA RELEASE

No: 2011-01
Date: 1 February 2011
Embargo: For Immediate Release

**STATEMENT BY GLENN STEVENS, GOVERNOR
MONETARY POLICY**

At its meeting today, the Board decided to leave the cash rate unchanged at 4.75 per cent.

Global output grew strongly in 2010, notwithstanding the relatively subdued performance of several of the major economies. The Chinese and Indian economies in particular have recorded very strong expansions, and price pressures, particularly for food and raw materials, have picked up. Concerns about sovereign creditworthiness in Europe have remained prominent and uncertainty from this source seems likely to persist for some time. Overall, however, the global economy continues to look strong going into 2011. Commodity prices have remained high and in many instances have risen further over recent months.

Australia's terms of trade are at their highest level since the early 1950s and national income is growing strongly. There have been further indications that private investment is beginning to pick up in response to high levels of commodity prices. In the household sector thus far, in contrast, **there continues to be caution in spending and borrowing, and an increase in the saving rate.** Asset values have generally been little changed over recent months and overall credit growth remains quite subdued, notwithstanding evidence of some greater willingness to lend.

Employment growth was unusually strong in 2010. Most leading indicators suggest further growth, though most likely at a slower pace. After the significant decline in 2009, growth in wages picked up somewhat last year. Some further increase is likely over the coming year.

Inflation is consistent with the medium-term objective of monetary policy, having declined significantly from its peak in 2008. Recent data show underlying inflation at around 2¼ per cent in 2010. The CPI rose by about 2¾ per cent, reflecting the once-off effect of the increase in tobacco excise. These moderate outcomes are being assisted by the high level of the exchange rate, the earlier decline in wages growth and strong competition in some key markets, which have worked to offset large rises in utilities prices. **The Bank expects that inflation over the year ahead will continue to be consistent with the 2–3 per cent target.**

The flooding in Queensland and Victoria is having a temporary adverse effect on economic activity and prices. Some production of crops and resources has been lost and some other forms of economic output have also been lower in the affected areas.

Prices for the relevant commodities have risen and are likely to remain elevated in the near term. Resumption of production is occurring at differing speeds by region and industry. **In setting monetary policy the Bank will, as on past occasions where natural disasters have occurred, look through the estimated effects of these short-term events on activity and prices. The focus of monetary policy will remain on medium-term prospects for economic activity and inflation.**

The floods also resulted in damage or destruction to physical capital in the affected regions. Over the next year or two, the efforts to repair or replace infrastructure and housing will add modestly to aggregate demand, compared with what would otherwise likely have occurred. The extent of this net additional effect will depend on the full extent of the damage, the speed of the rebuilding, and the extent to which other public and private spending is deferred. **The Bank's preliminary assessment is that the net additional demand from rebuilding is unlikely to have a major impact on the medium-term outlook for inflation.**

The Bank will of course continue to assess the effects of the floods and the subsequent recovery, along with all the other factors having a bearing on economic conditions. At today's meeting, the Board judged that the current stance of monetary policy remained appropriate in view of the general macroeconomic outlook.

What are the implications of today's decision?

- There would have been more chance of snow falling in Sydney today than the Reserve Bank moving interest rates in any direction. Simply, the Reserve Bank has no pressing need to change rate settings. The economy is not sufficiently soft as to require a cut in interest rates – no doubt the Reserve Bank quietly believes that current softness is temporary. It will require a few more months of weak data for the Reserve Bank to change its focus away from the terms of trade. But with the domestic economy stagnating and inflation under control, there is clearly no need for higher rates – a pre-emptive move or otherwise.
- Some economists have speculated that the floods would have a major impact on economic activity with the cost anywhere from $13-30 billion. That hasn't been our view, and it's not the view of the Reserve Bank. There are modest negative short-term effects on the economy and there is a modest longer-term positive impact from the rebuilding. But overall the Reserve Bank doesn't believe that the floods are a game-changer for interest rates.
- A period of interest rate stability should boost consumer and business confidence levels and eventually get people to start spending again. It has been the constant uncertainty about interest rates, the global economy, domestic politics and the weather that have caused people to effectively sit of their hands.
- Most people will probably tell you that their finances are in reasonable shape, but they just don't want to do anything new at present, whether it is making a major purchase or investment.
- The decision to leave rates unchanged is clearly positive for retailers and other consumer-facing businesses.

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