

RBA – CUTS RATES BY 25BP

Tuesday, 7 April 2009

Summary

- The Reserve Bank cut rates by 25bp to a fresh 45-year low of 3%, in line with our expectations.
- Weak economic conditions, globally and domestically, likely spurred the RBA to return to cutting rates.
- But improving conditions in global financial markets may have been a key factor in steering the RBA to a smaller rate cut of just 25bp.

The Reserve Bank cut the cash rate by 25bp, in line with our forecast. Financial markets attached around a 70% probability of a rate cut of 50bp in size (based on yesterday's close) and the median consensus among economists was for no change. We had judged that it would be a close call but the RBA would cut by 25bp once it weighed up economic conditions with financial conditions (please refer to our recent economic note published on April 2).

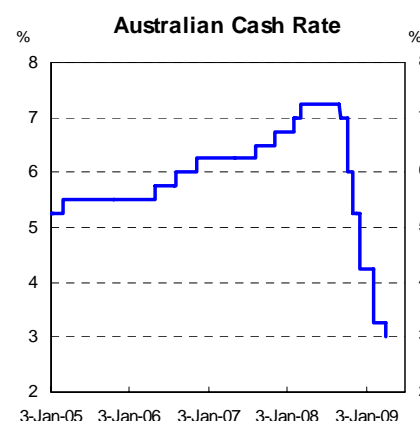
Weak economic conditions, globally and domestically, likely encouraged the RBA to return to cutting rates. But the RBA needed to weigh these economic trends against the financial ones. Improving conditions in global financial markets may have been a key factor in steering the RBA to a smaller rate cut of just 25bp. In particular, equity markets have lifted substantially off their lows. While market sentiment is still fragile, the recent run up in equities is fuelling some hope that economic conditions will improve later this year. Hence, the RBA likely judged a small rate cut of 25bp was more warranted, especially when considering "the considerable economic stimulus in train in most countries".

Furthermore, by slicing rates by a small amount, it leaves the scope to cut rates further in the future if needed.

As mentioned above, the primary reason for today's rate cut was likely to provide more protection to the Australian economy amid a global economic backdrop that continues to remain difficult and an Australian economy that continues to contract.

- The RBA notes that most recent assessments of the near-term outlook for the global economy have been further marked down.
- On the domestic front, the run of mostly weak data since they met in March we think would have played a part in their judgment to cut rates today. First, there's the Q4 GDP data that showed Australia experienced a reduction in economic activity for the first time in eight years. Second, the labour market continues to soften. In February, the unemployment rate shot up 0.4 percentage points to 5.2%. Leading indicators of employment, such as job advertisements, indicate that more rises in the unemployment rate are in store. Moreover, confidence among both consumers and businesses remains fragile at best, suggesting spending plans by these groups may continue to be curtailed. Indeed, retail sales in February witnessed its sharpest monthly percentage drop in almost nine years. The RBA made special mention of the weakness in the demand for credit in its accompanying statement today; indeed, private-sector credit slowed to an annual growth rate of just 5.4% in February, from the cyclical peak of 16.4% – the weakest pace since early 1994. The only ray of light in the local economy is that the pick up in housing lending is advancing and there are now early signs it is flowing through to more building approvals.

Where to for the cash rate from here? We still think we cannot rule out more rate cuts later this year. Our long-held projection for a low point in the cash rate of 2.25% by the end of this year remains. How low the cash rate goes will rely significantly on economic and credit-market developments. Key pieces of domestic data before the next RBA meeting in May include employment (April 9), consumer prices (April 22) and credit (April 30).



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