Interest Rate Outlook

Tuesday, 16 August 2016

Bank of Melbourne

Minutes of the August RBA Board Meeting

Reading Between the Lines

- After a range of commentary from the RBA in recent weeks, there were few new developments in today's minutes of the RBA August board meeting.
- There has been no explicit signal from the RBA in determining the future direction of monetary policy in recent months and we are left to read between the lines for the future direction of monetary policy.
- The RBA appears to be implying that we would need to see rates of growth well above 3% to see inflation return back to its target. We are expecting economic growth close to 3.0% this year, but the last time the Australian economy grew above 3.0% was in 2012 when the economy grew at 3.6% and the mining investment boom was in full swing.
- Comments from Governor Stevens in a speech last week stressed that monetary policy had limits in what it could achieve. However, the RBA appears to be of the mindset that even lower interest rates can have an impact, albeit a smaller impact, and will improve prospects for growth. While the RBA is willing to tolerate periods of inflation below target for a time, there does not appear to be much confidence in the RBA's commentary that inflation will return back to target, even over the medium-term.
- We expect that persistently low inflation will lead the RBA to lower official interest rates to as low as 1.0%. We expect the RBA will cut official interest rates by 25 basis points at its November meeting.

After a range of commentary from the RBA in recent weeks, there were few new developments in today's minutes of the RBA August board meeting. Reasons for the decision to lower official interest rates at its August meeting were reiterated – recent CPI data had "confirmed" that inflation was expected to remain low and that adverse risks from the housing market had eased.

Moreover, the RBA believes that low interest rates will assist in supporting economy and that there was "room for stronger growth".

In regards to the outlook for the economy, there was little change to growth, employment and inflation forecasts and the assessment of the global economy was also similar. "Growth in Australia's major trading partners had been a little below average".

The RBA's domestic growth outlook continues to be relatively firm. The RBA expects a moderation in GDP growth in the June quarter, but notes that growth is expected grow around 2.5%-3.5% in

2016, and to rise to 3 to 4% above estimates of potential growth by 2018.

Despite the RBA's expectation of relatively strong growth outcomes in coming years, the RBA remains less upbeat on the labour market, and hints that GDP outcomes may overestimate the labour market impact. Indeed, the RBA notes that "the past relationship between growth in GDP and employment might be a less useful as a guide for forecasting labour market conditions over the coming few years". This breakdown is because LNG production, which is set to contribute strongly to economic growth, is less labour intensive than other industries.

Thus, even if we see GDP growth close to, or just above potential, we may not see a fall in the unemployment rate, and a reduction in spare capacity. The RBA appears to therefore be implying that we would need to see rates of growth well above 3% to see inflation return back to its target. We are expecting economic growth close to 3.0% this year, but the last time the Australian economy grew above 3.0% was in 2012 when the economy grew at 3.6% and the mining investment boom was in full swing.

In regards to the housing market, the RBA seemed relaxed given that conditions in housing had eased. The RBA downplayed price data from CoreLogic in recent months, and cited other housing indicators as signs of moderation. The RBA also raised the risk of oversupply in housing in parts of the country.

Outlook for Monetary Policy

There has been no explicit signal from the RBA in determining the future direction of monetary policy in recent months, and we are left to read between the lines to current RBA thinking. Comments from Governor Stevens in a speech last week stressed that monetary policy had limits in what it could achieve. Stevens also emphasised that there needed to be flexibility in keeping inflation between the RBA's 2 to 3% per annum target band.

Nonetheless, the RBA appears to be of the mindset that even lower interest rates can have an impact, albeit a smaller impact, and will improve prospects for growth. While the RBA is willing to tolerate periods of inflation below target for a time, there does not appear to be much confidence in the RBA's commentary that inflation will return back to target, even over the medium-term.

Unless we see a strong resurgence in the housing market, we expect that persistently low inflation will lead the RBA to lower official interest rates to as low as 1.0%. We expect the RBA will cut official interest rates by 25 basis points at its November meeting.

Janu Chan, Senior Economist
Ph: 02-8253-0898

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

Senior Economist
Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898