Flashnote

HSBC Global Research

Macro
Australia Economics

The RBA Observer

On hold as bubble risks grow

- **The 50bp of cuts delivered in H1 2015 should support growth, but could also boost a booming housing market**
- **Authorities are increasingly aware of the risk that very low interest rates could inflate asset price bubbles: as a result, authorities are further tightening the prudential settings**
- **We expect the RBA to remain on hold in coming months, as it weighs the risk of inflating asset price bubbles against supporting a needed pick-up in real economic activity**

Balancing the real economy and financial cycle

The RBA continues to face a tricky trade-off. Low interest rates are needed to support the rebalancing of growth towards the non-mining sectors and encourage the AUD to fall. At the same time, low rates are also stoking a housing price boom in some cities, particularly Sydney (up 40% in three years) and to a lesser degree Melbourne (up 24%).

In response to this challenge, the Australian Prudential Regulation Authority (APRA) has been turning up the dial on lending standards, particularly as growth in lending to housing investors has been running ahead of the 10% target pace. Most of the major banks have reduced discounts on lending rates to housing investors in recent weeks as a result. Of course, this comes at the same time that the RBA has delivered another 25bp cut, on 5 May, so broader financial conditions are looser.

With the APRA more focused on managing the financial cycle, the RBA may be able to increasingly shift the balance of its focus to supporting the real economy. This month brought further signs of rising household demand: dwelling approvals are lifting and this is feeding through to retail sales. However, the capital expenditure survey still shows few signs that non-mining businesses are prepared to ramp up their investment plans, which is the next stage of the rebalancing act. The labour market looked more promising, with hours worked up and the unemployment rate steady. This could be providing the tell-tale signs of an improving business sector outlook, although it is too early to be confident.

The Federal budget, delivered in early May, included measures that were a bit more supportive of growth than last year's budget and drove a modest increase in consumer sentiment. The AUD has also fallen, as the USD has appreciated, which is helpful for growth, although, on our estimates, it still remains too high for the RBA's comfort.

We expect the RBA to be on hold in coming months as the central bank watches for the impact on local economic activity of the 50bp of cuts already delivered this year, monitor the impact of the APRA's tightening measures on the financial cycle, and hopes for a lower AUD.

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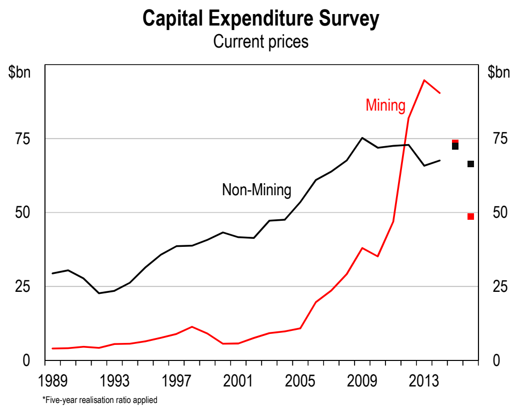
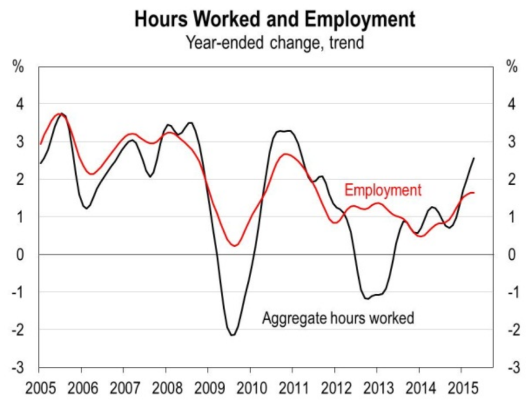
1. Non-mining business investment outlook a key concern



Source: ABS

2. Jobs growth appears to have lifted and hours even more



Source: ABS

Weak business investment outlook holding back growth

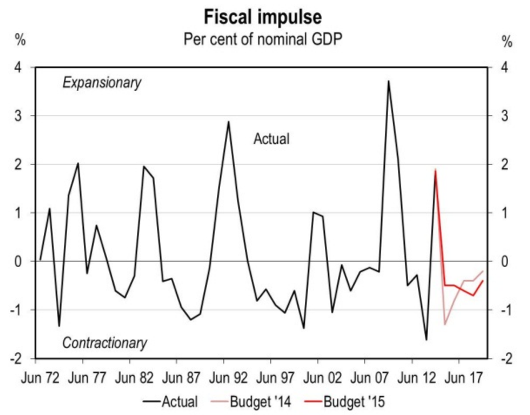
This month brought more signs that growth is still running at a below-trend pace and that this may continue for some time yet. Although the rebalancing of growth, from being led by mining investment to being supported by non-mining sectors, is underway, it has been slow.

