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Bank of Melbourne

Cash Rate Outlook – Shifting Sands

- Reserve Bank rhetoric has highlighted that stability in interest rates is the most likely course of action. But a lot has happened in a short space of time, causing risks to shift.
- The risks have shifted so much that a rate cut, as soon as next week, cannot be fully ruled out. We are sitting tight with our view that rates will remain on hold over 2015 but admit our seat is becoming less comfortable.
- The risks that have shifted towards the possibility of easier policy include the weaker global growth outlook and a deeper fall in our terms of trade. However, a fall in petrol prices and a weaker Australian dollar should help support economic growth.
- The RBA has said that confidence is holding the economy back, not the availability of finance. But if sections of the media and some analysts are behind a rate cut, an 'on-hold' decision could have an adverse impact on confidence.
- One thing seems certain. The first RBA meeting and decision for the year will be a close call. And if the RBA does cut, it is unlikely to be a one-cut wonder; another rate cut could follow later this year.

What a difference two months make. The RBA Board last met in early December and their rhetoric highlighted that stability in interest rates was the most likely course of action.

The rhetoric since that meeting has also not hinted at a forthcoming rate cut. Indeed, the RBA has made the point that confidence, rather than interest rates or the availability of finance, is the key factor holding back the economy. But a lot has happened in a short space of time.

Risks have shifted, arguably substantially, and in the process a rate cut cannot be fully ruled out. It has been our view for some time that rates will remain on hold and we are sitting tight with this view, but we are admittedly increasingly sitting in a less comfortable seat.

What risks have shifted?

There are the conditions in the global economy.

Conditions in Europe have deteriorated to such a state that the European Central Bank has recently implemented a large scale quantitative easing (QE) program. The implementation of QE highlights the weak prospects for Europe but QE should also ensure a brighter outlook if it is successful.

China's economic data flow has also continued to be mixed in flavour; further stimulus from Chinese authorities remains possible.

Canada's central bank surprised with a rate cut last week, but the factors driving that decision will not completely apply to Australia.

Closer to home, the Reserve Bank of New Zealand (RBNZ) yesterday toned down its rhetoric, suggesting further tightening was no longer as likely and even mentioned rate cuts. But it stayed on hold. Another major central bank that stayed on hold recently was the Bank of England, although two of its members who voted in the past for rate hikes did not do so this time.

The US Federal Reserve remains on course to raise rates this year but it seems to be becoming lonelier on this path.

Another factor that has emerged in recent months is oil prices. The collapse in oil prices has caused petrol prices to tumble, delivering more money to consumers. This can be spent in the economy and thereby support economic growth locally. However, the RBA's Christopher Kent, in speech late last year, suggested the impact on consumer spending would be marginal.

Oil prices also dampen inflationary pressures. Wednesday's data showed underlying inflation running at a 2.2% annual pace, which is in the lower part of the RBA's inflation target band. If the RBA wants to cut next week, inflation will not stand in the way. But nor does the inflation data suggest the RBA needs to immediately cut to support inflationary pressures.

Oil is also having another effect. The collapse in oil prices could pose the risk that our LNG export prices will also weaken, causing Australia's terms of trade to decline even more sharply. The collapse in the terms of trade represents a net transfer of income from Australia to the rest of the world. This is manifesting itself in subdued incomes growth.

Turning to the Australian dollar, it has depreciated against the greenback and in trade-weighted terms. Has the depreciation been enough for policymakers? Probably not, but the AUD looks to be on its way to levels that the RBA consider to be fair value. In December 2014, RBA Governor, Stevens indicated fair value for the AUD was around US 75 cents, although he also admitted that this was a moving target.

What about domestic economic data? On this front, arguably the data has looked a touch better. The RBA could hold fire and wait and see how the data continues to play out. On the other hand, the recovery in the economy remains gradual and the RBA might deem more easing as helpful.

Mining investment is turning down and this downturn will accelerate in 2015. Non-mining investment is needed to help fill the hole left by mining investment, but so far the rise has been only gradual. Housing construction is rising, but it won't be enough to make up for the decline in mining investment. Retail spending is growing above trend, but the annual rate is easing at a time when consumer sentiment is soft. The jobs market appears to be improving with job vacancies rising but the unemployment rate remains elevated.

We can't finish this debate without a discussion on house prices. Comments from the RBA last year suggested the RBA is worried about what further rate cuts could do to house prices. Has the tempering of the growth in house prices in recent months been enough to put the worry beads back in the drawer or is the RBA still worried? It's an important question. Perhaps, if the RBA cuts next week, they may also look to further rely on macro-prudential housing tools to cool the housing market.

So where does that leave us?

It should be clear that the call will be a close one.

The RBA can afford, in our opinion, to stay in wait-and-see mode and sit on the sidelines. But it might decide, given how far risks have shifted, that some insurance on the growth outlook is warranted.

Perhaps this is why market pricing is so divided. Financial markets, using pricing determined by interest-rate cash futures, attach a 60% probability to a rate cut next week.

With many in the media highlighting a rate cut is forthcoming and with the market divided, the RBA must also be juggling what its decision will mean for confidence. Against this backdrop of market pricing and media reports, doing nothing could have an adverse impact on confidence. And confidence is a factor holding the economy back.

Finally, it is worth noting, that if the RBA does deliver with a 25bp rate cut next week, it is unlikely to be a one-cut wonder, it would then likely follow up with another rate cut later this year.

Besa Deda, Chief Economist
Ph:02-8254-3251

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