Reserve Bank takes a punt

Reserve Bank Board meeting

- **For the first time in six months the Reserve Bank has elected to increase official interest rates, lifting the cash rate by 25 basis points to 4.75 per cent. While inflation is in the middle of the 2-3 per cent target band and economic indicators are decidedly mixed, the Reserve Bank believes that *"inflation is likely to rise over the next few years."* This is clearly a pre-emptive strike against inflation.**
- **The Reserve Bank Board *"concluded that the balance of risks had shifted to the point where an early, modest tightening of monetary policy was prudent."***

What does it all mean?

- The Reserve Bank has warned for some time that the next move in rates will likely to be up, not down. And today it delivered on that threat. So what has changed over the past month? Effectively nothing – the commentary from the October interest rate decision could have been issued again. But the Reserve Bank is clearly on edge about the future – believing that inflation has bottomed and that it will rise from here – even with a super-strong Aussie dollar.
- It is appropriate on Melbourne Cup Day that the Reserve Bank has decided to punt on a rate hike. The only justification for a rate hike is the Reserve Bank's assessment of the future. The latest data shows inflation under control and many parts of the economy going backwards, so the Reserve Bank is taking a risk in lifting interest rates at this current point in the cycle. Many Australians will feel that the Reserve Bank has lost touch with the average consumer and business-person but we have to remember that our central bank has guided the economy to 20 years without a recession.
- The developments since the last Reserve Bank Board meeting include:
  - Employment up 49,500 in September (above expectations) with unemployment rate stable.
  - The manufacturing sector is still contracting (49.4 in October)
  - Underlying inflation below the RBAs forecast at 2.5 per cent in the September quarter
  - Credit grew by only 0.1 per cent in September – slowest growth in 10 months
  - New home sales down 14 per cent in the September quarter
  - Home prices flat in the September quarter
  - Construction home loans fall for a record 10 straight months
  - Credit card debt fell in August.
  - Total lending finance fell 6.5 per cent in August.
- It is worth pointing out that a record number of products are cheaper now than a year ago. And a raft of products is set to get even cheaper with the high Australian dollar applying downward pressure to prices of imported goods. No one should downplay the role that the high Australian dollar is playing in dampening the economy. The Aussie dollar is just shy of the highest levels recorded in 28 years – this is clearly no 'garden variety' event.

Interest rate decision and past cycles

- The Reserve Bank Board has increased the cash rate from 4.50 per cent to 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 today.

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- 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 10 months. As a result, the Reserve Bank now looks more closely at the variable housing rate to gauge how close rates are to "normal". Currently the average bank variable housing rate stands at 7.40 per cent, above the long-term average or "normal" rate of 7.15 per cent.

Comparing the two most recent statements

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

MEDIA RELEASE

No: 2010-23
Date: 5 October 2010
Embargo: For Immediate Release

STATEMENT BY GLENN STEVENS, GOVERNOR MONETARY POLICY

At its meeting today, the Board decided to leave the cash rate unchanged at 4.5 per cent.

The global economy grew faster than trend over the year to mid 2010, but will probably ease back to about trend pace over the coming year. Recent information is consistent with a more sustainable, but still strong, pace of growth in China and most of the Asian region. In Europe and the United States, growth prospects appear to be modest in the near term, a legacy of the financial crisis and its impact on private and public finances. Financial markets are still characterised by a degree of uncertainty, and are responding both to differences in growth outlooks between regions and evident strains on public finances and banking systems in several smaller countries in Europe. Most commodity prices have changed little over recent months, and those most important to Australia remain very high.

Information on the Australian economy shows 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 the prospects for private demand, and in particular business investment, have been improving. This is to be expected given the large rise in Australia's terms of trade, which is now boosting national income very substantially.

Asset values are not moving notably in either direction, and overall credit growth is quite subdued at this stage, notwithstanding evidence of some greater willingness to lend. Inflation has moderated from the excessive pace of 2008. **The effects of the rise in tobacco taxes aside, CPI inflation has been running at around 2¾ per cent over the past year. That looks likely to continue in the near term.**

The current stance of monetary policy is delivering interest rates to borrowers close to their average of the past decade. The Board regards this as appropriate for the time being. If economic conditions evolve as the Board currently expects, it is likely that higher interest rates will be required, at some point, to ensure that inflation remains consistent with the medium-term target.

MEDIA RELEASE

No: 2010-26
Date: 2 November 2010
Embargo: For Immediate Release

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.

What are the implications of today's decision?

