Economic note

10 August 2009

Ch, Ch, Changes: RBA shifts gear. Employment surprises, but watch incomes

- **The RBA held the official cash rate unchanged at 3.0% early last week, as widely expected by markets.**
- **At the time of the Board meeting the RBA moved its signalling from an "easing bias" to a more neutral statement, noting that "the present accommodative setting of monetary policy is appropriate given the economy's circumstances."**
- **In Friday's more detailed "Statement on Monetary Policy", the RBA has gone a step further and outlined the conditions necessary to start taking interest rates back up "towards a more normal setting."**
- **In addition, the RBA also revised up their near-term economic growth forecasts, with negative growth no longer expected, but this has also seen the RBA revise their 2011 inflation forecasts higher. These forecasts were prepared under the assumption of a return to "a more normal setting of monetary policy" out to the end of 2011.**
- **Data released last week showed the labour market in better shape than expected, with a sharp rise in part-time jobs in July and a steady unemployment rate at 5.8%.**
- **However, hours worked are falling fast, implying downside risk to household incomes (and therefore spending), especially as direct government payments wane.**

At the Board meeting early last week, the Reserve Bank of Australia (RBA) decided to leave the cash rate unchanged at 3.0%. This outcome was widely expected in markets. The RBA did, however, move its policy 'bias'. In the July statement the RBA noted that "the Board's current view is that the outlook for inflation allows some scope for further easing of monetary policy, if needed", while they stated on Tuesday that "the present accommodative setting of monetary policy is appropriate given the economy's circumstances." The market read this as a move from an 'easing bias' to a 'neutral bias.'

In Fridays more detailed *Statement on Monetary Policy* (SMP) the RBA provided further information on its views and indeed, for the first time, **laid out the necessary conditions for a tightening in monetary policy, or more correctly, an increase in the cash rate from the current historic lows.** The RBA acknowledged that "the outlook for the Australian economy continues to be subject to considerable uncertainty", but that "the risks are more balanced than they have been for some time." Sounding a note of caution the RBA then stated that "with confidence globally still fragile, it remains possible that the outlook could weaken again".

But the main message from the RBA in Fridays SMP seems to be the sentence that "on the other hand, **with the cash rate at an unusually low level and the global economy stabilising, movement towards a more normal setting of monetary policy could be expected at some point if further signs of a durable recovery emerge."**

The two key messages from this sentence seem to be: 1) the current level of interest rates is unusually low and a return to more 'normal' settings will be needed at some stage and 2) the RBA will want to ensure that the recent signs of recovery, in both Australia and globally, are sustainable before they begin this process. In this context of course, as always, the outlook for inflation will be paramount.

What the RBA does not highlight, however, is how long the process of return monetary policy to a more normal setting will take and how many months of better economic data they will need to see before the process gets underway. At present financial markets are priced for a 25bp increase in the cash rate, to 3.25%, by November 2009, a move to 3.5% by February 2010 and with a further tightening to near 4.5% expected by mid-2010.

Some of the key statements from the RBA include:

- "The global economy is stabilising after contracting sharply in the December and March quarters."
- "the extreme risk aversion seen earlier in the year has receded somewhat."
- "reflecting this, forecasts for world growth are being revised up for the first time in more than a year."

- "the pick-up in economic conditions is most evident in China, where growth has been boosted by a large fiscal stimulus and increased bank lending."
- Economic conditions in the US look to have reached a "turning point, with the housing market showing signs of stabilisation."
- "This improvement in the global economy has been reflected in financial markets."
- Some risks remain, however, with some effects of the global recession "yet to show up fully on many banks' balance sheets" and with significant increases in public sector debt levels "likely to weigh on growth in many of the advanced economies for some time."
- On Australia, the RBA noted that "the economy continues to exhibit considerable resilience in the face of what has been a very difficult international environment."
- The RBA puts Australia's relative economic performance down to the combination of: 1) "the strong state of Australia's financial system"; 2) "significant monetary stimulus"; 3) fiscal stimulus, which has "provided a considerable lift to household disposable incomes over the past nine months"; 4) the early depreciation of the exchange rate, although much of this has now been unwound and 5) "the strong recovery in China, which has boosted commodity prices and demand for Australian exports."
- On inflation, the RBA noted that "recent data on prices continues to suggest that price pressures in the economy are abating gradually" and that "further reductions (in underlying inflation) is expected over the period ahead."

