CASH RATE OUTLOOK

RBA Board Meeting: Cash Rate Cut to 3.50%

Tuesday, 5 June 2012

Key Points

- **The Reserve Bank of Australia (RBA) reduced its offical cash from 3.75% to 3.50%.**
- **Developments in Europe, slowing growth in China and a low domestic inflation outlook were key factors in the RBA's decision today.**
- **Domestically, the RBA continues to acknowledge the difficult structural changes occurring within the economy.**
- **Lending rates are now accommodative and should act to support growth. However, weak consumer and business sentiment suggests that the RBA has room to cut rates again.**
- **The ructions in financial markets and the deteriorating situation in Europe have heightened the chance that another rate cut could be sooner rather than later. There remains considerable uncertainty in the global economy, and we could not rule out significant rate cuts if the worst transpires in Europe.**

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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 3.50 per cent, effective 6 June 2012.

Growth in the world economy picked up in the early months of 2012, having slowed in the second half of 2011. But more recent indicators suggest further weakening in Europe and some further moderation in growth in China. Conditions in other parts of Asia have largely recovered from the effects of last year's natural disasters, but the ongoing trend is unclear and could be dampened by slower Chinese growth. The United States continues to grow at a moderate pace. Commodity prices have declined lately, though they are mostly still high. Australia's terms of trade similarly peaked about six months ago, though they remain historically high.

Our view: *The RBA appears a bit more concerned about the moderation in growth in China and the potential dampening effect this could have on its Asian partners. We however, expect that Chinese authorities will act to support growth and have the means to provide plenty of fiscal and monetary stimulus. That said, there always remains a risk that China slows more sharply than anticipated and could weigh on growth in other parts of Asia and Australia.*

RBA Statement: Financial market sentiment has deteriorated over the past month. The Board has noted previously that Europe would remain a potential source of adverse shocks. Europe's economic and financial prospects have again been clouded by weakening growth, heightened political uncertainty and concerns about fiscal sustainability and the strength of some banks. Capital markets remain open to corporations and well-rated banks, but spreads have increased. Long-term interest rates faced by highly rated sovereigns, including Australia, have fallen to exceptionally low levels. Share markets have declined.

***Our view:** The recent developments in Europe are posing a significant risk to economic growth and the financial system. Declines in share markets and the deterioration in sentiment could weigh further on consumer and business spending domestically. There has been some increase in funding costs for corporates and banks, but both are still able to receive funding. Conditions remain much better than in the aftermath of Lehman Brother's collapse in 2008.*

RBA Statement: In Australia, available indicators suggest modest growth continued in the first part of 2012, with significant variation across sectors. Overall labour market conditions firmed a little, notwithstanding job shedding in some industries, and the rate of unemployment remains low. Nonetheless, both households and businesses continue to exhibit a degree of precautionary behaviour, which may continue in the near term.

***Our view:** The statement clearly reflects the painful structural changes occurring within the economy. Some sectors are shedding labour while others are hiring. Fear of job losses is holding back confidence and spending thus adding to weakness in sectors such as retailing and home construction. Today's rate cut should support spending but is unlikely to be a major tipping point.*

RBA Statement: There have been no new data for inflation since the previous meeting. Over the coming one to two years, and abstracting from the effects of the carbon price, inflation is expected to be in the 2–3 per cent range. In the near term, it is likely to be in the lower part of that range, though maintaining low inflation over the longer term will require growth in domestic costs to slow as the effects of the earlier high exchange rate wane.

***Our view:** The soft economy is helping to keep inflation under control and was a factor in allowing the RBA to cut rates today. An area of concern is domestically sourced inflation which is pushing close to 4.0%. Overall inflation has been pushed lower by the impact of the high Australian dollar. A weaker AUD may see some import prices rise and see inflation move up from its current low level.*

RBA Statement: As a result of earlier changes to monetary policy, interest rates for borrowers have declined to be a little below their medium-term averages. Business credit has increased more strongly in recent months, though credit growth remains modest overall. Housing prices had shown some signs of stabilising around the turn of the year, but have recently declined again. Generally, the housing market remains subdued. The exchange rate has declined over recent weeks, reflecting lower commodity prices, heightened risk aversion and expectations of lower interest rates.

***Our view:** The RBA is now accommodative with lending rates below their medium-term average. At these levels, interest rates are expected to counter the negatives of lower commodity prices and softer house prices.*

RBA Statement: At today's meeting, the Board judged that, with modest domestic growth and a weaker and more uncertain international environment, the outlook for inflation afforded scope for a more accommodative stance of monetary policy.

***Our view:** There remain economic hurdles to clear. Greece goes to the polls in mid-June and as that process unfolds we expect European leaders to give some clarity and direction to the debt and banking problems hounding the region. The possibility of a further rate cut is clearly open.*

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