Reserve Bank of Australia (RBA) - arguments for holding fire

The consensus overwhelmingly believes the RBA will ease again at their policy meeting this week. They might be right. But there are good reasons for not assuming that this is a done deal. We explore some of these reasons here.

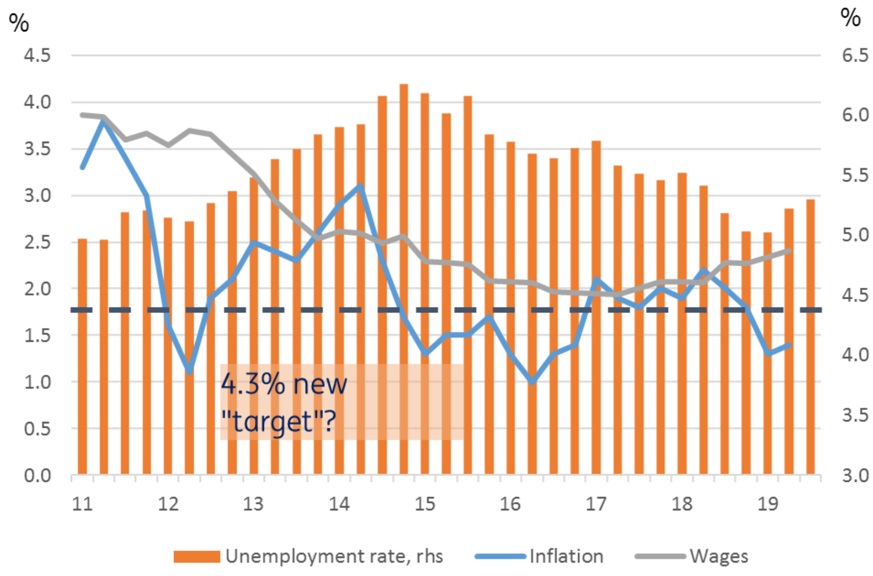
Its the unemployment rate stupid!

Perhaps the most damning piece of evidence against our own preference for a no-cut decision by the RBA this week was the latest labour market report. The key figure within this was a rise in the unemployment rate for August from 5.2% to 5.3%. The RBA themselves have noted that the unemployment rate would probably need to fall to closer to 4.3% to drive inflation higher. Inflation is currently 1.6%YoY, well short of its 2.5% mid-point target. So doesn't this seal the fate of this week's meeting?

The answer to this would be "yes", if the RBA really were just a mechanical, unthinking machine. You see, part of the problem with that sort of thinking is that to stimulate the economy sufficiently to drive the unemployment rate down to 4.3%, would probably mean cutting policy interest rates to zero, and then embarking on unorthodox monetary policy easing. Should the RBA cut rates next month too as the unemployment rate remains above 5.0%? And should it cut the following month too, and the one after that? The answer is very obviously no. Which brings us back to this month.

I think, and I believe the RBA is similarly persuaded, that monetary policy stimulus is not a linear function of the policy rate, and indeed, that at low rates, its effectiveness is extremely limited. Indeed, there is a compelling argument for thinking that at low positive rates, and certainly for negative rates, Central bank "easing" actually does more harm than good. That is a very strong reason for not easing this month.

Unemployment rate, wages and inflation



Source: CEIC

A "good" rise in the unemployment rate

So easing further at today's already low rates (the policy interest rate is already only 1.0%) might not work, and could backfire. But is it even necessary?

Apart from the increase in the unemployment rate in August, the last labour report wasn't actually all that bad at all. Admittedly, of all the 34.7 thousand jobs created in August, 50.2 thousand of them were part-time, and the numbers of full-time jobs created actually fell by 15.5 thousand. But one of the things we have noticed and used to our advantage when forecasting these numbers is their "negative autocorrelation". In other words, bad follows good, and vice versa. Not only this, but part time and full time jobs themselves tend to be negatively correlated. Both of them tend not to rise or fall in the same month, so a rise in one tends to feed off the other.

