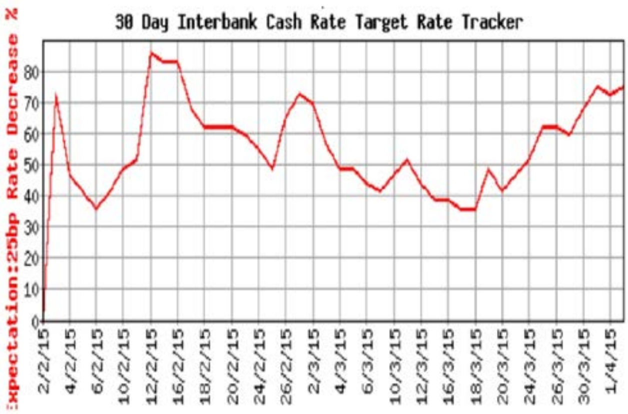
Another line-call decision for the RBA but expect no change

The Reserve Bank of Australia has confounded market expectations in recent months, first by easing policy in February then by holding fire in March. 90 day interbank futures suggest there is a 75% probability that the RBA will cut the Overnight Cash Rate to 2% at today's meeting (see chart).



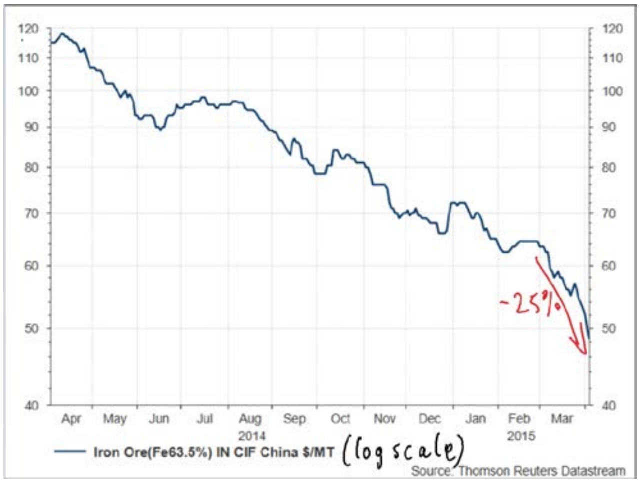
There has been little in the way of unambigously weak domestic data flow since the last RBA Board meeting on March 3rd to justify the market's shift. The five key releases have included: January building approvals (+9%), December quarter national accounts (+0.5%), January retail trade (+0.4%), February employment (+15.6k), and February new motor vehicle sales (+3%).

The key factor that appears to have convinced the market that a policy easing is forthcoming in April is the precipitous decline in the iron ore price. In the past month alone, the price has fallen by around 25%, the steepest monthly decline in the past year (see chart). The lower iron ore price in part reflects renewed weakness in Chinese residential property markets.

But the fact that the copper price has actually lifted in the past month while the Australian dollar has depreciated against the US dollar and on a TWI basis by only 3% suggests that there has not been a large and broad based contraction in global demand for iron ore and other commodities. Rather, a further lift in expected production of iron ore has probably exacerbated the lower demand for steel associated with the weakness in Chinese housing markets.

If the lower iron ore price has been the key swing factor influencing the market's expectations, investors are likely to be disappointed. Short-term gyrations in volatile commodity markets are unlikely to sway the RBA. If the central bank was to ease policy and cite the sharply lower price of iron ore (or any other commodity for that matter), it would have egg on its face if the iron ore price re-bounded in the near term.

On the other hand, if the price continued to slide, it might force the RBA to confront the market's expectation of another rate cut. The central bank would have the unenviable task of carefully managing investors' expectations around commodity price swings, thus reducing its policy discretion and flexibility.



The central bank is likely to maintain a systematic approach, rather than being reactive to shifts in comodity markets. The RBA Governor has previously said that any rate cuts would be framed in terms of a positive narrative to ensure that lower interest rates are not seen to reflect a weak economy at a time when consumer and business sentiment remain fragile. A slide in the iron ore price does not exactly provide the backdrop of a positive narrative.

The benign December quarter CPI print released in late January offered the RBA an ideal opportunity to use a positive narrative to justify the decision ease policy in February, particularly given the impact of lower energy prices in reducing headline inflation and inflation expectations.

The minutes from the March meeting revealed a desire by Board members to allow some more time to pass to assess the effects of the February rate cut. The bottom line is that the RBA will not be rushed into cutting interest rates, despite adopting an easing bias at the March meeting.

The RBA has plenty of scope to cut interest rates. The economy remains stuck in a nominal recession, revenue conditions are subdued, there is still considerable slack in the labour market, growth in private sector wages has reached a record low and the inflation outlook does not pose an obstacle to another rate cut.

I remain of the view that the central bank will ease policy in May, immediately following the release of another benign CPI print in late April, allowing the RBA to once again frame its decision in terms of a positive narrative.

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