Housing construction has been picking up strongly and retail sales have been rising, but this is yet to feed through to a pick-up in non-mining businesses investment intentions, which is the next stage of the rebalancing act. This month's Q1 capital expenditure survey continued to report that non-mining businesses see their investment falling in financial year 2015-16 (Chart 1). There are a range of potential reasons for this weak outlook, including that business confidence has remained subdued (for more on this see: *Downunder Digest: Australia's weak investment outlook*, 25 May 2015).

Labour market data look better, but are they believable?

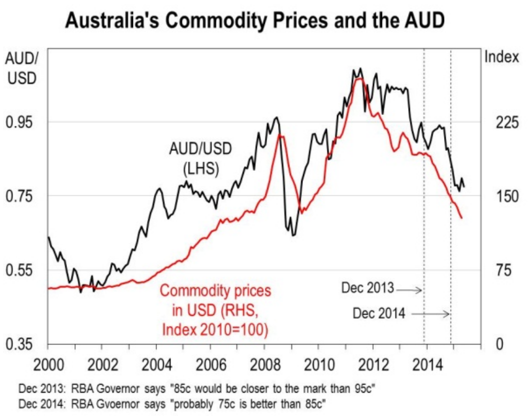
On a more positive side, this month's labour market data continued to suggest some improvement. According to the monthly survey, employment was growing at 1.5% y-o-y in April and there has been an even stronger pick-up in total hours worked, which is often a precursor to a further rise in jobs growth

3. Fiscal policy now a bit less of a drag on growth



Source: Australian Treasury

4. The AUD is still too high for the RBA, as it looks to USD0.70



Source: RBA

(Chart 2). The survey also showed that the unemployment rate has been broadly steady since October 2014 at a little over 6%. However, as the monthly labour force survey has been subject to significant measurement issues over the past nine months and has had numerous revisions, a few more data points may be needed to believe that the labour market is genuinely on the mend. This month's Q1 wages price index fell to a new low of 2.3% y-o-y. This could reflect the lagged effect of rising spare capacity in the labour market, which could mean that it is still consistent with the unemployment rate stabilising. Alternatively, it could be a sign of further weakness in the labour market.

The budget is less of a drag, but the AUD is still too high

This year's budget, delivered in early May, saw fiscal policy settings move in the right direction to be less of a drag on growth than before, although, according to our estimates, the budget still was not an outright stimulatory setting. The government backed away from its previous austerity plans and allowed the budget deficit to expand in line with its lower tax revenue estimates. The budget also contained a planned boost to childcare subsidies and a tax cut for small businesses. As a result, the fiscal impulse should be less of a drag on the economy than estimated in last year's budget (Chart 3).

However, the AUD still remains too high for the RBA, which means it remains a headwind to the rebalancing of growth towards non-mining sectors. We think the RBA would be more comfortable with the AUD around USD0.70 or 10% below the current level (Chart 4).

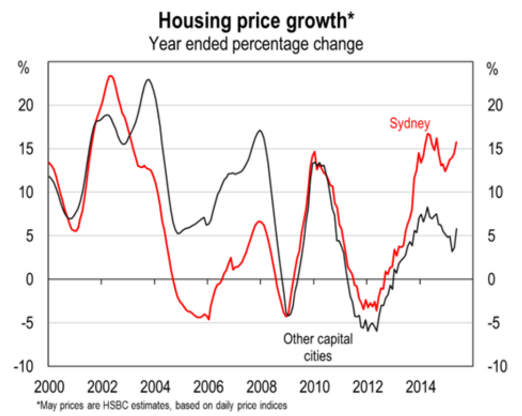
Asset price worries see the APRA tighten lending standards

With a pick-up in non-mining business investment needed, and the RBA trying to get the AUD to depreciate to assist the rebalancing process, the cash rate was cut to a new record low of 2.00% earlier this month.

