

THE CASH RATE OUTLOOK

The Rate Cut Door Opens a Little More

Tuesday, 20 September 2011

- The uncertainty stemming from the global economy is occupying the minds of the Reserve Bank board. But with little evidence available to gauge the effects of the European and US problems on other regions, the RBA appears to want to remain on hold.
- The RBA is still positive about the medium-term Australian growth outlook, but the RBA makes this expectation conditional on the world economy not deteriorating further. The future direction of monetary policy appears to hinge increasingly on developments globally.
- Since the RBA met on 6 September, worries about the world economy have escalated further with recent unfavourable developments in Europe.
- Our baseline scenario is still one of rates on hold this year, but we feel that the door for a rate cut is opening wider. If tangible evidence of negative effects emerge of the European and US problems on Asia, the domestic rate-cut door is likely to swing open.
- If rates were to be cut in Australia this year, we expect it to be a tap on the accelerator of just 25bp in November or December.

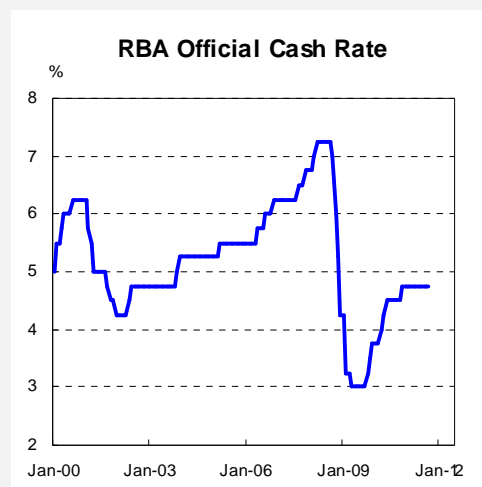
The uncertainty stemming from the global economy is occupying the minds of the Reserve Bank board. But with little evidence available to gauge the effects of the European and US problems on other regions, the RBA appears to want to remain on hold.

The RBA has noted that the near-term growth outlook was weaker than previously expected and while it is still positive about the medium-term Australian growth outlook, the RBA makes this expectation conditional on the world economy not deteriorating further.

Its concerns about inflation have been toned down, but are still at the fore. The consideration for further policy tightening which was present in the August minutes has been taken out, while the inflation outlook over the medium-term will depend on how global and domestic developments play out.

The future direction of monetary policy appears to hinge largely on developments globally, which since the RBA met on 6 September, have deteriorated further. Indeed, growth has been weak in the US and Europe, and the spreads of the peripheral economies of Europe have continued to widen, reflecting heightening worries about conditions in these economies. Although growth in Asia, in particular China, remains solid to date, there are heightening risks weaker growth in advanced economies will negatively impact this region.

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Financial markets are pricing in large cuts in the cash rate before the end of this year and were doing so at the time of the RBA's board meeting. Using inter-bank cash-rate futures for instance, the market is fully pricing in 75bp worth of cuts before the end of this year. We have been arguing for some time that the probability of such cuts in the current environment appears unlikely. And the RBA today noted that due to a range of technical factors "market pricing might not be giving an accurate reading of expectations in current circumstances".

An interesting aspect of the minutes was some of the discussion around financial markets and financial stability, which can be compared with the GFC period. The RBA highlighted rising market concerns about the European banking system as a result of exposures to peripheral Europe. Credit spreads had widened and US money market funds reduced their funding to European banks. Further the ECB's US dollar swap line with the Federal Reserve was used for the first time in several months although only by one bank and only for a small amount.

Australia's banking system however, was relatively well placed, and indeed Australian banks had benefited from a reallocation of funds away from their European counterparts. Further, the liquidity, funding and capital positions of Australian banks had improved over recent years. There was however some tightening in wholesale funding conditions but the effect was "modest" compared to other countries and in 2008, the GFC period.

In regards to currency markets, the RBA talked about the heightened volatility of the Australian dollar, but noted it was more stable than during the GFC.

The bond market had also been affected by recent turmoil, which had led to very low bond issuance globally and domestically, but that Australian banks did not have a need to issue given strong deposits and slow balance sheet growth.

Overall, while the RBA has noted the extreme volatility in financial markets reflecting worries about weaker global growth and concerns about the fiscal situations of the US and Europe, the underlying message from the RBA seems to be that dislocations within financial markets are not as severe as during the GFC.

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