Economic Research
Sydney
August 11, 2008

Stephen Walters (61-2) 9220-1599
Stephen.b.walters@jpmorgan.com

Australian economic update

RBA quarterly statement

As expected, the tone of today's quarterly Statement on Monetary Policy from the RBA mirrored the tone of last week's policy announcement. Indeed, in line with last week's shift in RBA verbiage to a more dovish tone, today's statement signaled clearly that RBA officials are close to cutting the cash rate. In particular, officials now place significantly more emphasis on the downside risks to growth in the economy - which were prominent in today's commentary - than the upside risks to inflation. We expect the first rate cut to be a 25bp move in early September, followed by a second quarter point move before year-end.

The key phrase from last week's policy statement announcing an unchanged cash rate - that the scope to move to a less restrictive policy stance is increasing - was repeated today. At the same time, though, today's statement also indicated that the policy stance is appropriate for the time being. This phrase conspicuously was missing from last week's commentary. Importantly, RBA forecasters now see headline inflation peaking at an unexpectedly high 5%oya later this year - double the mid-point of the RBA's target range. The upgrade to the RBA's inflation forecast seems to diminish the chances of a more aggressive start to the easing cycle.

Indeed, we believe talk of a 50bp rate cut was premature. First, it could send the unwanted signal that RBA officials were spooked by the abrupt slowdown in the indicators of domestic demand. Second, the aim of RBA officials in tightening policy in recent years has been to engineer a slowdown - this was made clear in today's statement. RBA officials, therefore, probably will be reluctant to throw the economy a lifeline in the form of a 50bp rate cut as soon as there is evidence that the economy was taking on water. The aim now, with inflation still above target, is to lessen the chances of the economy sinking, not fire up the engines with aggressive policy support.

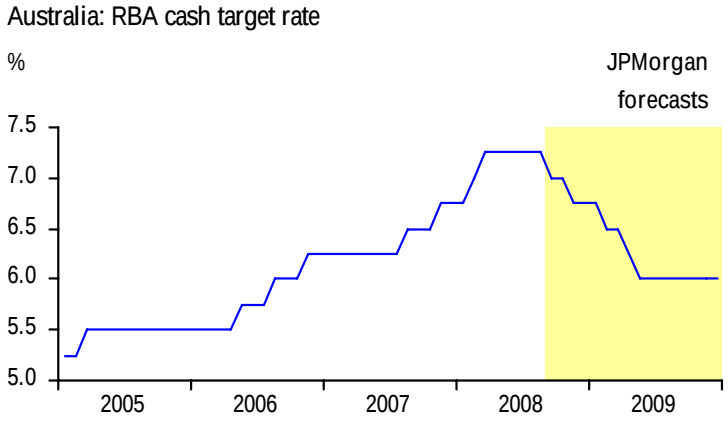
Moreover, the AUD's precipitous fall in recent weeks is doing some of the heavy lifting for the RBA in terms of easing monetary conditions. The AUD's steep decline since mid-July, therefore, lessens the need for the RBA to kick the easing cycle off with a 50bp move, even though each of the last two easing cycles - in 1996 and 2001, respectively - started with half point rate cuts. The economic circumstances at the start of each of these easing cycles, however, were significantly different to those prevailing now. Also, by adding to the upward pressure on import prices, the AUD's fall increases the risk that inflation will not return to target within the time indicated.

Stephen Walters (61-2) 9220-1599
Stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
Helen.e.Kevans@jpmorgan.com

RBA inflation forecasts
%oya

	Consumer price index		Underlying inflation	
	RBA	**Actual/JPM**	**RBA**	**Actual/JPM**
Sep-07	-	1.9	-	2.9
Dec-07	-	3.0	-	3.4
Mar-08	-	4.2	-	4.1
Jun-08	-	4.5	-	4.4
Dec-08	5.0	4.4	4.5	4.7
Jun-09	3.75	3.2	3.75	4.1
Dec-09	3.25	3.0	3.25	3.4
Jun-10	3.0	na	3.0	na
Dec-10	2.75	na	2.75	na

The statement listed a number of areas in which domestic economic activity has slowed. In particular, there has been a "significant moderation" in consumer spending, highlighted by consecutive quarterly declines in real spending, household wealth has contracted in the first half of 2008, some firms have scaled back investment plans, and there are early signs that demand for labour has cooled. The statement also highlighted that many observers expect growth in the global economy to be "well below the pace of recent years". On the flipside, though, the statement again emphasised the significant support to national income coming from Australia's high terms of trade. RBA officials remain unclear about which of these "opposing forces" will be dominant.



On inflation, the RBA now expects inflation to be higher in both 2008 and 2009 - the forecast for 2010 was unchanged. These assumptions still show core inflation above the 2-3% target range until mid-2010 - according to the RBA, inflation will not be back within the target until the end of 2010. In the past, a forecast profile showing inflation above target for an extended period would have the RBA at least on a tightening bias. Now, though, with the slowdown in domestic demand obvious, and probably more abrupt than RBA forecasters had expected, officials are indicating that they will look through elevated inflation prints in coming quarters, in expectation that the weakness

Stephen Walters (61-2) 9220-1599
Stephen.b.walters@jpmorgan.com
Jarrod Kerr (61-2) 9220-1669
Jarrod.w.kerr@jjpmorgan.com

in domestic demand will drag inflation back towards target within a reasonable period of time. Indeed, the RBA expects "a significant reduction in inflation over time".

A key complication for the policy outlook, however, is how quickly the Aussie banks pass on official rate cuts to customers. The big risk is that the banks may elect to boost margins rather than pass lower short-term rates through to borrowers. Not passing on the rate hikes, though, would attract intense political pressure; the Prime Minister and Treasurer already have implied that the banks should pass on cuts in official interest rates - the acting Prime Minister repeated this message last weekend. Banks, though, are under no obligation to comply. Competitive pressures in Australian banking are not what they were, but there probably is enough competitive tension to make it more likely than not that most, if not all, of the RBA's rate cut will be passed on to customers.