Tuesday, 18 October 2016

Minutes of the October RBA Board Meeting

A Lot On Its Mind

- **The Reserve Bank board has a lot on its mind. Debt in China, our major trading partner, is rising to what may be unsustainable levels. There remain serious issues within the European banking system and the US Federal Reserve appears set to lift its Fed funds rate in December.**
- **Then there are the domestic uncertainties. Is the unemployment rate really signalling improvement in the labour market? Why has the net increase in employment over 2016 been mostly part time workers and would workers prefer to work more hours? And what of the risks from the housing market?**
- **The RBA expects that there is "a reasonable prospect of sustaining growth in economic activity that would support further employment growth and, in time, a gradual increase in wage growth and inflation."**
- **We hope they are correct, but the Governor himself acknowledges that there are issues with excess capacity, low commodity prices and perceptions of business pricing power that are all working against higher inflation. These will likely require a further response from the RBA either this year or next. The September quarter CPI will be well worth a look.**
- **The quarterly CPI remains important and another downward shock on October 26th, when the latest CPI becomes available, would dent the RBA's current inflation forecasts and lift expectation of further rate cuts, even possibly in November.**

The Reserve Bank board has a lot on its mind. Debt in China, our major trading partner, is rising to what may be unsustainable levels. There remain serious issues with the European banking system and the US Federal Reserve appears set to lift its Fed funds rate in December.

Then there are the domestic uncertainties. Is the unemployment rate really signalling improvement in the labour market? Why has the net increase in employment over 2016 been mostly part time workers and would workers prefer to work more hours?

And what of the risks from the housing market? The RBA minutes note that housing credit growth has eased and that household finances appear to be in reasonable shape. But inner city apartment developments continue to make the RBA nervous.

The RBA minutes made several positive observations. The terms of trade have improved. While they may not lift much further, the downward drag on national income may be coming to an end. GDP in the September quarter is likely to show ongoing growth and the risks from rapid growth in housing prices appears to have waned – in the view of the RBA board.

Also on a positive note was the board's observation that LNG exports would support economic growth as might the forecast gradual decline in Australia's savings ratio. The RBA board was also encouraged by the competitiveness gained from the lower AUD since 2013 but again noted that its recent appreciation would complicate efforts to sustain economic growth.

The RBA minutes expressed the view, and we concur, that the overall reduction in interest rates over the past few years had supported domestic demand. This was in contrast to the experience in Europe where the minutes noted that "there had been little increase in the ECB's net lending to banks despite banks being able to borrow from the ECB at negative interest rates if certain on-lending targets were met."

There does appear to be a lower limit beyond which monetary policy is effectively pushing on a string. The RBA also noted that "Two corporate bonds had been issued in the euro area at negative yields." These are challenging times for central bankers.

Outlook for Monetary Policy

The final paragraph of the RBA minutes was telling.

"Members noted that data on CPI inflation for the September quarter and an update of the forecasts would be available at the next meeting. This would provide an opportunity to consider the economic outlook, assess the effects of previous reductions in the cash rate and review conditions in the labour and housing markets".

Monetary policy is always forward looking. The new agreement between the RBA and the government allows for inflation to move into the RBA's target zone 'over time'. This time is not specified but is unlikely to be a decade.

The RBA expects that there is "a reasonable prospect of sustaining growth in economic activity that would support further employment growth and, in time, a gradual increase in wage growth and inflation." We hope they are correct, but the Governor himself acknowledges that there are issues with excess capacity, low commodity prices and perceptions of business pricing power that are working against higher inflation. These will likely require a further response from the RBA either this year or next. The September quarter CPI will be well worth looking at.

The quarterly CPI remains important and another downward shock on October 26th, when the latest CPI becomes available, would dent the RBA's current inflation forecasts and lift expectation of further rate cuts, even possibly in November.

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