Tuesday, 2 October 2012

BankSA

Cash Rate cut 25 basis points to 3.25%

- **The Reserve Bank of Australia (RBA) cut it cash rate by 25 basis points to 3.25% today.**
- **The primary reason for today's rate cut was "on the back of international developments". The RBA was notably more downbeat on the global economy with China singled out as the main region of concern.**
- **The RBA now expects that the terms of trade will "probably decline further", although it will remain at historically high levels.**
- **The RBA has hinted it will be closely watching for an improvement in some of the softer areas of the economy, given that the investment boom is set to peak next year. These areas are likely to include housing and non-residential construction.**
- **Although the RBA has tended to wait for CPI data before making a move on rates, the RBA is clearly quite comfortable with the outlook for inflation.**
- **For another rate cut to emerge either the global scene must deteriorate further or there must be a significant slowdown in Australia's growth expectations.**

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 3.25 per cent, effective 3 October 2012.

The outlook for growth in the world economy has softened over recent months, with estimates for global GDP being edged down, and risks to the outlook still seen to be on the downside. Economic activity in Europe is contracting, while growth in the United States remains modest. Growth in China has also slowed, and uncertainty about near-term prospects is greater than it was some months ago. Around Asia generally, growth is being dampened by the more moderate Chinese expansion and the weakness in Europe.

Our view: *While the outlook for the world economy has softened, there have also been significant developments to address those issues. In the US, the Federal Reserve has committed to pumping liquidity into the system until the US employment situation improves. Europe has likewise committed to assisting nations with financing difficulties. In China, infrastructure spending has been ramped up. If Chinese growth slows further, then the RBA may be inclined to reduce rates again.*

RBA Statement: Key commodity prices for Australia remain significantly lower than earlier in the year, even though some have regained some ground in recent weeks. The terms of trade have declined by over 10 per cent since the peak last year and will probably decline further, though they are likely to remain historically high.

Our view: *The most notable change from the RBA's previous statement is the expectation that* *commodity prices "will probably decline further" and corresponds with a weakening outlook for global growth. However, the RBA and we expect commodity prices to stay at historically high levels.*

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. Low appetite for risk has seen long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Nonetheless, capital markets remain open to corporations and well-rated banks, and Australian banks have had no difficulty accessing funding, including on an unsecured basis. Share markets have generally risen over recent months.

Our view: *Developments in Europe remain a key concern to the outlook, and could still potentially be a source of financial market instability in coming months. However, the RBA has noted that sentiment has generally improved following some steps that European authorities have taken.*

RBA Statement: In Australia, most indicators available for this meeting suggest that growth has been running close to trend, led by very large increases in capital spending in the resources sector. Consumption growth was quite firm in the first half of 2012, though some of that strength was temporary. Investment in dwellings has remained subdued, though there have been some tentative signs of improvement, while non-residential building investment has also remained weak. Looking ahead, the peak in resource investment is likely to occur next year, and may be at a lower level than earlier expected. As this peak approaches it will be important that the forecast strengthening in some other components of demand starts to occur.

Our view: *Little changed over the quarter but the RBA is clearly concerned about a slowdown in resources sector investment spending and weakness in the construction industry. The reduction in the cash rate may improve activity at the margin but is unlikely to have much impact on overall capital spending.*

RBA Statement: Labour market data have shown moderate employment growth and the rate of unemployment has thus far remained low. The Bank's assessment, though, is that the labour market has generally softened somewhat in recent months.

Our view: *We agree and are concerned that job growth is stalling.*

RBA Statement: Inflation has been low, with underlying measures near 2 per cent over the year to June, and headline CPI inflation lower than that. The introduction of the carbon price is affecting consumer prices in the current quarter, and this will continue over the next couple of quarters. Moderate labour market 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 as the effects of the earlier exchange rate appreciation wane. The Bank's assessment remains, at this point, that inflation will be consistent with the target over the next one to two years.

Our view: *Although in the past, the RBA has waited until after a CPI data release (due 24 October) before making a move on rates, the RBA seems quite comfortable with the outlook for inflation. Indeed, we expect annual underlying inflation to be 2.3% in the year to the September quarter, the bottom half of the RBA's 2 to 3% per annum target band.*

RBA Statement: Interest rates for borrowers have for some months been a little below their medium-term averages. There are tentative signs of this starting to have some of the expected effects, though the impact of monetary policy changes takes some time to work through the economy. However, credit growth has softened of late and the exchange rate has remained higher than might have been expected, given the observed decline in export prices and the weaker global outlook.

Our view: *At previous meetings, the RBA's case to keep rates on hold was in part due to a pickup in business credit and increasing house prices. In today's Statement, the RBA notes that credit growth has softened in recent months further supporting its case to ease monetary policy. It continues to also 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$. Interestingly, nothing was said about house prices which have risen further, according to RP Data-Rismark.*

RBA Statement: At today's meeting, the Board judged that, on the back of international developments, the growth outlook for next year looked a little weaker, while inflation was expected to be consistent with the target. The Board therefore decided that it was appropriate for the stance of monetary policy to be a little more accommodative.

Our view: *Rates were cut today because, in the judgement of the RBA board, a weaker outlook for the global economy will lead to weaker economic growth in Australia and, presumably, to less pressure on inflation. For a rate cut to emerge from next month's meeting either the global scene must deteriorate further or there must be a significant slowdown in Australia's growth expectations.*

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