Economic Research
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Australian economic update

RBA to cut cash rate in October

For some time, we have argued that the macro-economic case for an RBA rate cut in October was not compelling. RBA officials, therefore, appeared in no rush to lower the cash rate again. Inflation, for example, almost certainly will accelerate in 3Q, firms have substantially upgraded their business investment plans, demand for home loans stabilised in July, the jobless rate fell sharply in August, retail sales unexpectedly boomed in July, and both business and consumer confidence rebounded following the RBA's rate cut in September, the first since December 2001. Also, the plunge in the AUD since mid-July has done some of the heavy lifting for the RBA in terms of easing monetary conditions.

Similarly, the most recent RBA commentary indicated that officials still believe there are "opposing forces" at work in the economy, so the case for further rate cuts was not "open and shut". On the one hand, RBA officials believed the booming terms of trade was a powerful source of support for national income. On the other hand, though, the pace of growth in domestic demand had slowed, which meant inflation probably would track back down towards the RBA's target range "over time". Even as recently as last week, in the early stages of the latest round of financial market instability, RBA Governor Glenn Stevens' speech indicated an absence of urgency in monetary policy deliberations. Our view, therefore, was that the RBA could wait until December before easing policy again.

Clearly, though, things have changed rapidly in recent weeks, so much so that **we now believe the RBA will cut the cash rate 25bp on 7 October**. RBA officials will, however, have to grit their teeth to tolerate the uncomfortable reality (particularly for an inflation-targeting central bank) that the CPI on 25 October will print almost double the mid-point of the 2-3% target range. This will be just after they have eased policy to mitigate against the downside risks to growth. This will not sit easily with some RBA officials.

In the current environment of heightened uncertainty, however, and with monetary conditions still very tight, easing too early is a mistake RBA officials now seem more willing to risk, rather than waiting too long before easing again and risking an even more abrupt slowdown in the economy. The RBA's macro-economic forecasts released back in August - well before the onset of the latest financial market instability - showed non-farm GDP growth of just 1.5% in the year to December 2008. Given what has happened in markets since August, the risks to this forecast must be skewed more to the downside, which means officials probably have to be more nimble than before.

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Importantly, futures markets already fully price a rate cut in October, albeit partly because of the turmoil in global financial markets, which has seen investors flood out of the riskier asset classes into perceived safe havens. In fact, the local market prices 41bp of official rate cuts for the October meeting alone. The fact that a rate cut is fully priced "greases the wheels" for the RBA; officials do not like surprising the market with unexpected policy moves, so this box at least is ticked. Also, although the RBA thus far has separated liquidity management and macro management functions, a rate cut next month may help to boost consumer and business confidence, both of which probably have been shaken by recent market developments.

There are seven main reasons for our change of rate call (in rough order of importance):

First, the instability in global financial markets means the downside risks to the global economic growth outlook have intensified. In particular, our US team today downgraded the US outlook to include consecutive quarters of falling GDP and more Fed easing, we recently downgraded our growth outlook for China, albeit modestly, and there now are darker shadows over the growth outlook for Australia's other major trading partners. This means Australia's terms of trade, which has risen 70% since 2001, almost certainly will be a less powerful source of support for national income. It follows that the potential for lower commodity prices and weaker demand offshore will influence business decisions on investment and hiring. In particular, the huge pipeline of investment spending that firms are forecasting for the current fiscal year is likely to be drained somewhat, with much of this spending pushed out to later years.

Second, with wholesale funding costs having risen sharply in recent weeks, an RBA rate cut now may at least dissuade commercial banks from raising market interest rates to minimize margin erosion. The only interest rates that matter in terms of influencing economic activity are market interest rates, not the cash rate target. One school of thought argues that only a 50bp RBA rate cut will get market interest rates down sufficiently to ease the debt-servicing burden on households and corporates. Our view, though, is that a combination of political and competitive pressure should be sufficient to trigger material falls in market interest rates, just as happened earlier this month, when each of the "Big Four" Aussie banks lowered their variable mortgage rates 25bp, following the RBA's rate cut.

