

# CASH RATE OUTLOOK

Tuesday, 3 November 2009

## Summary

- The RBA raised rates by 25bp, taking the cash rate to 3.50%. It marks the second rate hike in a row.
- The accompanying statement suggests a central bank that would be careful about raising interest rates by too much and too fast. But we still see a decent chance of a 25bp increase before Christmas.

The RBA has pulled the trigger again, explaining that, "With the risk of serious economic contraction in Australia now having passed, the Board's view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker". The usage of the word "gradually" in the phrase, however, indicates to us that the RBA would be careful in removing monetary policy stimulus by too much and too fast.

Indeed, the central bank today refrained from delivering a more aggressive rate increase of 50bp as some had projected. It noted that, "the rise in the exchange rate is likely to constrain output in the tradeables sector and dampen price pressures". In other words, the high Australian dollar could be argued to have done part of the central bank's job. Indeed, last week's Q3 CPI revealed that core inflationary pressures are not as strong as some feared.

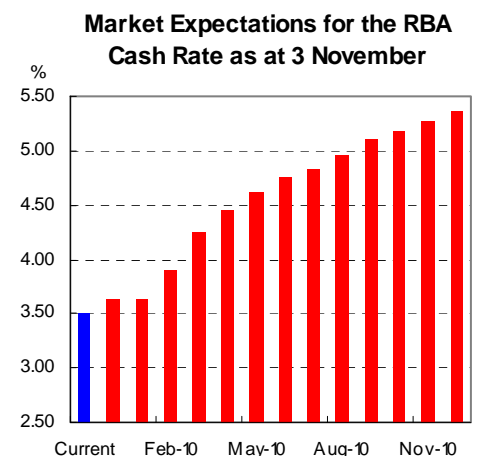
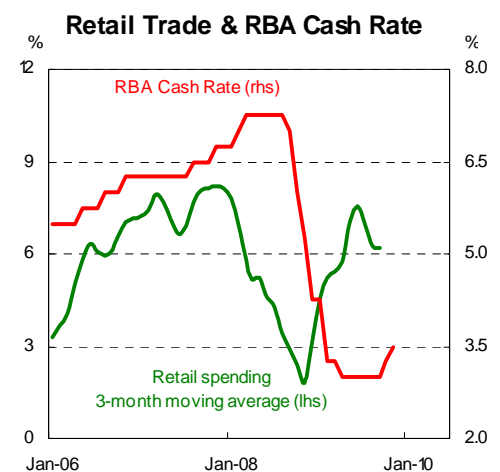
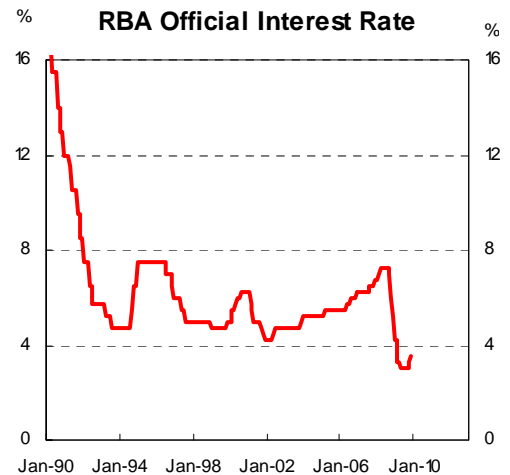
Uncertainty surrounding the extent of the global economic recovery also remains. It is clear that conditions have improved and are improving. But the impetus in the recovery could be tempered by the unwinding of some temporary government stimulus. In the US, for example, the end to the 'cash for clunkers' program in August saw the first fall in consumption spending in five months in September. Meanwhile, the \$8,000 tax credit for US first homebuyers is due to end this month. In Australia, it also remains to be seen how consumer spending and the housing sector will hold up without the government cash handouts and First Home Owners Boost (FHOB). All these developments suggest a "still fragile" economic recovery and argue for a prudent RBA. Indeed, financial markets have interpreted today's statement to signal a reduced probability of near-term rate hikes, with the Australian dollar selling off and the futures market lowering the chance of a December rate hike.

But we still see a decent chance of the RBA stepping on the brakes again in December, especially if economic activity continues to progress as it has. The RBA noted today that, "growth is likely to be close to trend over the year ahead and inflation close to target". This would suggest that interest rates should move closer to neutral (i.e. a level that neither restricts nor promotes growth) to be more in line with the economic backdrop. Accordingly, we project interest rates to move up to 5.00% by end 2010, which is level that could be argued to be close to "neutral".

The incoming flow of local data and developments in the global economic and financial landscape will be central for firming up interest rate expectations. This week's key local releases and events will include September retail sales and building approvals. The RBA also releases their updated growth and inflation forecasts in this Friday's Statement on Monetary Policy. Meanwhile, RBA rhetoric (from Governor Stevens tomorrow and Deputy Governor Batellino on Friday) could provide further assistance in firming up interest rate expectations.

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Please see the full statement to the RBA decision below:

**STATEMENT BY GLENN STEVENS, GOVERNOR**  
**MONETARY POLICY**

At its meeting today, the Board decided to raise the cash rate by 25 basis points to 3.5 per cent, effective 4 November 2009.

The global economy has resumed growth. With economic policy settings likely to remain expansionary for some time, the recovery is likely to continue during 2010 and forecasts have been revised higher. The expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis. Prospects for Australia's Asian trading partners appear to be noticeably better. Growth in China has been very strong, which is having a significant impact on other economies in the region and on commodity markets. For Australia's trading partner group, growth in 2010 is likely to be close to trend.

Sentiment in global financial markets is much better than earlier in the year. Nonetheless, the state of balance sheets in some major countries remains a potential constraint on their expansion.

Economic conditions in Australia have been stronger than expected and measures of confidence have recovered. Some spending has probably been brought forward by the various policy initiatives. With those effects now diminishing, these areas of demand may soften somewhat. Some types of capital spending are likely to be held back for a while by financing constraints, but it now appears that private investment will not be as weak as earlier expected. Medium-term prospects for investment appear, moreover, to be strengthening. Higher dwelling activity and public infrastructure spending are also starting to provide more support to spending. There have been some early signs of an improvement in labour market conditions. The rate of unemployment is now likely to peak at a considerably lower level than earlier expected.

Inflation has been declining for the past year. In underlying terms, inflation should continue to moderate in the near term, but now will probably not fall as far as earlier thought. Headline CPI inflation on a year-ended basis has been unusually low because of temporary factors, and will probably rise somewhat over the coming year. Both CPI and underlying inflation are expected to be consistent with the target in 2010.

Housing credit growth has been solid and dwelling prices have risen appreciably this year. Business borrowing has been declining as companies have sought to reduce leverage in an environment of tighter lending standards. For many business borrowers, increases in risk margins are still coming through. The decline in credit has been concentrated among large firms, which have had good access to equity capital and, more recently, to debt markets. Share markets have recovered significant ground.

The Board noted that the rise in the exchange rate is likely to constrain output in the tradeables sector and dampen price pressures. Nonetheless, growth is likely to be close to trend over the year ahead and inflation close to target. With the risk of serious economic contraction in Australia now having passed, the Board's view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. The adjustments at the October and November meetings will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead.

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