



Daily Note: 23 January 2008

## Fed cut need not derail RBA hike

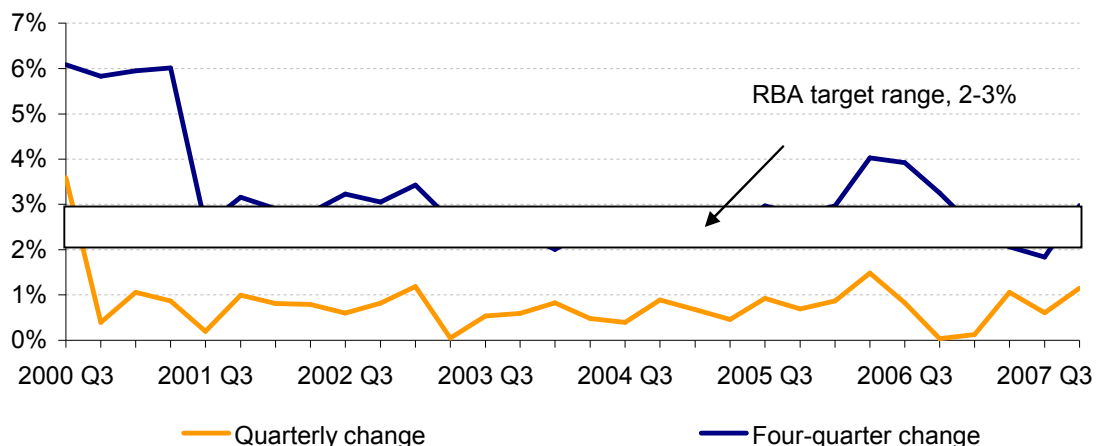
**WE SUGGEST: RBA rate hike no longer certain, but still more likely than not**

**SUMMARY: Until 24 hours ago, an RBA interest rate increase in early February seemed a near-certainty. But the Fed's intra-meeting cut in the Fed funds rate will mean strong pressure on other central banks to follow suit. On the other hand, the Australian economy is already overheating. On balance, it would still make sense for the RBA to raise interest rates one more time.**

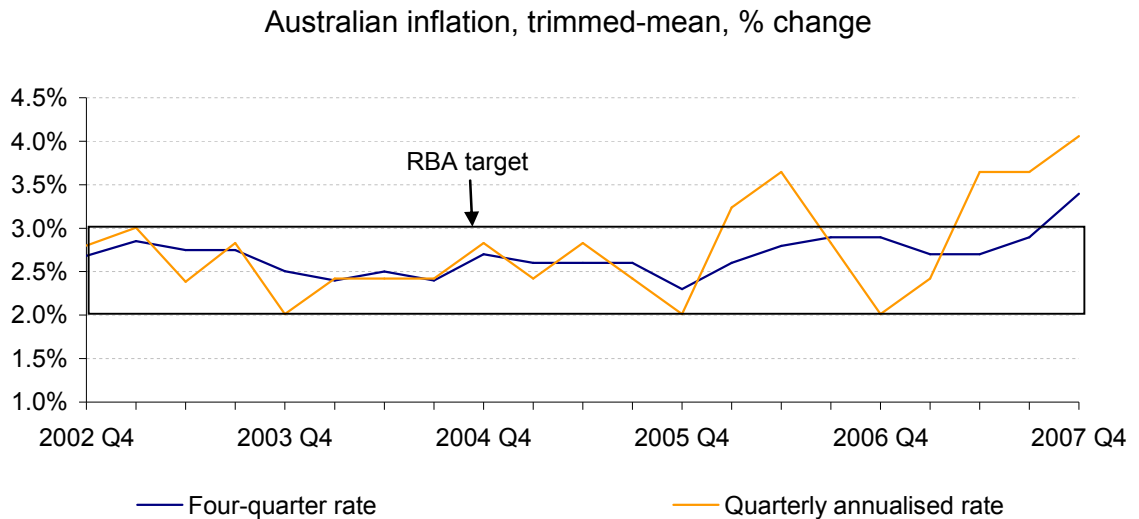
Two pieces of news have suddenly made the RBA's work much more difficult. The first was obviously the Fed's surprise interest rate cut yesterday. An intra-meeting cut, unprecedented in size and in response to global stock market turmoil, creates substantial pressure on other central banks to follow suit. The Bank of Canada (and assorted smaller central banks) have already done so. The Bank of England was in any case more likely than not to cut interest rates in February. As for the ECB, while there is much talk today of a shift in policy, that still seems to be market hopes, rather than based on anything tangible. M. Trichet fortuitously appears at the European Parliament today, which hopefully will give an indication of current ECB thinking. But the ECB was – tough talk notwithstanding – mainly likely to keep interest rates unchanged. By contrast, the RBA was all set to raise interest rates in the face of an overheating economy and above-target inflation..

That brings us to the second piece of news: this morning's release of Australian inflation data for Q4. The headline CPI rose by 0.9% in the quarter and was up by 3% from a year earlier; excluding volatile items, the changes were 1% in the quarter and again 3% in the year. This puts the rate right at the top of the RBA's 2-3% target range.

Australian inflation, % change



So far, so good. However, the RBA's trimmed mean inflation measure (which only includes the 70% of prices that *changed the least* in the quarter), prices rose by 1% in the quarter (again), but by 3.4% from a year earlier. Moreover, this comes after two quarters of 0.9% price rises, meaning Q4 was the third consecutive quarter when prices on this measure rose well above the RBA's target.



The numbers simply confirm the picture we already have from other sources, such as labour market data, broad money and credit growth and even some signs of revival in the housing market.

In itself, above-target inflation is not a problem. The RBA's inflation target is medium term and the Bank can perfectly well let the rate go both above and below target – *provided it believes this to be temporary*. However, the trend clearly implies that higher inflation is not a temporary phenomenon. Moreover, there is a further problem. Although the Australian economy is far larger than, eg, the Icelandic or New Zealand ones, it does suffer from some of the same problems: a carry trade and being at the mercy of the excess savings countries' capital flows. This means that the central bank's control over money and credit is diminished – or, rather, that it needs to do more to achieve the same effect.

A global economic slowdown, particularly a slowdown in the Far East, will of course dampen Australian activity. But the economy now has no output gap (or possibly a small positive one) and growth is likely to remain above-trend for at least another quarter, meaning some capacity constraints will appear. The RBA may still feel that the insurance of one more interest rate increase (which, after all, could quickly be reversed if need be) would be prudent. Hence, although the certainty of higher Australian interest rates is less than it was 24 hours ago, a hike in the early spring remains more likely than not.

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