Interest Rate Outlook

BankSA

Tuesday, 4 December 2012

Cash Rate reduced to 3.00% from 3.25%

- **The Reserve Bank of Australia (RBA) reduced its cash rate to 3.00% from 3.25% following the meeting of its board today. Little new information was provided in today's Statement and we are left unsure as to why the cash rate was not cut in November.**
- **The RBA noted that the high AUD is counteracting the impact of lower interest rates in the economy. It also acknowledges that business investment intentions within the resource sector are approaching their peak but without giving a timeframe.**
- **The RBA appears comfortable regarding the outlook for inflation despite the introduction of a carbon price. We concur.**
- **The RBA does not meet in January. We cannot rule out a further rate cut but this will depend upon the impact on the economy of today's decision and the impact of previous rate cuts. Overseas developments will also play a part in our view. We are leaning towards no further rate cuts but will bend as the data emerges.**

Below is the Governor's statement interspersed with our views.

RBA Statement: At its meeting today, the Board decided to reduce the cash rate by 25 basis points to 3.0%, effective 5 December 2012.

Global growth is forecast to be a little below average for a time. Risks to the outlook are still seen to be on the downside, largely as a result of the situation in Europe, though the uncertainty over the course of US fiscal policy is also weighing on sentiment at present. Recent data suggest that the US economy is recording moderate growth and that growth in China has stabilised. Around Asia generally, growth has been dampened by the more moderate Chinese expansion and the weakness in Europe.

Our view: The RBA's comments on the global backdrop are little changed from last month. Downside risks are appropriately acknowledged with a specific mention this month of US fiscal policy. US 'fiscal cliff' issues, however, were well known at its November meeting and hardly rank as a deciding factor in reducing the Australian cash rate. It was also widely acknowledged last month that growth in China was stabilizing at a respectable pace. Again nothing new.

RBA Statement: Key commodity prices for Australia remain significantly lower than earlier in the year, though trends have been more mixed over the past few months. The terms of trade have declined by about 15 per cent since the peak, to a level that is still historically high.

Our view: The RBA said little new on commodity prices. It notes that some commodity prices (such as iron ore) have picked up but continues to make the highly relevant point that our terms of trade (a comparison of export to import prices) is still at historically high levels. Australian incomes and *living standards are improved by a strong terms of trade as import prices remain subdued and export prices remain relatively firm.*

RBA Statement: Sentiment in financial markets remains better than it was in mid year, in response to signs of progress in addressing Europe's financial problems, though Europe is likely to remain a source of instability for some time. Long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Capital markets remain open to corporations and well-rated banks, and Australian banks have had no difficulty accessing funding, including on an unsecured basis. Borrowing conditions for large corporations are similarly attractive and share prices have risen since mid year.

Our view: The RBA points out the exceptionally low long term interest rates currently seen in well rated countries such as Australia. It would appear that markets have factored in further rate cuts – that may or may not transpire. If the RBA does not deliver further cuts in the cash rate it is possible the current low level of fixed rates seen in Australia will move up.

RBA Statement: In Australia, most indicators available for this meeting suggest that growth has been running close to trend over the past year, led by very large increases in capital spending in the resources sector, while some other sectors have experienced weaker conditions. Looking ahead, recent data confirm that the peak in resource investment is approaching. As it does, there will be more scope for some other areas of demand to strengthen.

Our view: Since the last Statement, capital expenditure data was released which revealed a downgrade to the investment intentions for the mining industry. Given there is significant variation between these intentions and what is actually spent, there remains considerable uncertainty about when the peak of resource investment will actually occur. The RBA does not appear overly concerned about the downgrade to intentions in that it merely confirms that the peak is approaching. We had flagged that the RBA had previously anticipated this downgrade. In this Statement, the RBA has refrained from predicting that the peak would occur next year.

RBA Statement: Private consumption spending is expected to grow, but a return to the very strong growth of some years ago is unlikely. Available information suggests that the near-term outlook for non-residential building investment, and investment generally outside the resources sector, remains relatively subdued. Public spending is forecast to be constrained. On the other hand, there are indications of a prospective improvement in dwelling investment, with dwelling prices moving a little higher, rental yields increasing and building approvals having turned up.

Our view: We agree that consumption will unlikely return to the pace of growth seen in earlier times, but will likely grow at a modest pace. An encouraging sign is a pick-up in consumer confidence back above 100, suggesting that consumers are now more optimistic. The RBA remains encouraged about an improvement in dwelling investment, but a new addition in RBA commentary is the subdued outlook for investment outside of the resources sector.

RBA Statement: Inflation is consistent with the medium-term target, with underlying measures at around 2½ per cent. The introduction of the carbon price affected consumer prices in the September quarter, and there could be some further small effects over the next couple of quarters. Partly as a result of that, headline CPI inflation will rise above 3 per cent briefly. Looking further ahead, with the labour market softening somewhat and unemployment edging higher, conditions are working to contain pressure on labour costs. A continuation of moderate wage outcomes and improved productivity performance will be needed to keep inflation low, since the effects on prices of the earlier exchange rate appreciation are now waning. The Bank's assessment remains that inflation will be consistent with the target over the next one to two years.

Our view: We were surprised that the RBA cited high inflation data as a reason to keep rates on hold last month. Despite no additional inflation data since its last Statement, it appears that the RBA is now agreeing that inflation is unlikely to be a problem, and that the pickup in headline inflation was due to the one-off impact of the carbon price.

RBA Statement: Over the past year, monetary policy has become more accommodative. There are signs of easier conditions starting to have some of the expected effects, though the exchange rate remains higher than might have been expected, given the observed decline in export prices and the weaker global outlook. While the full effects of earlier measures are yet to be observed, the Board judged at today's meeting that a further easing in the stance of monetary policy was appropriate now. This will help to foster sustainable growth in demand and inflation outcomes consistent with the target over time.

Our view: The RBA clearly expects a further positive response by the economy to its previous rate cuts and from the cut announced today. The high dollar, however, is working in the opposite direction by dampening exports and encouraging imports. In order to stimulate the economy and counteract the impact of the high Australian dollar, the RBA deemed it appropriate to cut the cash rate now rather than in November when the AUD stood at a similar high level. No new reasons are given but we applaud their move even if it comes a month later than we expected.

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