

Reserve Bank Board Meeting Outcome – November 2010

ECONOMIC ALERT

2 November 2010

KEY POINTS

The RBA Board decided to raise the official cash rate by 25 basis points to 4.75 per cent at its November 2010 meeting today. The key reasons behind the decision, as outlined in the RBA's related media release, were as follows:

- The global economy has grown at faster than trend over the year to mid 2010, although growth is likely to ease back to a trend rate over the coming year. At the same time concerns surrounding the possibility of a larger than expected slowing in Chinese growth have lessened. In addition, most commodity prices have firmed in recent months, and as a result Australia's terms of trade are at their highest level since the early 1950's.
- The Australian economy has expanded at around a trend pace over the past year. While there has been a degree of caution to date in private spending, the rise in the terms of trade is substantially boosting national income and is likely to result in stronger private spending during the next two years, particularly business investment.
- Reflecting high commodity prices and the respective outlooks for monetary policy in Australia and the major countries, the Australian dollar has strengthened significantly in the past year. This will assist in containing inflation at the margin.
- Labour demand has continued to firm and a further strengthening appears to be in prospect judging by trends in job vacancies. Growth in wages has also picked up and some further increase is likely over the next year.
- In view of these conditions, the moderation in inflation evident over the past two years is probably close to ending. The current underlying inflation rate is about 2.5% with CPI inflation a little higher due largely to increases in tobacco taxes. Unusual softness in food prices helped both results in the September quarter 2010. Inflation is likely to increase over the next few years and this outlook assumes some tightening in monetary policy.
- For some time the Board has held a steady monetary policy stance. This has resulted in borrowing rates being at around their average levels of the past decade, and allowed the Board some time to observe the impact of previous policy changes and to monitor the uncertain global outlook. However, the economy is now experiencing a large expansionary shock from the boost to the terms of trade and has relatively modest levels of spare capacity. Consequently, notwithstanding recent good results on inflation, the risk of inflation rising again over the medium term remains.
- **“At today's meeting, the Board concluded that the balance of risks had shifted to a point where an early, modest tightening of monetary policy was prudent.”**

Policy implications

- Today's decision by the RBA Board was a surprise for many economists and the markets after inflation grew at a tepid pace during the September quarter, and given the strength of the Australian dollar. The RBA expects that private domestic demand in the Australian economy will strengthen in the year ahead and lead to a pick-up in inflationary pressures.
- The forthcoming labour market, national accounts and retail trade data will shed further light on the strength of domestic demand. The economic forecasts in the RBA's Quarterly Monetary Policy Statement to be released on Friday will also be an important guide to the timing of the Board's next move.