



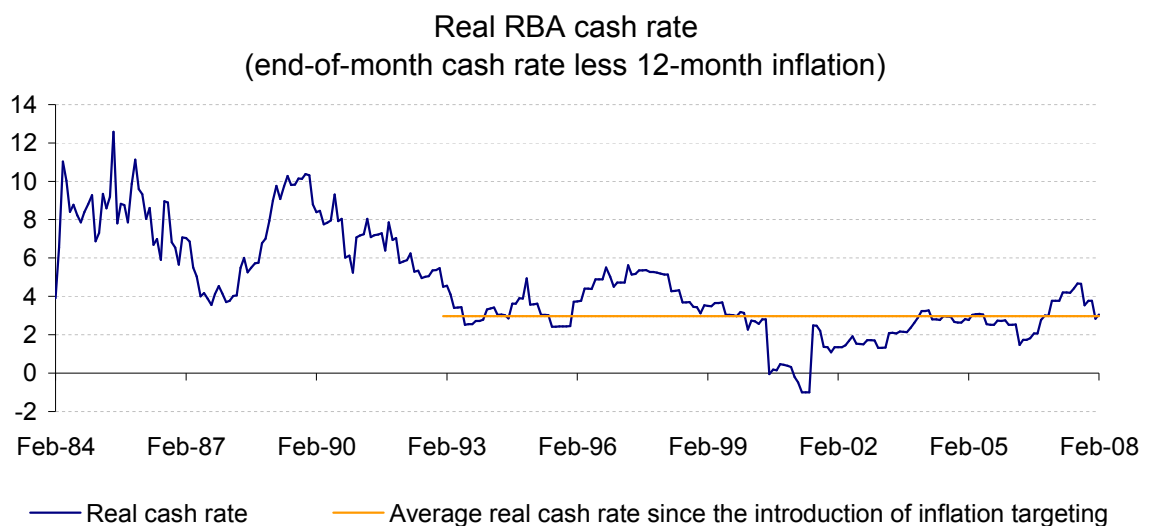
Daily Note: 11 February 2008

## RBA flags another hike

**WE SUGGEST: Odds of another RBA hike in the spring are better than evens**

**SUMMARY:** The RBA's latest *Statement on Monetary Policy* shows the importance of examining each country for where it is in the business cycle and for how exposed it is to global developments. Global weakness will hurt Australia; but not for some time yet. Meanwhile, inflation is above target, there is a positive output gap and the economy is warm, if not hot. When the Bank flags another interest rate increase in the spring, this must be taken seriously.

If a central bank today flags higher interest rates barely a week after having raised interest rates to a twelve-year high, is it mad, foolhardy or simply ignorant of the global environment? Or is it, *per contra*, a correct reflection of that country's current stage in the business cycle? Almost certainly, in fact, the latter. At a time when markets seem to have decided that central banks everywhere must follow the Fed's policy in slashing interest rates, it is salutary to remember (as pointed out by Chris Turner in his *GIO update* last Friday) that more central banks have raised interest rates than cut them over the past two months.

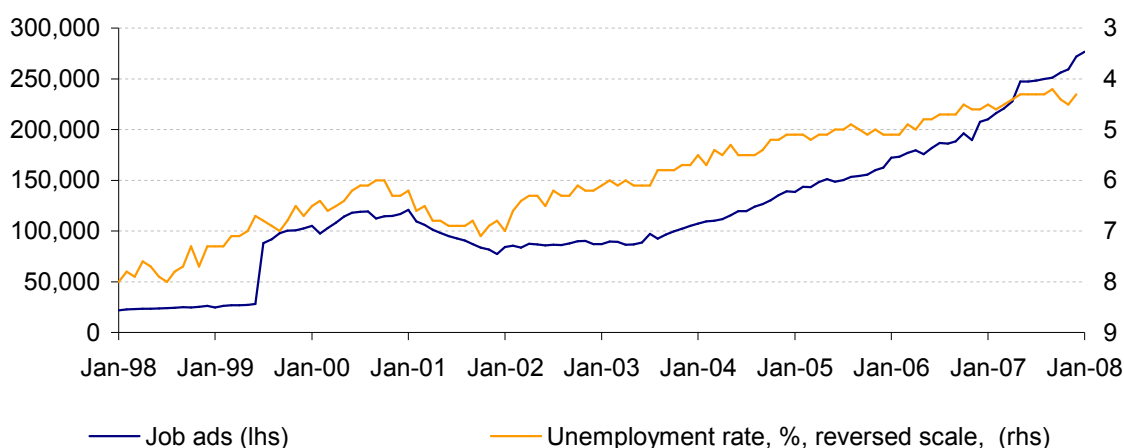


No one would say that the Reserve Bank of Australia is either mad, foolhardy or ignorant of the global economic environment. The RBA's latest *Statement on Monetary Policy* notes a more difficult international environment. But it also notes that domestic activity remains healthy and – crucially – that the rate of inflation continues to accelerate. Moreover, although the rate of inflation reached the top of the Bank's 2-3% inflation target range in the year to Q4, the rate was held down by falling fruit prices and a recent change to the child-care rebate. Assuming that inflation in Q1 2008 will be the same quarterly rate as in Q4 2007 (a reasonable, but not perfect, proxy) would take the four-quarter rate from 3% to just below 4%. Under those circumstances, the current

real cash rate target is by no means excessive. Rather, it is almost exactly on the average since inflation targeting was introduced in 1993. This would imply a neutral, but hardly restrictive monetary policy.

In addition to above-target inflation, there are other signs that the Australian economy may be uncomfortably warm. Housing loans continued to rise in December – not by much, only by 0.1%, but the mere fact that they continued to rise at a time when it was already clear that interest rates would rise further in the new year, was significant. Moreover, job advertisements continued to rise, up by 32% in the year to January after a 31% rise in December, at a time when unemployment already is at a 30-year low.

Australian job ads and unemployment



The Australian economy is unlikely to escape the consequences of a global slowdown – certainly not if this reaches China, as seems likely (not least because the Chinese authorities’ increasingly frantic attempts to cool down their own economy). However, this may well not occur until late 2008. In the meantime, the Australian economy almost certainly has a small positive output gap (Q4 growth numbers have not yet been published, but there was no output gap at all in Q3) and inflation expectations are still on the high side. From the RBA’s point of view, it might be preferable to tighten monetary policy further now, when the economy is still healthy, with a view to easing if necessary later on; rather than end up in a Fed-type situation where the economy is slowing and inflation is not only above target but accelerating.

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