

RBA takes another step towards average

Economic note

2 March 2010

- A further 25bp increase in the cash rate to 4.0% is a “further step in the process” of returning interest rates “closer to average”.
- This strategy is designed around an expectation of trend economic growth and within target inflation.
- Despite some ongoing risks in the global economy and markets, the RBA is likely to continue the normalisation process over the remainder of the year, taking the cash rate towards 5% by end 2010 or early 2011.

RBA takes another step towards average:

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to tighten monetary policy by a further 25bp, taking the cash rate to 4.0% (effective 3 March 2010). In announcing today’s decision, the RBA stated that “with the risk of serious economic contraction in Australia having passed, the Board moved late last year to lessen the degree of monetary stimulus that had been put in place when the outlook appeared to be much weaker.

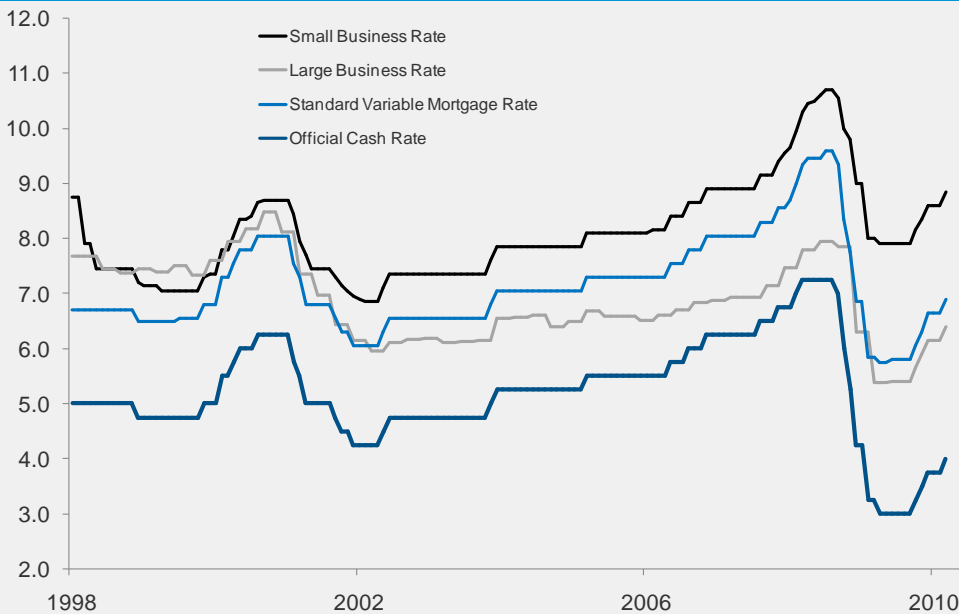
“Lenders generally raised rates a little more than the cash rate and most loan rates rose by close to a percentage point (see chart for details). Interest rates to most borrowers nonetheless remain lower than average. The Board judges that with growth likely to be close to trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average. Today’s decision is a further step in that process.”

This statement is a clear signal from the RBA that with economic growth expected to be at about trend in the year ahead and with inflation expected to be within the 2%-3% target range, then interest rates (monetary policy) also needs to be at about average. Through the combination of a higher cash rate and a widening in bank lending margins, the RBA is clearly determined to reach this goal over the remainder of the year (barring a dramatic deterioration in the global economy and/or financial markets).

As such, we would still expect the cash rate to be around 5.0% towards the end of 2010 or early 2011, implying four more 25bp rate hikes over the next 8-12 months. The lesson from the “pause” in February seems to have been that financial markets and the economy should not expect a rate hike at every monthly board meeting, but that the trend to higher official interest rates is well in place.

This is consistent with the view from a number of senior RBA officials (including the Governor and Deputy Governor) over the past few weeks that the medium term outlook for the Australian economy is positive, based largely on our strong links to the Asian growth nations, the strength of our banking system, the flexibility of our economy and the high level of population growth.

Australian official cash rate, housing mortgage rates and small and large business rates



Source: RBA, data to 2 March 2010

Other highlights from the RBA statement today are as follows:

- “The global economy is growing, and world GDP is expected to rise at close to trend pace in 2010 and 2011. The expansion is still hesitant in the major countries, due to the continuing legacy of the financial crisis, resulting in ongoing excess capacity. In Asia, where financial sectors are not impaired, growth has continued to be quite strong.”
- The RBA also makes the point that Australia is not alone in tightening policy, stating that “the authorities in some countries are now seeking to reduce the degree of stimulus to their economies.”
- On global financial markets, the RBA has noted that “global financial markets are functioning much better than they were a year ago and the extraordinary support from governments and central banks is gradually being wound back. Credit conditions remain difficult in some major countries as banks continue to face loan losses associated with the period of economic weakness.”
- In terms of the major concern over sovereign debt risks in Europe, the RBA simply states that “concerns regarding some sovereigns remain elevated.”
- Closer to home the RBA notes that “economic conditions in 2009 (in Australia) were stronger than expected, after a mild downturn a year ago. The rate of unemployment appears to have peaked at a much lower level than earlier expected. Labour market data and a range of business surveys suggest growth in the economy may have already been at or close to trend for a few months.”
- In a further positive tone the RBA also states that “there are some signs that the process of business sector de-leveraging is moderating, with the pace of decline in business credit lessening and indications that lenders are starting to become more willing to lend to some borrowers. Investment in the resources sector is very strong.”
- In terms of the local housing market, the RBA notes that “credit for housing has been expanding at a solid pace, and dwelling prices have risen significantly over the past year. New loan approvals for housing have moderated a little over recent months, however, as interest rates have risen and the impact of large grants to first-home buyers has tailed off.”
- On inflation the RBA has stated that “inflation has, as expected, declined in underlying terms from its peak in 2008, helped by the fall in commodity prices at the end of 2008, a noticeable slowing in private-sector labour costs during 2009, the rise in the exchange rate and the earlier period of slower growth in demand.”
- In terms of the outlook “CPI inflation has risen somewhat recently as temporary factors that had been holding it to unusually low rates are now abating. Inflation is expected to be consistent with the target in 2010.”

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