However, very low interest rates are also driving a strong pick-up in a number of asset prices, particularly housing prices in Sydney and to a lesser extent in Melbourne, as well as strong growth in commercial property prices. Sydney housing prices are growing at a y-o-y pace of 15% and are up 40% over the past three years, with most of the activity being driven by property investors (Chart 5 and 6).

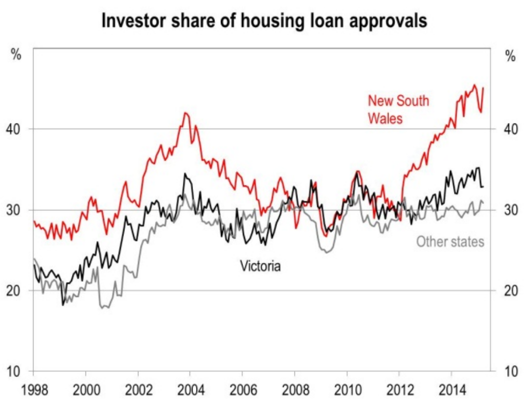
In the face of growing risks of asset price misalignments, the Australian Prudential Regulation Authority (APRA) has been turning up the dial on lending standards since late 2014. The dial appears to have been

5. House price growth strong in Sydney and rising elsewhere



Source: RP-Data Core-Logic

6. Loan approvals to investors are at very high levels



Source: ABS

tightened up further in recent weeks, following March credit data, which showed system-wide lending to investors growth of 10.4% y-o-y, above the APRA's preferred ceiling of 10% growth (introduced in December 2014). In recent weeks, Australia's major banks have reduced discounts on lending rates to housing investors, which seems likely to reflect the prudential regulator's tightening.

The APRA has also announced that it has further measures available to use, if necessary: including additional oversight, potentially increasing capital requirements on lending, and applying strict limits (rather than soft targets) on particular types of lending ('macro-pru'). For more details see: *Downunder Digest: Australia's evolving approach to macropru*, 20 May 2015.

The RBA needs to balance the financial cycle and the real economy

With the APRA more focused on managing the financial cycle, the RBA may be able to increasingly shift the balance of its focus to supporting the real economy. Nonetheless, comments by the RBA's Deputy Governor, Philip Lowe, following a recent speech, highlight that the central bank still has concerns about asset prices. He noted that 'household debt is high, property prices are very high, household income growth is slow, the unemployment rate has drifted up – all those things would suggest there has been an increase in the level of risk, particularly as people have bought property for investment purposes'.

Having just delivered a further 25bp cut in the cash rate earlier this month, we expect the RBA to be in 'watch and wait' mode. The RBA will be watching for signs that lower interest rates and the government's more positive budget message could drive a lift in business confidence, which may eventually translate into a pick-up in business investment over time. The central bank will also be watching for signs that the APRA's tighter lending standards may see a pull-back in the pace of growth in the Sydney and Melbourne housing markets and particularly reducing investor's appetite for involvement.

Finally, the RBA will continue to wait for the AUD to fall further. It is clear that the central bank would prefer an AUD depreciation to do the work for it in terms of further supporting the rebalancing of growth. However, if the AUD does not fall, the recent tightening by the APRA may allow the RBA to consider further cuts without excessive concern about overinflating asset prices.

7. HSBC's main forecasts for Australia

	Year-average (%)			Year-ended (%)							
	2014	2015f	2016f	Q314	Q414	Q115f	Q215f	Q315f	Q415f	Q116f	Q216f
GDP	2.7	2.6	3.0	2.7	2.5	2.1	2.4	2.9	3.3	3.5	3.2
CPI	2.5	1.8	2.8	2.3	1.7	1.3	1.6	1.9	2.4	2.9	2.9
Trimmed mean	2.7	2.4	2.8	2.6	2.4	2.3	2.2	2.5	2.5	2.8	2.8
Unemployment rate	6.1	6.4	6.2	6.1	6.2	6.3	6.4	6.5	6.4	6.3	6.2
AUD/USD^	0.78	0.72	0.70	0.87	0.82	0.75	0.74	0.73	0.72	0.71	0.71
Cash rate^	2.50	2.00	2.75	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00
Market pricing											
OIS implied^	NA	1.82	NA	NA	NA	NA	1.99	1.92	1.82	1.81	NA

Source: ABS, RBA, HSBC estimates. ^end-period

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