Vital Signs is a weekly economic wrap from UNSW economics professor and Harvard PhD Richard Holden (@profholden). Vital Signs aims to contextualise weekly economic events and cut through the noise of the data impacting global economies.

This week: the US and China disappoint, driving the Aussie dollar up, and hopes of an Australian rate cut down.

Depressing labour market news out of the US last Saturday AEST framed another concerning week of economic data and decisions.

The US economy added only 38,000 jobs in May, well below the average of 200,000 per month since the beginning of 2013.

Federal Reserve Chair Janet Yellen responded by observing in a widely-reported speech: “recent signs of a slowdown in job creation bear close watching.” She also referred to an increase in interest rates “over time”, rather than “in coming months”. This subtle, but noticeable, change in language led markets to almost completely discount a hike in rates at next week’s meeting.

And, as if to provide a reason why, Chinese trade figures showed that exports (in USD terms) fell 4.1% on an annual basis. This was worse than the 1.8% drop in April and even worse than market expectations of a 3.6% decline.

Global demand sure remains weak.

Housing lending continued to cool in Australia. ABS figures showed that in April the value of loans was down 1.8% on a seasonally adjusted basis – driven by a sharp 5.0% fall in investor loans. This is consistent with the tighter lending criteria from previous changes to

macro-prudential regulation.

The RBA left the cash rate unchanged at 1.75%, but created a flurry of activity in currency markets with the language of its statement. Governor Glenn Stevens ended his statement with this: "…having eased monetary policy at its May meeting, the Board judged that holding the stance of policy unchanged at this meeting would be consistent with sustainable growth in the economy and inflation returning to target over time."

Markets interpreted this as a signal that further rates cuts might not happen for many months, if at all. That seems like the right reading of the language – the low-inflation problem will take care of itself. Earlier in the text Stevens observed: "Inflation has been quite low. Given very subdued growth in labour costs and very low cost pressures elsewhere in the world, this is expected to remain the case for some time."

I read that as saying that the RBA expects growth to strengthen further, and the already relatively low unemployment rate means labour costs will rise, kicking inflation back into the 2-3% target range.

I disagree for two reasons. First, as I have said at length in Vital Signs before , the unemployment numbers are misleading, masking a fair bit of underemployment. Second, real wage growth has been sluggish for years, and this is due to structural factors (highlighted here by the RBA).

I'm not convinced that 3% GDP growth that is not translating into, even positive, net disposal national income growth is going to get inflation back in the target range – without further rate cuts.

This concern was underlined by the Melbourne Institute's “inflation gauge” . In the last 12 months it was up only 1.0%, and it has only been above zero once in the last four months.

In addition to this, the Aussie dollar has risen – now hovering around US75 cents – in large part because of the Fed's delayed tightening cycle. Mr Stevens has been adamant that a lower dollar was vital for exports and has been willing to cut rates to help affect that. How does that approach jive with his recent statement?

Perhaps we are seeing an example of “Greenspan’s Uncertainty Principle” , where central bankers intentionally send fuzzy messages.

The coming three months should clarify matters in Australia and the US quite a lot. If the US labour market rebounds then the Fed will probably start to raise rates. But if inflation in Australia won't budge from its dangerously low levels then we can expect more cuts by the RBA. If both of those things happen then the Aussie dollar will fall appreciably, which would be good news for exporters, but bad for businesses investing in capital equipment.

Just like the consumers and businesses standing on the sidelines of the Australian economy, we will wait and see.

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