

# RBA's Growth assessment will be important; impact of financial markets and not political considerations will be key

We will get two key updates from the RBA on July 20. Firstly at 11:30am the minutes from the Board meeting of July 6. Following that will be a speech from the Governor in Sydney to be delivered for the Anika Foundation and the Australian Business Economists.

The speech is titled "Some Long Run Effects of the Financial Crisis" and as such is unlikely to include any commentary that might provide guidance on near term policy.

However question time is likely to give the Governor the opportunity to update the market on the Banks' near term views if he is planning to send a message.

The reason why the Governor may choose to update the market on the Bank's views is that the last take we received on the Bank's growth forecasts was quite positive. Subsequent speeches and official publications maintained the guidance that the Bank expects that growth in 2010 will be around trend.

Our interest is in the Bank's view about growth in 2011 and 2012 – these are the years where current monetary policy can be expected to have an impact. The most recent forecasts for growth in 2011 and 2012 printed on May 7 – growth was forecast at 3.25% in 2010; 3.75% in 2011 and 4% in 2012. The growth forecasts for 2011 and 2012 are both comfortably above the trend growth rate of 3.25%.

If the Bank chooses to lower its forecast growth rates in 2011 and 2012 to, say, 3.25% (Westpac's forecasts) that would be extremely significant for the short term outlook for policy. Reasons for a lowering of growth forecasts could relate to the global growth outlook (see below) or a more cautious consumer. In that regard it is interesting that last week the government lowered its growth forecasts for 2010/11 and 2011/12 by 0.25% each – citing a more cautious consumer. However a similar 0.25% reduction from the RBA would still see growth expected to be above trend in 2011 and 2012.

While we would not expect a new point estimate from either the minutes or the Governor it would be relatively easy to clearly "talk down" the growth outlook.

A substantially weaker growth outlook would provide the Bank with flexibility in dealing with a potentially large CPI print on July 28. Westpac expects the trimmed mean (RBA's preferred measure of underlying inflation) to print 0.9%.

That result is by no means a *fait accompli*. Of the 13 current market forecasts which are available there are only 3 for 0.9%; 4 for 0.8%; 4 for 0.7% and 2 for 0.6%.

Westpac's forecast would see the recent fall in annual underlying inflation stalling at 3% – top of the Bank's target zone.

If the Bank maintains its growth forecasts of above trend growth in 2011 and 2012 it is not credible to argue that a further significant downleg in underlying inflation can be expected in 2010. With the unemployment rate only 0.1% above the NAIRU and Consumer Sentiment back to around 12% above average levels it becomes very difficult to make a case to keep rates at neutral and not push into the contractionary zone.

If however the Bank argues that growth in 2011 and 2012 will be below trend then it is credible to keep rates on hold despite a large print on inflation.

## RATES and THE ELECTION

The election campaign is not expected to be a factor in the rate decision. Recall that following a 0.8% print on underlying inflation which pushed annual underlying inflation to 2.9% the RBA raised rates to 6.75% on November 7 (day after Board meeting) – during the election campaign. Polling day was November 24 (exactly the same number of days from the RBA Board meeting as in 2010 – August 3 and August 21).

At that time rates were well into the contractionary zone with the 0.25% increase pushing the cash rate to 6.75% – well above the current level of 4.5%.

That move in November 2007 pushed the variable mortgage rate to 8.55% compared to the current reading of 7.4%. However it was at a more buoyant period for the labour market with the unemployment rate being 4.5%, clearly below NAIRU, in contrast with the current read of 5.1% (0.1% above NAIRU).

Consumer sentiment was around the same – 111 in 2007 compared with 113 today (up a stunning 11.1% in July).

The Bank's growth forecasts were more subdued in 2007 than today – with non farm GDP expected to grow by 3.5% over the forecasting period compared to the 3.75% (2011) and 4% (2012) today.

## GLOBAL ECONOMIC CONDITIONS

While growth prospects in the economy are not dissimilar to October/November 2007 market pricing only gives a 16% probability of a rate hike on August 3. This probability has been unaffected by the announcement of an election.

This rather complacent approach is probably driven by conditions in global financial markets.

In October 2007:

- 10 year US Treasury rates were 4.5% compared to current 2.9%.
- S&P 500 was 1550 compared to current 1065 (up 45%).
- ASX 200 was 6750 compared to current 4365 (up 54%).
- WCFI (Westpac's index of market traded commodities) was 121 compared to current 104 (up 16%).
- AUD was US 93¢ compared to US 87¢.

In contrast:

- US LIBOR was 100 bp's over risk free compared to current 38 bp's.
- EURIBOR was 51 bp's over risk free compared to current 26 bp's.

In 2007 frothy equity and bond markets were wildly underestimating the implications of the sharp deterioration in credit markets (as evidenced by LIBOR) for the real economy and prospective growth.

In contrast, credit markets in the US are now indicating a much more stable outlook. The weak equity markets and low bond rates are reflecting the impact of the structural damage which the credit collapse has done to confidence; growth and inflation in the developed world.

Of most importance here are the relative growth forecasts for world growth. In October 2007 the IMF was forecasting world growth of 4.75% for 2008. That compares with a (relatively close) current forecast for 2011 of 4.25%.

## CONCLUSION

Recall that the RBA's forecast for growth in Australia in 2011 is 3.75% and 4% in 2012. That compares with growth forecasts in October 2007 of 3.5% – "over the forecast period".

There does appear to be a large disconnect between equity and bond markets and official growth forecasts by both RBA and IMF.

Given likely developments on inflation and the labour market the near term future of rates will depend on how heavily officials are influenced by financial markets as forecasters of growth. Their spectacular failure in 2007 and the significant improvement in credit markets will be important factors.

We may get a clue on this issue in the Governor's speech on July 20.

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