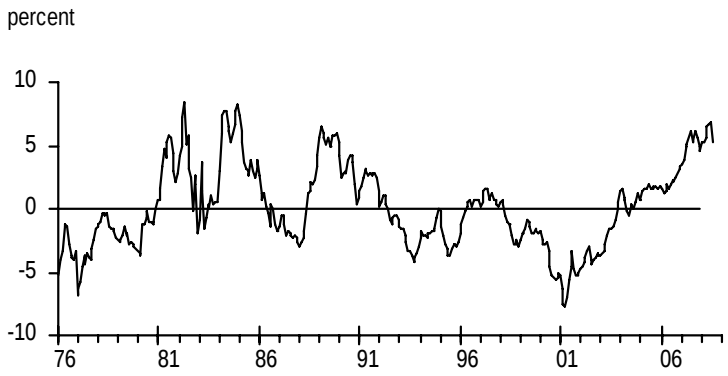
Third, while the latest round of economic data shows that Australia's economy has not fallen into as deep a hole as some expected, the data in coming weeks is likely to betray renewed weakness. Credit growth in August, for example, is likely to be the weakest since 1993, industry anecdotes reveal that retail sales in August were soft, and the unexpected drop in the unemployment rate in August is very likely to be reversed in September. Indeed, there has been a run of high-profile announcements of job losses in recent weeks in industries as diverse as finance, manufacturing, food processing, mining, media, telecommunications, airlines and government. The forecast is that the jobless rate will rise from the current 4.1% to above 5% in the first half of 2009.

Fourth, the biggest source of expenditure in Australia's economy, the consumer, already has dropped into recession. The 2Q national accounts showed the first

contraction in real consumer spending since 1993, and we already have printed two consecutive quarters of negative real retail sales growth. Households are struggling under the burden of very high mortgage rates - earlier this year, the commercial banks raised their market interest rates by an average of an extra 55bp, over and above the 50bp of rate hikes by the RBA - and petrol prices now look likely to rise again, partly because of the plunge in the AUD. Also, there has been widespread wealth destruction, not only via the collapse in listed equity prices, but also from falling house prices in the major cities. The personal income tax cuts delivered from 1 July seem to have disappeared without trace.

Fifth, monetary conditions in Australia now clearly are too tight given the intensification of the downside risks to growth. This is even after accounting for the RBA's 25bp reduction in the cash rate earlier this month, and the fact that the AUD has dropped sharply in trade weighted terms since mid-July. In fact, until recently, monetary conditions were the tightest since ahead of Australia's last recession in the early 1990s. While elevated inflation means RBA officials probably are keen to maintain a policy stance that leans to the tight side of neutral for some time, there is considerable scope to lower the cash rate while simultaneously maintaining a suitably restrictive policy stance. In other words, the RBA has plenty of room to move.

JPM monetary conditions index - Australia



Sixth, although the world's major central banks are unlikely to cut official interest rates in response to the financial market turmoil, at least in the very near term, the central banks in China and New Zealand, which preside over economies that, like Australia, have large export sectors, have eased policy in recent weeks. In fact, the RBNZ moved by an unexpectedly assertive 50bp earlier this month. The fact that central banks running economies that, like Australia, are acutely exposed to weaker global growth have eased policy may help convince RBA officials to move ahead of the major central banks. This would, however, be a break from recent history - our RBA forecasting tool shows there has been a correlation between the behaviour of the major central banks and the RBA.

Seventh, and for the record, our forecasting tool, which brings together a number of indicators of inflation, credit, and domestic and overseas economic activity, calls for a 25bp rate cut in October. The tool correctly forecast the two rate hikes earlier this year and the September rate cut. The tool calls for a cash rate target of 5.5% by June 2009 although, as we have pointed out before, the tool is not our sole means of predicting monetary policy decisions.

On balance, therefore, it now looks more likely than not that the RBA will lower the cash rate 25bp on 7 October. In addition, it also now seems likely that the RBA will cut the cash rate another time before the end of the year, probably in December when, hopefully, the dust of the financial market turmoil has had a chance to settle. We now look for a total of another 100bp of easing by June 2009 (25bp more than we previously forecast), and the rate cuts will be "front-loaded", relative to our earlier expectation.

Our expectation that the big banks will cut market rates broadly in line with the cash rate argues against the RBA being forced to cut 50bp next month, although the risk of more assertive easing has risen in recent weeks. Failure by the commercial banks to pass through enough of the RBA's October rate cut would make a follow-up 25bp November cut more likely. The commercial banks probably will make clearer their intentions as the RBA decision draws nearer, as was the case earlier this month.