

DATA SNAPSHOT

Reserve Bank Sends a Clear Message

Friday, 6 May, 2011

- The Reserve Bank has sent one of its clearest messages this year that more tightening is on the way. We continue to expect two rate hikes from the RBA this year and there is now a higher risk of a move as soon as June.
- The language of the Statement contains a hawkish flavour, more so than the previous Statement published in February.
- Furthermore, underlying inflation forecasts have been upgraded for June 2011 through to June 2012, such that there is now even less room, if any, for error on the inflation front. Indeed, underlying inflation for forecasts for the end of the forecast horizon are above the inflation target band, highlighting the RBA's inflation challenge.
- The RBA's technical assumptions for the AUD, TWI and oil might be relatively high if the correction underway in recent trading sessions is sustained. This scenario suggests there is the added risk that the RBA's inflation and growth forecasts are understated.

The Reserve Bank (RBA) has sent a clear message that more tightening is coming. The RBA said "further tightening of monetary policy is likely to be required at some point for inflation to remain consistent with the 2-3 per cent medium-term target". This is one of its clearest messages yet and compares with its previous Statement on Monetary Policy (SOMP) that "the current setting of monetary policy remained appropriate"

Financial markets are expecting more tightening and for some time have been expecting more rate rises. But the \$64 question has been when will tightening kick off this year and how much tightening would the RBA do.

We continue to expect two rate hikes from the RBA this year and there is now a higher risk of a move as soon as June.

The language of today's SOMP contains a hawkish flavour, more so than the previous Statement published in February. Furthermore, underlying inflation forecasts have been upgraded for June 2011 through to June 2012, such that there is now even less room, if any, for error on the inflation front. It supports the case for more rate hikes.

The RBA also extended its forecasts by six months to December 2013 and underlying inflation is forecast to be above the band by the end of the forecast horizon. It highlights the RBA's inflation challenge.

Reserve Bank Output and Growth Inflation Forecasts, %, Year Ended:

	Jun-11	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13
GDP growth	(3.25) 2.50	(4.25) 4.25	(3.75) 4.25	(3.75) 3.75	(4.00) 3.75	3.75
Non-farm GDP	(3.25) 2.50	(4.25) 4.50	(3.75) 4.00	(4.00) 3.75	(4.00) 3.75	3.75
CPI Inflation	(2.50) 3.50	(3.00) 3.25	(2.75) 2.50	(3.00) 3.00	(3.00) 3.00	3.25
Underlying inflation	(2.75) 2.50	(2.75) 3.00	(2.75) 3.00	(3.00) 3.00	(3.00) 3.00	3.25

Forecasts in parentheses are the forecasts set in February 2011. All other forecasts are from today's SOMP.

GDP growth meanwhile is expected to be at, or above, its trend pace over much of the forecast horizon. The GDP forecast for June 2012 has increased, which takes into account the expected rebound in coal and iron ore production. GDP forecasts for December 2012 and June

2013 have been revised downwards, which reflects a stronger Aussie dollar affecting sectors outside the mining sector.

Importantly, these inflation and growth forecasts are based on an AUD/USD exchange rate of 1.07, a trade-weighted index of 78.00 and an oil price of US\$126 a barrel. The correction underway in recent trading sessions in currency and commodity markets, if sustained, suggests upside risk to the RBA's growth and inflation forecasts, and therefore, a greater risk that the RBA needs to hike by more than once this year.

The Statement's overview is littered with references highlighting the upside risks to inflation.

Firstly, the RBA notes there is "growing risk that global inflation will rise further".

Second, the RBA describe a significant lift in commodity prices and terms of trade as boosting national income and creating inflationary pressures. Furthermore, the RBA repeats what was published in the board minutes that the terms of trade is likely to rise further than what was assumed a few months ago.

Third, the RBA notes that unit labour costs "have been growing quite quickly".

Fourth, the RBA said that "spare capacity in the overall economy is relatively limited".

These references speak volumes; it suggests that the RBA is sitting uncomfortably and has its hands full in juggling the economic influences.

The key risks to the RBA's forecasts that the RBA note are developments in Asia, sovereign creditworthiness issues, the behaviour of domestic households, the behaviour of the domestic labour market and the local exchange rate.

Broadly speaking, a good deal of the overview has mirrored recent RBA commentary.

For the international economy, the RBA has reiterated that growth in most of Asia remains strong and the world economy is expected to grow at an above-average pace over the next few years.

For the domestic economy, the RBA has restated households remain cautious and leading indicators point to further growth in employment over coming months (but at a slower pace than in 2010).

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