

# RBA's 'Cup Day' form remains in place

## Economic research note

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- The RBA 'surprised' the markets today with a 25bp rate hike, taking the cash rate to 4.75%. This is the fifth year in a row the RBA has changed monetary policy on Melbourne Cup day!
- Despite the recent lower-than-expected Q3 10 CPI report, the RBA remains focused on the medium-term, noting that the period of moderation in inflation "is probably now close to ending."
- The RBA also focused on the view that "economy is now subject to a large expansionary shock from the high terms of trade and has relatively modest amounts of spare capacity" and this suggests that further policy tightening could be expected in 2011.

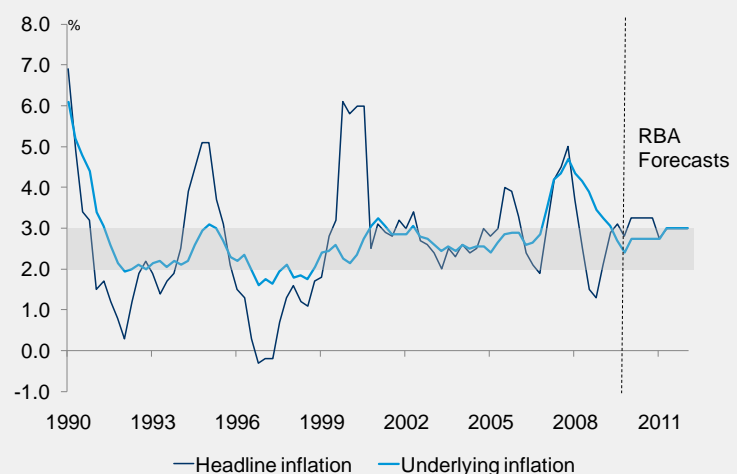
### RBA's 'Cup Day' form remains in place:

After 'surprising' the market and holding the cash rate steady last month, the Reserve Bank (RBA) Board 'surprised' again today with a 25 bp rate hike, taking the cash rate to 4.75%. (Note – the RBA has now changed monetary policy on Melbourne Cup day five years in a row!)

While financial markets were only pricing in around a 25% chance of a rate hike today after last week's lower-than-expected Q3 10 CPI report, it is difficult to argue with the medium-term policy objectives of the RBA in tightening policy again today – the first move since May.

In announcing the rate hike today the RBA stated that "the economy is now subject to a large expansionary shock from the high terms of trade and has relatively modest amounts of spare capacity. Looking ahead, notwithstanding recent good results on inflation, the risk of inflation rising again over the medium term remains. At today's meeting, the Board concluded that the balance of risks had shifted to the point where an early, modest tightening of monetary policy was prudent."

### Australian headline and underlying inflation



Source: ABS & RBA



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Given the medium-term inflation objectives of the RBA, it could be expected that further policy tightening will be on the agenda. Markets are priced for only a 15% chance of a move in December, but further policy tightening, perhaps to a cash rate around 5.5%-6.0% should be expected over 2011.

Highlights of today's statement from the RBA include:

- While the global economy “grew faster than trend over the year to mid 2010” it will “probably ease back to about trend pace over the coming year as strong recoveries in the emerging world give way to a more sustainable pace of expansion and growth remains subdued in the US and Europe.”
- “Concerns about the possibility of a larger than expected slowing in Chinese growth have lessened recently and most commodity prices have firmed, after a fall earlier in the year.”
- “The turmoil in financial markets earlier in the year has abated, though sentiment remains fragile.”
- On the Australian economy the RBA noted that “information ... indicates growth around trend over the past year. Public spending was prominent in driving aggregate demand for several quarters but this impact is now lessening.”
- On the domestic economy the RBA stated that “while there has been a degree of caution in private spending behaviour thus far, the rise in the terms of trade, which is now boosting national income very substantially, is likely to lead to stronger private spending over the next couple of years, especially in business investment.”
- The RBA also noted “asset values are not moving notably in either direction, and overall credit growth remains quite subdued at this stage notwithstanding evidence of some greater willingness to lend.”
- Importantly, on the AUD the RBA states that “the exchange rate has risen significantly this year, reflecting the high level of commodity prices and the respective outlooks for monetary policy in Australia and the major countries. This will assist, at the margin, in containing pressure on inflation.”
- The RBA also seems to be very focused on the labour market, stating that “the demand for labour has continued to firm. While the labour market is not as tight as in 2007 and 2008, some further strengthening would appear to be in prospect” and that given this “after the significant decline last year, growth in wages has picked up somewhat, as had been expected. Some further increase is likely over the coming year.”
- Critically, on inflation the RBA states that given the economic conditions “the moderation in inflation that has been under way for the past two years is probably now close to ending.”
- In what looks like an attempt to downplay the Q3 10 CPI report, the RBA stated that “recent information suggests underlying inflation running at about 2½ per cent, with the CPI inflation rate a little higher due mainly to increases in tobacco taxes. Both results were helped somewhat in the latest quarter by unusual softness in food prices. Inflation is likely to rise over the next few years. This outlook, which is largely unchanged from the Bank's earlier forecasts, assumes some tightening in monetary policy.”
- Financially, the RBA states that “for some time, the Board has held the stance of monetary policy steady, which has resulted in interest rates to borrowers being close to their average of the past decade. This allowed some time to observe the early effects of previous policy changes and to monitor the uncertain global outlook. The Board is also cognisant of differences in the degree of economic strength by industry and by region.”
- “However, the economy is now subject to a large expansionary shock from the high terms of trade and has relatively modest amounts of spare capacity. Looking ahead, notwithstanding recent good results on inflation, the risk of inflation rising again over the medium term remains. At today's meeting, the Board concluded that the balance of risks had shifted to the point where an early, modest tightening of monetary policy was prudent.”

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