HSBC Global Research

Macro
Australian Economics

The RBA Observer

On hold next week, but next move likely to be up

- **Activity indicators are lifting and this month brought more news that the labour market is also improving**
- **Inflation has already passed its trough, the housing market continues to boom and the cash rate is still at its historic low**
- **It seems likely that the RBA will soon need to consider that rates should start to head towards neutral: we expect that the cash rate may need to rise before year-end**

Growth and inflation are picking up

Local activity indicators are continuing to show that growth in Australia is rebalancing from being led by mining investment, as it has been in recent years, to being driven by the non-mining sectors of the economy. GDP picked up pace in Q4, supported by consumption and exports. In addition, retail sales are growing at their fastest rate since 2010, the housing market continues to boom, the forward-indicators of residential construction have picked up strongly and the business sentiment is at significantly higher levels than it was around the middle of 2013. Inflation has also lifted and appears to have passed its trough, which is another sign that demand has been picking up.

These facts alone might suggest that the current very low cash rate may not be the appropriate monetary policy setting and that rates should be lifted soon. But two key caveats remain: the labour market remains weak, with the unemployment rate at its highest level in 10.5 years; and, mining investment is set to fall further this year and next.

On both these factors we are more sanguine than many other commentators. We see the labour market as merely lagging the pick-up in activity that has already begun. We have long been arguing that as the economy shifts to being more driven by the non-mining sectors, employment growth should lift. After all, that is where most of the jobs are! The mining sector employs only a small number of people. This month brought support for our view with strong employment numbers in February.

With regard to the expected fall in mining investment, we forecast that it will be more than offset by a pick-up in resources exports, as new capacity comes on-line, and falling imports (recall that much of the capital for the mining investment was imported).

The past month has seen the market focus shift to the local data, consistent with our view that inflation and jobs are the keys for determining the RBA's next move. We expect the RBA to be on hold for the next few months, but for rates to rise before year-end.

28 March 2014

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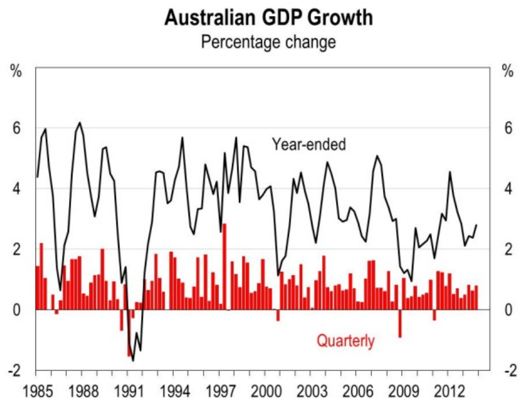
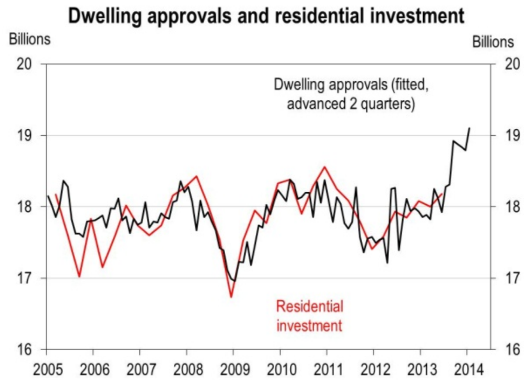
1. GDP growth picked up in Q4, led by consumption



Source: ABS

2. Forward indicators show a housing construction upswing



Source: Thomson Reuters Datastream

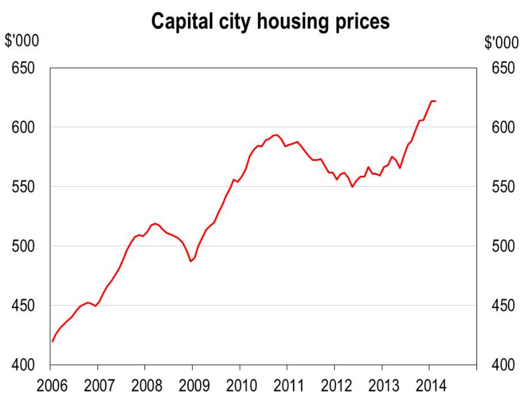
Activity still lifting and labour market now improving

This month brought further confirmation that Australia's great rebalancing act is underway. Despite a sharp decline in mining investment, overall GDP growth rose by a solid +0.8% in Q4 2013, to be +2.8 y-o-y (Chart 1). Household spending was a key driver of growth and the household saving rate declined.

