FINANCIAL MARKETS

THE FUTURE OF RBA MONETARY POLICY

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MORE OF THE SAME?

FOREWORD

On Tuesday 2nd October 2018, the board of the Reserve Bank of Australia (RBA) held its monthly meeting.

During this meeting, the RBA board opted to leave its benchmark interest rate unchanged, leading many traders to question when the central bank might change course.

The purpose of this eBook is to analyse the monetary policy of the RBA - and what we can expect in the months ahead.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

THE OCTOBER MEETING

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During the RBA's board meeting on Tuesday 2nd October 2018, it was decided that the cash rate would remain unchanged at 1.5%. This made October 2018 the 26th straight month of interest rate stability.

GLOBAL MONETARY POLICY

Globally, economic expansion continues for several advanced economies. With this in mind, we've seen some major central banks (such as the Federal Reserve and the Bank Of England) hike their interest rates.

This monetary policy trend is a signal that many central banks believe that the global economy has fully recovered from the financial crisis of 2008. In other words, the age of record low interest rates could be coming to an end.

However, it seems the RBA is not on that wavelength (yet). Let's explore why in further detail.

THE AUSTRALIAN ECONOMY

So why has the RBA opted to keep interest rates at 1.5%? At first glance, Australian economic data is impressive.

For instance, let's look at GDP.

In September 2018, Australia's annual GDP rate hit a healthy 3.4%. Furthermore, forecasts from the RBA suggest that GDP will stay just above 3% for 2018-19.

Australian unemployment is also low. It currently sits at 5.3%, the lowest rate in almost six years. There is, however, a rather high vacancy rate and a skills shortage across the country. Forecasts suggest that Australian unemployment could continue to fall towards 5%.

Australian business conditions are also looking positive. There has also been more investment in public infrastructure which has contributed to the Australian economy's growth this year. Plus - an increase in resource exports has also helped growth.

But there's one lingering issue: low inflation.

After October 2018's meeting, the RBA lowered its inflation forecast to 1.75% (from 2.25%) for 2018. This is below the RBA's target inflation rate of 2-3%.

This is why the RBA has kept its cash rate at a record low. Remember - central banks usually hike rates to taper inflation (the rate at which the costs of goods and services increase). At this moment in time, Australian inflation needs to increase, not decrease.

MONETARY POLICY OUTLOOK

IS A HIKE ON THE CARDS?

At the time of writing, it's likely that the RBA will continue to hold its cash rate at 1.5% until 2020.

Why? Primarily, the RBA will want to ensure inflation consistently falls within the upper band of its 2-3% target. Plus, there are a variety of global economic uncertainties that Australia is exposed too.

TRADE POLICY IMPLICATIONS

The biggest risk comes from trade tensions between China and the US. Australia is particularly vulnerable to changes in trade policy between these two countries because China is its largest export market.

Fundamental changes in China's trade policy could mean less demand for critical Australian exports, including iron ore and coal.

Exports in food and services could also face weakened demand.

The reason for this is simple. US tariffs on Chinese goods have the potential to damage import-reliant Chinese industries and jobs. Should this happen, Australia will find its demand from China reduced.

In fact, an estimate from UBS economists suggests that as much as 1.2 million Chinese jobs could be at risk because of US tariffs. Further estimates from KPMG suggest that Australia could lose $36 billion across the next ten years - the equivalent of 0.3% GDP growth - because of US/Chinese trade tensions.

DOMESTIC PRESSURES

The Australian economy also looks a little vulnerable in certain areas. For example, despite low unemployment, wage growth is largely stagnant.

Australian house prices have also dropped. In fact, in September 2018, Australian house prices experienced their largest monthly fall since the global financial crisis. Homes in Sydney and Melbourne were down 6.1% and 3.4% respectively year-on-year.

These factors indicate that the RBA is likely to keep interest rates at 1.5% for the foreseeable future.

EFFECT ON THE AUSTRALIAN DOLLAR

The Australian dollar is often referred to as a barometer for the health of global trade. With this in mind, it’s no surprise that the

Australian dollar index has fallen from 65.80 to 61.60 over 12 months.

US interest rates and the attractiveness of the US dollar have also weakened the Australian dollar. The truth is that USD is a much more preferable currency to hold for investors than its Australian counterpart.

We expect more of the same for the Australian dollar in the coming months, with AUD likely to be vulnerable to US and China trade talks.


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