CAMA RBA SHADOW BOARD – COMMENTS

FEBRUARY 2015

Each CAMA RBA Shadow Board member is invited (but not obliged) to provide a personal comment on monetary conditions. Neither the comments nor the probabilities constitute financial advice. The views of the Shadow Board members are not those of CAMA. Any individuals utilizing these comments, or the probabilities, do so at their own risk.

PAUL BLOXHAM

Since the last board meeting there have been a number of global developments with local relevance. The most significant has been the continued dramatic fall in global oil prices, which are now 60% lower than in the middle of last year. The fall in oil prices reflects both weaker global demand and a boost to supply, and it is still too early to tell which of these forces is the most significant. Markets have generally interpreted the fall as at least partly due to weaker demand, with global bond yields falling, as inflation is expected to be lower. Consumer price inflation is falling across many countries, with a number of central banks already responding by lowering interest rates. Europe has also seen significant financial developments in the past month, with the ECB beginning a sovereign bond purchasing programme, the Swiss abandoning their exchange rate ceiling and the election of a new government in Greece once again raising concerns about the possibility of that country exiting the Eurozone. This has generally seen a flight to quality assets, further pushing government bond yields lower in a number of countries.

For Australia, the economic indicators have continued to show signs that low interest rates are supporting a pick up in activity. Housing prices and construction activity have continued to pick up and retail sales have been growing solidly. Surveys suggest business conditions have generally been trending higher, although business confidence remains weak. Working in the other direction, mining investment is falling, although this is being largely offset by a ramp up in resources exports, as new capacity comes on-line. The net effect of these divergent forces on local demand is difficult to assess, but the solid underlying inflation numbers for the fourth quarter of 2014 (0.7% q-o-q) give some indication that demand is holding up. The 8% fall in the AUD since the last board meeting should further help to support the rebalancing of growth and local demand.

The fall in oil prices, combined with the repeal of the carbon tax last year, has seen headline CPI inflation fall below the bottom edge of the target band (1.7%), and lower petrol prices likely to see it fall further in Q1. However, for the setting of monetary policy it is the outlook for underlying inflation and inflation expectations that matter most. In principle, the fall in oil prices should be a net positive for local growth, as Australia is a net petroleum importer, and lower petrol prices should boost household disposable incomes and business profits. Although there is some scope to consider cutting the cash rate in the short run, as headline inflation will be lower than previously expected due to lower oil prices, it is the medium-term outlook for inflation that matters most. In the medium-term, the effect of lower oil prices is somewhat ambiguous, but I view it as more likely to be an upside risk than downside risk to underlying inflation, as I expect the boost to demand from lower petrol prices to more than offset the negative impact on the domestic economy of lower oil prices on energy exporters. In addition, there is the ongoing risk that further interest rate cuts could risk over-inflating an already booming housing market. I recommend that the cash rate is left unchanged.

MARK CROSBY

Despite recent headline inflation below 2% there is little reason for the RBA to take other than a wait and see approach to the cash rate. International developments remain highly uncertain, with Europe and Japan remaining weak, while the US continues to recover. With underlying inflation in the desired range, waiting would seem to be a better approach than using up ammunition given fragility in the global economy.

MARDI DUNGEY

No comment.

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BOB GREGORY

This is becoming very difficult because although the Australian economy is going down in my view I have no idea what will happen to world rates - except that the US and Europe will diverge - and no idea at this time as to how we will or should respond to this.

The increased uncertainty about world interest rates has encouraged me to essentially sit tight on our interest rates until I get a clearer fix on what is happening. Obviously, not expecting a large change in either direction.

GUAY LIM

No comment.

WARWICK MCKIBBIN

No comment.

JAMES MORLEY

Headline inflation, currently at 1.7%, should be expected to remain below the 2-3% target range in the near term given the dramatic recent decline in oil prices. This provides considerable scope for the RBA to delay any increases in the policy rate until at least the second half of the year.

The continued collapse of iron ore prices and the decline in oil prices has prompted some speculation that the RBA will lower rather than raise rates in the near term, especially after the Bank of Canada recently lowered its policy rate in response to the decline in oil prices. It is possible that the RBA will do so.

However, it should be noted that lower oil prices are more of a net positive for the Australian economy than for Canada. And the lower Australian dollar has meant that there will be a broader compensation for the end of the mining boom than just strong growth in interest-sensitive sectors (e.g., construction). In particular, non-mining exports (e.g., higher education and tourism) can be expected to perform well. A robust recovery in the United States also provides some offset for the weaker-than-normal (but still fast) growth in China.

Overall, then, I would recommend the RBA maintain, but not lower, its already low policy rate and monitor how effectively the lower dollar stimulates non-mining exports. Any change in policy direction should be signaled by public communications (i.e., moving away from a reference to “a period of stability in interest rates” in policy statements) rather than trying to surprise markets, as was recently done by the Swiss National Bank in terms of their unconventional monetary policies.

JOHN ROMALIS

There seems to be insufficient reason to change the current target cash rate. Inflation still seems likely to remain at moderate levels. Below-trend GDP growth and no obvious indicators of rapid expansion suggest that a low cash rate is still appropriate.

JEFFREY SHEEN

In the last 2 months, observed indicators of the Australian economy have weakened marginally. Aggregate hours worked declined by an annualized 3.7% though the unemployment rate has fallen slightly to 6.1%. Inflation is at the bottom end of the RBA’s target range, helped down by the fall in energy and transport costs which are likely to remain low for some time. The TWI

has depreciated significantly in the last half-year (by 15% annualized) which should eventually boost net exports---however more depreciation is needed to seriously stimulate the below-normal growth of the Australian economy.

External risks have increased as a result of the recent election in Greece. There is significant potential for destabilisation of asset markets within Europe. The ECB will surely conduct large quantitative easing, helping to keep interest rates low. The strengthening US economy is a major positive influence for the global economy, but not enough to prevent the IMF from predicting weakening global growth in 2015.

Overall, this indicates that the RBA should be delaying any plans to raise the cash rate in the future, and increases the probability of a cut in the next few months. I recommend no change this month.