ECONOMIC INSIGHTS

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KEY POINT

Setting monetary policy has become much more of a balancing act than it was back in May and August, with inflation now not the only key focus for the RBA.

In the balance

The Australian economy is showing signs of growing at an acceptably firm pace over the medium term and with inflation starting to lift towards the RBA's 2-3% target according to recent commentaries by the RBA including the speech given by Governor Philip Lowe yesterday. There are several key assessments and provisos with the RBA's view relating to fading headwinds to economic growth from the terms of trade and falling mining investment spending and views that the decline in annual wages growth and inflation are almost over too. The strong inference in the RBA's assessment is that the economy needs no more assistance from a lower cash rate. Apart from judging whether or not the RBA's economic assessment is right one problem with the RBA leaving the cash rate on hold is that it may reinforce pressures that are working to tighten monetary conditions, something the economy does not need at this stage.

Inflation data was RBA's key focus…

Before looking at what the impact of leaving the cash rate unchanged may do to Australian monetary conditions it is worth looking at whether there are any forces that may still lead to the RBA cutting the cash rate in the near-term. When the cash rate was cut at the May and then the August RBA board meetings it was essentially on evidence just before each of those meetings that annual inflation was tracking too far below the RBA's 2-3% target band and looked like staying too far below over the next year or so. In the simplest terms the RBA was resetting the cash rate to help drive a faster economic growth rate in the knowledge that the economy was unlikely to overheat in the sense of driving up inflation too quickly.

…with financial stability now formally in the mix

This simple policy reaction function to inflation travelling too low has become more nuanced over recent months. There is now some focus on too much upward price pressure in parts of the housing market as well as too much build-up in household debt outstanding. Financial stability has been recognised in contract signed by new RBA Governor Lowe and the Treasurer relating to the aims of monetary policy. At the heart of that contract is still the aim of achieving 2-3% inflation but over time providing flexibility for the RBA not to react to inflation travelling outside target band for an extended period, as it is now.

RBA now notes balancing stability as well

One sign that the RBA is trying to balance the need of financial stability with its inflation target showed in Governor Lowe's comment that "achieving the quickest return to 2.5% inflation would be unlikely to be in the public interest if it came at the cost of a weakening of balance sheets and an unsustainable build up of leverage to historically low interest rates".

This is not the only balancing act. The RBA feels that there is still some slack to be taken up in the labour market with the unemployment rate still travelling around half a percentage point above what it regards as the full-employment unemployment rate. Also there is the balancing act with the Australian dollar exchange rate which if it continues to appreciate could complicate the rebalancing of the drivers of Australian economic growth that has delivered reasonable economic outcomes so far and in the face of very big, although now fading, challenges from falling export prices; big cutbacks in mining investment; and persistently low wages growth.

The RBA has built quite a case to not do anything with the cash rate at its board meeting on 1st November, unless the Q3 inflation readings due next week are so low that they would necessitate significant downward revision to the RBA's already low inflation forecasts. Our forecasts for Q3 inflation, 0.3% q-o-q for the CPI, trimmed mean and weighted median with annual rates ranging 0.9% y-o-y for the CPI to 1.6% for the trimmed mean are very low, but the outcomes would need to be even lower to force the RBA to change its inflation forecasts. Surprisingly low Q3 inflation is possible but probably less than a 20% chance. In short, it is unlikely that very low inflation will provide the RBA with sufficient strong reason to offset the other reasons it has put forward for waiting before considering any further change to its cash rate.

Leaving the cash rate unchanged also impacts bonds and A$

While we do not expect a November 1st cash rate cut because of what the RBA has been saying, we do expect that not cutting will have consequences that the RBA either believes will not happen or is trying to ignore. We see leaving the cash rate unchanged adding to forces that have been pushing up bond yields over the past month or so and the Australian dollar exchange rate for rather longer. Over the past two months Australia's 10-year government bond yield has risen from a low point near 1.80% to currently around 2.30% and it is still rising erratically. Most other market related interest rates such as corporate bond yields and swap rates have risen similarly.

Turning to the exchange rate, since the end of last financial year the Australian dollar has appreciated more than 3% on trade-weighted basis and closer to 4% against the currencies of China and Japan, our two biggest trading partners. Overall monetary conditions are regarded as a combination of the relative height of interest rates as well as the relative strength of the currency exchange rate.

The extent of the upward movement in government bond yields, corporate bond yields and swap rates plus the underpinning of those movements on a likely decision by the RBA to leave its cash rate unchanged at its November policy meeting means that it is only a matter of time before higher bank funding costs push them to raise their lending interest rates. At that point, every interest rate that matters in the economy with the single exception of the RBA's cash rate says that monetary policy has effectively been tightened. On overall monetary conditions that tightening effect will probably be compounded by a stronger Australian dollar exchange rate driven by short-term foreign investment flows attracted in part by Australia's solidly high interest rates on offer by international comparison.

Setting monetary policy has become much more of a balancing act than it was back in May and August, but one more facet needs to be added to the balancing act. The main tool used to effect monetary policy change, the RBA's cash rate, needs to be reassessed too, otherwise the stance of monetary policy may end up being different to what the RBA intends as is threatening to be the case very soon.

About the Author

Stephen Roberts is Altair's Chief Economist and provides Altair's team with a comprehensive review and outlook of macro-economic factors likely to influence financial markets.

Stephen is an economist and investment strategist who has worked for over 40 years in the finance industry with extensive experience in banking, broking and funds management.

During his career Stephen has been Australian Chief Economist for SBC, Fay Richwhite, Equitilink, UBS, Grange Securities, Lehman Brothers and Nomura. He has also worked as a portfolio manager specialising in strategic asset allocation overlays for Westpac Investment Management, Sagitta and BT. In addition, Stephen was a contributing author to the Campbell Committee Report relating to the conduct of monetary policy, foreign exchange controls and floating the Australian dollar.