RBA underscores its independence

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The fact that the Reserve Bank Board's decision to lift the cash rate by 25 basis points to 6.5% had been widely anticipated in financial markets in no way diminishes its significance.

In fulfilling Governor Glenn Stevens' commitment in February that 'if in August it needs to be done, it will be done', the Reserve Bank has emphatically demonstrated its independence and its credibility. This is not a decision that would have been taken lightly, given the political sensitivity attaching to interest rates; but it is a decision that would probably not have been taken at all had the Bank still been required to obtain the approval of the Treasurer. It is therefore also to the Treasurer's credit, in formalizing the *de facto* independence which the Reserve Bank had acquired during the first half of the 1990s, that he has no role in the process by which this decision was made.

The statement by Glenn Stevens makes it clear that the higher-than-expected June quarter inflation outcome was critical to the timing of this increase in interest rates. Earlier, the Reserve Bank had been pleasantly surprised by lower-than-expected inflation results for the December quarter of last year and the March quarter of this year, prompting it in May to lower its forecast for underlying inflation in 2007 to 2.5% (the mid-point of its inflation target range), and giving it more time to assess whether the Board's previously-held concerns that stronger economic conditions would put upward pressure on inflation would be borne out.

The June quarter result, which on the Reserve Bank's preferred measures showed 'underlying' inflation had not fallen to the mid-point of its 2-3% target range but was instead running in the upper half of the band, appears to have prompted the Bank to reverse that downward revision to its inflation forecast, leading in turn to the conclusion that a further tightening of monetary policy was warranted.

In explaining that conclusion, Glenn Stevens' statement highlights a pick-up in recent months in the pace of growth in demand and activity in the Australian economy, in the context of high levels of capacity utilization and declining unemployment, strong business and household confidence, and increasing demand for finance.

It is striking how little impact last year's three interest rate increases had on any of those indicators, particularly when one recalls the dire warnings which accompanied each of them. Obviously, last year's rate rises did cause some pain, as evident (for example) in the rising number of mortgage delinquencies and repossessions (albeit from an extremely low base). But for the economy as a whole, the negative effects of those three rate increases were obviously offset by other factors.

One of those offsetting factors has been the continuing strength in commodity prices. As Glenn Stevens noted yesterday, that remains 'an important source of stimulus to Australia's national income and spending'. It is one reason why the Reserve Bank Board was not dissuaded from raising rates again by the recent turmoil in financial markets, which in its view does 'not appear to have changed significantly the broader global outlook' The global economy is currently experiencing its longest period of above-trend growth for more than three decades, notwithstanding the slowdown in the US economy this year.

Another offsetting factor, which wasn't mentioned in the Reserve Bank's statement, is the stimulus to household spending coming from recent Federal Budgets.

That may seem puzzling at first, given that the Federal Budget has been and is forecast to remain in surplus. But the mere fact that the Budget is in surplus does not necessarily mean that it is not providing some stimulus to demand. That judgement can't be made without an examination of the impact of the various components of the Budget on the saving and spending behaviour of different sectors of the economy.

Each of the last three Budgets has benefited substantially from higher-than-anticipated company tax collections, partly as a result of commodity prices being higher than expected for longer than forecast. Rather than saving any of these windfall revenue gains in the form of higher-than-previously-forecast Budget surpluses, successive Budgets have handed most of them over to households in the former of income tax cuts or increases in a wide array of cash payments. And because the corporate sector saves, on average, the equivalent of about 4% of GDP while the household sector dis-saves, on average, about 0.5% of GDP, this redistribution of income through the Budget boosts overall private sector spending.

Thus for example the personal income tax cuts in the past three Budgets will boost aggregate household disposable incomes this financial year by close to $21 billion. That more than outweighs the full-year impact of last year's three rate rises and this week's which will cost households in aggregate around $7 billion.

Although it's most unlikely that there will be another rate increase this year, the possibility of further increases in 2008 will depend importantly on whether underlying inflation accelerates in the September and December quarters. It may also be influenced by extent of any 'bidding war' between the two major parties in the lead-up to the election, which could accentuate the conflict between fiscal and monetary policy and, at the margin, put further upward pressure on interest rates.

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