CASH RATE OUTLOOK

RBA Board Meeting: Cash Rate on hold at 3.50%

Tuesday, 7 August 2012

Key Points

- **The Reserve Bank of Australia (RBA) left its cash rate unchanged at 3.50%.**
- **The RBA continues to note that Australia's terms of trade remain high by historical standards. This is one reason why it is reluctant to further reduce interest rates.**
- **Global economic growth is regarded as being close to trend, however the 'very difficult task' of fixing Europe's debt problems is again acknowledged.**
- **The RBA 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 the RBA does not seem significantly more concerned about the currency's strength than in its previous commentary. That being said, any further appreciation in the Australian dollar would add weight to the case for another rate cut later this year.**
- **Given growth is expected to be close to trend, the RBA is satisfied with current monetary policy settings. We expect the RBA to keep rates on hold when it meets next month, but softer global growth and potential for an adverse outcome in Europe suggests that there is scope for another 25 basis points of easing in this cycle, later this year.**

Hans Kunnen , Chief Economist
Ph: (02) 9320-5854

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. Most commodity prices have declined, which has helped to reduce inflation and provided scope for some countries to ease macroeconomic policies. Australia's terms of trade peaked nearly a year ago, though they remain historically high.

Our view: *There was little change in the RBA's view of the global economy. We would concur with their view that global growth over the remainder of 2012 will be close to trend. The fact that Australia's terms of trade remain high by historical standards suggests that the RBA remains a little wary of the income flows the higher terms of trade will generate. This is one reason why the RBA is reluctant to cut rates further than it has so far.*

RBA Statement: China's growth has moderated to a more sustainable pace, but does not appear to be slowing further. Conditions in other parts of Asia have recovered from the effects of last year's natural disasters, though the ongoing trend is unclear and could be dampened by the effects of slower growth outside the region. Growth in the United States continues, but at only a modest pace. The most significant area of weakness continues to be Europe, where economic activity has been contracting and policymakers confront the very difficult task of seeking to put both bank and sovereign balance sheets onto a sound footing, while promoting conditions for improved long-term growth.

Our view: *We are relaxed about the slowdown in China and expect authorities there will act to stimulate activity if social unrest threatens to emerge. China does not have the fiscal constraints faced by the US and Europe. China also has a vast Western interior that remains significantly underdeveloped. Infrastructure projects in that region would stimulate both Chinese growth and productivity. There is no 'silver bullet' to solve the woes of Europe and it will remain a risk factor for many years.*

RBA Statement: Financial markets have responded positively to signs of progress, but Europe will remain a potential source of adverse shocks for some time. Low appetite for risk has seen long-term interest rates faced by highly rated sovereigns, including Australia, decline to 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 remained volatile, though in net terms they have generally risen over the past couple of months.

Our view: *The rhetoric out of Europe is slowly moving towards reform and more creative solutions to the banking and sovereign debt troubles. As austerity measures continue to bite across Europe, the German economy is also beginning to slow. The more this symbiotic relationship is understood, the more likely that solutions will emerge.*

RBA Statement: In Australia, most indicators suggest growth close to trend overall. Labour market data show 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. The RBA appears to have quite a positive assessment on the labour market; however, leading indicators are suggesting softer job growth in months ahead and 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 effects of the price on carbon will start to affect these measures over the next couple of quarters. The Bank's assessment of the outlook for inflation is unchanged: it is expected to be consistent with the target over the next one to two years. Maintaining low inflation over the longer term will, however, require growth in domestic costs to continue their recent moderation as the effects of the earlier exchange rate appreciation wane.

Our view: *Q2 CPI, which was released in late July, was in line with the RBA's expectations. There is evidence that domestic cost pressures are easing and this will offset the waning deflationary impact of the strong Australian dollar. That being said, if the recent appreciation of the Australian dollar is sustained, the RBA's assessment on inflation would likely be lower than anticipated, and would add weight to the case for the RBA to cut rates once again.*

RBA Statement: As a result of the sequence of earlier decisions, monetary policy is easier than it was for most of 2011, with interest rates for borrowers a little below their medium-term averages. While it is too soon to see the full impact of those changes, dwelling prices have firmed a little over the past couple of months, and business credit has over the past six months recorded its strongest growth for several years. The exchange rate, however, has remained high, despite the observed decline in the terms of trade and the weaker global outlook.

Our view: *The RBA 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 the RBA does not seem significantly more concerned about the currency's strength than in its previous commentary. These concerns could grow if the Australian dollar were to stay around current levels (around USD1.06) or if it were to appreciate further.*

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 scope for another 25 basis points of easing in this cycle, later this year. A softer global growth outlook, the relative strength of the Australian dollar, a soft outlook for the labour market, minimal inflationary pressures and the potential for an adverse outcome from Europe all support this view.*

Contact Listing

Economics Group

Chief Economist	Hans Kunnen	kunnenh@bankofmelbourne.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@bankofmelbourne.com.au	(02) 9320 5751
Economist	Janu Chan	chanj@bankofmelbourne.com.au	(02) 9320 5892

The Detail