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Reserve Bank Sees the Glass as Half Full

- **The Reserve Bank (RBA) left the cash rate at a record low of 1.50% today, as widely expected. The tone of its media statement struck a more optimistic tone compared with its previous statement in December. Indeed, the RBA viewed even weaker parts of the economy as a glass half full.**
- **The RBA's take on the global economic outlook was encouraging. It has expectations of above-trend growth in a number of the advanced economies.**
- **The RBA expects economic growth in Australia of around 3% over the next couple of years. Consensus forecasts and our own forecasts for growth are weaker. So the risk of a rate cut down the track cannot be fully dismissed.**
- **However, today's language from the RBA sends a message that rates are on hold this year. Unless data on growth and employment continues to deteriorate, the RBA is more likely to sit pat on the cash rate this year.**
- **Of course, the RBA's view on inflation is crucial to its interest-rate settings. It expects inflation to remain low for 'some time'. Some time might be longer than usual because of the difficult juggling act the RBA faces.**
- **The RBA must weigh up the benefits of lower rates to growth with the potential risks to household balance sheets. It suggests the RBA might allow inflation to run below the inflation target for an extended time without any policy action.**
- **Fixed borrowing rates, however, are likely to head higher over this year. Australian bond and swap yields will press higher over this coming year, as US bond and swap yields move higher on expectations of firmer growth and inflation in the United States.**

The cash rate was left at a record low of 1.50%, as widely expected. The Reserve Bank (RBA) struck a more optimistic tone in its accompanying media statement compared with its previous statement in December. Indeed, the RBA viewed even weaker parts of the economy as a glass half full.

The RBA kicks off its statement with the global economy. It notes that conditions in the global economy have improved over recent months and that above-trend growth is expected in a number of advanced economies. The small and open nature of Australia's economy means that the improvement in the global growth outlook is positive for the traded sector in Australia.

China remains a key economy for Australia's ongoing prosperity. Higher spending on infrastructure and construction has led to stronger growth in China over the second half of 2016. However, the rapid increase in borrowing means that the RBA sees "medium-term risks to Chinese growth" remaining.

The most recent GDP figures in Australia showed a contraction in economic activity for the

September quarter. The RBA acknowledges this data was weaker than expected, but expects a "return to reasonable growth" in the December quarter.

The RBA expects economic growth of around 3% over the next couple of years, supported by a pick up in consumption and some further pick-up in non-mining business investment. Our forecasts for this year and next year are weaker. Consensus forecasts are also softer, especially for this year. Consensus growth forecasts are for 2.5% this year and 2.8% next year. As we see the risk that growth might miss the RBA forecasts, we cannot completely dismiss some risk of a rate cut later this year.

On the growth front, we see risks that consumption growth will stay sluggish. But, there have been some encouraging signs on non-mining business investment. Business credit has grown strongly in recent months and if this trend continues, we should see a more noticeable improvement in spending by businesses outside of the mining sector.

Unless data on growth and employment continues to deteriorate, the RBA is more likely to sit pat on the cash rate this year.

On the labour market, the RBA maintains the view that labour indicators are mixed. The RBA notes that growth in full-time employment turned positive late in 2016, but the data is still nascent. Full-time jobs grew by 95,000 in the three months ending December, but nearly 110,000 jobs were shed in the previous three months. Full-time jobs on an annual basis are still contracting. A further run of data is needed to assure us of a turnaround in full-time jobs.

The RBA adjusts its interest-rate levers with the 2-3% per annum inflation target in mind. Inflation in both headline and underlying terms is below this target. The RBA expects inflation to remain low for "some time". How long is some time is unclear. However, we might be able to surmise that "some time" is longer than usual because of the difficult juggling act the RBA faces.

The RBA must weigh up the benefits of lower rates to growth with the potential risks to household balance sheets. It suggests the RBA might allow inflation to run below the inflation target for an extended time without any policy action from the RBA.

The RBA determines the cash rate. But fixed rates for borrowers are priced off the swap yield curve. Swap yields are set to rise further over this year. The move up in US bond and swap yields press Australian yields higher. US yields are being influenced by expectations that the US Federal Reserve will need to raise its benchmark rate, the Federal funds target rate, this year. The US Federal Reserve has already hiked it twice in the past fifteen months.

The policies of the new US President complicate the outlook. It is unclear if he will emphasise trade restrictions or fiscal stimulus or both. An emphasis on fiscal stimulus in the form of tax cuts and infrastructure spending would give a fiscal boost to the US economy and raise the probability that the Federal Reserve will need to hike rates by more.

The Reserve Bank will release a quarterly update on the economic outlook this Friday, including its forecasts for growth and inflation.

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