Interest Rate Outlook

Tuesday, 4 April 2017

Bank of Melbourne

Labour Market Comes into Focus

- **The Reserve Bank (RBA) left the cash rate at a record low of 1.50% today. There was additional information on the labour market, household borrowing and supervisory measures directed at housing lending in this statement compared with previously.**
- **Today's RBA meeting and statement is hot on the heels of additional supervisory measures to lenders from the Australian Prudential Regulatory Authority (APRA). The RBA indicated that these recently announced measures "should help address the risks associated with high and rising levels of indebtedness".**
- **We saw these risks as tying the RBA's hands in cutting the cash rate further at a time when both economic growth is running below potential and underlying inflation growth is soft. However, it is still too early to assess the impact of these measures and if they will sufficiently cool dwelling prices in Sydney and Melbourne.**
- **The RBA showed greater concerns about the labour market and justifiably so. Our forecasts have the Reserve Bank keeping the cash rate steady this year, but we have highlighted for some time that the labour market needs to be watched closely. This continues to remain the case, especially given the close linkages between jobs growth and consumer spending.**

The Reserve Bank (RBA) left the cash rate at a record low of 1.50% today, as widely expected.

There was additional information on the labour market, household borrowing and supervisory measures directed at housing lending in this statement compared with previously. There was a bit more information on the global economy also.

The most notable change in our opinion is the commentary on the labour market. The RBA seems more concerned about the labour market and justifiably so.

Our forecasts have the Reserve Bank keeping the cash rate steady this year, but we have always highlighted that the labour market needs to be watched closely. If evidence builds that jobs growth is deteriorating and growth in house prices in the widely-watched Sydney and Melbourne softens, then a risk of another rate cut from the Reserve Bank can be entertained.

The Reserve Bank's hands are tied in cutting the cash rate to bolster growth and inflationary pressures while the risks to household balance sheets continue to prevail from the reacceleration of house prices.

However, today's RBA meeting and statement is hot on the heels of additional supervisory measures to lenders from the Australian Prudential Regulatory Authority (APRA). These additional measures came in on March 31 and are designed to "reinforce sound residential mortgage lending practices in an environment of heightened risk."

They include include limiting new interest-only lending to 30% of total new residential mortgage lending. Interest-only loans currently represent nearly 40% of total residential mortgage lending.

APRA also introduced measures to place strict internal limits on the amount of interest-only lending at loan-to-valuation ratios (LVRs) above 80%.

The RBA remarks in today's statement that these recently announced measures "should help address the risks associated with high and rising levels of indebtedness". However, it is still too early to assess the impact of these measures and if they will sufficiently cool dwelling prices in Sydney and Melbourne.

On jobs, the RBA said that "some indicators of conditions in the labour market have softened recently" and that "employment growth is modest". In its previous statement, it mentioned that employment growth was concentrated in part-time employment. While this reference to part-time employment has been removed, it remains the case that part-time jobs growth is firm while full-time jobs are contracting. Close to 23,000 full time jobs have been lost in the past twelve months while nearly 128,000 part-time jobs have been created.

Full-time employment is the more stable form of employment and provides greater jobs security. When consumers feel more secure about their jobs, they tend to have a greater tendency to spend. Growth in retail spending has softened and suggests economic growth will continue to be only moderate in coming months.

On economic growth, the RBA notes that "recent data are consistent with ongoing moderate growth". The RBA stated again that most measures of business confidence are at, or above, average and non-mining business investment has risen over the past year.

On the global economy, the RBA continued to highlight that conditions have improved. In this statement, it added that "both global trade and industrial production have picked up" and "labour markets have tightened in many countries". However, it added an extra sentence in this statement noting that core inflation (headline inflation stripped of the prices of volatile items) "remains low".

Summary

Overall, the message from this statement is one of a central bank a bit more worried about the labour market and a bit more comfortable about risks associated with high and rising levels of indebtedness, especially in relation to lending for housing.

We are maintaining our forecast for an RBA on hold this year, but continue to highlight that the labour market bears watching. If it continues to deteriorate and there is enough of a pullback in growth in house prices, then a rate cut comes back into the radar.

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