

Reserve Bank minutes: 'Neutral' interest rate around 3.5pc, Australian dollar surges

By senior business correspondent Peter Ryan

Updated Tue 18 Jul 2017, 4:03pm

The Reserve Bank is continuing its campaign to soften up highly leveraged borrowers for eventual interest rate rises after a long period at record low levels.

Although this has had the unintended side effect of sending the Australian dollar soaring.

The central bank is now busy estimating what a "neutral" interest rate might look like as the Australian economy continues to show patchy signs of recovery.

In the minutes from its July meeting a fortnight ago - when rates were left on hold at 1.5 per cent - the RBA signalled that the "neutral nominal cash rate" would need to rise to around 3.5 per cent to keep inflation in check and growth at reasonable levels.

"All estimates of the neutral real interest rate for Australia suggested that monetary policy had been expansionary for the previous five years or so," the minutes said.

That implies a 2 percentage point increase in official interest rates from their current level, although there was no hint how long it might take to get there.

Citi's economists calculate that it is unlikely to happen next year on the Reserve Bank's current trajectory.

"In our analysis, assuming a 3.5 per cent neutral nominal cash rate and taking the RBA's forecasts for underlying inflation and the unemployment rate generates no change in the cash rate next year via a standard Taylor rule," they observed in a note.

The minutes come as central banks around the world, such as the US Federal Reserve, indicate conditions are right to slowly raise rates from emergency levels.

The predictions for a higher cash rate will put investor and residential borrowers on alert given high levels of loans issued at the current record low cash rate.

However, Westpac's chief economist Bill Evans believes the RBA's estimate is too high.

"If the mortgage rate increased by a further 200 basis points, the evidence of 2011 suggests that house prices would likely fall – hardly what one might assess as a neutral policy stance," he wrote in a note on the minutes.

"Overall, in the current circumstances, this neutral rate looks too high."

The Reserve Bank, though, warned that its current estimate of the so-called neutral rate could rise back closer to previous levels, which were 1.5 percentage points higher prior to the global financial crisis.



PHOTO: The RBA's minutes pushed the Australian dollar up almost a cent to 79.04 US cents. (AAP: Joel Carrett)

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Key points:

- RBA says neutral cash rate 3.5pc, 2 percentage points higher than current rate
- AUD surges a cent to a two-year high above 79 US cents on the RBA minutes
- RBA warns that a rising dollar could "complicate" Australia's economic adjustment



AUDIO: Reserve Bank softens up borrowers for cash rate hikes; Australian dollar surges (The World Today)

"A reduction in risk aversion and/or increase in the potential growth rate could see the neutral real interest rate rise again," the minutes noted.

"A number of central banks had become more positive about domestic economic conditions, and financial market pricing suggested that there had been upward revisions to the expected path of future monetary policy."

Australian dollar surges a cent on minutes

While the July meeting was held before the recent resurgence of the Australian dollar, the minutes showed the economy remains exposed to any spike against the US currency.

"The depreciation of the exchange rate since 2013 has assisted the economy in the transition from the mining boom," the minutes said.

"An appreciating exchange rate would complicate this adjustment."

Although that is exactly what happened after the minutes were released, with the Australian dollar jumping a full cent to a fresh two-year high of 79.04 US cents.

The RBA noted that despite slower economic growth in the March quarter, key indicators such as the labour market, wages growth and retail sales had been gradually improving in Australia.

Reserve Bank members were also concerned about rising wholesale electricity prices in the first half of 2017.

"This has led to significant increases in the context of efforts to address climate change and to alter Australia's energy mix," the minutes noted.

"Concerns about energy security, reliability and costs has been heightened ... partly reflecting policy uncertainty."

How high could the dollar go?



There are a number of factors at play that could push the Australian dollar through 80 cents for the first time in two years.

Although the Australian Prudential Regulation Authority (APRA) has been cracking down on banks to maintain a cap on investor loans, the RBA said it is too early to assess their full effect.

Despite the RBA's efforts to manage expectations, concerns remain that anything but a gradual increase would leave indebted borrowers in Sydney, Melbourne and Brisbane struggling to meet higher mortgage repayments.

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First posted Tue 18 Jul 2017, 1:05pm

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