Mining investment was a significant drag in the quarter, but this was offset by strong growth in resources exports, as new capacity has been coming on-line, and a sharp fall in imports. Engineering and equipment investment subtracted -1.3ppt from GDP growth in the year to Q4, but this was largely offset by a fall in imports worth 1.0ppt of GDP. Over the same period, total exports have added +1.4ppt to GDP, supported by strong growth in resources exports.

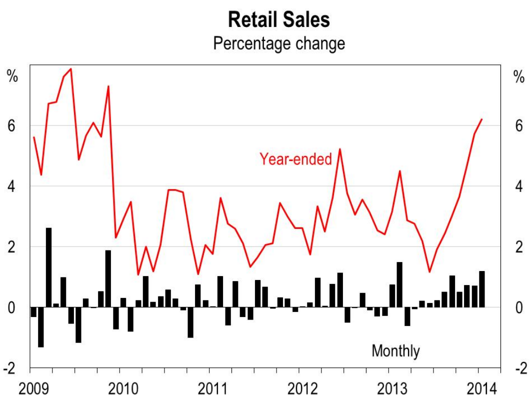
Timely indicators suggest that the rebalancing of growth has continued into Q1 2014. Building approvals have risen strongly in the past few months, suggesting that dwelling investment is likely to rise sharply in H1 2014 (Chart 2). The continuing rise in housing prices and low interest rates appear to be supporting a pick-up in consumers' willingness to spend (Chart 3). Retail sales have risen for the past nine months and are now growing at their fastest y-o-y pace since 2010 (Chart 4).

3. Housing boom is continuing, supported by low rates



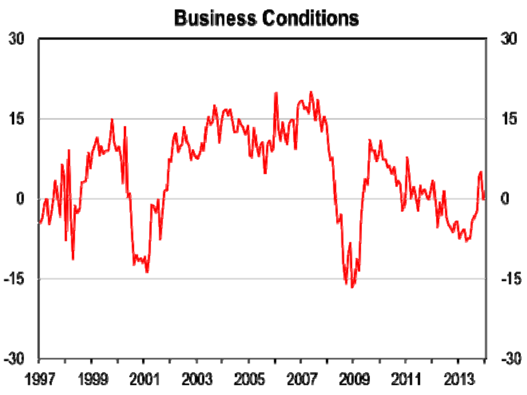
Source: RP-Data/Rismark

4. Low rates and rising asset prices supporting retail sales



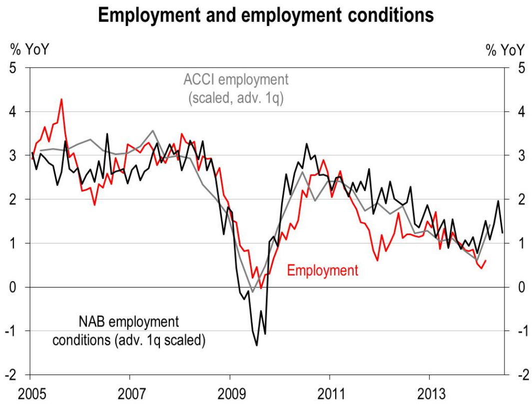
Source: ABS

5. Business conditions have improved since last year



Source: Thomson Reuters Datastream

6. Labour market is starting to improve



Source: ABS; Thomson Reuters Datastream

Broader measures continue to show that business conditions and confidence have improved from the low levels reached in the middle of 2013 (Chart 5). As these surveys tend to focus more on the non-mining industries they also support the notion that growth is rebalancing towards the non-mining sectors.

One weak spot in the economy has been the labour market, although this month brought some further evidence that hiring conditions appear to be improving. While the January print of the labour force survey had showed very weak employment, the February print showed both strong growth in the month and upward revisions to the historical data. Over the year to February the numbers suggested that 70,000 jobs were created on net (the January print had suggested no jobs were created over the year to January). Suffice to say, the official labour force numbers are now looking more similar to the more timely business survey indicators of labour market conditions (Chart 6).

