The top six reasons the RBA should not cut rates

In this Weekly, we set out six reasons why the RBA should not cut rates. Before that, it’s worthwhile to review Friday’s US payrolls report that was one out of the box, softer than expected in almost all respects. Not only was there a downside surprise on the headline payroll number (142k vs. 201k expected) both July and August were revised down not up as many expected, August’s by 37k to 136k and July’s by 22k to 223k.

That is the final payrolls report before the upcoming October 29 FOMC, this payrolls report now virtually ruling out Fed rate lift-off then. The next day sees the release of the first estimate of US Q3 GDP, the Atlanta Fed’s *GDPNow* latest estimate dialled back to +0.9% from 1.8% on the back of recently weaker goods trade data for August, US net exports now estimated to detract 0.9% points from Q3 GDP growth, down from -0.2% points.

So far, the fallout for the AUD has been quite benign with the AUD up a modest 0.21% to 0.7045 from lower US yields and a softer USD on Friday night, the AUD trading at around 0.7050 in early morning trade today.

**Six reasons the RBA should not cut rates**

The RBA Board is likely to leave the cash rate at 2% tomorrow and the accompanying Statement is likely to again signal only a modest easing bias - one which suggests that if economic conditions were to deteriorate that the Bank could further support growth, but also, which suggests little inclination to lower rates further at this point in time.

What follows then is our top six reasons why we think the Bank should not cut interest rates again anytime soon, but also consider what circumstances could bring the Bank back to the table.

1. **The non-mining economy is improving**.

Perhaps this is stating the obvious, but the case for a further cut in interest rates will remain weak in the near-term, while the data continue to suggest that the non-mining economy is strengthening, especially at a pace that is sufficient to offset the impact on the labour market from the weakness in mining investment and lower commodity prices.



The changed growth mix is evidenced by improving trends in business conditions and capacity utilisation in the NAB business survey and in rising job advertising, and indeed the trends for business conditions and job advertising are both currently more consistent historically with rates tilting higher than being lowered further.

Chart 1: Capacity utilisation improving



1. **Mining investment, business investment and commodity prices are not interest sensitive.**

We think it’s also important to recognise that monetary policy cannot directly address the main sources of weakness or restraint on Australia’s economic growth at the current time. Irrespective of the level of interest rates, major mining investment projects will complete over the next 18 months. And commodity prices are also insensitive to interest rates, although a lower $A may offset some part of weaker US$ commodity prices. While the Bank would like to see stronger non-mining investment – and while interest rates are part of any business case – any significant business investment will consider a broad range of factors of which interest rates are only one variable – and where small changes are not significant to the outcome of the business case.

1. **Still lower interest rates would boost the rate sensitive sectors of the economy and increase financial risks.**

Third, the interest rate sensitive sectors of the economy – predominantly housing and admittedly with a significant Chinese tailwind – are responding well to lower interest rates, with a significant upswing in housing construction underway. Indeed, the strength of the upswing in investor lending has led to action from the regulator and also to continued warnings from the RBA about potential risks to financial stability. Cutting interest rates further, without a significant negative development in the outlook for the Australian economy, would counteract the intent of these macroprudential policy moves and risk renewed house price rises and borrowers becoming over-stretched.

1. **Rates are already very low and the full impact of the cuts to 2% in H1 2015 is still to flow through.**

It’s also hard to argue that the current level of interest rates is proving a hindrance to the economy or unduly rationing the availability of credit. Indeed, in the NAB June quarter business survey, only 2.5% of firms cited interest rates as a constraint on profitability, whereas just over 50% of firms cited demand as a constraint on profitability. Some of the impact of the two rate cuts in the first half of 2015 is still flowing through to the economy, as is the benefit to growth from the lower $A of recent months. The RBA must be (and usually is) very cognisant of the lags that operate both with changes in interest rates and the exchange rate.

1. **The $A is now more clearly supporting growth.**

Fifth, the $A has now fallen to a level where it is more clearly supporting growth. Anecdotes of stronger domestic tourism abound. The lower $A would also be offsetting some of the weakness in US$ commodity prices. And importantly, the $A has fallen recently independently of US and Australian interest rate developments, which is a break from the situation a few months back, when the Aussie was stubbornly high in the face of declining commodity price fundamentals.

1. **The RBA only has 200bps of rate cuts left**

Our final argument incorporates many of the top five arguments. Given the above conjunction whereby the economy appears to be strengthening, the interest rate sensitive sectors are strong (and in some aspects, too strong), the currency has fallen, there is still some further boost coming through from previous rate cuts and the weakness in the economy cannot be addressed with rate cuts, it would seem irresponsible for the RBA to use part of its remaining monetary policy arsenal for what would likely be little benefit at the present time (and which conceivably might add to medium-term problems for the economy). Until there is a clear case for lower rates, the remaining policy ammunition should be conserved in case a significant shock was to hit the economy.

**So what could bring the RBA back to the table?**

So what events or developments would need to occur to cause the RBA to reassess monetary policy and decide to cut rates? For us, there are three to four issues that deserve consideration:

* The most obvious catalyst would be a significant deterioration in the global growth outlook. This argument deserves further explanation however. Already, a slowdown in Chinese housing construction and other indicators of industrial activity, in conjunction with substantially increased commodity supply, has resulted in a significant weakening in the mining sector, which is arguably in recession. With the RBA’s rate cuts and the currency fall out of sync with these developments, that weakness has not been mirrored in Australia’s non-mining economy, while to date, the US economy has continued to improve in spite of China’s woes. Currently, we are monitoring whether recent developments in China significantly impact either US or European growth or the parts of Chinese demand that have still been providing strong support for Australian growth, namely, tourism and housing investment. Evidence of any such development would likely show up in renewed deterioration in business conditions, weaker job advertising and a renewed rise in unemployment. It has yet to do so.
* Relatedly, another financial crisis would likely see the RBA spring quickly to action. This could have its genesis either in China, or as a result of the Fed finally raising interest rates. But again this has not happened and the RBA is not likely to pre-empt something that may not happen.
* Third and perhaps the most likely scenario to upset our forecast that the RBA has finished cutting rates for this cycle, is the possibility that in 6-12 months’ time, if the unemployment rate had stabilised but had shown little decline and was not forecast to decline soon, the Bank may decide that it has scope to try to reduce the unemployment rate more quickly. This would particularly be the case, should the housing market have cooled further due to recent policy moves.
* Finally, and also something of a longer term possibility rather than a current reality, it’s possible that if the Fed were to remain on hold for an extended period that the conditions could emerge whereby 2% cash rates again look very attractive on a global basis, attracting significant capital to Australia resulting in renewed appreciation in the $A that runs counter to our economic fundamentals. That could again prompt the RBA to think about lowering interest rates.

**Market implications**

The market is pricing 37bps of cuts over the year ahead. Given our view on the RBA detailed above, our rate strategists see the short end as getting close to sell levels.

**The week ahead**

The main focus points for the market in the week ahead are ANZ Job Ads on Monday – which is also a public holiday in NSW, ACT, Qld and SA – and the RBA’s meeting on Tuesday. We’ll also be watching the trade balance on Tuesday (where we look for a modest improvement to $2.3bn, on the back of slightly lower imports and stronger iron ore exports – note that to date, iron ore shipments continue to breach new records). Housing finance data on Friday should show a decent 5-6% m/m bounce. Most interest will be on the words issued by the RBA. Also please note that Australia switched to daily savings time on Sunday morning (GMT/UTC+11).

ivan.colhoun@nab.com.au

Calendar of Economic Releases



 Forecasts



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