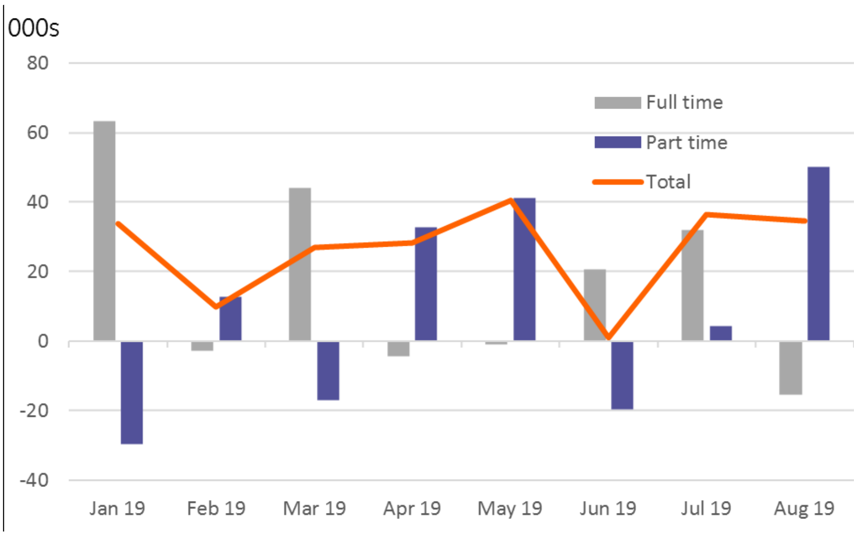
On this basis, the decline in full-time jobs in August was certainly due, following a solid 34.5 thousand increase the previous month. We will likely see these jobs rebound in the September report, though the numbers of part-time jobs will probably flop as a result, as some of these convert to full-time jobs. The overall numbers of employed will also probably grow at a slower rate or even decline in the September release, but for "good" reasons (full-time jobs will be rising).

As for the unemployment rate itself, this is always a fiddly figure for any economy, being made up of two very volatile components. The first part is the numbers of unemployed. In August, this rose a very modest 4 thousand. Not in itself much more than a rounding error, and much smaller than the numbers of jobs created in the same month.

The second part is the labour force, which refers to all those in work, plus those out of work but who are looking for work. This number swings around as marginal members of the labour force reassess the benefits of paid work against their prospects for actually getting work and drop in and out of the statistic.

Last month, the labour force grew by fractionally more than the numbers of jobs created, 38.8 thousand versus 34.7 thousand. That difference, entirely accounts for the rise in the numbers of unemployed. In other words, in net terms, no one lost their job in August, but more people started looking for work, which took them from economically inactive, to being part of the labour force, and for now, "unemployed".

Even then, the impact on the unemployment rate was tiny. To six decimal places, the unemployment rate rose from 5.238344% to 5.253583%, a difference of 0.015239 percentage points. In any language, this is insignificant, and a poor basis for any change in monetary policy.



