Interest Rate Outlook

Tuesday, 7 March 2017

Bank of Melbourne

Reserve Bank Remains Sidelined

- The Reserve Bank (RBA) left the cash rate at a record low of 1.50% today.
- There was very little difference from the previous statement except for one paragraph that provided an update on Australian economic growth. References to consumption growth and non-mining investment picking up were removed. Instead, the RBA referred to confidence measures at, or above, average, but the nature of confidence readings are fickle.
- Other notable tweaks to the language are references to Australia's national income and the labour market. The boost to national income from the lift in national income is now described as "significant" but employment growth was charaterised as concentrated in the part-time sector.
- The RBA must weigh up the benefits of lower rates to growth with the potential risks to household balance sheets. The re-acceleration in house prices in recent months underscores these risks. On house prices and lending, the RBA added very little new information.
- The RBA is likely to remain sidelined this year and next; we expect no change to the cash rate.
- The RBA determines the cash rate, but fixed borrowing rates are priced off the swap curve. Australian swap yields are off their lows recorded in August 2016 and we expect they will finish the year higher due to US economic and inflation developments. US fiscal policy remains unclear and is a potential risk to the outlook.

The cash rate was left at a record low of 1.50% today, as widely expected. The Reserve Bank's accompanying statement was not significantly altered from the previous statement it released after February's board meeting.

The main change in today's statement was the third paragraph that discussed Australian economic growth. Since the last meeting, national accounts data was released. It showed the economy grew by 1.1% in the December quarter, after an unexpected contraction in the September quarter.

The Reserve Bank (RBA) underscores that the Australian economy is continuing in its transition following the end of the mining investment boom. But where last time the RBA mentioned it expects consumption growth and non-mining investment to pick up, this time there was no mention. Instead, the RBA referred to measures of consumer and business confidence that are at, or above, average. Confidence, however, can be fickle and does not always translate to improvements in real spending. In our opinion, the better GDP result is encouraging but the omission of projected pick ups in consumer spending and non-mining investment perhaps indicates the RBA is less certain of these forecasts. That said, consumption growth was relatively strong in the December quarter, leaving less scope for a meaningful pick up.

Other notable tweaks to the language are references to Australia's national income and the labour market.

The improvement in commodity prices is giving a boost to Australia's national income, which the RBA now labels as "significant". The RBA remained upbeat on global growth and cautiously upbeat on China, which if proves correct should help to continue to support commodity prices.

On the labour market front, the RBA notes that employment growth over the past year has been "concentrated in part-time jobs". In the previous statement, the RBA remarked that full-time employment growth turned positive in late 2016. But more recent data shows that this improvement was short-lived. In the past twelve months, 56,100 full-time jobs have been lost while nearly 160,000 part-time jobs have been created. Full-time jobs are the more stable component of employment. Therefore, shrinking full-time employment poses risk to the economic outlook if it continues. It will bear close watching in coming months.

The RBA adjusts its cash-rate levers with a mandate to keep inflation in a 2-3% per annum band over time. Inflation in both headline and underlying terms is below this target. The RBA expects inflation to remain low for "some time". Headline inflation is expected to pick up over 2017 to be above 2% and the rise in underlying inflation is expected to be more gradual. How long is "some time" and how long is "gradual" remains unclear. However, we might be able to surmise that both terms suggest longer than in the past because of the difficult juggling act the RBA faces.

The juggling act is that the RBA must weigh up the benefits of lower rates to growth with the potential risks to household balance sheets. It suggests the RBA might allow inflation to run below the inflation target for an extended time without any policy change from the RBA.

The potential risks to household balance sheets arguably have grown in recent months with the re-acceleration in house prices, especially for Sydney and Melbourne. Annual growth of house prices for these capital cities are now over 18% and 13%, respectively.

So the media statement today was pored over for any fresh information on how the RBA perceives the housing market. The RBA gave very little new information on this front.

The RBA determines the cash rate. But fixed rates for borrowers are priced off the Australian swap yield curve. Australian swap yields have risen considerably from their lows struck in late August of 2016; Australian 3-year swap yields are up nearly 60 basis points and 5-year swap yields are up over 80 basis points.

The move up in US bond and swap yields has pressed Australian bond and swap yields higher. US bond and swap yields are being influenced by expectations that the US Federal Reserve will raise its benchmark rate further this year. Another rate hike as soon as next week is fully priced in by financial markets. US Federal Reserve Chair, Janet Yellen, used strong rhetoric in a speech last week to indicate a rate hike next week is on the cards.

The policies of the new US President continue to complicate the outlook, especially as policies lack detail. Trump's talk to the Joint Congress last week failed to deliver on detail. Leaving the complication of US fiscal policy aside, we expect US bond and swap yields to finish 2017 higher than where they are today and to continue to drag our bond and swap yields higher, but by a lesser extent.

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

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Besa Deda	Josephine Horton	Janu Chan
dedab@bankofmelbourne.com.au	hortonj@bankofmelbourne.com.au	chanj@bankofmelbourne.com.au
(02) 8254 3251	(02) 8253 6696	(02) 8253 0898