

RBA update and impact of commodity boom

Economic Research note

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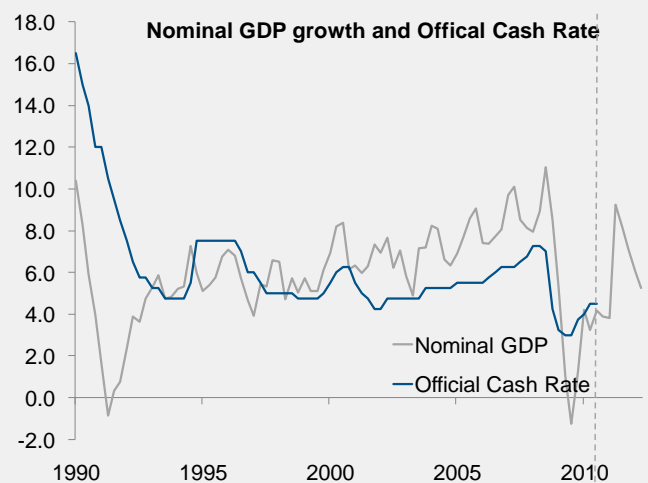
- The RBA's 'Statement on Monetary Policy' continues to send the signal that the cash rate is likely to remain on hold for a few more months, driven by uncertainty in the global economic outlook, near-trend Australian economic growth and inflation remaining within the 2%-3% target zone.
- This situation is likely to remain in place until at least the November Board meeting, which will be after the Q3 2010 CPI report.
- However, with the income effect on nominal GDP growth from the terms of trade surge yet to fully flow through the economy, the risk to monetary policy in the year ahead remains to the upside.
- Indeed, the June trade data showed an all-time record high surplus of \$A3.5bn, with a 7% surge in exports driven by iron ore and coal. This is a timely reminder of the significant impact on the economy from Australia's surging terms of trade.

RBA 'Statement on Monetary Policy'

After leaving the cash rate unchanged at 4.5% earlier this week, for the third month in a row, the Reserve Bank of Australia (RBA) has today released their latest 'Statement on Monetary Policy' (SMP). The SMP notes that "with growth in the Australian economy likely to be close to trend over the year ahead, underlying inflation having declined into the 2%-3% range and lending rates around average, the Board views the current setting of the cash rate as appropriate at this stage."

This statement from the RBA implies that they are likely to be happy to hold monetary policy steady for a few more months yet. At this stage it is likely that the RBA will continue to hold policy steady until at least the November Board meeting, which will be after the late October release of the Q3 2010 CPI. No doubt the RBA will also continue to monitor closely the global economy, for any signs that the current period of heightened uncertainty is lifting, as well as domestic economic data and/or any signs by Australian financial institutions to lift rates independently of the RBA.

Australian nominal GDP growth and cash rate (%)



Source: RBA & ABS



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Markets are currently priced for around 7bp of tightening (28%) to the end of this year and 17bp or 68% to mid-2011. However, it is worth noting (as detailed below) that the surge in Australia's terms of trade to a new record high will add considerably to Australian nominal GDP growth and this points to the next move in monetary policy still being a tightening.

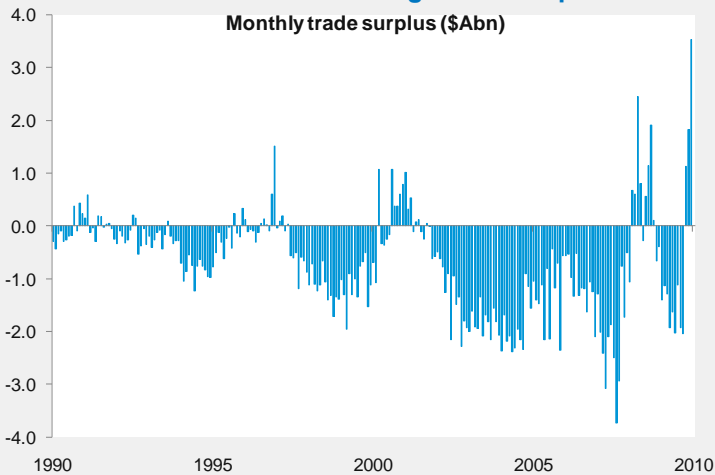
In today's SMP the RBA has made some relatively minor changes to its GDP and inflation forecasts. The RBA now expects the Q2 10 GDP reading, due 1 September, to show growth of 3.0%, up from 2.5% previously. This is probably due to a stronger than anticipated contribution from net exports. The GDP forecasts out to end 2012 are unchanged at 3.25% for end 2010, 3.75% over 2011 and 4% and end 2012.

