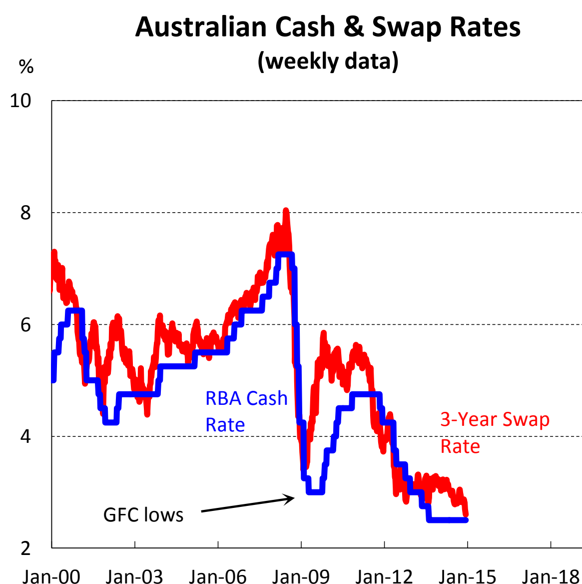
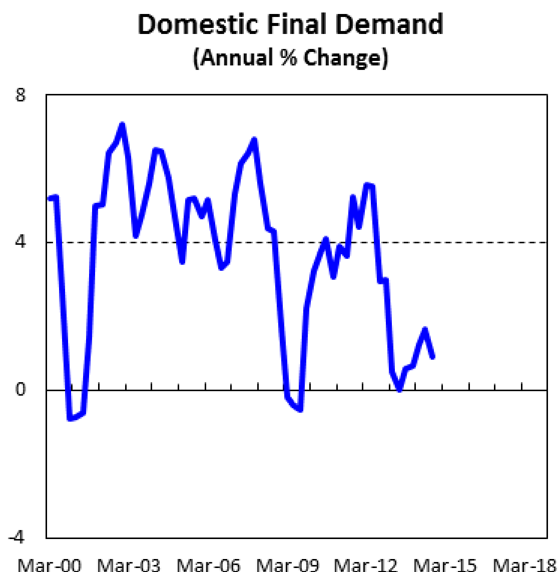
Monday, 8 December 2014

Cash Rate Outlook: On hold for 2015

- **A weaker than expected outcome for September quarter GDP has prompted a rethink of the outlook for the RBA's cash rate in 2015. We now expect the RBA to remain on hold throughout 2015.**
- **The record low cash rate is having a positive impact on economic activity, however, the pace of growth remains below trend. It now seems unlikely that growth will gather sufficient pace during 2015 to warrant lifting the cash rate.**
- **The risk of a cut in the cash rate has increased. Investment in the resources sector is declining and the growth of non-mining investment remains very modest. Low wage growth also suggests that inflation is unlikely to emerge as a problem over the next few years. There is also a risk that the unemployment rate will head higher during 2015.**
- **However, the RBA has made the point that confidence, rather than the interest rate or the availability of finance, is the key factor holding back the economy.**
- **The pace of economic growth is expected to stay within the range of the RBA's forecasts. A stronger US economy; the recent cut in Chinese interest rates and the 15.7% decline in the AUD (trade weighted terms) since its recent peak in April 2013, will assist the Australian economy.**
- **We do not expect the RBA to cut rates in 2015 unless there is a sharp deviation from the RBA's current economic growth forecasts.**





In July this year we wrote that Australia's official interest rates were at the bottom of their cycle.

We also suggested that it would take a slump in economic activity well beyond the weakness currently forecast by the Reserve Bank of Australia (RBA) for the RBA to cut its cash rate again. We stand by that view.

The September quarter national accounts were weaker than we and most others expected and have led us and others to reconsider the outlook for the RBA's cash rate.

A lot has happened since July. Globally, the US economy has gathered strength and ceased its quantitative easing program. After several months of job growth in the 200k region, the US economy witnessed 314k jobs added in the month of November.

At the other end of the global spectrum, European economic growth is anaemic. The European Central Bank has cut rates and is contemplating the possibility of its own quantitative easing program. Japan, a major trading partner, has slipped into a technical recession.

Domestically, the economy continues to grow but at a pace that is unable to absorb the growing labour force. Strong mining exports add to GDP but are not as job intensive as the mining construction phase.

The key to future economic growth remains business investment. It is required to lift output and create jobs. At this stage of the economic cycle, non-resource private sector business investment has picked up very modestly over the past year. The 15.7% decline in the trade weighted value of the AUD will aid in the rebalancing of the economy away from mining construction but the process is slow.

The RBA has made the point that confidence rather than the interest rate or the availability of finance is the key factor holding back the non-mining private sector business investment.

Housing investment has been spurred by low interest rates and construction is expected to remain firm during 2015 and beyond. Interest rates will remain low and the population continues to grow. The RBA wants to avoid a 'boom-bust' scenario in the housing sector and a risk from reducing the cash rate would be to encourage boom conditions, even if macro-prudential restrictions were to be implemented.

Without doubt, the risk of a cut in the RBA cash rate has increased. For us, the risk has not increased to the point where we believe the RBA will cut rates. The sub-trend pace of economic growth, however, has pushed out our expectation of the first rate rise in the next cycle from June 2015 to March 2016.

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