

RESERVE BANK RATE DECISION

RBA Delivers Another Cut

Tuesday, 6 December, 2011

- The Reserve Bank cut the cash rate by 25bp to 4.25% in line with our expectations. It is the second rate cut in two months.
- It is clear from the accompanying statement that European developments were high on the RBA's agenda to cut rates. The RBA spent considerable space in their accompanying statement discussing Europe and its effects.
- The RBA highlighted that trade in Asia is seeing "some effects of a significant slowing in economic activity in Europe", financing conditions have "become more difficult" and the likelihood of a "further material slowing in global growth has increased".
- We still believe the RBA will deliver one more cut in the March quarter of next year, but European developments will be the overwhelming guide as to how much easing the RBA ultimately delivers.
- The deeper the crisis and the longer it takes to arrive at an effective solution for Europe, the greater the downside risks to the global economic and financial system and the more likely the RBA might need to tap on the accelerator further.

The Reserve Bank (RBA) met to decide interest rate settings today and delivered another 25bp easing to take the cash rate to 4.25%. It was in line with our forecasts. A recent poll showed economists were generally split while financial markets were fully pricing in a cut. The cash rate is now the lowest in 18 months.

It is clear from the accompanying statement that the overwhelming factor in the RBA's decision to cut policy was the downside risks from the European sovereign debt crisis. Last week's co-ordinated action by six major central banks (led by the US Federal Reserve) to lower the cost of borrowing and ease liquidity pressures highlights the depth of the European sovereign debt crisis.

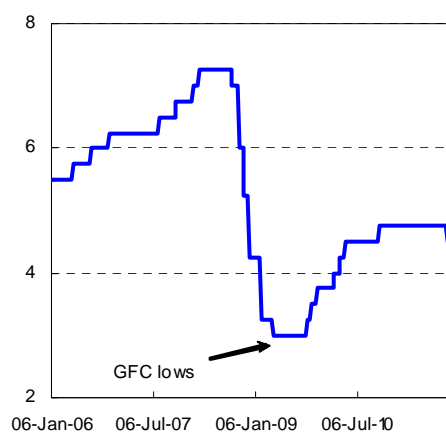
The RBA spent considerable space in their accompanying statement discussing Europe and its effects. It notes that "trade in Asia is...seeing some effects of a significant slowing in economic activity in Europe". This slowing in trade most likely also partly explains China's recent decision to ease policy by cutting its reserve requirement ratio.

The RBA also further note that "financial markets have experienced considerable turbulence, and financing conditions have become much more difficult, especially in Europe". The RBA concludes that together with precautionary behaviour by firms and households, the likelihood of a "further material slowing in global growth has increased".

The RBA suggests in its statement that its inflation outlook and softer labour conditions has given it the ability to cut rates again today. The RBA continues to see inflation consistent with its target next year and the year after.

Last month, the RBA gave a clear hint that it would cut rates again by stating that "a more neutral stance of monetary policy" would now be consistent with its inflation target over time. However, this reference was omitted today. Instead, the RBA in its final sentence of its

Australian RBA Cash Rate



statement says that “it will continue to set policy as needed to foster sustainable growth and low inflation over time”.

In our view, how much more easing the RBA will do will be highly dependent on European developments. There were some encouraging developments in relation to the crisis overnight and these developments led to big falls in the bond yields of most European peripheral economies. However, it is still early days.

The longer a solution for Europe takes, the deeper the crisis and its effects on the global economy and financial system and thus the more stimulus the RBA will need to deliver. At this stage, we are expecting one more rate cut from the RBA in February next year.

Financial markets are fully priced for another 25bp rate cut from the RBA in February and expect more easing to follow.

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