- The Reserve Bank has punted that rates need to rise to keep the economy on the straight and narrow. But what if the assumption is wrong? What happens if the Reserve Bank has over-estimated the underlying strength of the economy? Simply it means that interest rates are likely to remain at current levels for an extended period.
- Clearly today's rate hike serves as a body blow for retailers, other consumer-focussed businesses and the housing industry. Consumers remain super-cautious about spending, and the lift in rates will give people even more reason to stay away from the shopping malls, real estate offices and car yards.
- If the surprise rate hike wasn't enough there is still the risk that individual banks will lift rates independently. But if that does occur, the Reserve Bank will have more reason to sit on the interest rate sidelines in the New Year.
- If there is one positive from today's rate decision it is that the pre-emptive strike against inflation could prevent rates from going even higher in 2011. At present economists tip cash rates to lift to 5.50 per cent in a year's time.
- It's not all bad news; there are actually some winners today. Those planning trips abroad will clearly applaud the Reserve Bank's decision as it has served to catapult the Aussie dollar even higher.
- The other big winners today are those investors who rely on interest income. There are already attractive returns offered by financial institutions, and the deals are set to get even better.
- The rates decision won't yet cause widespread pain in the community. The Commonwealth Bank has revealed that 75 per cent of its home loan customers are ahead in their loan repayments. This hardly suggests that mortgage repayments are causing significant hardship across the country. But with rates up again there will clearly be fewer borrowers that will be in front.

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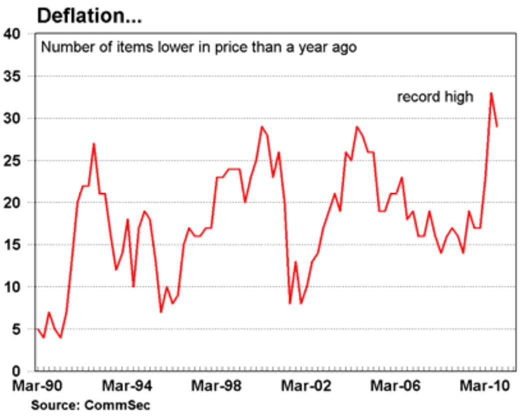
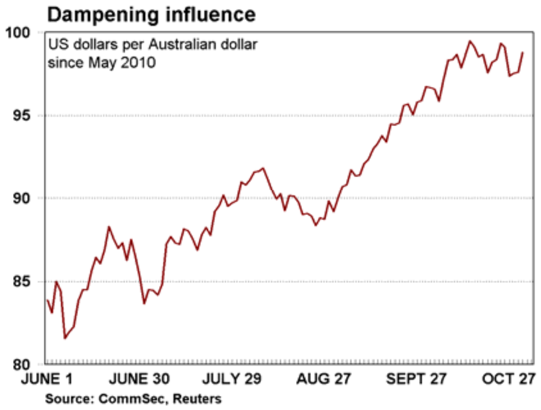
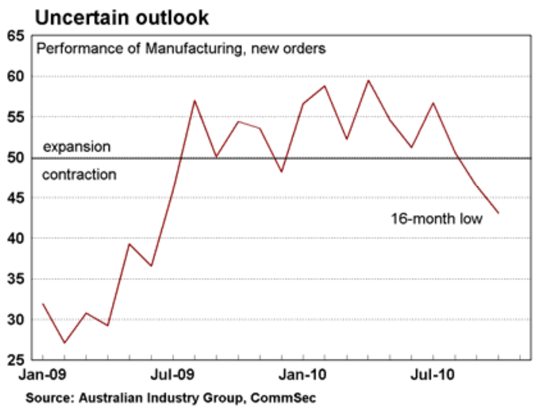
MORTGAGE CALCULATOR (Monthly repayments, 25 years)

