RBA Watch

11 April 2006

Market Economics

NAB Changes Interest Rate Call

- **We have revised our interest rate outlook and now expect one rate hike of 25 basis points, most likely in July/August. But timing is dependant on the accumulation of data, and could possibly be as early as May if the next core CPI is unexpectedly high**
- **A host of indicators have been strong since the start of 2006, most recently the NAB survey for March. This has led to upward revisions to our forecasts for GDP and underlying inflation. We also no longer expect unemployment to rise materially**
- **Our interest rate forecast has been revised up because of these forecast revisions, against a backdrop of an economy operating at close to full employment and at historically high rates of capacity use**

Background

NAB has maintained the view from April last year that the most likely outlook for interest rates was unchanged for the foreseeable future. This view was predicated on on-going softness in the economy with sub-3% growth in our forecasts for 2006. However, in recent months the economic outlook has changed tangibly for the better.

Recent developments

Stronger growth in domestic demand ahead has been signaled by the following data:

- NAB surveys for first three months of the year showed sharply higher Business Confidence and Business Conditions jumped in March, signaling stronger activity Importantly, capacity use is only ½% off near record highs of 83%
- Retail trade in Q1 is running at a quarterly rate of around 1.8% in nominal terms faster than for the December quarter, a real rate greater than 1%. Motor vehicle sales are running at a quarterly rate of 2½%
- House prices rose for all capital cities in the December quarter and the market appears to have turned upwards late last year and further in early 2006
- Home lending data, a leading indicator for housing activity, is trending higher. Investment lending is also improving
- Unemployment bottomed at 5.0% during June to August 2005, tracked higher to 5.3% by January but then dropped back to 5.0% over February and March. 5% is the rate which the RBA has identified as consistent with full employment in the economy
- Job vacancy data suggests a renewed recruitment drive on the part of employers. Skilled vacancies, ANZ's newspaper ads series and the ABS quarterly series are all up in the latest readings
- RBA credit measures trended lower after May 2004 but have since re-accelerated
- Added to the mix are the 9% rise in the Aussie stock market since the beginning of the year (7.7% since the RBA February MPS) adding positive wealth effects to consumption, a 25% rise in industrial metals commodity prices (14% since the MPS)

Forecast revisions

This strong run of economic data and an improved outlook has resulted in an upwards revision to our activity forecasts, which feed through into our outlook for unemployment and inflation. The results of these revisions are summarized in the table below.

For the RBA, our changed forecasts suggest that the balance of risks has changed from neutral on rates to a situation where the upside risks on core inflation will be unacceptably high. Hence, we now expect the RBA to raise rates by 25 bp at some point in the not too distant future. On the timing, it will be driven by data and most likely in July or August as the evidence accumulates. Though it could be as early as May, if the CPI was a shocker. If the economy continues to surprise on the upside, two hikes of 25 bp could eventuate by year end.

Table: Revisions to NAB Forecasts

Calendar Year	2006		2007	
ann avge % growth	old	new	old	new
Consumption	~~3.25~~	3.5	~~3.0~~	3.25
Domestic Demand	~~3.5~~	4.0	~~3.2~~	3.4
Net exports[1]	~~-0.5~~	-0.6	~~0.0~~	0.1
GDP	~~2.7~~	3.0	~~3.3~~	3.5
Unemployment Rate[2]	~~5.7~~	5.1	~~5.5~~	5.2
Core CPI[2]	~~2.7~~	3.0	~~2.7~~	2.7
RBA Cash Target[2]	~~5.5~~	5.75	~~5.5~~	5.75

1. Contribution to growth
2. Year end rate

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Important Notices