CommSec

Economics
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Reserve Bank more relaxed about the road ahead

Reserve Bank Board meeting

- **The Reserve Bank Board has left the cash rate at 4.75 per cent at its final meeting for 2010. The next meeting is on February 1 2011.**
- **The Reserve Bank Board notes that lending rates are now a little above average and believes that this tight policy is *"appropriate for the economic outlook."***

What does it all mean?

- After what amounted to a double-whammy rate hike in November, there would have been more chance of snow falling in Sydney than for the Reserve Bank to lift rates again at the December meeting. Thankfully there were no surprises.
- The gaggle of financial market economists may have their own opinions, but it's clear that investors and Reserve Bank officials alike don't expect significant rate hikes in the months ahead. The overnight indexed swap rate is factoring in a one-in-four chance of a rate hike in the next six months. And at the recent Parliamentary testimony the Reserve Bank Governor was unusually clear in his language: *"At the moment, most commentators do not anticipate and market pricing does not anticipate any further near-term change by us for quite some time. I think that is probably a reasonable position for them to have based on the information we have now*."
- So what about 2011? Again the Reserve Bank Governor has made the position clear at his recent testimony: *"We may need some more (rate hikes) than we have at the moment at some point, but at this stage the expectations are for only fairly gradual and not very close together increases. At this point, I certainly do not want to steer people away from that today."*
- Given that many businesses and consumers feel that current conditions are tougher than they were at the height of the global financial crisis, a period of interest rate stability is certainly what the doctor ordered. With so many cross currents, the Reserve Bank hasn't got clear vision, having to rely instead on touch, feel and gut instinct. The economy almost went backwards in the September quarter and the initial readings for the December quarter aren't overly bright, especially with retail spending sliding markedly.
- It is worth pointing out that Australia currently maintains the tightest monetary policy in the world. In contrast many advanced countries are still pursuing their easiest monetary policy settings on record. And those countries that have lifted rates, have done so very gradually. Australia is clearly ahead of the pack. If the global economy tanks again, then the Reserve Bank has plenty of scope to slash rates. But if global economic growth surprisingly rebounds, with inflation rearing its ugly head, then the Reserve Bank is well positioned to tighten further.
- One thing Australia can't afford is a policy mistake. If the US situation has taught us anything, when recessions come, unemployment soars to 10 per cent very quickly and it then takes five years plus to get back to normal.

Interest rate decision and past cycles

- The Reserve Bank Board has left the cash rate at 4.75 per cent. In October 2009 the cash rate stood at a 49-year low of 3.00 per cent. But then the RBA embarked on a process to remove the emergency stimulus, lifting the cash rate by a quarter of a percent in October, November and December 2009, and then in March, April, and May 2010 and following it up with the recent move in November.
- In the last rate-cutting cycle the cash rate fell to a low of 4.25 percent in December 2001. In the two previous rate-cutting cycles, the cash rate fell to lows of 4.75 per cent.
- In response to funding pressures, banks have been forced to lift rates above the cash rate over the last year. As a result, the Reserve Bank now looks more closely at the variable housing rate to gauge how close rates are to

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"normal". Currently the average bank variable housing rate stands at 7.80 per cent, well above the long-term average or "normal" rate of 7.15 per cent.

- The Reserve Bank is clearly more relaxed and comfortable, believing that employment growth will slow and inflation will remain under control. We have changed our rate view, now expecting the next rate hike in April 2011 (rather than February) with cash rates to end 2011 at 5.50 per cent rather than 5.75 per cent.

Comparing the two most recent statements

- The statement from the November meeting is on the left; the statement from today's December 2010 meeting is on the right. Emphasis has been added to significant changes in wording in the recent statement.

MEDIA RELEASE

No: 2010-26
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**STATEMENT BY GLENN STEVENS, GOVERNOR
MONETARY POLICY**

At its meeting today, the Board decided to raise the cash rate by 25 basis points to 4.75 per cent, effective 3 November 2010.

The global economy grew faster than trend over the year to mid 2010. Global growth will probably ease back to about trend pace over the coming year as strong recoveries in the emerging world give way to a more sustainable pace of expansion and growth remains subdued in the United States and Europe. At the same time, concerns about the possibility of a larger than expected slowing in Chinese growth have lessened recently and most commodity prices have firmed, after a fall earlier in the year. The prices most important to Australia remain at very high levels, with the result that the terms of trade are at their highest since the early 1950s. **The turmoil in financial markets earlier in the year has abated, though sentiment remains fragile**.

