Tuesday, 6 November 2012

Cash Rate held steady at 3.25%

- **The Reserve Bank of Australia (RBA) left its cash rate unchanged at 3.25% following a meeting of its board today. We believed they would cut, although we had acknowledged that it would be a close call.**
- **The RBA seemed more concerned about inflation than we would have expected, given the one-off factors that impacted on the September quarter outcome.**
- **The RBA believes that its previous rate cuts are beginning to work and is now waiting for a further positive response from the Australian economy. It appears encouraged by the stabilization in the housing market.**
- **The RBA's assessment of the global outlook was also more balanced given the stabilization of growth in China.**
- **In our opinion, the soft labour market and still difficult conditions in areas of the domestic economy support the case for another rate cut.**
- **The RBA's stance suggests that it is not looking to cut the cash rate anytime soon, and we expect it to delay a decision to do so until at least February next year.**

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

RBA Statement: At its meeting today, the Board decided to leave the cash rate unchanged at 3.25 per cent.

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, where economic activity is still contracting. Risks elsewhere seem more balanced. The United States is recording moderate growth, while recent data from China suggest growth there has stabilised. Around Asia generally, growth has been dampened by the more moderate Chinese expansion and the weakness in Europe.

Our view: The RBA acknowledges that downside risks remain for the global economy. While the US is experiencing a modest recovery, we note that it has very serious fiscal issues that must be dealt with before 31 December. In the same vein, concerns regarding aid for Greece, and Spain's reluctance to seek aid are unsettling markets. We remain broadly positive on the outlook for China but China is not immune, in the short-term, to a decline in demand. The global economy continues to make us nervous and could emerge as a reason to reduce the cash rate in the future.

RBA Statement: Key commodity prices for Australia remain significantly lower than earlier in the year, though trends have been more mixed over the past couple of months, with some prices recovering some ground while others declined further. The terms of trade have declined by about

13 per cent since the peak last year, but are likely to remain historically high.

Our view: *A weaker terms of trade implies lower income than might have been expected a year ago and reduced pressure on inflation. That said, commodity prices are still by historical standards and Australian income is higher than it would otherwise have been. It would take further large declines in commodity prices before the terms of trade became a trigger for reducing the cash rate.*

RBA Statement: Financial markets have responded positively over the past few months to signs of progress in addressing Europe's financial problems, but expectations for further progress remain high. 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. Share markets have generally risen over recent months.

Our view: *The European Central Bank (ECB) has done a good job in calming the market's fears regarding Europe's sovereign debt problems. It has 'talked the talk' and now must 'walk the walk'. Recent murmurings regarding Greece and Spain have again unsettled markets. While today access to capital exists, financial markets have shown that this can change rapidly. If the market's high expectations are not met, ructions in financial markets could return and precipitate a cut in the cash rate.*

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. Looking ahead, the peak in resource investment is likely to occur next year, at a lower level than expected six months ago. As this peak approaches, the Board will be monitoring the strength of other components of demand.

Our view: *What other components of demand does the RBA have in mind? Key contributors to activity are private consumption, non-mining business investment and the housing construction sector. Retail spending was firm in September and housing approvals have trended up in recent months. Non-mining business investment, however, remains problematic. The non-mining business sector continues to express its concern that all is not well.*

RBA Statement: Some of the consumption strength in the first half of 2012 was temporary, but there have been some signs of ongoing growth, though a return to very strong growth in consumption is unlikely. While investment in dwellings has been subdued for some time, over recent months there have been some indications of a prospective improvement. Non-residential building investment has remained weak. Public spending is forecast to be subdued.

Our view: *In our view, there is some evidence of softer consumption growth into the second half of 2012. Retail sales volumes declined in the September quarter, while consumers remain pessimistic about the outlook according to consumer confidence surveys. The RBA appears to be encouraged about an improvement in dwelling investment, and is likely referring to a pickup in building approvals data. We have previously pointed out the signs of a stabilising housing market, although conditions remain difficult.*

RBA Statement: Recent outcomes on inflation were slightly higher than expected, though they still show inflation consistent with the medium-term target, with underlying measures around 2½ per cent over the year to September, and headline CPI inflation a little lower than that. 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. With the labour market having generally softened somewhat in recent months, and unemployment edging higher, conditions should work to contain pressure on labour costs in sectors other than those directly affected by the current strength in resources. This and some continuing improvement in 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: The RBA's comments on inflation were the most surprising in today's Statement. Firstly, the RBA's forecasts in the August Statement on Monetary Policy put underlying inflation at 2.5% at the end of December quarter, and would only require another quarterly outcome of 0.7% in the December quarter for its forecast to come to fruition. Secondly, most of the factors that boosted inflation for the September quarter were one-offs and we would have expected the RBA to look through these factors.

RBA Statement: Over the past year, monetary policy has become more accommodative. Interest rates for borrowers have declined to be clearly below their medium-term averages and savers are facing increased incentives to look for assets with higher returns. While the impact of these changes takes some time to work through the economy, there are signs of easier conditions starting to have some of the expected effects. Business demand for external funding has increased this year, the housing market has strengthened and share prices have risen in line with markets overseas. The exchange rate, though, remains higher than might have been expected, given the observed decline in export prices and the weaker global outlook.

Our view: The RBA has been encouraged by the improvement in the housing market and business demand for external funding. Interestingly, the RBA has omitted any mention of credit growth in which has remained soft and was one of the reasons for cutting rates in October. It continues to recognise that the exchange rate is higher than expected, although we think it is unlikely the RBA can do much to influence the high A$.

RBA Statement: Further effects of actions already taken to ease monetary policy can be expected over time. The Board will continue to monitor those effects, together with information about the various other factors affecting the outlook for growth and inflation. At today's meeting, with prices data slightly higher than expected and recent information on the world economy slightly more positive, the Board judged that the stance of monetary policy was appropriate for the time being.

Our view: The RBA seems like it is satisfied with the impact so far of earlier rate cuts, and expects these to continue to flow through to the economy. This along with an improved global outlook and higher than expected inflation were reasons for the RBA to leave rates on hold today. A further rate cut would require a deterioration in the global outlook or a significant softening of demand in Australia.

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