Interest Rate Outlook

Tuesday, 20 December 2016

Bank of Melbourne

Minutes of the December RBA Board Meeting

Watchful And Prepared

- The minutes from the December board meeting demonstrated their range of concerns as well as highlighting the positives within current conditions.
- The board was rightly concerned about the potential harm to global economic growth if the US were to enact policies that restrict trade. The board lists this issue as one of uncertainty and one that will unfold over 2017. Trade is not a zero sum game and misguided policy has the potential to harm living standards in the US as well as in its trading partners.
- The board noted that China was stimulating its economy but that its high and rising levels of debt were a risk to its longer term outlook. This is not a new issue but something that requires monitoring given the downside risks of excessive debt.
- The board's views on the domestic economy were realistic and more downbeat than previously. The labour market appears soft, retail spending is not robust and there continues to be a drag from the lack of business investment. That said, the negative impact of weak business investment should decline in 2016-17 compared to 2015-16.
- Despite these areas of softness, the board is still of the belief that inflation will return to the RBA's target band over time. But just how long is 'over time'?
- In our view, the RBA remains overly optimistic regarding economic activity and inflation. If activity and inflation remain below their forecasts 'over time' then there is a strong chance the RBA is not done cutting rates in this cycle.

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The board was rightly concerned about the potential harm to global economic growth if the US were to enact policies that restrict trade. The board lists this issue as one of uncertainty and one that will unfold over 2017. Trade is not a zero sum game and misguided policy has the potential to harm living standards in the US as well as in its trading partners.

Future US Federal Reserve policy was also discussed. The board noted that increases in the Fed funds rate were likely to be gradual but possibly steeper than earlier thought if US fiscal policy becomes more expansionary. With US labour markets relatively strong, further stimulus from fiscal policy could generate stronger wage demands and lead to inflation. Higher oil prices were also seen as possible source of inflation but we doubt that oil prices can continue to rise significantly.

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The RBA board remains acutely aware of the impact of interest rates on asset prices, borrowing decisions and household debt. Stretched household balance sheets present a risk to the economy in the event of a slowdown in activity. The board appear to be watchful and prepared.

Outlook for Monetary Policy

The RBA appears confident that inflation will be on an upward trajectory and will return towards its target over time. This confidence comes despite a current patch of softness in economic activity. Given this view, it is appropriate that monetary policy remain on hold. If conditions deteriorate and inflation remains stubbornly low then the Governor and the board have the capacity to lower the cash rate. This remains a possibility.

Keeping the board and markets on their toes will be fiscal policy developments in the United States; developments in the market for oil; US trade policy and global trends in wage inflation.

While Europe was discussed at the board meeting it was not listed as a matter of concern. This was surprising given the impact of issues in Greece in recent years. Political or economic disturbances in Europe still have the potential to unsettle markets and the real global economy. An escalation of instability in Italy or growing fears of a Eurozone breakup could require a lower cash rate to settle nerves. However, we see this as only an outside possibility at this stage.

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