Cash Rate on Hold at 3.00%

- **The Reserve Bank of Australia (RBA) left its cash rate unchanged at 3.00%.**
- **The Statement in April was little changed in substance from its accompanying Statement in March. The chairs were rearranged but the message was essentially the same.**
- **The RBA rightly recognises the vulnerability of the European financial system to shocks. Events in Cyprus have been unsettling for many people.**
- **At some point in time, investment in the resources sector will pull back. When it does, economic growth will slow unless something steps into its place. If this investment fails to materialise the RBA is well placed to cut rates a little further. Some investment is emerging and we expect exports will add to growth.**
- **The RBA Board says it 'will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the target over time.' The notion that growth needs to be fostered suggests to us that the RBA retains an easing bias.**
- **We continue to believe the RBA has room to cut rates once more by 25 basis points given there remain pockets of weakness in the domestic economy. However, we also believe that the RBA will need more time to assess how earlier rate cuts are taking effect. Recent data on jobs, retail spending and building approvals has kept the RBA on hold. It seems highly unlikely that any cut will occur before June.**

Below is the Governor's statement interspersed with our views.

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 3.0 per cent.

Global growth is forecast to be a little below average for a time, but the downside risks appear to be reduced. While Europe remains in recession, the United States is experiencing a moderate expansion and growth in China has stabilised at a fairly robust pace. Around Asia generally, growth was dampened by the earlier slowing in China and the weakness in Europe, but again there are signs of stabilisation. Commodity prices have declined somewhat recently, but are still at historically high levels.

Our view: The United States is taking three steps forward with its job growth and manufacturing resurgence but is also taking one step back with its government debt woes. The net result is modest growth. Europe may pull out of recession in 2014 but it will add little to global demand this year. Chinese growth remains firm as do commodity prices – in an historical sense. There was nothing new in the RBA's comments on the global economy.

RBA Statement: Internationally, financial conditions are very accommodative. Risk spreads are narrow and funding conditions for financial institutions have improved. Long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Borrowing conditions for large corporations are similarly very attractive. Share prices are substantially above their low points. However, the task of putting private and public finances on sustainable paths in several major countries is far from complete. Accordingly, financial markets remain vulnerable to setbacks.

Our view: The lesson from Cyprus is that financial conditions in Europe are still vulnerable. Seemingly small events and small nations can unsettle global sentiment. If such turmoil can occur in Cyprus, why not in other vulnerable parts of Europe? That said, stronger nations, including Australia can borrow at very low rates of interest. One wonders if long-term borrowing, at low rates of interest, could be used to develop infrastructure that would lift national productivity.

RBA Statement: In Australia, growth was close to trend over 2012, led by very large increases in capital spending in the resources sector, while some other sectors experienced weaker conditions. Looking ahead, the peak in resource investment is drawing close. There will, therefore, be more scope for some other areas of demand to strengthen.

Our view: It will take an awful lot of home building and commercial construction to fill the hole left by mining projects (no pun intended!) On a brighter note, these projects should see a lift in exports which will make a positive contribution towards economic growth. What will be the catalyst for stronger demand in the non-resource sector?

RBA Statement: Recent information suggests that moderate growth in private consumption spending is occurring, though a return to the very strong growth of some years ago is unlikely. While the near-term outlook for investment outside the resources sector is relatively subdued, a modest increase is likely to begin over the next year. Dwelling investment is slowly increasing, with rising dwelling prices and high rental yields. Exports of natural resources are strengthening. Public spending, in contrast, is forecast to be constrained.

Our view: There are 'green shots' in parts of the economy. We hope they grow to maturtity but they may yet need a dose of 'RBA fertilizer' in the form of a further rate cut. The RBA is being patient as it awaits the full impact of its earlier cuts.

RBA Statement: Inflation is consistent with the medium-term target, with both headline CPI and underlying measures at around 2¼ per cent on the latest reading. Labour costs remain contained and businesses are focusing on lifting efficiency. These trends should help to keep inflation low, even as the effects on prices of the earlier exchange rate appreciation wane. The Bank's assessment remains that inflation will be consistent with the target over the next one to two years.

Our view: The RBA remains on message. Inflation is unlikely to be a threat for the next year or two. Some firms are being forced to raise productivity in order to survive. If resource sector construction pulls back, wage growth in that, and associated sectors, will be subdued.

RBA Statement: There are a number of indications that the substantial easing of monetary policy during late 2011 and 2012 is having an expansionary effect on the economy. Further such effects can be expected to emerge over time. On the other hand, the exchange rate, which has risen recently, remains higher than might have been expected, given the observed decline in export prices. The demand for credit has also remained low thus far, as some households and firms continue to seek lower debt levels.

Our view: *The level of the AUD is creating forces for change in the Australian economy. Much of this change is painful and confusing for those involved. Structural change is not new in Australia and has been part of our economic history. The RBA has reduced debt burdens but cutting the cash rate, in part to ease the pain in the worst affected sectors.*

RBA Statement: The Board's view is that with inflation likely to be consistent with the target, and with growth likely to be a little below trend over the coming year, an accommodative stance of monetary policy is appropriate. The inflation outlook, as assessed at present, would afford scope to ease policy further, should that be necessary to support demand. At today's meeting, the Board judged that it was prudent to leave the cash rate unchanged. The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the target over time.

Our view: *Once again, the RBA is keeping the door open for another easing. The key is future demand and especially non-resource related investment spending. If it fails to materialise, the RBA is ready to step in with lower interest rates. We will be watching investment expenditure plans with great interest in the months ahead as well as job creation and retail spending.*

We continue to believe the RBA has room to cut rates once more by 25 basis points given there remain pockets of weakness in the domestic economy. However, we also believe that the RBA will need more time to assess how earlier rate cuts are taking effect. Recent data on jobs, retail spending and building approvals has kept the RBA on hold. It seems highly unlikely that any cut will occur before June.

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