

RBA heading back to 'neutral'

Economic research note

1 November 2011

- The RBA has eased monetary policy by 25bp, taking the cash rate to 4.5%.
- This decision was made as a result of a downward revision in the RBA's inflation forecast, which is now expected to be within the 2%-3% target range over 2012 and 2013.
- As a result, the RBA no longer sees the need for monetary policy to be "mildly restrictive" and that a "neutral" stance is more appropriate.
- Such a neutral stance in policy is likely to involve a further 25bp move to 4.25% in the months ahead.
- The RBA then will likely to sit back and assess the impact of this neutral policy stance on confidence, activity and inflation.
- The RBA has now joined other 'early tightener' central banks in easing policy in a clear sign the outlook for the global economy has moderated and inflation pressures have subsidised.

RBA heading back to 'neutral'

At the Reserve Bank of Australia (RBA) Board meeting today the decision was made to begin returning monetary policy to "a more neutral stance" with a 25bp rate cut to 4.5%. (Note; this is the sixth year in a row monetary policy has been altered on Melbourne Cup day).

In announcing today's easing the RBA noted that over the past year they had "maintained a mildly restrictive stance of monetary policy" given "concerns about inflation"

However, the RBA is now of the view that "with overall growth moderate, inflation now likely to be close to target and confidence subdued outside the resources sector, the Board concluded that a more neutral stance of monetary policy would now be consistent with achieving sustainable growth and 2%-3% inflation over time."

The big question is, therefore, what interest rate will constitute a "neutral" stance on monetary policy. It would be very unlikely for the RBA to consider that just one 25bp move was sufficient to achieve this goal and so a further 25bp easing to 4.25% should be expected in the months ahead.

The RBA will no doubt watch very closely the impact this easing will have on domestic confidence and spending levels and then reassess the stance of policy as 2012 gets underway.

Importantly, as at the time of writing, a number of banks had announced that they would pass on the full 25bp rate reduction to their mortgage loan customers.

Significantly, on Friday the RBA will release the latest *Statement on Monetary Policy* in which they will formally revise down both their growth and inflation forecasts. Indeed, in announcing today's rate cut the RBA stated that "inflation is likely to be consistent with the 2%-3% target in 2012 and 2013." This is downward revision from the current forecast of 3%-3.25% out to 2013.

The chart below shows the recent trend in both headline and underlying inflation in Australia.

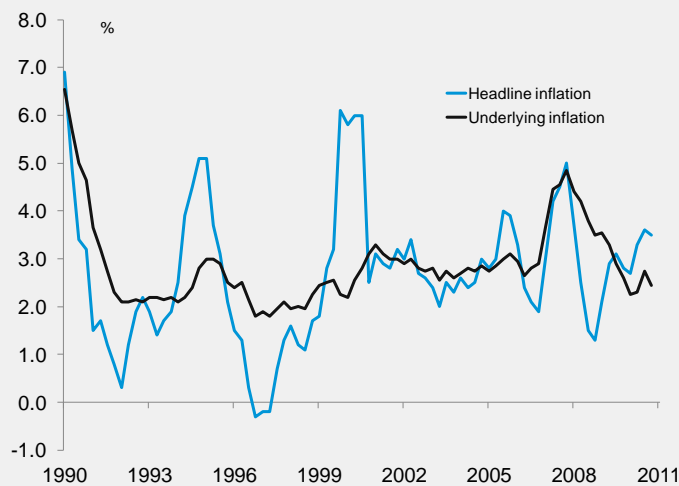


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Australian inflation. Headline and underlying



Source: ABS to 30 September 2011

Highlights of the RBA statement

In announcing today's interest rate cut, the RBA also highlighted the following:

- There has been a "moderation in the pace of global growth, though fears of a major downturn have not been borne out."
- The pace of growth in China has slowed. But this has been "as policymakers there had intended".
- In Europe the "prospects are for economic weakness to continue."
- "Financial markets have recovered somewhat from the turmoil of recent months", "but it is likely to be sometime yet before concerns about the European situation can definitively be laid to rest."
- In addition "the effects of the recent turmoil on confidence may result in a period of precautionary behaviour by firms and households."
- Here in Australia the RBA now states that "information about the Australian economy suggests moderate growth overall."
- In a slight change of message, the RBA now expects that "the terms of trade have now peaked and will decline somewhat in the near term, but they remain very high."
- "In response, investment in the resources sector is picking up very strongly, with much more to come. Some related service sectors are enjoying better-than-average conditions."
- The RBA also notes that "in other sectors, cautious behaviour by households and the high exchange rate have had a noticeable dampening effect."
- They also noted the labour market still remains pretty solid stating that "the unemployment rate has increased a little over recent months, though it remains close to 5%."
- As noted, on inflation the RBA has clearly changed its forecast, stating that "after underlying inflation started to pick up in the first half of the year, recent information suggests the subdued demand conditions and the high exchange rate have

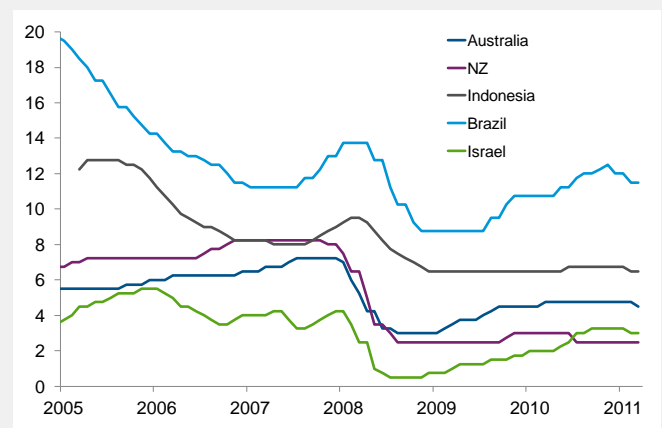
contained inflation more recently, notwithstanding continuing sizeable increases in utilities charges."

- "CPI inflation on a year-ended basis remains above the target, due to the effects of weather events last summer, but is now starting to decline as production of key crops recovers."
- On the wages outlook the RBA notes that "with labour market conditions now softer, the likelihood of a significant acceleration in labour costs outside the resources and related sectors in the near term has lessened."
- "Accordingly, the Bank's current judgement is that inflation is likely to be consistent with the 2%-3% target in 2012 and 2013, abstracting from the impact of the carbon pricing scheme."
- In addition "financial conditions have been easing somewhat recently, with market interest rates declining a little and competition to lend increasing. But overall conditions have remained tighter than normal, with borrowing rates still a little higher than average, credit growth subdued and asset prices lower than earlier in the year. The exchange rate has been very variable over the past few months, but on the whole has remained at historically high levels."

It is also interesting to note that today's rate cut by the RBA brings the Australian central bank into line with other central banks around the world who were early tighteners in reducing interest rates, including Brazil, Indonesia, Israel and Turkey.

This is a clear demonstration of the level of concern among these early tighteners that the pace of global economic growth is lower than previously expected and that the risks to higher inflation have moderated.

The early tighteners start easing



Source: Bloomberg

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