DATA SNAPSHOT

RBA Board Decision: The Balancing Act

Wednesday 3 May, 2011

- **The Reserve Bank (RBA) left the cash rate unchanged at 4.75% for the sixth straight month.**
- **The key changes in today's statement highlight that a number of competing influences are at work in the economy and the RBA's balancing act is becoming increasingly difficult. These influences include a higher-than-expected terms of trade, underlying inflation past its low point offset by softening house prices, weaker household credit growth and a stronger-than-expected Aussie dollar.**
- **This month, on balance, the influences warranted the RBA leaving rates on hold. In coming months, we also expect the RBA to sit on the sidelines because the competing influences mean that there is no sense of urgency for the RBA. However, we still believe that the balance of risks is such that more tightening is likely with the timing of the first rate rise for 2011 in August.**

The RBA left the cash rate unchanged at 4.75% for the sixth straight month. This decision was widely expected. The accompanying statement was where the centre of attention was.

There were a number of changes in the accompanying statement when compared with the previous statement in March. But in our view, there were four changes in the accompanying statement that were notable. Two of the changes suggest a stronger growth and inflation profile while the other two suggest the risks of a weaker profile for growth and inflation.

Firstly, the RBA noted that the "terms of trade are reaching higher levels than assumed a few months ago". This statement suggests that there is a stronger boost to national income coming through for the Australian economy than previously expected. This income boost underpins economic activity and inflationary pressures. It also suggests that there may not be much room for error on the inflation front if the economy recovers strongly.

The RBA confirms its limited breathing room on inflation by noting that the "marked decline in underlying inflation from the peak in 2008 has now run its course". Last week's consumer prices data also made it clear that underlying inflation was passed the low point.

On inflation, the RBA further noted it expects that "CPI inflation will be close to target over the year ahead" as opposed to April's statement that said it expects inflation to be "consistent with the 2-3 per cent target" when the temporary price effects dissipate. One could read the change to mean that the RBA is suggesting inflation may sit outside of the top of the band, albeit close to it. Inflation outside of the band is likely to make the RBA less comfortable.

The dovish changes to the statement were the new insertions that growth in credit to households and housing prices in several cities has "softened".

Further, the RBA inserted commentary on the Australian dollar. It noted that the currency has "risen further and…if sustained, could be expected to exert additional restraint on the traded sector". However, the RBA notes that while the rising Australian dollar will be helping to hold down prices…over the longer term inflation can be expected to increase somewhat if economic conditions evolve broadly as expected.

The key changes in the RBA statement highlight that a number of competing influences are at work in the economy and that the balancing act is difficult. This month, on balance, these influences warranted the RBA leaving rates on hold. In coming months, we also expect the RBA to sit on the sidelines because the competing influences mean that there is no sense of urgency for the RBA. However, we still believe that the balance of risks is such that more tightening is likely with the timing of the first rate rise for 2011 in August.

Financial markets lengthened the odds of a near-term rate hike but lifted the chances of a hike before the end of this year. Interbank cash-rate futures are attaching a 107% chance of one 25bp rate hike before the end of this year (i.e. one rate hike of 25bp is fully priced in).

The complete changes in today's statement are outlined below in a side-by-side analysis:

Indicates text which was dropped from the previous month, Indicates text the same, Indicates new text

