

RBA continues gradual return to normal

Economic note

1 December 2009

- The RBA Board today announced a further 25bp cash rate increase to 3.75%.
- The increase, the third in a row, is part of the RBA's strategy to "lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker."
- Markets continue to expect a further lessening in monetary stimulus, ie. a higher cash rate, in calendar 2010, with a return to more normal levels around 4.25% priced in by June and 4.75%-5.0% by year-end.

RBA continues return to normal

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to raise the cash rate by a further 25bp, which following the moves in the last two month, will take the cash rate to 3.75%, effective 2 December 2009

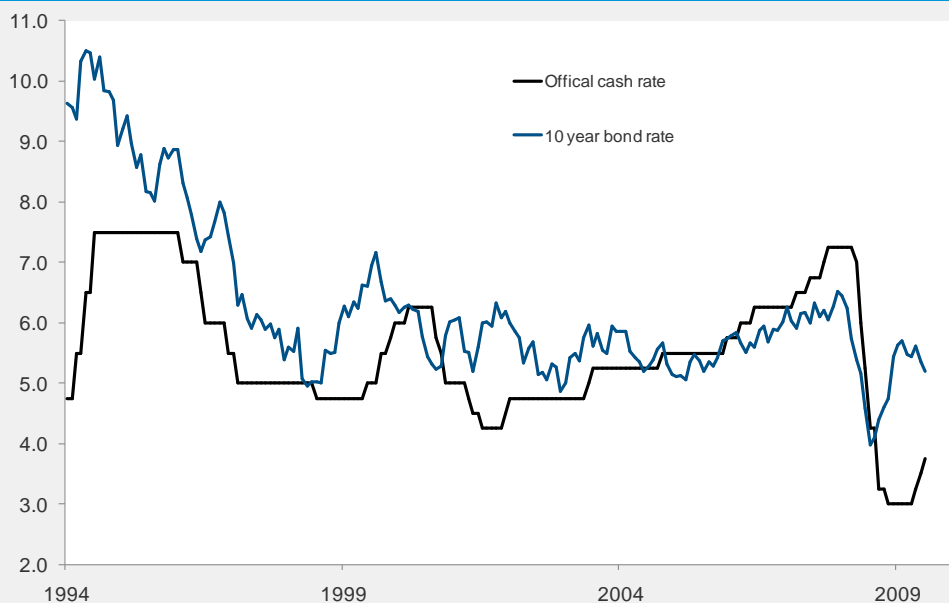
In tightening monetary policy again today the RBA stated that "with the risk of serious economic contraction in Australia having passed, the Board has moved at recent meetings to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. These material adjustments to the stance of monetary policy will, in the Board's view, work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead."

Importantly, the RBA also stated that "growth in 2010 is likely to be close to trend and inflation close to target". This suggests that further policy tightening could be expected in the new year, with a 3.75% cash rate unlikely to be consistent with trend-like growth and mid-target inflation.

However, the RBA also made the point that the monetary policy adjustment over the past three months has been "material". This will likely give the RBA some breathing space over the extended summer break (ie. there is no meeting in January) to assess the impact of the policy tightening to date and developments in the global economy.

The interest rate markets are currently priced for a move to 4.0% early in the new year, around 4.25% by mid-2010 and 4.75%-5.0% by the end of the coming year.

Australian official cash rate and 10-year bond yields



Source: RBA and Iress

Other highlights from the RBA statement today are as follows:

- “The global economy has resumed growth. With economic policies remaining expansionary, growth is likely to continue next year, though it will probably be modest in the major countries, due to the continuing legacy of the financial crisis”.
- Critically, for Australia’s major trading partners the RBA made the point that “in China and Asia generally, where financial sectors are not impaired, recovery has been much quicker to date and prospects appear to be for good growth in 2010”.
- On markets as a whole, the RBA stated that “financial markets have improved considerably during 2009, notwithstanding periodic setbacks, and capital flows into Asia and other emerging market regions have been picking up”.
- Turning to the local economy the RBA notes that “in Australia, the downturn was relatively mild, and measures of confidence and business conditions suggest that the economy is in a gradual recovery”.
- Importantly, the RBA also states that “the effects of the early stages of the fiscal stimulus on consumer demand are fading, but public infrastructure spending is starting to provide more impetus to demand. Prospects for ongoing expansion of private demand, including business investment, have been strengthening. 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”.
- On inflation the RBA is now looking for an outcome consistent with the 2%-3% target band, noting that “inflation has declined from its peak last year, helped by the fall in commodity prices at the end of 2008 and a noticeable slowing in private-sector labour costs during 2009. In underlying terms, inflation should continue to moderate in the near term, though it will probably not fall as far as thought likely six months ago. 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”.
- Commenting directly on the AUD the RBA has stated that “the rise in the exchange rate during this year will have some impact in containing prices for traded goods and services in the period ahead, and will dampen growth in the trade-exposed sector of the economy”.
- On local credit and liquidity conditions the RBA notes that “credit for housing is expanding at a solid pace, and dwelling prices have risen significantly this year”.
- “Business credit has fallen, as companies have reduced leverage in an environment of tighter lending standards, and as some lenders have scaled back their balance sheets. The decline in credit has been concentrated among large firms, which generally have had good access to equity capital and, more recently, to debt markets”.
- Finally, on the markets the RBA stated that “share markets have recovered significant ground, which, together with higher dwelling prices, has meant a noticeable recovery in household wealth”.

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