We expect the labour market to improve further from here. Our view has been that the lift in activity indicators, which appears to have begun from September 2013, would start to feed through to a pick-up in employment, but that it would occur with a lag. Our empirical work suggested that the typical lag between a rise in activity and a lift in employment was 2-4 quarters (see Bloxham, P. and Richardson, A. (2014) *Downunder digest: Australia's labour market in focus*, 10 February). If the turning point in activity was Q4 last year, this implies the labour market should show significant improvement from Q2 this year.

Market focus has (rightly) shifted to domestic data

While the local data have been improving, the data for China, Australia's major trading partner, have been weakening in recent months. China's PMI has fallen below its breakeven level in recent months and growth in industrial production and exports has slowed. The prices of hard commodities, such as iron ore and copper, have fallen over the past month, in line with weaker Chinese data.

However, the Australian markets have generally taken these data in their stride for a number of reasons. First, there is an expectation -- which HSBC shares -- that if growth falls much below the Chinese authorities' target of 7.5% for this year, they will use discretionary fiscal measures to support growth. Second, Australia's growth story has shifted to being more about domestic conditions. While a sharp negative shock to the Chinese economy would clearly have significant implications for Australia, a modestly weaker Chinese growth profile may not mean as much for Australia as domestic momentum is already building. We expect that the market focus will continue to shift towards local indicators.

RBA: No more jawboning the AUD, for now

Officials from the RBA have made a number of public appearances in the past month, including testifying to a House of Representatives standing committee, and a number of speeches, including by Governor Glenn Stevens. There have been a number of key messages.

First, as we expected, RBA officials have been unwilling to 'jawbone' the AUD lower, even though it has rallied in recent weeks. In our view this reflects that inflation has surprised them on the upside, so they cannot seek a lower AUD until they know if the pick-up in inflation was temporary or not. Jawboning could recommence after the Q1 CPI print (due on 23 April) if it is a low number, though we expect it to be solid and that the ongoing rebalancing of growth will mean that the RBA is broadly comfortable with the AUD around its current level.

Second, RBA officials were directly questioned about their view on the potential growth rate of the Australian economy. The responses were far more direct than we expected, with the Governor noting that his view is that the potential growth rate is "probably about 3%".

Our own view is a little more pessimistic, suggesting potential could be closer to 2.8%, given the structural slowdown in productivity growth and the impact of the aging population (see Bloxham, P. and Richardson, A. (2014) *Downunder digest: Australia's lowered potential*, 22 January). To the extent that the potential growth rate is higher, it may suggest that interest rates can remain lower for longer without putting upward pressure on inflation. Again, upcoming inflation prints are key to this assessment.

Third, the commentary from the RBA over the past couple of months has gradually shown more confidence that growth is rebalancing from being mining-led to being supported by the non-mining sectors of the economy. In short, monetary policy appears to be working.

Bottom line

We expect the cash rate to remain unchanged next week.

With activity lifting, inflation already in the upper half of the target band and tentative signs that the labour market is also improving, we expect that the RBA's next move is likely to be up.

With the cash rate currently at its historic low, we expect the RBA may need to consider starting to move rates back towards neutral before the end of this year.

For now, we expect the RBA to maintain a neutral stance, but if the labour market improves in coming months, as we think it will, by mid-year we expect this stance to shift to a mild tightening bias.

1. HSBC's main forecasts for Australia

	Year-average (%)				Year-ended (%)						
	2012	2013	2014f	2015f	Q413	Q114f	Q214f	Q314f	Q414f	Q115f	Q215f
GDP	3.6	2.4	2.8	3.2	2.8	2.9	2.7	2.8	2.7	2.9	3.2
CPI*	1.8	2.4	2.8	2.8	2.7	2.9	3.1	2.6	2.5	2.7	2.8
Trimmed mean*	2.2	2.4	2.8	2.8	2.6	2.8	2.8	2.8	2.5	2.7	2.8
Unemployment rate	5.2	5.7	5.9	5.6	5.8	6.0	6.0	5.8	5.7	5.6	5.6
AUD/USD** ^	1.04	0.89	0.86	0.86	0.89	0.89	0.88	0.87	0.86	0.86	0.86
Cash rate^	3.00	2.50	2.75	3.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25

Source: HSBC estimates; *Includes effect of carbon tax from Q312; **AUD forecasts detailed in 'Currency Outlook: March 2014' ^end-period

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