

Investment markets research – Economic note

8 April 2009

RBA compromises with 25bp rate cut

Heading into yesterday's Reserve Bank of Australia (RBA) Board meeting the market was divided between expecting no change and a 50bp easing. So the decision by the RBA to ease policy by just 25bp, taking the cash rate to 3.0%, looks a little like a compromise – providing evidence that the RBA sees the need for a further near-term easing in policy, but leaving the RBA with plenty of ammunition left if the economic outlook deteriorates further.

Nevertheless, with yesterday's 25bp rate cut the RBA has eased monetary policy by a total of 425bp since September 2008, a very aggressive move in anybody's language. Market expectations remain, however, for further interest rate reductions in the months ahead, with a terminal cash rate of near 2.25%-2.5%, given general expectations that further poor economic news is ahead of us.

In announcing the 25bp rate cut, the RBA kept to its recent themes, highlighting that:

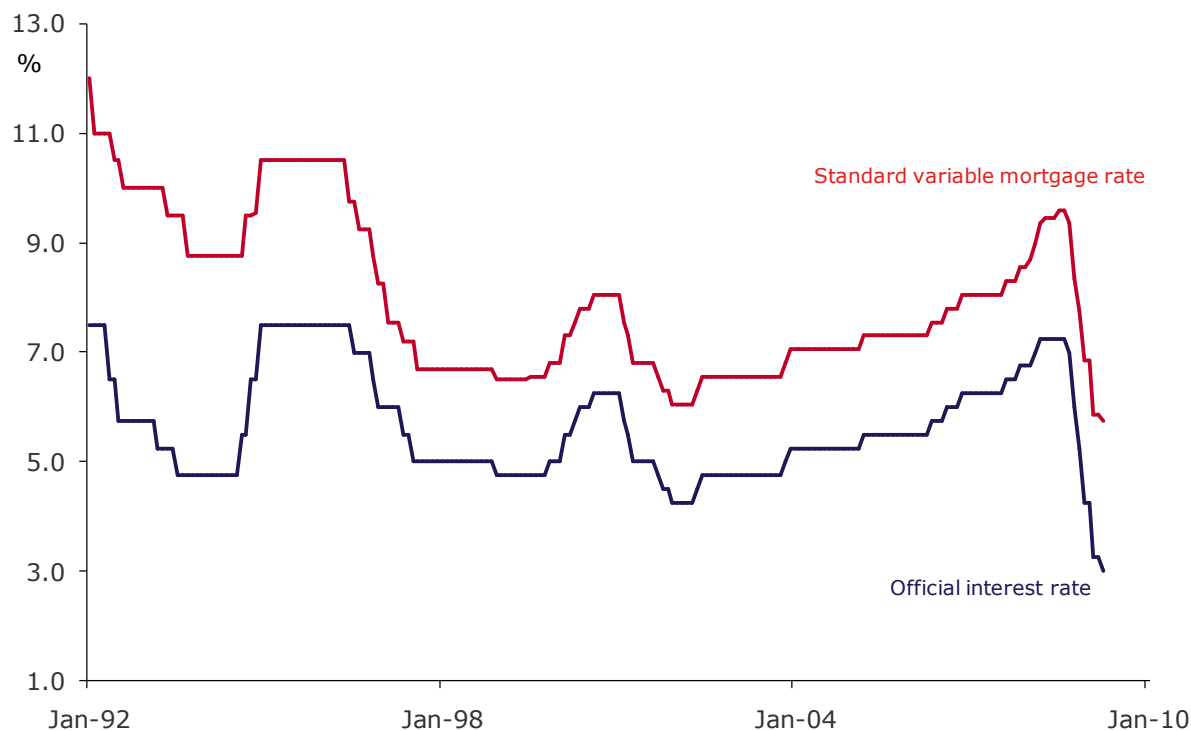
- the global economy continues to deteriorate and “most assessments of the near-term outlook have been further marked down”;
- considerable economic stimulus has been put in place in most countries, “the full effects of which are not yet discernible, but which should help contain the downside over the rest of the year”;
- in terms of our major trading partner, the RBA stated, “there are tentative signs of stabilisation in several countries, including China, though it is too early to judge how durable these will prove to be”;
- on global financial markets the RBA noted, “conditions in global financial markets have continued to improve gradually, helped by progress towards a resolution of banking system difficulties in the United States and other major countries”, but they also stated that “sentiment remains fragile”;
- In terms of the outlook for Australia the RBA repeated the view first offered by the Deputy Governor last week that, “the Australian economy is contracting, though by less than those of its trading partners” and “with demand for labour weakening, growth in labour costs will probably also fall”;
- Importantly, the RBA also added that “inflation over the medium term is likely to be lower than it has been over the past two years”;
- On the outlook for policy, the RBA stated that “there has already been a major change in both monetary and fiscal policy in Australia. Market and mortgage rates are at very low levels by historical standards and business loan rates are below recent averages, reducing debt servicing burdens considerably”;
- Given all of the above “the Board judged that there was scope for a further moderation to the cash rate” and that “the stance of monetary policy, together with the substantial fiscal initiatives, will provide significant support to domestic demand over the period ahead.”

The impact of yesterday's RBA easing on mortgage rates looks like it will be mixed, with at least one major bank announcing a 10bp reduction in the standard mortgage rate, while another has announced no change. Nevertheless, as shown in the chart below, the 425bp easing in the cash rate has allowed mortgage rates to fall sharply over the past six months or so, dramatically reducing the interest cost/income ratio for many households.

Indeed, one of the key reasons why the Australian economy has managed to outperform other countries is that the monetary policy transmission mechanism is still working. This is a function of both the stability of the banking system and the better overall fundamentals for the local housing market.

Significantly, the strength of the Australian banking system was also likely a key reason why the Commonwealth government was able to get an agreement from the ‘big four’ banks to help support those mortgage holders who face financial difficulties in the year ahead.

As announced over the weekend, the government-bank agreement will “place obligations on the four major trading banks to provide temporary relief to borrowers and to provide assistance options that take into consideration the needs of the borrower concerned.” These assistance options include a 12 month postponement on payments, with interest to be capitalised into the loan; an extension of the period of the loan and a subsequent reduction in each payment; interest-only breaks on loan repayments; and fee waivers.



Source: RBA. Assumes a 10bp reduction in the standard variable mortgage rate. Data to 7 April 2009

Colonial First State Global Asset Management Investment Markets Research

Contact details

Stephen Halmarick	Head of Investment Markets Research	+612 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+612 9303 3110	ballen@colonialfirststate.com.au

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