Statement following April Board meeting	Statement following May Board meeting
At its meeting today, the Board decided to leave the cash rate unchanged at 4.75 per cent.	At its meeting today, the Board decided to leave the cash rate unchanged at 4.75 per cent.
The global economy is continuing its expansion, led by very strong growth in the Asian region. The recent disaster in Japan will have a noticeable effect on Japanese production in the near term, although the impact on the broader Asian region is expected to be limited. Commodity prices, including oil prices, have risen over recent months, pushing up measures of consumer price inflation in many countries. A number of countries have been moving to tighten their monetary policy settings. Overall, though, financial conditions for the global economy remain accommodative.	The global economy is continuing its expansion, led by very strong growth in the Asian region. The recent disaster in Japan is having a major impact on Japanese production, and some effects on production of manufactured products further afield. Commodity prices, including oil prices, have generally continued to rise over recent months, pushing up measures of consumer price inflation in many countries. A number of countries have been moving to tighten their monetary policy settings. Overall, though, financial conditions for the global economy remain accommodative. Uncertainty remains over the prospects for resolution of the banking and sovereign debt issues in Europe.
Australia's terms of trade are at their highest level since the early 1950s and national income is growing strongly. Private investment is picking up, mainly in the resources sector, in response to high levels of commodity prices. In the household sector thus far, in contrast, there continues to be caution in spending and borrowing, and a higher rate of saving out of current income.	Australia's terms of trade are reaching higher levels than assumed a few months ago, and national income is growing strongly. Private investment is picking up, mainly in the resources sector, in response to high levels of commodity prices. In the household sector thus far, in contrast, there continues to be caution in spending and borrowing, and a higher rate of saving out of current income.
The natural disasters over the summer have reduced output and the resumption of coal production in flooded mines is taking longer than initially expected. Production levels should, however, recover over the months ahead, and there will be a mild boost to demand from the rebuilding efforts as they get under way.	The natural disasters over the summer have reduced output in some key sectors and the resumption of coal production in flooded mines is taking longer than initially expected. It is likely this caused a decline in real GDP in the March quarter. Production levels should, however, recover over the months ahead, and there will be a mild boost to demand from the rebuilding efforts as they get under way. Over the medium term, overall growth is likely to be at trend or higher.
Asset values have generally been little changed over recent months and overall credit growth remains quite subdued, notwithstanding evidence of some greater willingness to lend. Business balance sheets generally are being strengthened, and the run-up in household leverage has abated.	Growth in employment has moderated over recent months and the unemployment rate has been little changed, near 5 per cent. Most leading indicators suggest further growth in employment, though most likely at a slower pace than in 2010. Reports of skills shortages remain confined, at this point, to the resources and related sectors. After the significant decline in 2009, growth in wages has returned to rates seen prior to the downturn.
Growth in employment has moderated over recent months and the unemployment rate has held steady at 5 per cent. Most leading indicators suggest further growth in employment, though most likely at a slower pace than in 2010. Reports of skills shortages remain confined, at this point, to the resources and related sectors. After the significant decline in 2009, growth in wages has returned to rates seen prior to the downturn.	Overall credit growth remains quite modest. Signs have continued to emerge of some greater willingness to lend, and business credit has resumed growth after a period of contraction. Growth in credit to households, on the other hand, has softened recently, as have housing prices in several cities. The exchange rate has risen further and, in real effective terms, is at its highest level in several decades. This, if sustained, could be expected to exert additional restraint on the traded sector.
Inflation is consistent with the medium-term objective of monetary policy, having declined significantly from its peak in 2008. These moderate outcomes are being assisted by the high level of the exchange rate, the earlier decline in wages growth and strong competition in some key markets, which have worked to offset large rises in utilities prices. Production losses due to weather are temporarily raising prices for some agricultural produce, which will boost the March quarter CPI, but these prices should fall back later in the year. Overall, looking through these temporary effects, the Bank expects that inflation over the year ahead will continue to be consistent with the 2–3 per cent target.	Recent data on inflation show the effects of production losses due to the floods and Cyclone Yasi. The affected prices should fall back later in the year, though substantial rises in utilities prices are still occurring. The Bank expects that, as the temporary price shocks dissipate over the coming quarters, CPI inflation will be close to target over the year ahead. Looking through these short-term movements, however, the recent information suggests that the marked decline in underlying inflation from the peak in 2008 has now run its course. While the rising exchange rate will be helping to hold down prices for some consumer products over the coming few quarters, over the longer term inflation can be expected to increase somewhat if economic conditions evolve broadly as expected.
At today's meeting, the Board judged that the current mildly restrictive stance of monetary policy remained appropriate in view of the general macroeconomic outlook.	At today's meeting, the Board judged that the current mildly restrictive stance of monetary policy remained appropriate. In future meetings, the Board will continue to assess carefully the evolving outlook for growth and inflation.

St.George Contact Listing

Chief Economist	Besa Deda	dedab@stgeorge.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@stgeorge.com.au	(02) 9320 5751
Economist	Janu Chan	chanj@stgeorge.com.au	(02) 9320 5892