

# Path to RBA Rate Cuts, Revisited

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Over the past few months, the case for the Reserve Bank of Australia to revisit rate cuts has been gathering pace. Recent falls in commodity prices—and growing angst about the impact on the broader economy—tilt the balance. We expect to see further policy easing by the middle of next year.

Five weeks ago, we laid out a scenario in which the Reserve Bank of Australia would again contemplate easing monetary policy (“What Would Bring RBA Easing Back to the Table?” *Australasian Perspectives*, October 17, 2014). The argument revolved around four factors: (1) increasing angst surrounding the commodity market downturn; (2) a recognition that housing construction momentum was ebbing; (3) a drift higher in the unemployment rate and (4) acknowledgment that there was sufficient inflation headroom.

Those factors are by and large falling into place, and it’s worth revisiting a couple of them. The most clear-cut is the commodity story. A continued decline in the iron-ore price, to below US\$70 per metric tonne (MT) (**Display 1**), has again ignited the gloom around Australia’s commodity sector. This has been reinforced by the sharp fall in oil prices. While Australia is not yet recognized as a large-scale energy producer (as, for example, Norway and Canada are), the completion of seven new liquefied natural gas (LNG) “mega

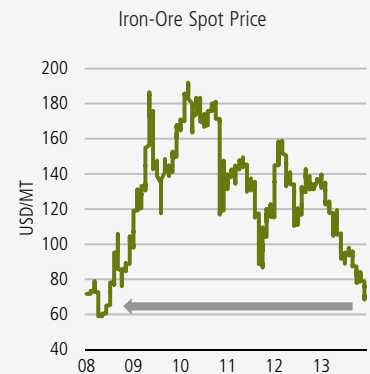
projects” over the next four years will catapult Australia to the position of one of the largest LNG exporters in the globe, according to the Bureau of Resources and Energy Economics. The new projects will increase the capacity in the sector from 24.3 million tonnes per annum (mtpa) in 2013 to 86.1 mtpa in 2018.

A large part of that export capacity has long-term contracts attached. Nonetheless, prices remain variable and are in general linked to oil prices. In other words, a sustained period of lower oil prices certainty has implications for revenues, profitability and so on from the projects.

And one way that this decline in national income is spread across the broader economy is via declining tax revenue, thus applying more fiscal stress. The extent of this stress should be revealed in the government’s next budget update in mid-December.

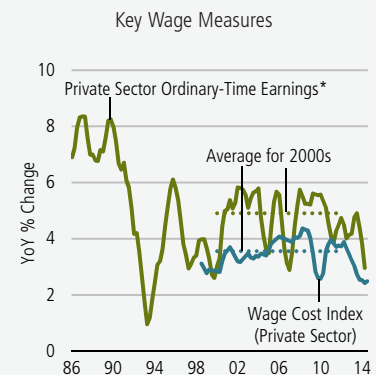
The other area worth exploring is inflation headroom. The fall in oil prices—in

Display 1  
Iron Ore Comes Full Circle



As of November 27, 2014  
Source: Bloomberg

Display 2  
Wage Dynamics Suggest Lower Inflation



As of 3Q:2014  
\*Rolling annual average change  
Source: Australian Bureau of Statistics and Thomson Reuters Datastream

Australian-dollar terms down 18% in fourth quarter to date versus the third quarter—could trim 0.3 point off headline consumer price index (CPI) inflation. Given that the relatively large fall in the fourth quarter of 2013 drops out of the calculation, this means that the annual CPI inflation rate could conceivably fall to 1.5% in the fourth quarter—below the bottom of the RBA's target band.

Just as important, however, in determining the inflation story is the wages picture. Here, things could not be clearer. Wage inflation, on any metric, is running at or close to historic lows (**Display 2, previous page**). And with productivity trending higher, unit labor cost growth is close to zero—clearly tilting the risks on core inflation to the downside.

The combination over the next six months of unemployment drifting higher and inflation moving lower clearly puts a return to monetary policy easing on the RBA's agenda. A renewed rate cut cycle beginning mid-2015 seems increasingly likely, in our view. ■

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