

Rate Hikes Remain on the Table

Thursday, 3 February 2011

- **The recent floods and Cyclone Yasi are likely to have a short-term effect on output and prices.**
- **The RBA emphasised that the medium-term prospects for the economy are largely the same.**
- **We continue to expect the RBA to resume raising rates, possibly as soon as before the end of June.**

According to the Chinese calendar, 2011 marks the year of the rabbit. A rabbit year is quiet, giving respite. But 2011 so far could not be any different to this description. The most unpredictable of events - the weather - has spread havoc and tragedy to Australia.

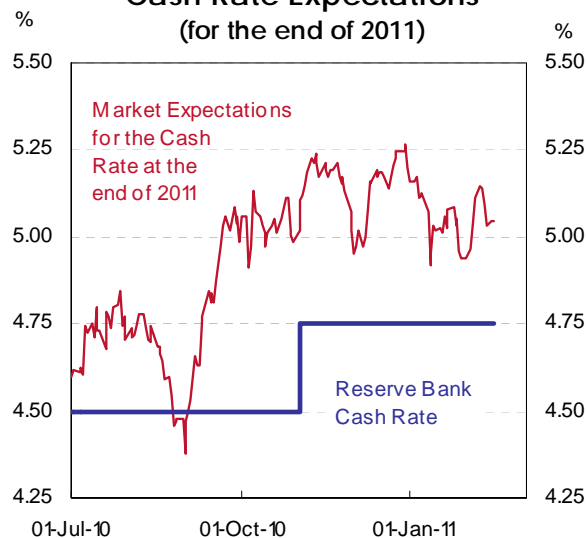
From an economic perspective natural disasters, such as the recent floods, typically depress economic activity in the near term but boost activity down the track as disruptions ease and reconstruction is in full swing. In the near term, activity is depressed because production is disrupted and public infrastructure, houses, cars and business assets are damaged. Agriculture and spending are also affected.

Assuming there are no further weather disasters, it is likely that the greatest adverse impact to economic activity will occur in the three months to March. It is estimated that economic growth in this quarter could be half a percentage point lower had the floods not occurred. Indeed, in the March quarter we are forecasting the economy will go backwards and contract by 0.2 per cent.

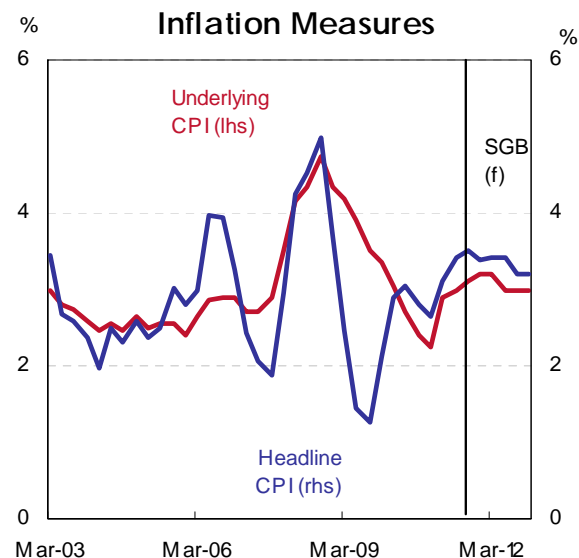
However, after the June quarter, economic activity is likely to be higher than otherwise would be the case. Experience from other natural disasters suggests that the planning and building of infrastructure projects and the like will probably be spread over several years. The Reserve Bank estimates that these projects could be around \$8 billion, spread over two years from the middle of 2011. The overall effect is to boost the level of gross domestic product

Where does this leave the economy? It leaves an economy weaker in the near term but stronger over the medium term. In the medium term the economy will get a boost from rebuilding at a time when the mining-investment boom is underway. It means after the June quarter, Australia will again be battling with little spare capacity. The labour market is a prime example of where little spare capacity exists; the unemployment rate stands at 5 per cent and forward-looking indicators of labour demand point to more tightening in labour market conditions.

Cash Rate Expectations (for the end of 2011)



Inflation Measures



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Over the medium term, the global backdrop should also be more favourable. The world economy is on the recovery road, despite lingering pockets of stress. The International Monetary Fund expects the global economy to expand by more than 4 per cent per annum this year and next. Further, Australia's trading partners are expected to grow at a rate of more than 5 per cent per annum.

The Reserve Bank, of course, will take a forward-looking approach when steering interest-rate settings. This episode with the floods is no exception.

The Reserve Bank is betting that economic activity will grow at a rate above average in 2011/12 and 2012/13 (see table below). Our forecasts also centre on economic growth above the long run average. The Reserve Bank aims to keep inflation on average within a 2 to 3 per cent per annum target band over the medium term. And inflation is expected to be running in the top half of the band over these time frames.

Indeed, given the Reserve Bank has a medium term inflation target, one can reasonably expect that official interest rates are changed taking into account the medium-term outlook. On this front, the Reserve Bank said in its board minutes today "the medium-term prospects for the economy were largely the same as they had been prior to the floods". Again, that is a green light in our view that more tightening is to be expected because the underlying economic fundamentals in the economy are firm.

So this mixture of strong growth and inflationary pressures near the top of the band is a recipe for more interest rate hikes.

Therefore, the floods may keep the Reserve Bank on the sidelines for the next few months, but we still think the Reserve Bank is not likely to keep its foot off the brakes all year. We are still preparing for the Reserve Bank to hike rates a further two times this year. Moreover, we believe that we cannot fully rule out tightening resuming before the end of June, although there is some risk the Reserve Bank waits until the September quarter. The Reserve Bank in

the recent past has taken a pre-emptive approach to hiking rates but with impact of the floods muddying the near-term outlook, there is some risk it may delay tightening to better assess the economic picture.

Interestingly, prior to the flooding, financial markets were expecting at least two further rate hikes from the Reserve Bank with the first rate hike in 2011 as soon as June; the market has now shifted the first rate hike to November with only one rate hike fully priced in and another rate hike partially priced in before the end of 2011.

The reaction of financial markets is not unusual; financial markets can overreact. We saw a similar reaction by financial markets when Hurricane Katrina struck in the United States in August 2005. It was the costliest natural disaster of the United States just as these floods are one of Australia's costliest disasters. Financial markets unwound their expectations for tightening by the Federal Reserve. However, these expectations were soon reversed, as the US central bank raised rates in August and followed up with more tightening in September, November and December of that year. Time will tell if history repeats.

Today's Reserve Bank board meeting minutes were consistent with the testimony provided by the RBA Governor Stevens on Friday and also the Statement on Monetary Policy issued on February 4. Our views, therefore, after the minutes remain unchanged.

** Note that a version of this article also appears in the finance section of ninemsn.*

Output Growth and Inflation Forecasts^(a)
Per cent, over year to quarter shown

	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013
GDP growth	3.1	2¾	3¼	4¼	3¾	4	4
Non-farm GDP growth	3.2	2½	3¼	4¼	3¾	4	4
CPI inflation	3.1	2.7	2½	3	2¾	3	3
Underlying inflation	2¾	2¼	2¼	2¾	2¾	3	3

(a) Technical assumptions include A\$ at US\$1.00, TWI at 74, WTI crude oil price at US\$96 per barrel and Tapis crude oil price at US\$103 per barrel
Sources: ABS; RBA

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