Interest Rate Outlook

bankSA

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RBA Cuts Cash Rate to 2.25%

- In step with other central banks around the world to ease monetary policy, the RBA today cut its cash rate from 2.50% to 2.25%. It now seems that a further cut, in March, is highly likely.
- The decline in Australia's terms of trade, mostly via lower commodity prices, have reduced national income. Further falls are possible and the RBA board determined that a rate cut would assist in supporting domestic demand.
- Key to the RBA's decision appears to be a downgraded assessment on the growth outlook. We will gain insight into the RBA's growth and inflation forecasts on Friday, when it publishes its quarterly Statement on Monetary Policy.
- The RBA remains dissatisfied with the level of the Australian dollar, despite its significant depreciation of late. It maintains that "a lower exchange rate is likely to be needed to achieve balanced growth in the economy."

RBA Statement: At its meeting today, the Board decided to lower the cash rate by 25 basis points to 2.25 per cent, effective 4 February 2015.

Growth in the global economy continued at a moderate pace in 2014. China's growth was in line with policymakers' objectives. The US economy continued to strengthen, but the euro area and Japanese economies were both weaker than expected. Forecasts for global growth in 2015 envisage continued moderate growth.

Our view: Global risks have increased with Europe now joining Japan in resorting to large scale quantitative easing. While the US is a relative bright spot, growth in China seems to be a constant concern of the markets. It is not so much a concern to the RBA or too us with growth expected to remain firm over the medium term. The RBA maintains that the global economy will grow moderately, but concerns remain. This could have implications for the demand of Australia's key exports.

RBA Statement: Commodity prices have continued to decline, in some cases sharply. The price of oil in particular has fallen significantly over the past few months. These trends appear to reflect a combination of lower growth in demand and, more importantly, significant increases in supply. The much lower levels of energy prices will act to strengthen global output and temporarily to lower CPI inflation rates.

Our view: Increased supply and potentially weaker demand for commodities would reduce Australia's national income. As such, the RBA is seeking to support activity via its rate cut. A rebound in commodity prices seems unlikely in the near-term, although the price of oil has *rebounded in the past few days on potential cuts in supply from the US.*

RBA Statement: Financial conditions are very accommodative globally, with long-term borrowing rates for several major sovereigns reaching new all-time lows over recent months. Some risk spreads have widened a little but overall financing costs for creditworthy borrowers remain remarkably low.

Our view: Other central banks have reduced their official interest rates and / or lifted liquidity in their economies. This left Australia with a relatively high yield and subject to capital inflows that would unhelpfully lift the AUD. The lower global interest rate environment has contributed towards today's rate cut.

RBA Statement: In Australia the available information suggests that growth is continuing at a below-trend pace, with domestic demand growth overall quite weak. As a result, the unemployment rate has gradually moved higher over the past year. The fall in energy prices can be expected to offer significant support to consumer spending, but at the same time the decline in the terms of trade is reducing income growth. Overall, the Bank's assessment is that output growth will probably remain a little below trend for somewhat longer, and the rate of unemployment peak a little higher, than earlier expected. The economy is likely to be operating with a degree of spare capacity for some time yet.

Our view: The RBA has downgraded its assessment for the growth outlook, and is now expecting growth will remain below trend "for somewhat longer" and the unemployment rate is expected to peak "a little higher". The RBA also seems to be concerned about the decline in the terms of trade on incomes.

RBA Statement: The CPI recorded the lowest increase for several years in 2014. This was affected by the sharp decline in oil prices at the end of the year and the removal of the price on carbon. Measures of underlying inflation also declined a little, to around 2¼ per cent over the year. With growth in labour costs subdued, it appears likely that inflation will remain consistent with the target over the next one to two years, even with a lower exchange rate.

Our view*: Inflation remains well contained, and certainly gave room for the RBA to cut rates today. The fall in oil prices will place further downward pressure on inflation. However, a lower exchange rate will work to push up prices.*

RBA Statement: Credit growth picked up to moderate rates in 2014, with stronger growth in lending to investors in housing assets. Dwelling prices have continued to rise strongly in Sydney, though trends have been more varied in a number of other cities over recent months. The Bank is working with other regulators to assess and contain economic risks that may arise from the housing market.

Our view: *Recent data would have done little to dispel the RBA's concerns about imbalances within the housing market. The growing proportion of property investors will weigh further on the RBA's mind now that the RBA has decided to lower the cash rate, but it appears that the RBA will be willing to lean on "macro-prudential" tools. Measures by APRA to cool investor housing activity are now more than likely to be adopted.*

RBA Statement: The Australian dollar has declined noticeably against a rising US dollar over recent months, though less so against a basket of currencies. It remains above most estimates of its fundamental value, particularly given the significant declines in key commodity prices. A lower exchange rate is likely to be needed to achieve balanced growth in the economy.

Our view: *The RBA maintains that "a lower exchange rate is likely to be needed to achieve balanced growth in the economy." This is despite the depreciation in the AUD against the US dollar and trade weighted terms of late. The AUD was trading at around 78 US cents before the announcement.*

RBA Statement: For the past year and a half, the cash rate has been stable, as the Board has taken time to assess the effects of the substantial easing in policy that had already been put in place and monitored developments in Australia and abroad. At today's meeting, taking into account the flow of recent information and updated forecasts, the Board judged that, on balance, a further reduction in the cash rate was appropriate. This action is expected to add some further support to demand, so as to foster sustainable growth and inflation outcomes consistent with the target.

Our view: *A weaker outlook for the global and domestic economies sits behind today's rate cut. The possibility of weaker commodity prices and softer national income give room for rates to fall further in March. The RBA is less sanguine about the domestic labour market and this too suggests that today's rate cut will not be the last.*

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