

RBA Board Meeting, July 2010: Central bank extends policy pause.

- As expected, the RBA Board decided to leave the cash rate steady at 4½%.
- RBA notes that current policy settings leave interest rates to borrowers at their average levels of the past decade.
- The general tone of RBA commentary suggests that the RBA is a little more concerned about the external environment than a few months ago, remains positive about the local growth outlook, but is wary of upside inflation risks.
- The RBA sees underlying inflation in the upper half of the target zone over the next year, and the rate of CPI increase at a little above 3 per cent in the near term. This suggests to us that policy will ultimately be pushed into restrictive territory on inflation risks as the economy picks up steam, the labour market tightens further and spare capacity in the economy dissipates.
- Hence, we are happy to hold with our call of a 5% cash rate by the end of 2010, and a move towards 6% in 2011.

Summary

Since October 2009, the RBA has moved very quickly to remove the emergency component of interest-rate settings as it became clear that Australia had side-stepped recession. The cash rate was taken from 3% to 4% during this stage. Since then, the central bank edged up rates to 4½% by May. This policy rate of 4½% is seen by the RBA as being back to “normal” or average levels for an economy that has “normalised” again. After today’s decision, the RBA expects that “rates for most borrowers will be around their average levels of the past decade”.

The general tone of today’s RBA commentary, however, is consistent with the idea that ultimately local monetary policy settings will be pushed into restrictive territory. We suspect that the issue for policy makers now is the upside inflation risks for 2011, rather than downside risks to local growth. Indeed, the RBA says that its now expects, “underlying inflation to be in the upper half of the target zone over the next year, and the rate of CPI increase to be a little above 3 per cent in the near term, due to the effects of increases in tobacco taxes announced earlier in the year and significant increases in prices for utilities”.

The RBA commentary remains positive about the domestic growth outlook. The Board sees the high level of the terms of trade boosting incomes and demand, and therefore even though the effects of earlier expansionary policy measures will be fading, Australia’s output growth over the year ahead is likely to be about trend (ie 3¼%).

The central bank sees “consumption spending is recording a modest increase at present, with households displaying a degree of caution, but most indicators suggest business investment will increase over the coming year”. It also notes that “credit outstanding for housing has continued to expand at a solid pace, but dwelling prices are rising more slowly than earlier in the year”. The RBA also believes that the labour market has continued to firm gradually, and after the significant decline last year, growth in wages has picked up a little, as expected.

So how long will the current policy pause last?

The fundamental issue for the RBA in terms of the policy outlook derives from the renewed commodity boom. That boom is set to inject a sizeable amount of income into an economy already running close to full capacity. The resultant tension between income, spending and production is where the inflation risks lie. As mentioned above, the RBA notes that “inflation now appears likely to be in the upper half of the target zone over the coming year”.

The next pivotal event for the RBA rates outlook, will be the QII CPI figures, due for release on 28 July. We think that higher inflation outcomes, combined with ongoing robust jobs market outcomes (*starting with next Thursday’s June labour force numbers which we forecast will show another 20k jobs rise*), will see the central bank pushing rates up to 5% by the end of 2010. Hence, we believe the current pause will not be as long lasting as markets are anticipating, and expect the policy screws to be tightened another couple of notches before the end of 2010 (versus current market expectations of no further RBA rate rises in 2010). This further tightening action will be due to heightened inflation risks as economy accelerates and the labour market tightens further and spare capacity in the economy dissipates. We see QII headline CPI rise of 0.7% (3.1%pa), and an QII underlying CPI lift of 0.6% (2.8%pa), with risks tilted to upside.



Research

Commodities		Telephone	Email Address
David Moore	Base & Precious Metals, Oil	+612 9118 1099	MoorDa@cba.com.au
Luke Mathews	Agri Commodities	+612 9118 1098	luke.mathews@cba.com.au
Lachlan Shaw	Iron Ore, Coal, Steel, LNG	+613 9675 8618	lachlan.shaw@cba.com.au

Economics		Telephone	Email Address
Michael Blythe	Chief Economist	+612 9118 1101	michael.blythe@cba.com.au
Michael Workman	Senior Economist	+612 9118 1019	michael.workman@cba.com.au
John Peters	Senior Economist	+612 9117 0112	john.peters@cba.com.au
James McIntyre	Economist	+612 9118 1100	james.mcintyre@cba.com.au

Fixed Income		Telephone	Email Address
Adam Donaldson	Head of Debt Research	+612 9118 1095	adam.donaldson@cba.com.au
Philip Brown	Fixed Income Quantitative Strategist	+612 9118 1090	philip.brown@cba.com.au
Michael Bors	Credit Research Analyst	+612 9118 1108	borsma@cba.com.au
Steve Shoobert	Credit Research Analyst	+612 9118 1096	steve.shoobert@cba.com.au
Winnie Chee	Securitized Product	+612 9118 1104	winnie.chee@cba.com.au
Tally Dewan	Quantitative Analyst	+612 9118 1105	tally.dewan@cba.com.au
Kevin Ward	Database Manager	+612 9118 1960	kevin.ward@cba.com.au

Foreign Exchange		Telephone	Email Address
Richard Grace	Chief Currency Strategist	+612 9117 0080	richard.grace@cba.com.au
Joseph Capurso	Currency Strategist	+612 9118 1106	joseph.capurso@cba.com.au

Delivery Channels & Publications		Telephone	Email Address
Monica Eley	Internet/Intranet	+612 9118 1097	monica.eley@cba.com.au
Ai-Quynh Mac	Information Services	+612 9118 1102	maca@cba.com.au

New Zealand		Telephone	Email Address
Chris Tennent-Brown	CBA NZ Economist	+64 9374 8819	chris.tennent-brown@asb.co.nz
Nick Tuffley	ASB Chief Economist	+64 9374 8604	nick.tuffley@asb.co.nz
Jane Turner	Economist	+64 9374 8185	jane.turner@asb.co.nz
Christina Leung	Economist	+64 9369 4421	christina.leung@asb.co.nz

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