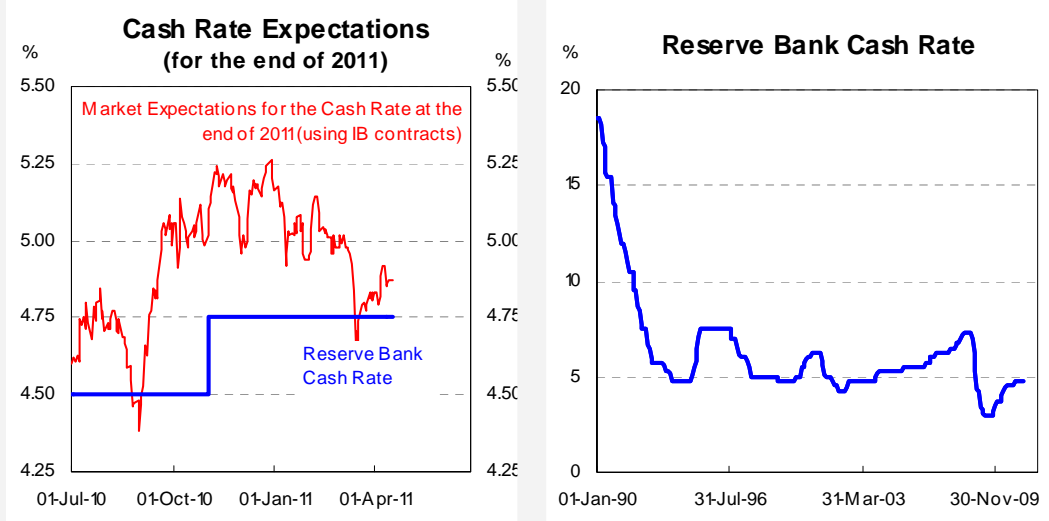


CASH RATE OUTLOOK

RBA Minutes – The Challenge Ahead

Tuesday, 19 April 2011

- The Reserve Bank appears comfortable with sitting on the sidelines for now but warns of the challenges ahead.
- The challenge is whether the Aussie economy can accommodate the expected high rate of investment without undue pressure on inflation.
- The little room for error on the inflation front means we think the Reserve Bank is still likely to tap on the brakes later this year.



A strong pick-up in business investment remains the central element in Australia's medium-term outlook and also the biggest risk for inflation. It was one of the key takes from the minutes taken from the Reserve Bank's board meeting on April 5.

The challenge for the Reserve Bank is that the expected high rate of investment may be accompanied by rising costs. With the RBA itself forecasting headline inflation to be at the top of its target band later this year, the RBA is left with little room for error on the inflation frontier.

In the second last sentence of the minutes, the Reserve Bank typically notes that the current stance of policy is appropriate. Unusually this month, the RBA used this sentence to include reference to Australia's high level of the terms of trade and prospective further large increases in investment.

The rest of the domestic economy received a more mixed assessment in the minutes. The RBA notes that domestic demand is growing at a solid pace and is likely to continue to do so in the medium term. Stronger-than-average growth in business investment is expected to offset weaker-than-average growth in consumption and dwelling investment.

Consumption and dwelling investment remain the relatively softer spots in the Aussie economy. The RBA noted that the household sector continued to show "restraint" in spending. The minutes note that there is considerable optimism about prospects for the broader economy, but consumers were less positive about their own finances. Conditions meanwhile in the housing market were characterised as "subdued". Auction clearance rates were described as "a little below average" whereas in previous Minutes they had been described as "close to average". House prices are now described as "down slightly" compared with "broadly stable" in the March minutes.

On employment, the RBA remains upbeat but one could argue less so than in the previous Board meeting. The Bank notes that forward-looking indicators point “to a continuation of employment growth” but this compares with “solid employment growth” used in the previous March minutes.

Turning to the global economy and the RBA’s language took a more positive tone than in the March minutes. Growth in the global economy is described as “relatively strong”. That compares with the previous minutes where the world economy was described as growing “at an above-trend rate”.

However, references to China, Australia’s largest trading partner, were a little less upbeat. The RBA minutes state that growth in China has “remained strong” but that there are “tentative signs that it has eased”.

The natural disasters in Japan also occurred between the March and April board meetings. On Japan, the RBA sees the effects on global activity as being “relatively limited”. For Australia, in the short term there is likely to be some disruption of exports to Japan but beyond this the RBA sees the rebuilding effort providing a “boost” to Australian exports.

Our view remains unchanged. We expect the Reserve Bank to raise rates later this year. The timing remains the big question; we see the likely timing as August, followed by November.

Besa Deda, Chief Economist

Ph: (02) 9320-5854

Email: dedab@stgeorge.com.au

St.George Contact Listing

Economics & Strategy:

Chief Economist	Besa Deda	dedab@stgeorge.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@stgeorge.com.au	(02) 9320 5751

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