

Australian economic update

RBA's December Board meeting minutes

The RBA today released minutes of the 4 December Board meeting, at which officials decided to leave the cash rate unchanged at 6.75%. The key phrases in the minutes are that, at the time of the meeting, RBA officials were concerned about the outlook for inflation, that the decision at the December meeting was 'finely balanced', and that only problems in credit markets kept the RBA sidelined. With this in mind, we still look for a February 2008 policy tightening. In fact, in the wake of the release of the minutes, we are more comfortable with this view than before.

Today's release of Board minutes is the first in which the market had advance knowledge. The RBA unexpectedly released minutes of the November Board meeting two weeks ago. Also, the RBA surprised by releasing minutes of all other Board meetings dating back to October 2006 last week to coincide with Governor Glenn Stevens speech on central bank communication. The release of minutes and statements even when policy is unchanged are crucial components of the RBA's new communication regime, details of which the RBA announced earlier this month.

One qualification with the minutes, though, is that they summarize a meeting that took place two weeks ago, and things inevitably have changed since then. With that limitation in mind, the minutes nevertheless reveal that RBA officials held a clear tightening bias at the time of the December Board meeting. In fact, the minutes indicate that, if not for the problems in global credit markets, which pushed up market yields in Australia, there was a strong case to raise the cash rate early this month. The fact that officials elected to leave the cash rate unchanged suggests the RBA is content to let the domestic banks do some of the work in bringing GDP growth back down towards potential.

The minutes reveal that Board members remained concerned about the outlook for inflation. Domestic credit growth is rapid despite slower growth in housing credit, there is considerable pressure on capacity, the labour market remains very tight, the terms of trade is providing a boost to local incomes, wage growth has accelerated, albeit modestly, and Australia is less affected by global credit market dislocation than elsewhere - sound borrowers have ample access to finance. On the global economy, the minutes indicate that GDP growth in the third quarter was very strong and, although global growth was likely to slow in coming quarters, high prices for food, energy and natural resources pose a significant threat to global inflation. Crucially, officials believe that core inflation in Australia will be above target in coming quarters, and will be close to the top of the RBA's 2-3% target range at the end of the forecast horizon.

In our view, as the RBA minutes indicate, the case for further monetary tightening remains strong; we expect a 25bp rise in the cash rate on February 5 (at 2.30pm, rather than 9.30am the day after the Board meeting). Core inflation is likely to be close to 3.5%oya in coming quarters, well above the RBA's own projection, and it is clear that the domestic economy retains considerable momentum, so resources will remain stretched for some time to come. Also, as the minutes indicate, the terms of trade remains a significant source of support for domestic income, and the global macro-economic backdrop remains supportive of further growth in Australian export volumes and prices, even though we agree that GDP growth will be weaker in the near term. Also, the lower AUD in recent weeks means import prices are unlikely to fall as much as previously forecast.

There are, however, a number of factors mitigating against the RBA raising the cash rate again. There is a risk that global economic growth will be weaker than we currently forecast; already, we estimate a 35% probability of recession in the US. Also, the problems in credit markets have intensified since the December Board meeting, which may prompt RBA officials to tread more cautiously than they would otherwise. Also, the major Australian banks indeed are doing some of the heavy lifting for the RBA; the banks recently raised interest rates on variable rate business loans to help offset the impact of the rise in wholesale funding costs, and may raise interest rates on variable rate home mortgages in the near term.

How these conflicting factors play out in coming weeks will determine whether, and by how much, the RBA tightens policy in coming months. At this stage, though, the inflation outlook looks sufficiently bleak to justify an early February tightening. The keys from here will be whether, and by how much, the Aussie banks raise interest rates on variable rate home loans, and how dysfunctional credit markets are as we move into 2008. The RBA is unlikely to tighten if market yields rise significantly from current elevated levels, even if core inflation readings also are high.

RBA cash target rate

Percent per annum, end of period

