Economic Research
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Australian economic update

RBA quarterly statement

The RBA today released its quarterly Statement on Monetary Policy (SMP). The statement highlighted that the outlook for economic growth and inflation depended on several opposing forces. The RBA acknowledged that the impact of the rising terms of trade on economic growth and inflation is working against the slowdown in global growth, ongoing turmoil in financial markets, and the tightening in domestic financial conditions.

As always, the main focus of the quarterly statement was the RBA's inflation forecasts, which were unexpectedly revised higher. Headline CPI inflation in the year to the December quarter 2008 is now forecast at 4.5%, up a full percentage point from the previous forecast of 3.5%, owing mainly to higher oil prices. Underlying inflation is expected to be around 4% over the same period, up from 3.5% in the previous SMP, and even further above the top end of the RBA's 2-3% target range. Thereafter, inflation is forecast to fall gradually, although will remain outside the target band until June 2010.

RBA output and inflation forecasts
%oya

	Consumer price index	Underlying inflation
Dec-07	3.00	3.60
Mar-08	4.20	4.20
Jun-08	4.25	4.25
Dec-08	4.50	4.00
Jun-09	3.50	3.50
Dec-09	3.25	3.25
Jun-10	3.00	3.00
Dec-10	2.75	2.75

Source: RBA

On the global economy, the RBA reiterated that global growth is slowing, particularly in the US and other developed countries, such as the Euro area and Japan. In contrast, growth in developing countries remains strong, particularly in China and other Asian economies, which have shown few signs of slowing in recent months. Inflation, though, remains a key concern in many countries, owing to elevated food and commodity prices and, more recently, the spike in oil prices. On financial markets, sentiment has improved, although still remains fragile.

With regard to Australia's economic growth outlook, the RBA lowered its 2008 GDP growth forecast from 3.25% to 2.25%. The RBA believes that a significant moderation in domestic spending is now occurring; this is evident in recent data

on retail sales, consumer and business sentiment, and housing construction. Other indicators, including the fall in home loan approvals and auction clearance rates, are pointing toward more subdued demand this year. The Bank anticipates that the continued moderation in domestic demand will help curb inflationary pressure.

In contrast, though, the rising terms of trade should provide significant economic stimulus in the year ahead. The RBA forecasts that the terms of trade will rise 20% this year (JPMorgan forecasts a 28% rise) owing to rising contract prices for commodities, such as iron ore and coal. The rise in the terms of trade is much more than the RBA forecast a few months ago and, therefore, will provide an even greater stimulus to economic activity this year.

The key focus of the SMP was that the net effect on demand and inflation of the opposing forces at work is “subject to considerable uncertainty.” There are signs that domestic demand is easing and, given the significant tightening in the policy pipeline, further easing is anticipated. At the same time, the stimulus from the soaring terms of trade is also expected to grow going forward. The Board currently believes, however, that the forecast moderation in economic growth this year will help reduce inflation pressure over time.

In our view, the primary risk is that the rising terms of trade, the fiscal stimulus in the pipeline, and tight labour market conditions, will prevent the significant easing in domestic demand currently forecast by the RBA. We currently forecast that the RBA will sit on the policy sidelines in 2008, although we will monitor upcoming domestic economic data closely to assess whether or not current monetary settings are appropriate, and whether additional tightening may be warranted.

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