The other key part of the SMP was revisions to economic growth and inflation forecasts. As shown in the table below, the RBA has significantly upgraded in near-term growth forecasts, now expecting growth of +0.5% in the year to December 2009, well up on the previous forecast of -1.0%. Growth in calendar 2010 is now forecast at 2.25% (2.0% previously), while the 2011 growth forecast is unchanged at 3.75%.

Inflation forecasts have been revised up a little over the forecast period, reflecting the stronger economic outlook. The low for both the Headline and Underlying inflation rates is now expected to be 2.0% in 2011, rather than the 1.5% previously expected. Significantly, however, **inflation is still expected to trend lower over the next two years, reflecting the lagged response to the extended period of below trend economic growth.**

Significantly, the RBA has changed the monetary policy assumption used to produce these forecasts. Normally the RBA would base its growth and inflation forecasts on an unchanged monetary policy setting over the forecast period. However, in the current environment **the RBA has stated that "it is not particularly realistic to assume that the cash rate remains at the historically low level of 3% out to the end of 2011."**

As such the RBA state that **"the current forecasts have been prepared on the technical assumption of a return towards a more normal setting of monetary policy over the forecast horizon."** Just to make sure that the market did not read too much into this statement, however, the RBA also made it clear that this "technical assumption … in no way constitutes a commitment by the Board to a particular future path of the cash rate."

Table 1. Changes to RBA key economic forecasts (as at May 2009 and August 2009)

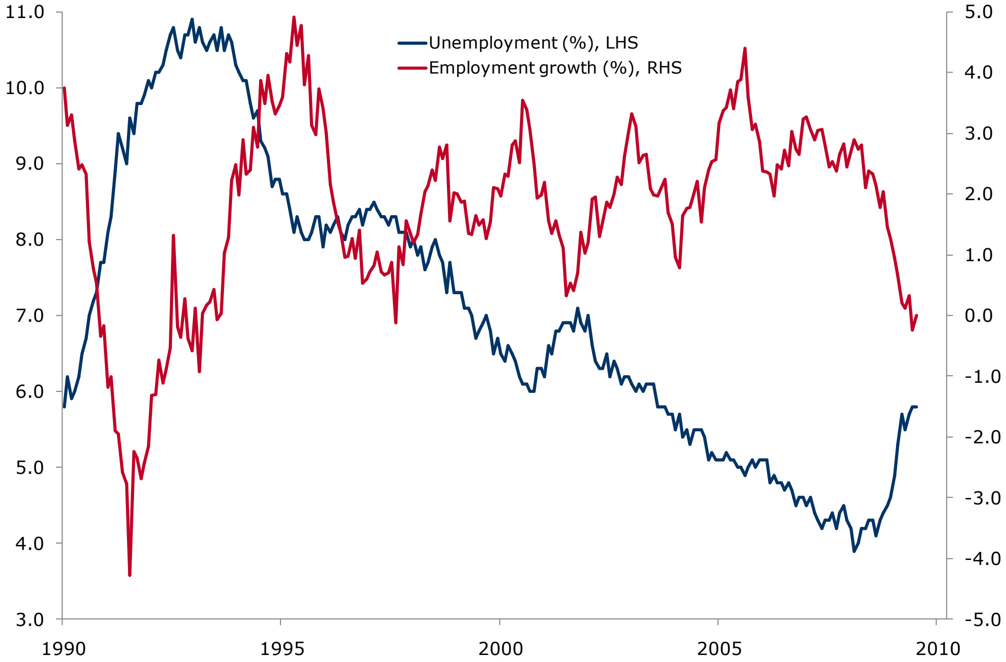
% yr	**Old**	New	**Old**	New	**Old**	New	**Old**	New	**Old**	New
	Dec 2009	**Dec 2009**	**June 2010**	**June 2010**	**Dec 2010**	**Dec 2010**	**June 2011**	**June 2011**	**Dec 2011**	**Dec 2011**
GDP	-1.0	***+0.5***	+0.5	***+1.0***	+2.0	***+2.25***	+3.25	+3.25	+3.75	+3.75
CPI	2.25	2.25	2.5	***2.75***	2.0	2.0	1.5	***2.0***	1.5	***2.0***
Underlying inflation	3.25	3.25	2.5	2.5	2.0	2.0	1.5	***2.0***	1.5	***2.0***

Source: RBA. Changed forecasts are in ***bold and italics***.

