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# Australian economic update

## RBA decision - October

The RBA today stunned markets by announcing an unexpected 100bp reduction in the cash rate target to 6%. This is the second official rate cut in as many months, but the first triple-figure cut since 1992. The tone of the commentary announcing the decision was a mixed bag, with RBA officials highlighting increased downside risks to the domestic growth outlook, but also the likelihood of an acceleration in inflation to "around 5%" in the September quarter. Talk of "opposing forces at work in the economy", however, has been jettisoned; this aggressive rate cut is all about ensuring market interest rates - the only ones that matter for the real economy - fall substantially. Also, RBA officials are very concerned about the negative feedback loop from global financial market instability to the real economy.

The RBA's commentary makes clear that this assertive rate cut does not set a pattern for future decisions, and described the unexpected move as "unusual". In the wake of today's shock move, our revised forecast calls for at least another 50bp of rate cuts by the end of this year, with the pace of the decline highly dependent on developments in financial markets, the evolution of the macro-economic outlook, and how the Aussie banks respond in coming days. With the RBA having moved so assertively, so quickly, the chances of an "out-of-schedule" emergency rate cut, the odds of which appeared to have increased in recent days, are much less likely. That said, we now expect a 5% cash rate by mid-2009 (previously 6%), with the risks skewed to the downside.

Rather than refer to material downgrades to RBA officials' expectations for the real economy (the RBA's commentary indicates that the economy is tracking broadly as forecast), the RBA's commentary highlighted the sharp deterioration in global financial market conditions, particularly the dislocation in interbank markets, heightened instability in other markets, and weaker share markets as the main justification for today's move. Obviously, this, and elevated bank funding costs, which make it uneconomic for the commercial banks to pass on in full the cut to the official cash rate, are the main sources of concern for RBA officials. Inflation, previously RBA officials' prime source of anxiety, has been taken off the back burner and hidden in a cupboard.

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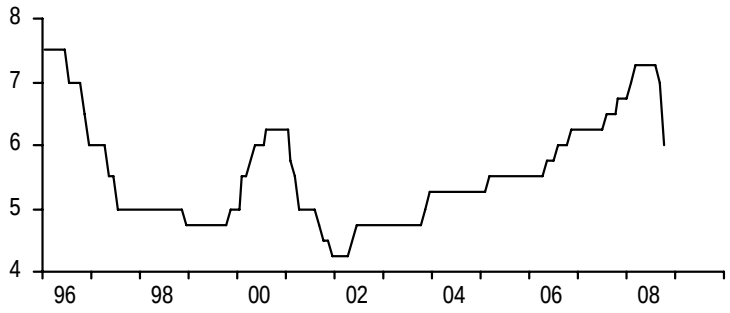
Although officials believe Australia's growth trajectory is little different from that envisioned back in August, the statement makes clear that the downside risks to economic growth now have become much more acute. In particular, weaker activity in the global economy means the terms of trade will fall, with some major export prices already falling. Previously, RBA officials believed the soaring terms of trade was a powerful source of support for the economy. Another key source of downside risk is tighter credit conditions, even for "creditworthy borrowers". The abrupt change to the risk profile for growth means, according to the RBA, that inflation now may be more likely to decline over the medium term, although it will stay above target for some time yet.

Some of the traditionally more hawkish RBA officials, though, probably are gritting their teeth while cutting the cash rate so aggressively as inflation accelerates from already elevated levels. Indeed, the plunge in AUD in recent days makes worse an inflation outlook that, on our forecasts, has headline CPI approaching 5% (double the mid-point of the RBA's inflation target) in 3Q. Inflation, though, no longer is the name of the game.

We have downgraded our forecast for growth in Australia's economy for 2009 to just 2.0%, from 2.5% previously. This reflects mainly the downgrades to our global growth forecasts, which will hurt the terms of trade and export volume growth. Also, there now will be weaker domestic demand, mainly via downgrades to corporate capex plans and softer job growth. A partial offset will come from accelerated public sector infrastructure spending. Weaker growth means inflation probably will return to target earlier than the mid-2010 timing forecast by the RBA in the August statement. This means there is greater scope for the RBA to ease policy assertively, should this again prove necessary in coming months.

RBA cash target rate - Australia

Percent per annum, end of period



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