

RBA FOCUSES ON MINING BOOM

Friday, 4 February 2011

Summary

- The tone of today's quarterly 'Statement on Monetary Policy' (SOMP) was mostly upbeat. The RBA acknowledged the short-term adverse impact of the floods on growth and inflation but stressed that it will look beyond this in setting policy and will focus on the medium-term outlook. The latter is broadly unchanged from the time of the November SOMP, despite recent softer than expected growth and inflation outcomes.
- The RBA's forecasts, however, do not include the impact of Cyclone Yasi as at the time of writing the full extent of the disruption and damage was not yet known. Cyclone Yasi could have a further short-term adverse impact on inflation and growth. Nonetheless, the impact on inflation should still be quick to unwind. And it also means that the medium-term boost to the economy from flood/cyclone rebuilding and repair-work efforts could be greater.
- Looking past the discussion on the floods, a key theme that resonates throughout the statement is the 'mining boom'. We are currently experiencing a 60-year high in the terms of trade and the signs are that it could even move higher. The high level of export earnings is contributing to an investment boom, a key positive for growth. And the RBA highlighted today that it has even greater confidence in such projections, given that several very large resource projects have recently got the go-ahead.
- With the RBA expecting GDP growth to remain above trend for quite some time and upside risks to inflation, we see the risk of further monetary policy tightening. The RBA could deliver a rate hike in June as flood recovery and rebuilding efforts coincide with the investment boom and upside risks to inflation. Thereafter, we see the risk of a further rate hike by the end of the year.

The flood impact on inflation

On the price front, the RBA expects the floods to add up to 0.25 percentage points (pp) to headline inflation in the March quarter. But the effects of this are to unwind quickly and the high Australian dollar will help contain price pressures by lowering the cost of imported goods (although the effect of this will eventually fade).

The RBA has upgraded their headline inflation forecast for end 2011 to 3.0% (previous forecast 2.75%) but kept their core inflation forecast steady at 2.75%. It, however, sees upside risks to these forecasts from global price pressures, surging commodity prices and the tight jobs market.

The flood impact on GDP

In terms of GDP, the floods are seen as lowering output by 0.5pp this financial year, with most of the negative effect in the December and March quarters. Post this, however, growth will be boosted by a recovery in coal exports and as households and firms affected by the floods replace damaged items and amid public sector repairing and rebuilding of flood affected areas. Strong growth in mining investment and higher commodity prices will also boost national income and demand.

The RBA sees GDP growth ending this year at 4.25%, which is an upgrade from its previous forecast of 3.75%. For the rest of the forecast period (i.e. up to mid 2013), growth is expected to remain at an above-average pace of around 3.75% - 4.0%, which is above the economy's long-term potential of around 3.5%.

The 'mining boom' as a significant contributor to growth

The RBA today, highlighted that the indicators (e.g. the announcement of a number of large resource-sector projects) continue to point to a pick up in private investment from the mining boom. Further, the profile for mining investment projects has been revised slightly higher since the November SOMP. This includes a number of large LNG and iron ore projects, the \$43 billion Gorgon LNG project and two large coal-seam methane projects in Queensland.

Strong growth in mining investment along with rising commodity prices is to be a significant contributor to national income and demand. The tight labour market will also add to inflationary pressures via higher wages (employment has been strong not only in the mining industry but also in several service

industries). Such developments are expected to coincide with the boost to growth via flood recovery and repair efforts. Hence, we see a strong case for the RBA to lift rates further this year.

Some other key comments on global conditions made by the RBA:

- * The global economy grew at an above-trend pace in 2010. Strong growth is still expected for the next few years but with some moderation in pace.
- * There is, however, large disparity across economies: in advanced countries output remains around, or below, pre-crisis levels and unemployment rates are still very high; emerging market economies have, however, experienced strong recoveries with limited spare capacity.
- * The Chinese economy is growing strongly and this is helping to prop up other economies in the region. For China and the rest of Asia, however, rising inflation pressures have raised the risk of a slowdown. The near-term outlook for the US has improved, while the Euro area as a whole continues to experience a modest recovery.
- * The improving global economy and weather-related disruptions to supply has pushed up global commodity prices. Higher commodity prices are adding to global inflationary pressures, and for the commodity-exporting countries (like Australia), helping to improve the terms of trade.
- * An ongoing downside risk, however, is if the sovereign debt problems in some Euro area economies deteriorates further.
- * Sentiment has generally improved in financial markets. However, concerns about sovereign creditworthiness in a number of European countries are likely to remain high for quite some time.

Some other key comments on domestic conditions made by the RBA:

- * While the resources sector and some service industries are expanding strongly, parts of the manufacturing, education, retail and tourism sectors are experiencing difficult trading conditions. Business credit remains weak, with much of the expansion of the resources sectors being financed through internal funds. Commercial property construction also remains at low levels.
- * The household sector has continued to exhibit considerable caution in its spending and borrowing behaviour. Retailers report that consumers continue to be very value-conscious. Nationwide measures of housing prices have been broadly flat since mid 2010. Overall, many households appear to be taking a more cautious approach to their finances than was the case in earlier years. This should reduce the pressures on capacity that are likely to arise over the period ahead.
- * Although last year's very strong creation of jobs is unlikely to be sustained, forward looking indicators of the labour market, including on job vacancies, job ads and business surveys are still suggesting continued solid growth in employment.
- * Wage growth increased over 2010, consistent with the strengthening in labour market conditions. Looking ahead, a gradual increase in wage growth is expected as the labour market tightens further.

February 2011 RBA Forecasts (does not include any estimate of impact from Cyclone Yasi)

Table 6.1: 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 AS 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

November 2010 RBA Forecasts

Table 15: 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	3.3	3½	3½	3¾	3¾	4	4
Non-farm GDP growth	3.3	3¾	3¾	3¾	3¾	4	4
CPI inflation	3.1	2¾	2¾	2¾	2¾	3	3
Underlying inflation	2¾	2½	2½	2¾	2¾	3	3

(a) Technical assumptions include AS at US\$1.00, TWI at 74, WTI crude oil price at US\$87 per barrel and Tapis crude oil price at US\$90 per barrel
Sources: ABS; RBA

For a copy of the February Statement on Monetary Policy:
<http://www.rba.gov.au/publications/smp/2011/feb/pdf/0211.pdf>

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