Information on the Australian economy indicates growth around trend over the past year. Public spending was prominent in driving aggregate demand for several quarters but this impact is now lessening. While there has been a degree of caution in private spending behaviour thus far, the rise in the terms of trade, which is now boosting national income very substantially, is likely to lead to stronger private spending over the next couple of years, especially in business investment.

Asset values are not moving notably in either direction, and overall credit growth remains quite subdued at this stage notwithstanding evidence of some greater willingness to lend. The exchange rate has risen significantly this year, reflecting the high level of commodity prices and the respective outlooks for monetary policy in Australia and the major countries. This will assist, at the margin, in containing pressure on inflation.

The demand for labour has continued to firm. While the labour market is not as tight as in 2007 and 2008, some further strengthening would appear to be in prospect, judging by the trends in job vacancies. After the significant decline last year, growth in wages has picked up somewhat, as had been expected. Some further increase is likely over the coming year.

Given these conditions, the moderation in inflation that has been under way for the past two years is probably now close to ending. Recent information suggests underlying inflation running at about 2½ per cent, with the CPI inflation rate a little higher due mainly to increases in tobacco taxes. Both results were helped somewhat in the latest quarter by unusual softness in food prices. Inflation is likely to rise over the next few years. This outlook, which is largely unchanged from the Bank's earlier forecasts, assumes some tightening in monetary policy.

For some time, the Board has held the stance of monetary policy steady, which has resulted in interest rates to borrowers being close to their average of the past decade. This allowed some time to observe the early effects of previous policy changes and to monitor the uncertain global outlook. The Board is also cognisant of differences in the degree of economic strength by industry and by region.

However, the economy is now subject to a large expansionary shock from the high terms of trade and has relatively modest amounts of spare capacity. Looking ahead, notwithstanding recent good results on inflation, the risk of inflation rising again over the medium term remains. At today's meeting, the Board concluded that the balance of risks had shifted to the point where an early, modest tightening of monetary policy was prudent.

MEDIA RELEASE

No: 2010-30
Date: 7 December 2010
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**STATEMENT BY GLENN STEVENS, GOVERNOR
MONETARY POLICY**

At its meeting today, the Board decided to leave the cash rate unchanged at 4.75 per cent.

Since the previous Board meeting, concerns about the creditworthiness of a number of European governments have again become the main focus of financial markets, with a marked rise in sovereign bond spreads for some euro-area countries and an increase in volatility. At the same time, recent data suggest that the Chinese and Indian economies have continued to grow strongly and price pressures, particularly for food, have picked up in China as well as a number of other economies in Asia. Modest growth is continuing in the United States.

For Australia, the terms of trade are at their highest level since the early 1950s, and national income is growing strongly as a result. Recent information indicates that, as had been expected, **private investment is beginning to pick up** in response to high levels of commodity prices. In the household sector thus far**, there continues to be a degree of caution in spending and borrowing, which has led to a noticeable increase in the saving rate**. Asset values have generally been little changed over recent months and overall credit growth remains quite subdued, notwithstanding evidence of some greater willingness to lend.

Employment growth has been very strong over the past year, though some leading indicators **suggest a more moderate pace of expansion in the period ahead**. After the significant decline last year, growth in wages has picked up somewhat, as had been expected. Some further increase is likely over the coming year.

The exchange rate has risen significantly this year, reflecting the high level of commodity prices and the respective outlooks for monetary policy in Australia and the major countries. This will assist, at the margin, in containing pressure on inflation over the period ahead. **Over the next few quarters, inflation is expected to be little changed,** though it is likely to increase somewhat over the medium term if the economy grows as expected.

Following the Board's decision last month to lift the cash rate, and the subsequent increases by financial institutions, lending rates in the economy are now a little above average. The Board views this setting of monetary policy as appropriate for the economic outlook.

What are the implications of today's decision?

- The Reserve Bank is clearly in 'wait-and-see' mode on interest rates. This is clearly great news for all concerned, allowing Aussies to get on with life, get a little more confidence back, and start spending and investing again.
- Even though rates are on hold, the threat of higher rates in 2011 together with lofty utility charges and higher petrol prices will ensure that consumer conservatism continues into the New Year.
- Investors and borrowers need to go into 2011 with their eyes wide open. The RBA Governor has indicated that rates are still more likely to rise, not fall, in the coming year. Simply, if you factor in higher rates over the next year then you have the best chance of maintaining your current lifestyle without major disruption.
- A period of interest rate stability means that investors will have to scour more widely for the best yield returns – whether it is in cash, bond, share or property markets.

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