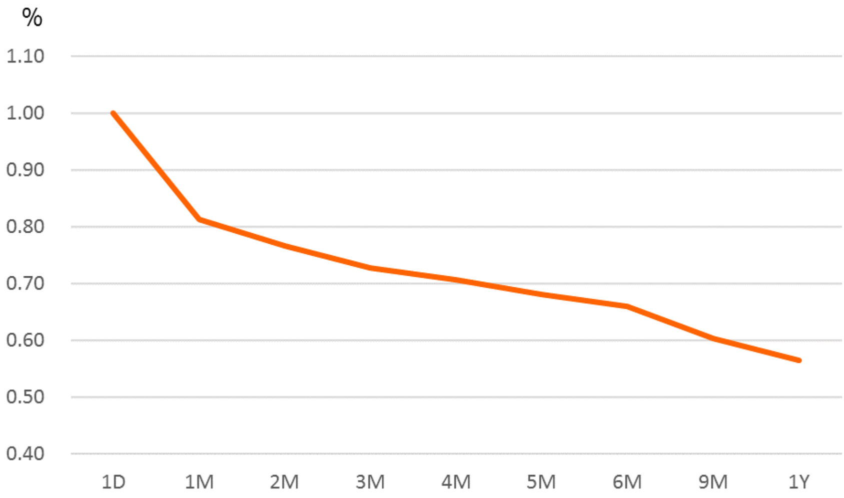
Source: Bloomberg

But wait, there's more - what about housing?

One of the biggest worries for households in Australia, after their employment prospects, was the value of their main asset - their home. With house prices falling for much of the last two years, the consumer had been fighting a very plucky rear-guard action to keep spending going in the face of balance sheet wealth declines and soft business investment.

Recent data from CoreLogic indicates that house prices are rising solidly again with gains in the important Sydney and Melbourne markets. Whilst no-one is seriously suggesting that the Australian housing market is becoming a bubble, it is equally hard to see it needing yet further stimulus as it recovers. Not surprisingly, many commentators from the residential real estate industry claim that this is exactly what it does need.

Australian implied policy rates from OIS curve



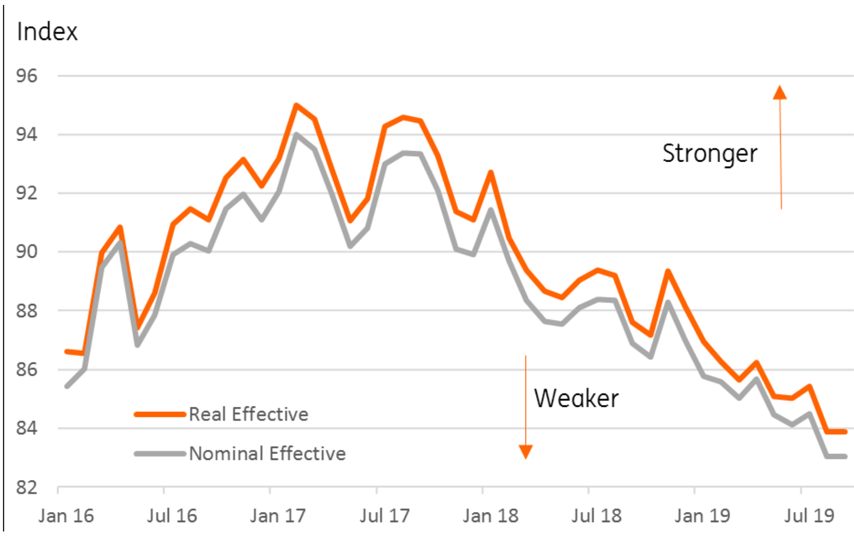
Source: Bloomberg

Economy at a "gentle turning point"

In a set-piece speech last week, RBA Governor Lowe did not give too much away. Sure, he noted the difficult external environment, and the easing being undertaken by other central banks which could yet play a part in his ultimate decision. But he also repeated three times that the Australian economy was at a "gentle turning point", suggesting he was not going to rush into further easing after the June and July rate cuts. And might still try to ride this one out.

Markets, as well as the consensus of economists, are braying for more easing. The OIS curve shows an implied probability of a rate cut this week at 80%. And failure by the RBA to deliver a cut at this week's meeting will likely see the AUD spike higher. But both real and nominal effective exchange rates for the AUD have weakened since the end of last year, and a small near-term spike should be quite manageable. If AUDUSD bounces back to a little over 0.68 following a no-change decision this week, then this would not derail Governor Lowe's "gentle turning point" for the Australian economy. It would also leave policy rates closer to a level at which, even if they aren't actually doing all that much good, they won't actually be doing any harm.

BIS - Australian effective Exchange rates



Source: Bloomberg

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