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An RBA dilemma

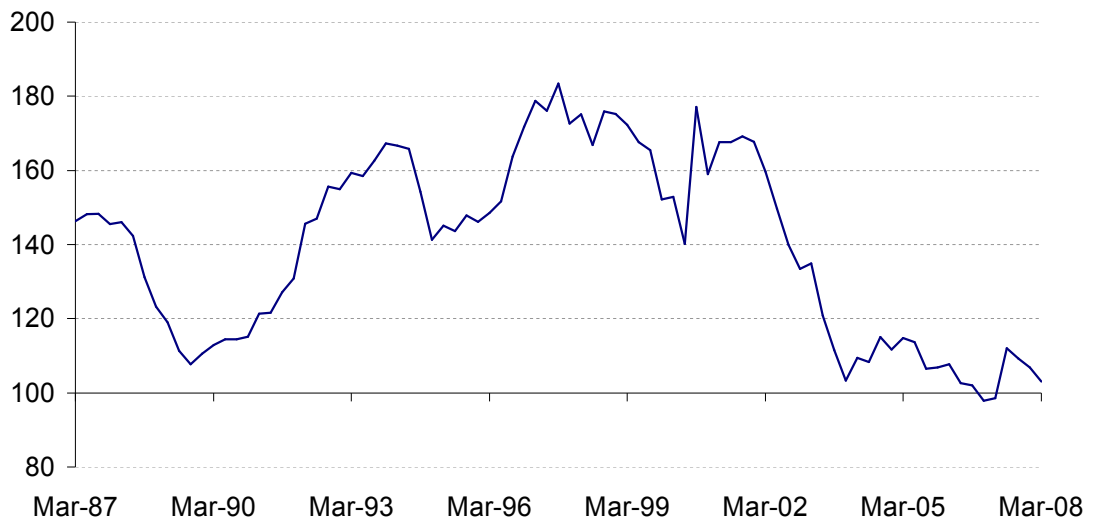
WE SUGGEST: Australian interest rates still less likely to rise

SUMMARY: The news that the RBA had considered raising interest rates pushed the Aussie dollar to an all-time high. Moreover, income tax cuts are boosting consumer confidence. But there are also clear signs of slower output growth, and the global climate is deteriorating. The RBA may feel the need to tighten monetary policy over the next six months. But, on balance, this should not be necessary.

Yesterday's release of the minutes from the RBA Board's Monetary Policy Meeting on 6th May sent the Aussie dollar to an all-time high of US¢96.3 (and higher on intraday trading). This was because the minutes showed the Board discussing a possible rise in interest rates. However, the key to future RBA policy presumably lies in three facts. First, the Bank has tightened monetary policy substantially over the eight months, taking the overnight cash rate from 6½% in August 2007 to 7¼% as of early March 2008. Quite rightly, the RBA now wishes to gauge the effects of this tightening before continuing. Second, although there is a lag involved in the transmission of weakness from the US to Australia via China, the rest of the world economy is slowing down. Third, the RBA's inflation target (2-3%) is flexible. In common with, eg, the ECB, the Bank aims to meet its target over the medium term. By 2009 and 2010, inflation should have eased back to within target again. By contrast, the Bank of England is required to meet its target at all times.

Certainly when it comes to the housing market, Australian activity is easing. Building permits are falling, both by numbers and by value. Moreover, the HIA housing affordability index showed a further fall in Q1.

HIA housing affordability index



Although consumer confidence picked up in May following government announcements of impending income tax cuts, it remains at near 15-year lows. Other indicators of household spending are also weakening, eg car sales fell by 6% from December 2007 to last April.

The main strength of the Australian economy is currently mainly in the hard commodities sector. (Food prices may be booming, but Australia is facing another drought and so has less ability to take advantage of this. Moreover, high food prices also erode domestic spending power.) But that strength is almost exclusively export-dependent. While the economies of East Asia have maintained surprising strength, they are ultimately very export-oriented. With both the US and the European economies (EMU and non-EMU) slowing, they too will eventually slow – not least since the Chinese authorities remain committed to slowing down their overheated economy.

The crucial period for the RBA is the next six months. If Australian economic activity accelerates under the impact of tax cuts and strong foreign demand, it may become necessary to raise interest rates again. If, on the other hand, activity remains at current levels or even eases somewhat further, there should be no need to tighten monetary policy. On balance, the arguments seem to favour the latter development. But it is not a foregone conclusion.

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