Bank of Melbourne

CASH RATE OUTLOOK

RBA Board Meeting: Cash Rate on hold at 3.50%

Tuesday, 4 September 2012

Key Points

- **The Reserve Bank of Australia (RBA) left its cash rate unchanged at 3.50%.**
- **The RBA continues to note that despite recent falls, Australia's terms of trade remain high by historical standards. This is one reason why it is reluctant to further reduce interest rates.**
- **Downside risks exist in Europe. The RBA appears to be warning markets not to lift their expectations of resolution too high. The problem is complex and progress is difficult for both economic and politcal reasons.**
- **Much of the commentary in today's Statement very closely mirrors its previous Statement in August, and it does not appear that the RBA is looking to move rates any time soon.**
- **Domestically, the RBA remains upbeat with growth expected to be close to trend, and inflation to be within target.**
- **In our view, the balance of risks are skewed to the downside. A potential adverse outcome from Europe and the possibility that China could slow more sharply than anticipated remain key risks to the global outlook.**
- **The downside risks suggests that another rate cut cannot be ruled out. We believe scope exists for a rate cut of 25 basis in November, especially if the labour market is weak and the global outlook deteriorates.**

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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 3.50 per cent.

Having picked up in the early months of 2012, growth in the world economy has since softened. Current assessments are that global GDP will grow at no more than average pace in 2012, with risks to the outlook still on the downside. Economic activity in Europe is contracting, while growth in the United States is only modest. Growth in China remained reasonably robust in the first half of this year, albeit well below the exceptional pace seen in recent years. Some recent indicators have been weaker, which has added to uncertainty about near-term growth. Around Asia generally, growth is being dampened by the more moderate Chinese expansion and the weakness in Europe.

Our view: *If this paragraph sounds familiar it's because much of it is a repeat of what was said in August. The words have been rearranged but the sentiments remain the same. The RBA's sentiments are soundly based. Europe remains a downside risk, the US is growing at a snail's pace and China is* *slowing as expected and not at a pace to cause undue alarm. A stimulus package in China remains a real possibility before Christmas.*

RBA Statement: Markets for key natural resources are adjusting accordingly. Some commodity prices of importance to Australia have fallen sharply in recent weeks. The terms of trade peaked a year ago and have declined significantly since then, though they remain historically high.

Our view: *Some commodity prices have fallen sharply in recent weeks. The price received for Australian iron ore exports is down 35% since April but they are still over 120% higher than they were in 2005.The RBA is right to note that our terms of trade are still high by historical standards. A high terms of trade means Australia's income is higher than it would otherwise be and we believe this is one reason why the RBA has been reluctant to reduce interest rates further than it has.*

RBA Statement: Financial markets have responded positively over the past couple of months to signs of progress in addressing Europe's financial problems, but expectations for further progress are high. Low appetite for risk has seen long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Nonetheless, capital markets remain open to corporations and well-rated banks, and Australian banks have had no difficulty accessing funding, including on an unsecured basis. Share markets have generally risen over the past couple of months, on very light volumes.

Our view: *The RBA seems to be warning markets not to get too excited about any European stimulus or bond buying program. These things take time and move in small steps. Along with other central banks, the RBA appears to be of the opinion that the mess will be resolved over time rather than overnight.*

RBA Statement: In Australia, most indicators available for this meeting suggest growth has been running close to trend, led by very large increases in capital spending in the resources sector. Consumption growth was also quite firm in the first half of the year, though some of that strength was temporary. Labour market data have shown moderate employment growth, even with job shedding in some industries, and the rate of unemployment has thus far remained low.

Our view: *The RBA is expecting close to trend growth domestically, suggesting that it is quite satisfied with current monetary settings. Some of the very strong growth witnessed over the first half of this year is expected to be temporary, partly reflecting the cash handouts mid this year. Furthermore, it is likely that the strength in business investment will begin to wind down. Although we expect a solid Q2 GDP outcome released tomorrow, growth will likely soften in coming quarters. Additionally, we expect the labour market to soften in the months ahead and there is a risk that the unemployment rate will edge higher.*

RBA Statement: Inflation remains low, with underlying measures near 2 per cent over the year to June, and headline CPI inflation lower than that. The introduction of the carbon price is starting to affect consumer prices in the current quarter, and this will continue over the next couple of quarters. The Bank's assessment is that inflation will be consistent with the target over the next one to two years. Maintaining low inflation will, however, require growth in domestic costs to remain contained as the effects of the earlier exchange rate appreciation wane.

Our view: *The RBA's assessment on inflation is largely unchanged, although it is more confident in asserting that inflation will be within target "over the next one to two years".*

RBA Statement: As a result of the sequence of earlier decisions, interest rates for borrowers are a little below their medium-term averages. The impact of those changes is still working its way through the economy, but dwelling prices have firmed a little and business credit has picked up this year. The exchange rate has declined over the past month or two, though it has remained higher than might have been expected, given the observed decline in export prices and the weaker global outlook.

Our view: *The sentiment from the RBA echoes its last Statement in that it seems encouraged by signals that lower interest rates might be taking effect. These include the stabilisation in house prices and a pickup in business credit growth. The RBA is keeping a close eye on the Australian dollar, but it has fallen slightly over the past month or so.*

RBA Statement: At today's meeting, the Board judged that, with inflation expected to be consistent with the target and growth close to trend, but with a more subdued international outlook than was the case a few months ago, the stance of monetary policy remained appropriate.

Our view: *The RBA is satisfied with current monetary policy settings, and we expect the RBA to keep rates on hold when it meets next month. However, we believe that the balance of risks suggests that there is still scope for another 25 basis points of easing in this cycle, later this year. A softer global growth outlook, lower terms of trade, a soft outlook for the labour market, minimal inflationary pressures and the potential for an adverse outcome from Europe all support this view.*

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