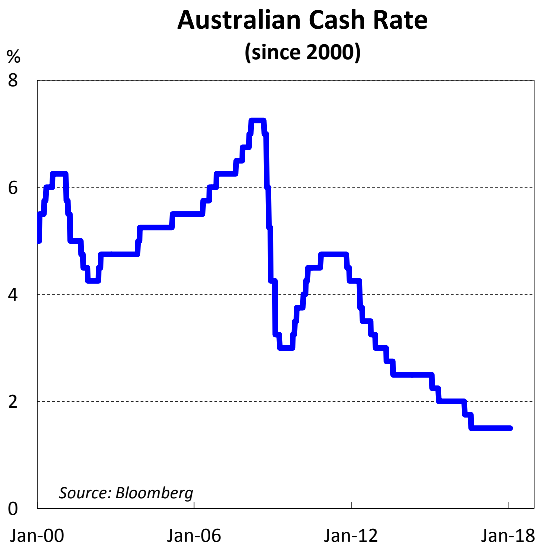
Interest Rate Outlook

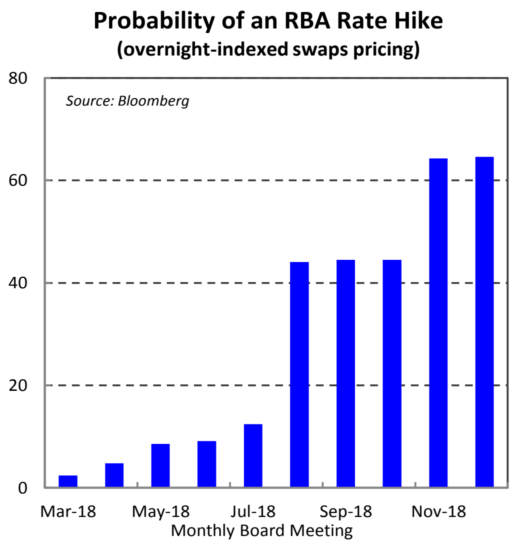
Tuesday, 6 February 2017

Bank of Melbourne

Reserve Bank Starts 2018 With More Optimism

- **The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today.**
- **The RBA's accompanying statement suggested the RBA is more optimistic about the economic outlook, despite the ructions in financial markets over recent days. This optimism was most evident when discussing the global economy and the domestic labour market.**
- **On the global economy, the RBA now describes the pick-up in the global economy in 2017 as being "broad-based" and notes that "a number of advanced economies are growing at an above-trend rate".**
- **The RBA also seemed to have a brighter outlook for the Australian economy and this may well be reflected in revisions to its forecasts this Friday in the Statement on Monetary Policy. We anticipate upgrades to GDP growth and a lower forecast for the unemployment rate.**
- **The RBA expects GDP growth to pick up, to average "a bit above 3%" over the next couple of years. It compares to the previous expectation of "around 3%". The RBA also chose stronger language to describe its expectation of a continued improvement in the jobs market.**
- **The RBA continues to highlight the outlook for household consumption as "one continuing source of uncertainty".**
- **The flavour of this statement is of an RBA that is not in any rush to alter cash-rate settings. It is more of an RBA that is likely to raise the cash rate in its next move, but with this move not coming for some time. We remain comfortable with our view that the cash rate will stay on hold at 1.50% this year.**
- **Financial market pricing has changed considerably since the last RBA board meeting on 5 December 2017. At that time, markets attached a probability of 94% of a 25 basis point rate hike by the end of 2018. Today, this probability is much lower at 65%.**





The first Reserve Bank (RBA) meeting for this year was held today. As widely anticipated, the RBA Board kept the cash rate steady at 1.50% where it has remained for eighteen months now.

The RBA's accompanying media statement suggested the RBA is more optimistic about the economic outlook, despite the ructions in global financial markets over the past few days. This optimism was most evident when discussing the global economy and the domestic labour market. Sentiment about other areas of the economy, such as housing and the Australian dollar, remained little changed from the previous board-meeting statement published in December.

On the global economy, the RBA now describes the pick-up in the global economy in 2017 as being "broad-based". Further, the RBA notes that "a number of advanced economies are growing at an above-trend rate".

The RBA devoted considerable text to the global economy; in today's statement three paragraphs were on global economic conditions compared with one or two typically.

Recent ructions in global financial markets have been triggered by fears of inflation pressures escalating in the United States, after remaining muted for so long. On global inflation, the RBA notes that "higher commodity prices and tight labour markets are likely to see inflation increase over the next couple of years".

The RBA also seemed to have a brighter outlook for the Australian economy and this may well be reflected in revisosn to its forecasts this Friday with the release of the quarterly Statement on Monetary Policy. We anticipate upgrades to GDP growth and a lower forecast for the unemployment rate.

The RBA when describing the central fgorecast for the Australian economic outlook said it expects GDP growth to pick up, to average "a bit above 3%" over the next couple of years. It compares to the previous expectation of "around 3%". The improvement in non-mining business investment and the increased public infrastructure investment are supporting the economic outlook.

On the domestic outlook, the RBA continued to highlight the outlook for household consumption as "one continuing source of uncertainty". Weak household incomes growth and high household debt levels are acting as constraints for household consumption and are likely elevating uncertainty.

Closely tied to economic activity, is the shape of the labour market. Again, the RBA chose stronger language to describe its expectation of a continued improvement in the jobs market. The RBA reiterated that various forward-looking indicators continue to point to solid growth in employment over the year ahead and added that "a further gradual reduction in the unemployment rate" is also expected. The RBA also noted that the rise in employment in all states has been accompanied by a "significant rise" in labour force participation.

The RBA devoted the remainder of the statement to the domestic inflation outlook, the Australian dollar and housing. On these three fronts, the statement was very little altered from the previous statement published in December. The central forecast remains for inflation to be a bit over 2% in 2018. The RBA again said an appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation than currently forecast. It also again said the Australian dollar is "within the range that it has been in over the past two years", but was specific this time in referring to the Australian dollar in trade-weighted terms. And on nationwide house prices, the RBA repeated they are little changed over the past six months and further, a considerable additional supply of apartments is coming on stream over the next couple of years.

In the last paragraph the RBA inserted a new sentence that "further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual”. It highlights the importance of labour market conditions in guiding when the RBA could first hike the cash rate.

The flavour of this statement is not an RBA that is in any rush to alter cash-rate settings. It is more of an RBA that is likely to raise the cash rate in its next move, but with this move not coming for some time. We remain comfortable with our view that the cash rate will stay on hold at 1.50% this year.

Financial market pricing has changed considerably since the last RBA board meeting on 5 December 2017. At that time, the overnight-indexed swap market attached a probability of 94% of a 25 basis point rate hike by the end of 2018. Today, this probability is much lower at 65%.

Besa Deda, Chief Economist
Ph: 02-8254-3251

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Besa Deda	Josephine Horton	Janu Chan
dedab@bankofmelbourne.com.au	hortonj@bankofmelbourne.com.au	chanj@bankofmelbourne.com.au
(02) 8254 3251	(02) 8253 6696	(02) 8253 0898