

# RBA goes again – upside risks to rates remain

## Economic Research note

4 May 2010

- With the third rate hike in a row, the RBA has tightened policy by a further 25bp to 4.5%.
- The RBA specifically noted that Australia's terms of trade was heading back to the highs of 2008 and that this would boost both resources investment and growth in economic output.
- On prices the RBA noted that the outlook is for inflation in the upper half of the target zone.
- The RBA has noted that most borrowing rates are now "around average levels", one of their stated aims of the tightening phase.
- This may see the RBA pause in its tightening cycle for a month or two, perhaps till August, but with upside risks to both growth and inflation, the outlook remains for a cash rate of 5% before year-end.

### RBA goes again:

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to tighten monetary policy by a further 25 basis points (bp), taking the cash rate to 4.50% (effective 5 May 2010). In announcing today's decision, which follows similar moves in March and April, the RBA stated that "Australia's terms of trade are rising by more than earlier expected, and this year will probably regain the peak seen in 2008. This will add to incomes and foster a build-up in investment in the resources sector. Under these conditions, output growth over the year ahead is likely to exceed that seen last year."

On inflation the RBA stated that "the extent of decline (in inflation) from here may not be quite as much as earlier forecast and inflation now appears likely to be in the upper half of the target zone over the coming year."

In terms of both growth and inflation, the RBA is widely expected to revise upwards its forecasts in Friday's "Statement on Monetary Policy" (SMP). In the May SMP the RBA expected economic growth of 2.5%-3.5% from mid-2010 to mid-2012, with inflation, both headline and underlying, expected to range around 2.5%-2.75%. The comments above suggest, however, that forecasts for growth and, especially inflation, will be revised higher at the end of the week.

Having moved monetary policy for three months in a row, it would now seem that the RBA may pause in its rate hike cycle for a month or two, especially as the RBA has noted that with today's rate hike interest "rates for most borrowers will be around average levels." However, this pause may only last until early in H2 2010, with expectations remaining for a move to a 5% cash rate well before year-end.

The next phase for the RBA, however, will likely be to move its rhetoric away from returning interest rates to "average" and start laying out the agenda for a move to a slightly restrictive setting of monetary policy – a move that could be expected to unfold over 2011.



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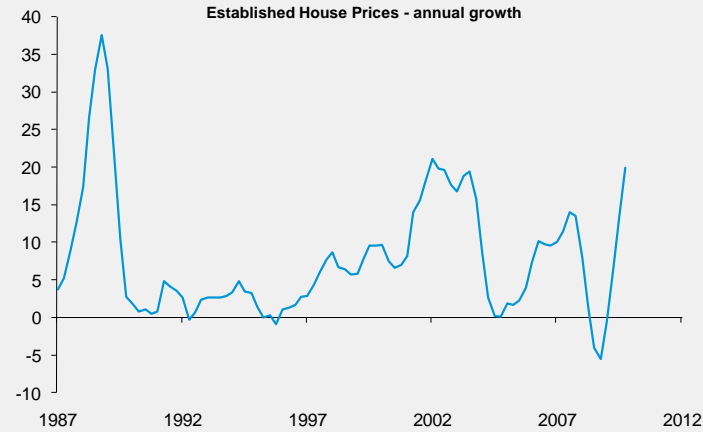
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It is significant to note that the latest tightening from the RBA come on the back of very strong price increases for both Australian house and commodity prices.

According to the ABS, Australian house prices rose by 4.8%/qtr in Q1 2010, to be up a very strong 20%/yr. Perhaps just as importantly, the largest price rises were in the key cities of Melbourne and Sydney.

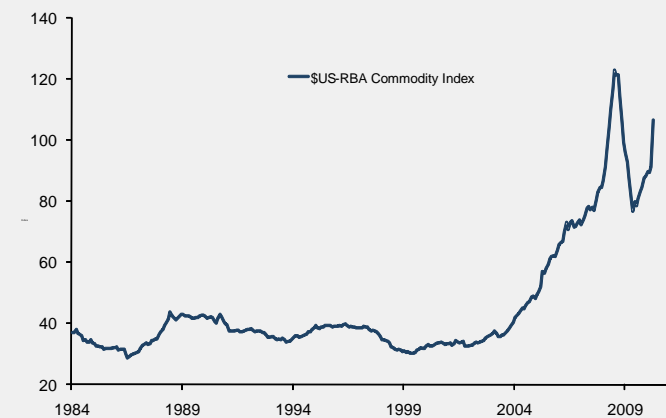
**Australian house prices**



Source: ABS

In addition, the April RBA commodity price index increased by a very large 17.6%/mth, in SDR terms, after rising 2.8%/mth in March. Not surprisingly, the largest price increases on the month were for iron ore and coal. It is also worth noting that this commodity price increase was also reflected in AUD terms, ie. with the currency barely moving over the month. Indeed, in AUD terms commodity prices were up 15.1%/mth in April.

**Australian commodity prices**



Source: RBA

**Other highlight:**

Other highlights from today's statement from the RBA include:

- "Forecasts for world GDP growth have been revised up again. Conditions in Europe remain quite weak, though recent data suggest growth is becoming more established in North America."

- "In Asia, where financial sectors are not impaired, growth has continued to be strong, contributing to pressure on prices for raw materials."
- "The authorities in several countries outside the major industrial economies (ie. China, India, Brazil, Singapore) have now started to reduce the degree of stimulus to their economies."
- "Global financial markets are functioning much better than they were a year ago, but sovereign risk concerns have escalated significantly in Europe (although) to date, there has been very little contagion outside Europe."
- "The process of business sector deleveraging is moderating, with business credit stabilising and indications that lenders are starting to become more willing to lend to some borrowers, though credit conditions for some sectors remain difficult."
- "Credit outstanding for housing has been expanding at a solid pace. New loan approvals for housing have moderated over recent months as interest rates have risen and the impact of large grants to first-home buyer has tailed off."
- "Nonetheless, at this point the market for established dwelling is still characterised by considerable buoyancy, with prices continuing to increase over recent months."
- "With the risk of serious economic contraction in Australia having passed some time ago, the Board has been adjusting the cash rate towards levels that would be consistent with interest rates to borrowers being close to the average experience over the past decade or more."
- "The Board expects that, as a result of today's decision, rates for most borrowers will be around average levels. This represents a significant adjustment from the very expansionary settings reached a year ago."

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