Labour force: Better-than-expected, but watch incomes

Data released last week showed a surprising increase in total employment of 32.2k in July. However, all the jobs created in the month were part-time, which rose by 48.2k, more than offsetting a 16.0k fall in full-time employment. With the participation rate unchanged at 65.3%, the unemployment rate was also unchanged at 5.8%. The annual employment growth rate improved marginally, to zero in July from -0.2% in June, but remainder well off the peaks seen in better economic times. Please see Chart 1 for details.

Chart 1: Annual employment growth rate and unemployment rate



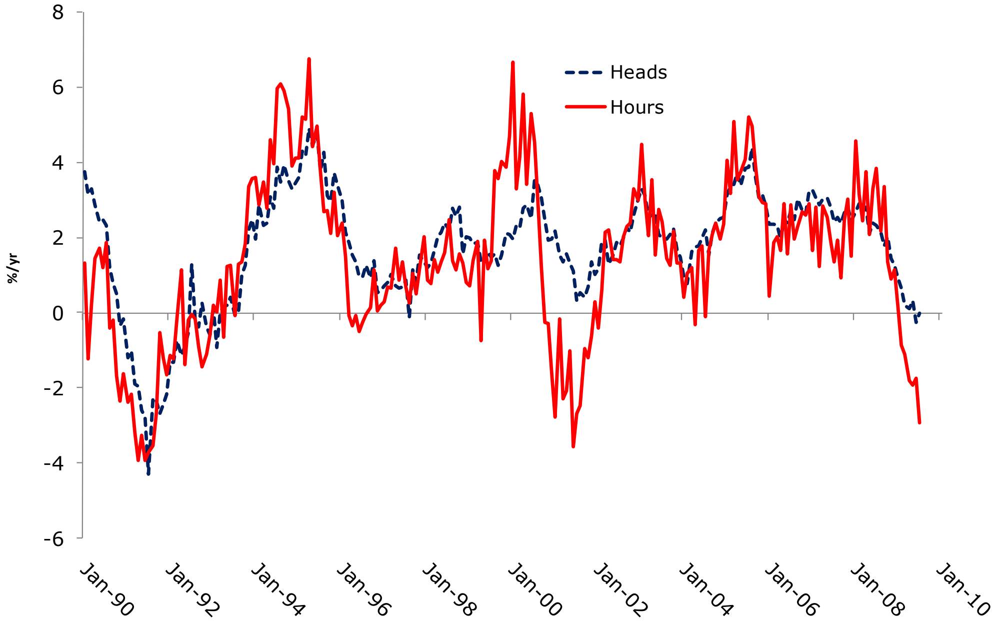
Source: ABS and Colonial First State Global Asset Management

While it is certainly true to say that the deterioration in Australia's headline labour market data has been less than could have been expected during a recession period (and this is good news), it is also important to look at the data in more detail.

The most striking feature of the employment data in recent months has been the big shift to part-time employment. This can be taken as a sign that employers have decided to move employees onto a part-time basis, rather than remove them from their workforce given the time and expense taken to hire and train people when the labour market was significantly tighter than it is now. The good news here is that employers can decide to quickly increase hours worked again if/when economic conditions allow.

However, the bad news is that the surprisingly low unemployment rate is masking a more dramatic deterioration in household incomes. As can be seen from Chart 2, household incomes are falling at a much faster pace than employment, at -2.9%/yr in July. This is down from -1.7%/yr in June and a peak of +4.6%/yr in January 2008. **This decline in household incomes will likely have negative implications for household spending, especially in the months ahead as the stimulus from direct government payments to the consumer subsides.**

Chart 2: Annual % change in total employment and hours worked



Source: ABS and Citi

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