

RBA raises GDP and inflation forecasts – but waiting for more information

Economic note

5 February 2010

RBA upgrades growth and inflation – but waits and watches interest rates

Today's RBA "Statement on Monetary Policy" (SMP) followed this week's decision to leave the cash rate unchanged at 3.75%. **The SMP contains a note of caution on the global economic outlook** (see below for details), although the RBA does highlight the view that the Asian region is expected to experience the strongest growth.

The RBA notes that there has "been a general improvement in sentiment in financial markets", but they do note the recent increase in concerns over sovereign debt quality – an issue that is likely to become even more relevant after last night's/today's market moves.

For the local economy, **the RBA states that "economic conditions were better than expected in 2009" and the RBA has made meaningful upgrades to both its GDP growth and inflation forecasts**...with growth now forecast at 3.25%-3.5% through 2011-2012, while underlying inflation is now f/c to range 2.5%-2.75% across the f/c horizon, up from 2.25%-2.5% previously (see table below). One of the key positives for the RBA on the local economy has been the performance of the labour market (see below for further details).

The SMP notes that the outlook is for within target inflation over the f/c horizon, with further declines expected in the near-term as the "significant slowing in wages growth seen last year and the appreciation of the exchange rate have yet to fully work their way through."

The SMP overview concludes by re-stating the view that with the RBA having tightened by 75bp and lending rates up around 100bp that **"interest rates no longer (are) at exceptionally low levels."** Perhaps most importantly, the SMP re-states the view that "relatively little information (is) available as to the impact of the recent (rate) increases."

It needs to be highlighted, however, that the RBA's economic and inflation forecasts are based on an AUD around \$US0.88 (currently \$US0.8650), oil price of \$US85bp (currently \$US72.90pb) and "the technical assumption of a rise in the cash rate over the forecast period, with the assumed path broadly consistent with market expectations" – which currently are for a cash rate near 4.5% by year-end.

It seems clear, therefore, that the **RBA continues to expect to tighten monetary policy further over the course of the year, but with more information needed to assess the impact of the late 2009 tightening and continued caution over the global economy.**

In this context **it seems logical to assume that the "pause" in rate rises we saw in February will last more than one month**, i.e. the RBA will require more than an extra months information before being able to reassess the economic outlook. **This suggest that the next rate hike will more likely in April or May and that further increases will be skewed into H2 2010, rather than earlier this year.**

Other highlights of the SMP were:

- The SMP makes the point that the global economic recovery now underway “represents only a relatively mild recovery from what has been a severe global downturn” and that “significant uncertainties remain.” Indeed, sounding more cautious on the global economy, the SMP states “one question is the durability of the recent growth in the major advanced economies. In many of these economies, current growth rates are being boosted by the dynamics of the inventory cycle and temporary fiscal measures. This is to be expected at this stage, but for a sustained recovery to take hold, a substantially stronger pick-up in private demand than has been evident to date will be required. Many of these countries also face very significant fiscal challenges that will need to be addressed over time and have banking systems that are still experiencing credit losses from the weak economic conditions.”
- On Asia, however, the SMP makes the point that “in Asia, the issues are somewhat different. The Chinese economy has expanded very strongly and a number of other countries have been favourably affected as a result. Industrial production and international trade have rebounded, with the economies in the region operating with much less spare capacity than is the case for the advanced economies. Reflecting this, unemployment rates have started to fall and inflation pressures are emerging, with some countries taking steps to reduce the degree of policy stimulus that is in place.”
- On the local economy the RBA highlights the strength of the labour market, noting that “it now looks likely that the unemployment rate has peaked at around 5.75%, a much better outcome than thought likely early last year.”
- The RBA also notes the lift in consumer confidence, although the rise in the household savings ratio does suggest some caution. The SMP is relatively positive on housing construction, stating that a “significant pick-up in home-building (is) under way.”
- Highlighting one of the key factors behind this week’s decision to leave rates on hold, the SMP notes that “in terms of business financing, total credit outstanding has continued to fall, reflecting both demand and supply factors. On the demand side, many businesses are using equity raisings and retained earnings to reduce their debt levels while, on the supply side, lending conditions for the commercial property sector remain very tight.”
- The SMP also makes the point that gains in commodity prices will mean that Australia’s terms of trade “are now expected to rise over the next year.”
- The SMP does make the point that the strong rise in the AUD “will restrain activity in a number of industries that are exposed to international competition” – after the past week and especially overnight, however, this may not be such a big concern!

	Dec 09 (previous f/c)	Jun 10	Dec 10	June 11	Dec 11	June 12
GDP growth	2.0 (1.75)	2.5 (2.25)	3.25 (3.25)	3.5 (3.25)	3.5 (3.25)	3.5 (3.5)
CPI inflation	2.1	3.0 (2.5)	2.5 (2.25)	2.5 (2.25)	2.75 (2.5)	2.75 (2.5)
Underlying inflation	3.25	2.5 (2.5)	2.5 (2.25)	2.5 (2.25)	2.75 (2.5)	2.75 (2.5)

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

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