On inflation, the headline CPI is now forecast at 3.25% at mid-2011, up from 3.0%, but remains at 2.75% at end 2011 and 3.0% over 2012. The underlying inflation forecasts are unchanged at 2.75% over 2011 and 3.0% in 2012.

Trade surplus hits record high in June:

The other key event in Australia this week was the news that Australia's trade surplus reached a record high (since data has been collected in 1971) of \$A3.5bn. This surplus was well up on the May surplus of \$A1.8bn and follows trade deficits that were recorded from May 2009 to March this year.

Australia's trade account surges into surplus



Source: ABS

The surge in Australia's trade surplus in June is a timely reminder of just how powerful the impact of the rise in the terms of trade (the ratio of export prices to import prices) will be on the economy.

With new iron ore and coal price contracts signed earlier this year, the economic impact of the rise in prices and still solid demand is now appearing in the data.

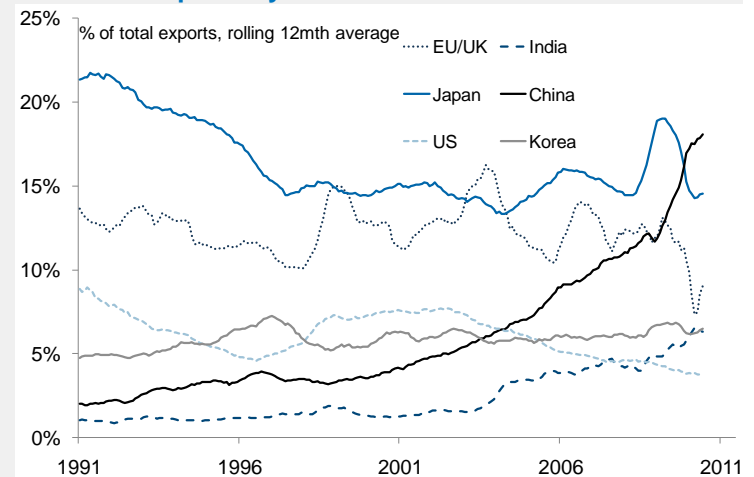
For June, exports rose by 7%/mth, led higher by a 23%/mth increase in metal ores (including iron ore) and a 15%/mth increase in coal exports.

In contrast, imports were all-but unchanged on the month. While consumer imports were up 1%/mth, capital imports were down 3.4%/mth. It could be expected, however, that as the mining sector capex program reaccelerates in the months ahead that capital imports will rise again. These imports should be counted as 'good' imports, given that, once in place, they will begin to earn income for the economy and add to future productive capacity.

On a rolling 12 month basis China continues to accelerate as Australia's major export destination and is opening up a clear gap on the no. 2 nation of Japan – although the GFC inspired decline in exports to Japan now seems to have turned back up.

Exports to the UK and EU also look to be turning up again after a sharp decline over the past 18 months. In addition, South Korea and India are now neck-and-neck for third and fourth place. But, as can be seen in the chart below, India is increasing rapidly and is sure to become a much more significant trading partner for Australia in the years ahead.

Australian exports by destination



Source: ABS and CFS GAM

Of special significance is that net exports could now be expected to make a positive contribution to economic growth of around 0.3%-0.5%/pts when the Q2 2010 GDP data is released on 1 September. A positive contribution from net exports in Q2 2010 will be in contrast to the -0.5%/pts contribution to growth in Q1 2010 and would be the first positive contribution since Q1 2009. Further positive contributions could be expected in the quarters and years ahead as the positive impact from the terms of trade increase flows through the economy.

There are, however, some risks to the outlook for the terms of trade which the RBA highlighted in today's SMP and were discussed by the Commonwealth Treasury in its Pre-Election Economic and Fiscal Outlook. Both highlighted the sensitivity of the terms of trade outlook to contract prices for iron ore and coal, with movements in commodity prices in recent months prompting a small downward revision to contract prices.

However despite this the terms of trade is expected to remain near a historically high level, but it does suggest that going forward the performance of the Australian economy will be much more linked to commodity prices and performance of our major trading partner, China.

For further information

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