RBA: Start of an extended rate pause?

Reserve Bank Board meeting

- **The Reserve Bank Board has left the cash rate at 4.75 per cent at its second meeting for 2011. The next meeting is on April 5 2011.**
- **The Reserve Bank Board provided a relatively short accompanying statement. The statement suggested that the Reserve Bank remains comfortable with how labour market conditions are evolving at present – noting that "*reports of skills shortages remain confined, at this point, to the resources and related sectors. After the significant decline in 2009, growth in wages has returned to rates seen prior to the downturn.*"**

What does it all mean?

- Given the amount of commentary we have received from the Reserve Bank over the past couple of weeks it is no surprise interest rates have been left on hold, and the accompanying statement is relatively short. Since the last rate decision we have had no less than two Reserve Bank speeches, the release of the last board minutes, plus the latest monetary policy statement and the Reserve Bank Governors testimony to the House of Representatives Standing Committee on Economics. So it is hardly surprising that the central bank is pretty much talked out.
- Clearly the Reserve Bank is in wait and see mode. As the Governor alluded to in his testimony to parliament, the central bank is ahead of the game (on the rate front) and as such can afford to wait and monitor developments in coming months. The Reserve Bank is certainly showing no tendency to act on interest rates. The $64 question is how long will they remain on the sidelines.
- From the Reserve Bank's perspective the economy is certainly throwing up some conflicting thematics. Key sectors of the economy remain weak, consumer spending remains sluggish but on the other side of the equation the high terms of trade, or injection of income into Australia, has been at the forefront of Reserve Bank concerns. The terms of trade boost continues to gain traction and remains well ahead of Reserve Bank forecasts. Added to which last week's CAPEX data suggests that businesses are banking on a second half recovery with future investment plans being ramped up.
- The Reserve Bank has once again reassured borrowers that it will look through the impact of the floods on activity and prices. And while growth is expected to be subdued in the near term, the rebuilding phase in the second half of the year will ensure a robust turnaround in activity levels. 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 the Queensland rebuilding work to 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.

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 can afford to stay on the interest rate sidelines for a few months. Key sectors of the economy are going backwards, like 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.

Comparing the two most recent statements

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

MEDIA RELEASE

No: 2011-01
Date: 1 February 2011
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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.

MEDIA RELEASE

No: 2011-03
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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.

The global economy is continuing its expansion, led by very strong growth in the Asian region. Commodity prices have risen further over recent months, pushing up measures of consumer price inflation in many countries. A number of countries have been moving to tighten their monetary policy settings. Overall, though, financial conditions for the global economy remain accommodative.

Australia's terms of trade are at their highest level since the early 1950s and national income is growing strongly. Private investment is picking up, mainly in the resources sector, 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 a higher rate of saving out of current income. The effects of the natural disasters over the summer have reduced output, but production levels should recover over the months ahead, and there will be a mild boost to demand from the rebuilding efforts as they get under way

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. Business balance sheets generally are being strengthened, and the run-up in household leverage has abated.

The labour market firmed in 2010, with unusually strong growth in employment and a decline in the rate of unemployment. Most leading indicators suggest further growth in employment, though most likely at a slower pace. Reports of skills shortages remain confined, at this point, to the resources and related sectors. After the significant decline in 2009, growth in wages has returned to rates seen prior to the downturn

Inflation is consistent with the medium-term objective of monetary policy, having declined significantly from its peak in 2008. **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**. Production losses due to weather are temporarily raising prices for some agricultural produce, but these should fall back later in the year. **Overall, looking through these temporary effects, the Bank expects that inflation over the year ahead will continue to be consistent with the 2–3 per cent target.**

At today's meeting, the Board judged that the current mildly restrictive stance of monetary policy remained appropriate in view of the general macroeconomic outlook.

What are the implications of today's decision?

- The Reserve Bank is clearly in 'wait-and-see' mode on interest rates. A sustained period of interest rate stability should boost consumer and business confidence levels and eventually get people to start spending again. This is clearly great news for all concerned, allowing Aussies to get on with life.
- Even though rates are on hold, the threat of higher rates in the later part of 2011 together with lofty utility charges and higher petrol prices will ensure that consumer conservatism continues well into the second half of the year. Simply, if you factor in higher rates over the next year then you have the best chance of maintaining your current lifestyle without major disruption.
- 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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