

RBA Cash Rate held at 2.50%

- The Governor's Statement presented a balanced assessment of the Australian economy. There is reason for optimism but risks remain.
- The risk of higher inflation, due to a weaker Australian dollar, was countered by noting that wage growth is constrained. This should see non-traded goods and services inflation moderate from annual rates that are currently above 3.0%.
- The global economic situation is portrayed as positive but in some cases modest and fragile. Bad weather in the US will 'muddy' US statistics for a month or so.
- Exports are rising. This is important for overall economic growth as resources sector investment declines and as government spending is expected to be subdued.
- The RBA notes better news in the housing sector. There are real prospects of a pick-up in construction during 2014. It also notes that consumer demand is firmer than in previous months.
- The decline in the Australian dollar will assist the economy to achieve balanced growth over time. We note, however, that the RBA has reinstated its comment that it remains high by historical standards.
- We remain comfortable with our long-held view that the RBA will be on hold for the bulk, if not all, of 2014. After that it could be time for rates to rise from their historically low level as global and Australian interest rates normalise.

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 2.5 per cent.

Growth in the global economy was a bit below trend in 2013, but there are reasonable prospects of a pick-up this year. The United States economy, while affected by adverse weather, continues its expansion and the euro area has begun a recovery from recession, albeit a fragile one. Japan has recorded a significant pick-up in growth, while China's growth remains in line with policymakers' objectives. Commodity prices have declined from their peaks but in historical terms remain high.

Our view: The opening paragraph is positive about the outlook for the global economy and fits well with our view of a slow, synchronised expansion in 2014. The US is pulling back on its stimulus measures because its economy is improving and Japan's stimulus measures have lifted activity. Emerging markets run the risk of becoming a source of instability and events in Ukraine have yet to fully play out.

RBA Statement: Financial conditions overall remain very accommodative. Long-term interest rates and most risk spreads remain low. Equity and credit markets are well placed to provide adequate funding, though for some emerging market countries conditions are considerably more challenging than they were a year ago.

Our view: Prior to US 'tapering', US and global bond yields were suppressed. As tapering began US and global bond yields rose. This led to instability in some emerging markets and US and Australian bond yields declined as safe haven were sought. It is probable that as 'tapering' continues, bond yields will again edge higher.

RBA Statement: In Australia, recent information suggests slightly firmer consumer demand and foreshadows a solid expansion in housing construction. Some indicators of business conditions and confidence have shown improvement and exports are rising. At the same time, resources sector investment spending is set to decline significantly and, at this stage, signs of improvement in investment intentions in other sectors are only tentative. Public spending is scheduled to be subdued.

Our view: This is a balanced assessment of the Australian economy. We cannot pretend that a decline in resource project construction will not act as a drag on the economy. At the same time there are areas of growth and these will be encouraged by a stronger global economy and by the low interest rate environment.

RBA Statement: The demand for labour has remained weak and, as a result, the rate of unemployment has continued to edge higher. Growth in wages has declined noticeably. If domestic costs remain contained, some moderation in the growth of prices for non-traded goods could be expected over time, which should keep inflation consistent with the target, even with lower levels of the exchange rate.

Our view: Rising unemployment will limit wage growth but it also has the capacity to derail consumer confidence. At some stage in the next few months it would be helpful to see some months of solid job growth. The recent ANZ job ads result was a step in the right direction.

RBA Statement: Monetary policy remains accommodative. Interest rates are very low and savers continue to look for higher returns in response to low rates on safe instruments. Credit growth remains low overall but is picking up gradually for households. Dwelling prices have increased significantly over the past year. The decline in the exchange rate seen to date will assist in achieving balanced growth in the economy, though the exchange rate remains high by historical standards.

Our view: Monetary policy is slowly but surely doing its job and the lower Australian dollar will help. The economy is in a period of transition and there is only so much that interest rates can do. Rising exports of minerals will help the GDP numbers but they are not labour intensive. The economy is set to grow but not at a startling pace.

RBA Statement: Looking ahead, the Bank expects unemployment to rise further before it peaks. Over time, growth is expected to strengthen, helped by continued low interest rates and the lower exchange rate. Inflation is expected to be consistent with the 2–3 per cent target over the next two years.

Our view: *The RBA recognizes that growth will remain below trend in the short-term, and that the unemployment rate will rise further. However, the RBA seems relatively confident that low interest rates and the lower Australian dollar will result in stronger growth beyond the short-term.*

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 view is in accord with our view on interest rates. It appears to be content with its current settings and is prepared to be patient while the economy responds to what are still historically low interest rates. It's a case of 'steady as she goes'.*

Hans Kunnen, Senior Economist
Ph: 02-8254-8322

Contact Listing

Chief Economist

Besa Deda

dedab@bankofmelbourne.com.au

(02) 8254 3251

Senior Economist

Hans Kunnen

kunnenh@bankofmelbourne.com.au

(02) 8254 8322

Senior Economist

Josephine Horton

hortonj@bankofmelbourne.com.au

(02) 8253 6696

Economist

Janu Chan

chanj@bankofmelbourne.com.au

(02) 8253 0898

The information contained in this report ("the Information") is provided for, and is only to be used by, persons in Australia. The information may not comply with the laws of another jurisdiction. The Information is general in nature and does not take into account the particular investment objectives or financial situation of any potential reader. It does not constitute, and should not be relied on as, financial or investment advice or recommendations (expressed or implied) and is not an invitation to take up securities or other financial products or services. No decision should be made on the basis of the Information without first seeking expert financial advice. For persons with whom Bank of Melbourne has a contract to supply Information, the supply of the Information is made under that contract and Bank of Melbourne's agreed terms of supply apply. Bank of Melbourne does not represent or guarantee that the Information is accurate or free from errors or omissions and Bank of Melbourne disclaims any duty of care in relation to the Information and liability for any reliance on investment decisions made using the Information. The Information is subject to change. Terms, conditions and any fees apply to Bank of Melbourne products and details are available. Bank of Melbourne or its officers, agents or employees (including persons involved in preparation of the Information) may have financial interests in the markets discussed in the Information. Bank of Melbourne owns copyright in the information unless otherwise indicated. The Information should not be reproduced, distributed, linked or transmitted without the written consent of Bank of Melbourne.

Any unauthorized use or dissemination is prohibited. Neither Bank of Melbourne- A Division of Westpac Banking Corporation ABN 33 007 457 141