The RBA Remains in a Bind

- **The RBA reiterated a "period of stability in interest rates" again confirming it will most likely sit on its hands for some time. The RBA remains in a bind. On one hand, the RBA is still worried about an uncertain growth outlook and the high AUD. However, low interest rates appear to be doing what they can to support the economy and should rule out any further cuts.**
- **The RBA's frustration over the high Australian dollar has kicked up a notch. The central bank today was more explicit in implying that the AUD was overvalued. It stated that the exchange rate "remains above most estimates of its fundamental value". Previously, the RBA described the exchange rate as "high by historical standards".**
- **There was a touch more optimism on the outlook for non-mining investment, but "only moderate growth" was expected. The Board also seemed encouraged by the lift in consumer and business confidence readings of late and downplayed the recent lift in the unemployment rate. However, the RBA continues to expect growth to be "a little below trend over the year ahead."**
- **While mining investment is set to drag significantly on growth, further evidence of a recovery in non-mining investment, household spending and exports should see the case build for a lift in the official cash rate some time in 2015.**

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 2.5 per cent.

Growth in the global economy is continuing at a moderate pace. China's growth remains generally in line with policymakers' objectives, with weakening property markets a challenge in the near term. Commodity prices in historical terms remain high, but some of those important to Australia have declined this year.

Our view: *There remains a recovery in the global economy, but that recovery remains uneven. The RBA has noted the downturn in the Chinese property market as a downside risk.*

RBA Statement: Financial conditions overall remain very accommodative. Long-term interest rates and risk spreads remain very low. Volatility in many financial prices is currently unusually low. Markets appear to be attaching a very low probability to any rise in global interest rates or other adverse event over the period ahead.

Our view: *The RBA continues to highlight that volatility in financial markets remains low, suggesting that investors continue to be complacent about the level of risk in the global economy. This is despite the geopolitical risks arising from Ukraine and the Middle East, and the possibility* *that global interest rates could begin lifting next year.*

As the US economy continues to improve and the risk of rate rises from the Federal Reserve grow, the greater the chance that longer term rates will trend higher.

RBA Statement: In Australia, the most recent survey data indicate gradually improving business conditions and some recovery in household sentiment after a weaker period around mid year, suggesting moderate growth in the economy is occurring. Resources sector investment spending is starting to decline significantly. Investment intentions in some other sectors continue to improve, though these areas of capital spending are expected to see only moderate growth in the near term. Public spending is scheduled to be subdued. Overall, the Bank still expects growth to be a little below trend over the year ahead.

Our view: *We expect a soft outcome for GDP in Q2. However, the RBA is focusing on more timely indicators and is taking heart from improving household and business confidence. The RBA is also seemingly more optimistic on the outlook for non-mining investment and now expecting "moderate growth in the near term", but the RBA is probably still uncertain whether it is sufficient to offset the sharp decline in mining investment. Nonetheless, this improvement in non-mining investment was described as "tentative" previously. The RBA continues to expect growth to be "a little below trend over the year ahead." We continue to expect that Australia's GDP growth will be a touch above 3% for 2014, in comparison to the RBA's 3% forecast.*

RBA Statement: The recorded rate of unemployment has increased recently, despite some improvement in most other indicators for the labour market this year. The Bank's assessment remains that the labour market has a degree of spare capacity and that it will probably be some time yet before unemployment declines consistently. Growth in wages has declined noticeably and is expected to remain relatively modest over the period ahead, which should keep inflation consistent with the target even with lower levels of the exchange rate.

Our view*: The RBA is downplaying the jump in the unemployment rate to a 12-year high of 6.4%, and reiterating its assessment on the labour market. Given the recent improvement in leading indicators of employment (also noted by the RBA), and the volatile nature of economic data, this would seem wise. Nonetheless, the RBA is noting that a fair degree of spare capacity exists which could limit wage growth.*

RBA Statement: Monetary policy remains accommodative. Interest rates are very low and have continued to edge lower over recent months as competition to lend has increased. Investors continue to look for higher returns in response to low rates on safe instruments. Credit growth has picked up a little, including most recently to businesses. The increase in dwelling prices continues. The exchange rate, on the other hand, remains above most estimates of its fundamental value, particularly given the declines in key commodity prices. It is offering less assistance than would normally be expected in achieving balanced growth in the economy.

Our view: *The RBA's frustration over the high level of the Australian dollar has kicked up a notch. The exchange rate "remains above most estimates of its fundamental value" is more explicit in suggesting that the AUD is overvalued. Previously the RBA has stated that the exchange rate "remains high by historical standards". This isn't surprising given that the terms of trade has declined further, while the AUD has remained stuck in the 93.0 to 93.5 cent range for some time.*

Our view is that the terms of trade will tend to move with the AUD over the long-run. In the near-term, we expect that the AUD will remain resilient. The low risk environment, relatively high interest rates and triple-A credit rating are conducive to carry trade activity.

Despite the RBA's concerns, we continue to think that the bar for currency intervention remains high.

The RBA also highlights that low interest rates are doing what they can to support the economy and further competition for lending has lowered interest rates even further. Additionally, the ongoing growth in house prices should rule out any further rate cuts.

RBA Statement: Looking ahead, continued accommodative monetary policy should provide support to demand and help growth to strengthen over time. Inflation is expected to be consistent with the 2–3 per cent target over the next two years.

Our view: *The RBA remains relaxed about the outlook for inflation, despite downgrades to their forecasts in the latest Statement on Monetary Policy.*

RBA Statement: In the Board's judgement, monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates.

Our view: *The RBA has unsurprisingly reiterated that "the most prudent course is likely to be a period of stability in interest rates" continuing to suggest that the RBA will most likely sit on its hands for some time. Rising asset prices and increased "risk taking" will rule out any further rate cuts, but the below trend growth outlook and discomfort with the resilient Australian dollar are concerns for the RBA. While mining investment is looking to drag significantly on growth, further evidence of a recovery in non-mining investment, household spending and exports should see the case build for a lift in the official cash rate in 2015.*

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