Cash Rate lowered to 2.75%

- **The Reserve Bank of Australia (RBA) cut the official cash rate to a record low of 2.75% at its meeting today.**
- **It would appear that predominantly domestic factors were behind the decision to cut rates. Lower-than-expected inflation and evidence of weakness in the domestic economy seem to be the main rationale.**
- **It comes as a surprise that the RBA hasn't chosen to take a more cautious approach in reading some of the recent soft economic data (employment, retail sales, building approvals), which tend to be volatile month-to-month. We were of the view that recent economic data came on the back of strength earlier in the year, and that the RBA would prefer to see some further weakness in the data before acting.**
- **The pockets of weakness in the domestic economy and subdued inflation however, supported our view that there was room for one more rate cut in this cycle. The language in today's statement neither rules out further rate cuts nor does it hint at more. After receiving that 25 basis point cut today, we expect the RBA to remain on hold in coming months, unless we are strongly persuaded by the data.**

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

RBA Statement: At its meeting today, the Board decided to lower the cash rate by 25 basis points to 2.75 per cent, effective 8 May 2013.

The global economy is likely to record growth a little below trend this year, before picking up next year. Among the major regions, the United States continues on a path of moderate expansion and China's growth is running at a more sustainable, but still robust, pace. Japan has announced significant new policy initiatives aimed at strengthening demand and ending deflation. The euro area remains in recession. Commodity prices have moderated a little in recent months though they remain high by historical standards.

Our view: The RBA's view on the global economic outlook is little changed. The RBA doesn't seem perturbed by slower-than-expected growth in Q1 growth in China, and rightly so. Annual growth of at least 7% should be considered solid.

RBA Statement: Financial conditions internationally continue to be very accommodative, with risk spreads reduced, funding conditions for most financial institutions improved and borrowing costs for well-rated corporates and sovereigns exceptionally low.

Our view: The RBA has omitted earlier commentary on the concerns on fiscal consolidation, and the potential shocks in financial markets from Europe. While these concerns remain, this suggests *that global developments do not appear to be a major factor in the RBA's decision today.*

At some point, the accommodative financial conditions and very low interest rates should help to support global growth.

RBA Statement: Growth in Australia was close to trend in 2012 overall, but was a bit below trend in the second half of the year, and this appears to have continued into 2013. Employment has continued to grow but more slowly than the labour force, so that the rate of unemployment has increased a little, though it remains relatively low.

Our view: This paragraph is one of the major shifts in the RBA's commentary. Previously, the RBA focused on the economy growing close to trend over 2012. Today, the RBA seems more concerned about the weakness in the domestic economy towards the end of 2012 and early 2013. The addition of commentary on the labour market also suggests that the RBA is a bit more concerned about the rising unemployment rate. We expect the unemployment rate to edge higher, but to remain below 6 percent.

RBA Statement: With the peak in the level of resources sector investment likely to occur this year, there is scope for other areas of demand to grow more strongly over the next couple of years. There has been a strengthening in consumption and a modest firming in dwelling investment, and prospects are for some increase in business investment outside the resources sector over the next year. Exports of raw materials are increasing as increased capacity comes on stream. These developments, some of which have been assisted by the reductions in interest rates that began 18 months ago, will all be helpful in sustaining growth.

Our view: The RBA continues to be optimistic that other areas outside of mining investment are picking up. It is perhaps a bit more confident that this will occur after the decision to cut rates today.

RBA Statement: Recent data on prices confirm that inflation is consistent with the target and, if anything, a little lower than expected. The CPI rose by 2½ per cent over the past year, and measures of underlying inflation gave a broadly similar outcome. These results have been pushed up a little by the impact of the carbon price. Growth of labour costs has moderated slightly over recent quarters while productivity growth appears to be improving. This should help to lessen increases in prices for non-tradables. The Bank's forecast remains that inflation over the next one to two years will be consistent with the target.

Our view: Inflation "a little lower than expected" is likely a key factor behind the RBA's decision to cut rates. Underlying CPI Q1 rose a subdued 0.4% for the quarter. In the year to the March quarter, annual underlying inflation was unchanged at 2.4%, close to the middle of the RBA's target band.

RBA Statement: Over recent meetings, the Board has noted that interest rates have already been reduced substantially, with borrowing rates approaching previous lows, and that the effects of this on the economy are continuing to emerge. Savers have been changing their portfolios towards assets with higher expected returns, asset values have risen and some interest-sensitive areas of spending have increased.

Our view: The RBA continues to hold the view that its previous cuts are having the desired impact. But in light of today's decision, that impact was either too weak or too slow. It appears their *patience has run out hence the cut of 25 basis points.*

RBA Statement: The exchange rate, on the other hand, has been little changed at a historically high level over the past 18 months, which is unusual given the decline in export prices and interest rates during that time. Moreover, the demand for credit remains, at this point, relatively subdued.

Our view: The continuing strength of the AUD may have been part of the reason for cutting the cash rate today. It has subdued profitability in some sectors and restrained competitiveness. A reduction in the cash rate has the potential to reduce the pain by reducing debt costs and by possibly seeing the currency weaken. The rate cut also appears to be aimed at lifting the pace of business borrowing given its comments regarding the subdued pace of credit growth.

RBA Statement: The Board has previously noted that the inflation outlook would afford scope to ease further, should that be necessary to support demand. At today's meeting the Board decided to use some of that scope. It judged that a further decline in the cash rate was appropriate to encourage sustainable growth in the economy, consistent with achieving the inflation target.

Our view: In light of issues associated with the AUD, modest inflation, subdued credit growth and a softer pace of economic growth in the early months of 2013 the Board exercised its discretion and cut the cash rate. It had previously stated that scope existed for such a cut but their earlier comments on the pace of growth led us to believe a rate would come a touch later.

It would be tempting to say that the bottom of the rate cutting cycle has now been reached. Our call had been for a cut in September. Our concern was with the pace of business investment and new statistics are due at the end of May. Our call for beyond September was for no more cuts. To remain consistent we will stay with that view unless we are strongly persuaded by the data.

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