

RBA Observer Update

Keeping its powder dry

The RBA held rates steady today at 4.25%. This surprised economists (24 of 27 expected a cut) and the market. More stable global conditions were clearly a key part of the story. Domestically, while the RBA acknowledged the softened labour market and divergences across the economy, they still deemed that the economy is tracking at 'close to trend' overall. With inflation concerns having eased, and our general view that the global economy still has significant challenges ahead, we still think the RBA will need to cut rates further this cycle. Though the 80bps or so priced into markets over 2012 seems overdone.

Facts

- The RBA remained on hold at 4.25% today contrary to the market pricing of around a 70% chance of a cut and the expectation of 24 of 27 economists in the Bloomberg survey (including ourselves).
- The statement suggested that while the risks in Europe remain 'skewed to the downside' the 'acute financial pressures on banks in Europe were alleviated considerably late in 2011 by the actions of policymakers'.
- The statement also suggested that domestically, growth was 'close to trend' despite 'differences between sectors' and while 'labour market conditions softened during 2011' they had been 'steady over recent months'. The job advertisement data for January, released yesterday, were clearly consistent with this view.
- On inflation, they are seemingly unconcerned. 'In underlying terms, inflation is around 2½ per cent.' And 'over the coming one to two years, and abstracting from the effects of the carbon price, the Bank expects inflation to be in the 2-3 per cent.'
- On the exchange rate, they suggested the AUD strength largely reflected the 'decline in the euro against all currencies', though they also conceded 'the Australian dollar in trade-weighted terms is somewhat higher than the Bank had previously assumed.'
- Overall, they suggested that 'should demand conditions weaken materially, the inflation outlook would provide scope for easier monetary policy.' Clearly, they will be watching the global risks very carefully.

Implications

With global conditions having stabilised, the RBA has taken the view that it can afford to still sit for now and keep its powder dry.

While they acknowledged that global growth forecasts have been lowered, the calmness in markets and better run of data in recent weeks has clearly seen their concerns dissipate for the moment.

Domestically, they see the economy as currently tracking at 'close to trend' growth, and seemed to show only limited concern about the easing labour market and divergent performance across the economy.

They tacitly acknowledged that financial conditions had tightened, by suggesting that the strength of the AUD had surprised them, but this was clearly not enough to trigger a rates response at this stage.

As is so often the case, the future path for Australian monetary policy will mostly be driven by the global outlook.

As we still deem that there are still significant challenges ahead for the global economy, we are still of the view that the cash rate will need to be cut further.

However, we remain of the view that the current 80bps priced into markets is overdone.

The domestic economy is still in good shape, and last year's cuts will start to provide support for some of the more interest-rate sensitive sectors over coming months, such as housing and retail.

Bottom line

The RBA remained on hold today, surprising the markets and the majority of economists.

We still expect further cuts from the RBA given the global downside risks. At this stage we still expect a cut in Q1 and another in Q2, before they hold for the rest of the year at 3.75%.

We will be watching out for Friday's RBA statement on monetary policy to elucidate more of the RBA's thinking on today's decision.

Paul Bloxham, Chief Economist (Australia and New Zealand)

Disclosure appendix

Additional disclosures

- 1 This report is dated as at 07 February 2012.
- 2 All market data included in this report are dated as at close 07 February 2012, unless otherwise indicated in the report.
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