

Economic note

6 April 2010

RBA quickens the pace of the journey

- With the first back-to-back move of the year, the RBA has quickened the pace of the journey back to a more 'normal' setting of monetary policy with a 25bp hike to 4.25%.
- The RBA notes that "with growth likely to be around trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average."
- Looking ahead expectations remain for a move to a 5.0% cash rate before year-end.
- An expected further acceleration in nominal GDP growth, on the back of higher commodity prices and the strength in the labour market, are driving this policy shift.

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to tighten monetary policy by a further 25 basis points (bp), taking the cash rate to 4.25% (effective 7 April 2010). In announcing today's decision, which follows a similar move in March, the RBA stated that "with growth likely to be around trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average" and that today's decision "is a further step in that process".

On economic growth and inflation the RBA noted given Australia's rising terms of trade, adding to incomes and investment in the resources sector "output growth over the year ahead is likely to exceed that seen last year, even though the effects of earlier expansionary policy measures will be diminishing." On inflation the RBA noted that "inflation is expected to be consistent with the target in 2010" but recent temporary factors holding it lower are abating.

Today's further tightening of monetary policy is completely consistent with the recent signals from the RBA. In both public speeches and on commercial TV (in an unprecedented move by the RBA Governor to bring his message of caution on interest rates to the 'mums and dads') the RBA leadership has been making the consistent case that with the Australian expected to be growing close to trend in the year ahead and with inflation likely to be at the top half of the 2%-3% target band, then monetary policy must be returned to a more normal or average setting.

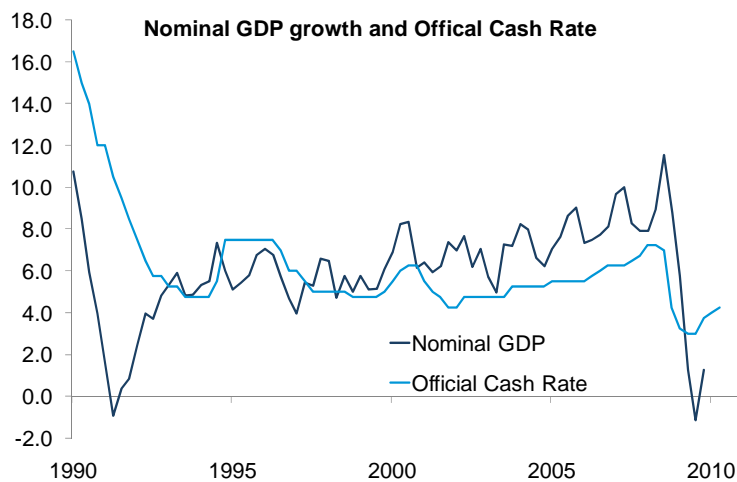
Expectations remain for this 'normal' or 'average setting to imply a cash rate near 5% and this is the rate that markets have largely priced in for year end. The RBA has also noted that it expects to return policy to this setting in a 'gradual' way –

although the back-to-back rate hikes over March-April do suggest that there could be a little more urgency in this regard.

While there have been some uncertainties in global economic developments in recent months, and local consumer spending numbers have been disappointing, the RBA looks to be increasingly focused on the strength in the local housing market and seems determined to work against signs of a re-leveraging by the household sector into residential property.

As shown in the chart below, the RBA is also working ahead of the expected sharp rebound in nominal GDP growth that could be anticipated over 2010 and into 2011. This increase in nominal GDP will likely flow from the rapid acceleration in the terms of trade that will come from new contracted iron ore and coal prices and the signs of wages growth on the back of the strengthening labour market.

Australian cash rate and nominal GDP



Source: RBA and ABS.

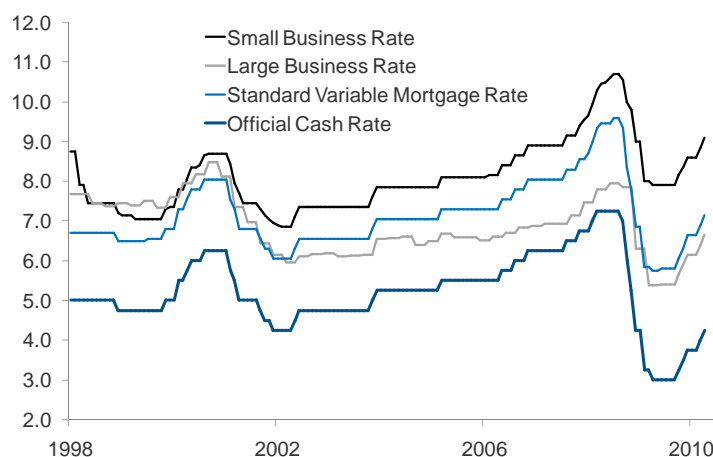
Other highlights

Other highlights from today's statement from the RBA include:

- In terms of the global economy the RBA noted that the "The global economy is growing, and world GDP is expected to rise at close to trend pace in 2010 and 2011"
- A two speed global economy is still evident with "the expansion is still hesitant in the major countries, due to continuing legacy of the financial crisis" but in "Asia, where financial sectors are not impaired, growth has continued to be quite strong, contributing to pressure on prices for raw materials".
- "Global financial markets are functioning better than they were a year ago and the extraordinary support from governments and central banks is gradually being wound back"
- In terms of recent concerns around sovereign risk, the RBA notes that "the concerns regarding some sovereigns appear to have been contained at this stage".

- In relation to Australia, the RBA noted that “terms of trade are rising, adding to incomes and fostering a build-up in investment in the resources sector”.
- In more evidence of a positive tone, the RBA notes “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”.
- In relation to the housing market, the RBA notes recent weakness in approvals “but at this point the market for established dwellings is still characterised by considerable buoyancy, with prices continuing to increase in the early part of 2010”.
- Inflation has declined “helped by 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” but in terms of the outlook “CPI inflation has risen somewhat recently as temporary factors that had been holding it to quite low rates are now abating”.
- “With the risk of serious economic contraction in Australia having passed some time ago, the Board has been lessening the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker.”
- “Lenders have generally raised rates a little more than the cash rate but interest rates to most borrowers nonetheless have been somewhat lower than average”.
- The Board judges that with growth likely to be around 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”.

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



Source: RBA

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