Interest Rate Outlook

Tuesday, 6 June 2017

Bank of Melbourne

RBA Shrugs Off Weak GDP

- **The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today. The decision was widely expected by markets.**
- **A key stand out was the RBA's sanguine view in regards to the domestic economy. The RBA has focused on the expectation growth will pick up to above 3 percent, and the transition occurring in the economy away from mining investment as being "almost complete".**
- **We are less relaxed about the growth outlook than this commentary would suggest. While the weak economic growth outcome for the March quarter reflects some volatility from quarter to quarter, it highlights some underlying vulnerabilities within the economy.**
- **The RBA has previously highlighted two key factors warranting close attention. These were the labour market and the housing market.**
- **On the labour market, the RBA remains cautious, noting that employment growth was "stronger over recent months" but that growth in "total hours worked remains weak".**
- **In regards to the housing market, the RBA notes that "there are some signs that these conditions are starting to ease" but it is too early for the RBA to relax on the risks associated with the housing market and high household debt. Indeed, given that housing debt continues to outpace household incomes, these concerns are unlikely to go away anytime soon.**
- **The RBA's upbeat view continues to be predicated on a strengthening economy, which is expected to in turn drive a a gradual increase in inflation. There are reasonable factors underpinning this optimism, but there is a risk that growth will undershoot the RBA's expectations.**
- **That said, the RBA does not appear likely to be moving official interest rates anywhere in a hurry. While the concerns regarding high household indebtedness and the housing market remain, we expect the RBA will leave official interest rates on hold.**

The Reserve Bank (RBA) left the cash rate unchanged at 1.50% at its board meeting today. The decision was widely expected by markets.

There were few changes to the RBA's stance in today's accompanying Statement. Once again, it was judged that "holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time".

The RBA's steady hand does not come as a surprise, given that developments over the past month would not have been sufficient to notably shift the RBA's view of the world.

Nonetheless, there are a few points worth noting from the RBA's commentary.

A key stand out was the RBA's sanguine view in regards to the domestic economy. Indeed, GDP is likely to be weak in the March quarter. We are forecasting 0.1% growth in the March quarter and for annual growth of 1.4% in the year. Markets are expecting 0.3% growth for an annual pace of 1.6% in the year. The RBA notes that “Year-ended GDP growth is expected to have slowed in the March quarter”but that “looking forward, economic growth is still expected to increase gradually over the next couple of years to a little above 3 per cent”.

The RBA also focuses on the transition occurring in the economy away from mining investment as being “almost complete”, and the RBA had highlighted the improvement in business conditions and capacity utilisation.

We are less relaxed about the growth outlook than this commentary would suggest. While the weak economic growth outcome for the March quarter reflects some volatility from quarter to quarter, it highlights some underlying vulnerabilities within the economy. Consumer spending growth is being weighed down by weak growth in wages. Meanwhile, while business investment is improving and the drag from mining investment is expected to lessen, the recovery in non-mining investment remains uneven. In addition, the residential construction cycle appears to be turning and will in time, begin to drag on growth.

On the labour market, the RBA remains cautious, noting that employment growth was “stronger over recent months” but that growth in “total hours worked remains weak”. The RBA does note that “slow growth in real wages is restraining growth in household consumption”.

The other key factor the RBA is paying close attention to was the housing market. Dwelling prices have softened in recent months, and have fallen in the two hottest markets, Sydney and Melbourne. The RBA notes that “there are some signs that these conditions are starting to ease” but it is too early for the RBA to relax on the risks associated with the housing market and high household debt. Indeed, given that housing debt continues to outpace household incomes, these concerns are unlikely to go away anytime soon.

Summary

The RBA’s upbeat view continues to be predicated on a strengthening economy, which is expected to in turn drive a a gradual increase in inflation.

There are reasonable factors underpinning this optimism – these include an improvement in the global growth outlook and a softening drag from mining investment.

Nonetheless, the weakness in household spending and the turning point of the residential construction cycle suggests that the RBA’s growth forecasts seem optimistic in our view. The weak GDP outcome in the March quarter further highlight the risk that growth will undershoot the RBA’s expectations.

That said, the RBA does not appear likely to be moving official interest rates anywhere in a hurry. While the concerns regarding high household indebtedness and the housing market remain, we expect the RBA will leave official interest rates on hold.

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