

# RBA INTEREST RATE DECISION

Reading between the lines

Tuesday, 1 February 2011

- The RBA leaves rates on hold at 4.75%
- The central bank is optimistic about growth going forward
- The impact of the floods is likely to be temporary

It was almost certain the RBA would remain on hold at its first meeting of 2011. Firstly the impact of the Queensland floods won't be known for some months and there is real risk Q1 GDP will be negative. A contraction in employment is also possible seeing some reversal in the unemployment rate in the first half of this year.

The prospect of a sharp decline in output – albeit temporary – is being reflected in business confidence. Predictably, national indicies are being weighed down by the more negative responses from Queensland – although there is also evidence that Australian corporates are nervous there will be knock-on effects to overall demand.

The other reason the RBA is able to stay on hold is inflation. Not only is core price growth well within the bank's target range it is also trending lower. This is at odds with the RBA's prognosis made in November that the economy is on the verge of rising supply and demand pressures. Here the central bank could not have foreseen the impact of the stronger dollar on prices and further retail discounting. It is also probable that emerging wage pressures are occurring in industries, which have high enough profit margins that they are not being passed on as higher prices.

That said, looking at the statement, which accompanies today's decision, there is a sense that the floods are a temporary distraction to the bank's outlook. It expects the effect of the floods will be concentrated in a fall in agriculture and resources output. Other industries are also likely to be affected to the extent they were located in the floods' way. This will include areas of Ipswich and outer Brisbane where there is a concentration of manufacturing.

Even with the slow down the central bank remains unequivocally optimistic. It believes the global economy will remain strong going into 2011. It mentions Australia's terms of trade is at its highest levels since the early 1950s and national income is growing strongly. It highlights that private investment is picking up – not slowing down – in response to higher commodity prices. And it notes that employment growth was strong over 2010 and that there is a further pick up in wages to come into the new year.

These are descriptions, which normally would suggest the bank is in tightening mode, the floods being a short-term reprieve. Prior to the natural disaster the economy was nearing full capacity with an unemployment rate at 5% and leading indicators suggesting it would trend lower. Without the events in Queensland and a further decline in unemployment the RBA could have been raising rates as early as March.

The bank says that as in past occasions when natural disasters have occurred it has the ability to look through these short-term events on activity and prices. This means even if the March quarter growth number is negative the bank will be focused on underlying momentum, which at this point looks increasingly positive.

Some in the market saw the statement as neutral because the bank expects that inflation over the year ahead will continue to be consistent with the 2–3 per cent target. This says little as these forecasts include hypothetical rate rise to keep price pressures in check. As such focus should be on more recent actions of the RBA, which has shown a capacity to over look existing low inflation rates – as it did last year – and to tighten policy preemptively.

One of the key issues the RBA touches upon is whether Queensland's recovery will eventually add to inflationary pressures. This is important because when the RBA does resume its tightening policy – which we believe will be around mid this year – there is a risk it will need to tighten even more in time to offset the additional activity. Theoretically the levy is likely to be stimulatory while the rebuilding of homes and infrastructure should more than offset any job losses during the floods' initial impact.

For now the bank does not seem to believe that it will have a major impact on its medium-term outlook for inflation. This is possible as Queensland's growth has been lagging the other states since the global financial crisis, including its construction sector. This means jobs created due to Queensland's reconstruction may not result in the skill shortages as it would in other states. Moreover ongoing bad weather, which is predicted to last another six months, could delay the rebuilding program and result in it being spread over a greater period of time. We expect this to be discussed further when it releases its Statement on Monetary Policy on Friday.

St.George believes interest rates will be raised again in June this year and that a further rate rise is probable before the end of 2011.

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For a copy of the February Monetary Policy decision:

<http://www.rba.gov.au/media-releases/2011/mr-11-01.html>

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