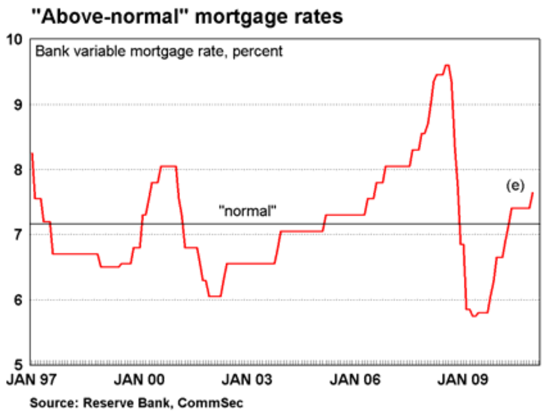
Mortgage		Change in Interest Rates					
	7.40	+0.25% 7.65	+0.50% 7.90	+0.75% 8.15	+1.00% 8.40	+1.25% 8.65	+1.50% 8.90
$100,000	$732.50	$748.78	$765.20	$781.78	$798.50	$815.36	$832.36
$150,000	$1,098.75	$1,123.16	$1,147.81	$1,172.67	$1,197.75	$1,223.04	$1,248.54
$200,000	$1,465.00	$1,497.55	$1,530.41	$1,563.56	$1,597.00	$1,630.72	$1,664.72
$250,000	$1,831.25	$1,871.94	$1,913.01	$1,954.45	$1,996.25	$2,038.40	$2,080.90
$300,000	$2,197.50	$2,246.33	$2,295.61	$2,345.34	$2,395.50	$2,446.08	$2,497.08
$350,000	$2,563.75	$2,620.71	$2,678.21	$2,736.23	$2,794.75	$2,853.76	$2,913.26
$400,000	$2,930.00	$2,995.10	$3,060.81	$3,127.12	$3,194.00	$3,261.44	$3,329.44
$450,000	$3,296.24	$3,369.49	$3,443.42	$3,518.01	$3,593.25	$3,669.12	$3,745.62
$500,000	$3,662.49	$3,743.88	$3,826.02	$3,908.90	$3,992.50	$4,076.80	$4,161.80
			Change in repayments per month				
$100,000		$16.28	$32.70	$49.28	$66.00	$82.86	$99.86
$150,000		$24.42	$49.06	$73.92	$99.00	$124.29	$149.79
$200,000		$32.55	$65.41	$98.56	$132.00	$165.72	$199.72
$250,000		$40.69	$81.76	$123.20	$165.00	$207.15	$249.65
$300,000		$48.83	$98.11	$147.84	$198.00	$248.58	$299.58
$350,000		$56.97	$114.47	$172.48	$231.00	$290.02	$349.51
$400,000		$65.11	$130.82	$197.12	$264.00	$331.45	$399.44
$450,000		$73.25	$147.17	$221.76	$297.00	$372.88	$449.37
$500,000		$81.38	$163.52	$246.40	$330.00	$414.31	$499.30

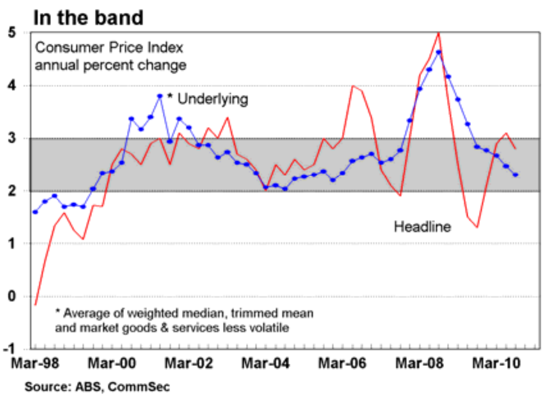
Source: CommSec

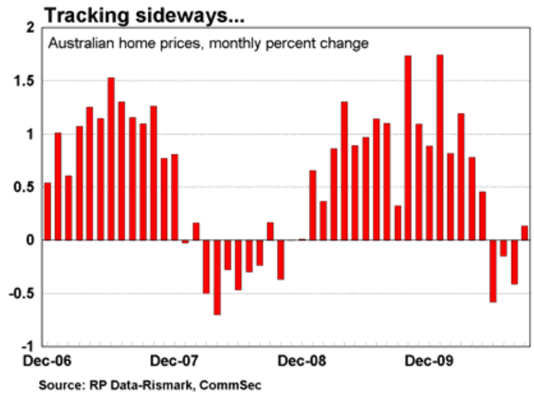

Deflation...
Number of items lower in price than a year ago
record high
40
35
30
25
20
15
10
5
0
Mar-90
Mar-94
Mar-98
Mar-02
Mar-06
Mar-10
Source: CommSec


Dampening influence
US dollars per Australian dollar
since May 2010
100
95
90
85
80
JUNE 1
JUNE 30
JULY 29
AUG 27
SEPT 27
OCT 27
Source: CommSec, Reuters


Uncertain outlook
Performance of Manufacturing, new orders
expansion
contraction
16-month low
65
60
55
50
45
40
35
30
25
Jan-09
Jul-09
Jan-10
Jul-10
Source: Australian Industry Group, CommSec


"Above-normal" mortgage rates
Bank variable mortgage rate, percent
"normal"
(e)
10
9
8
7
6
5
JAN 97
JAN 00
JAN 03
JAN 06
JAN 09
Source: Reserve Bank, CommSec


In the band
Consumer Price Index
annual percent change
* Underlying
Headline
* Average of weighted median, trimmed mean
and market goods & services less volatile
5
4
3
2
1
0
-1
Mar-98
Mar-00
Mar-02
Mar-04
Mar-06
Mar-08
Mar-10
Source: ABS, CommSec


Tracking sideways...
Australian home prices, monthly percent change
2
1.5
1
0.5
0
-0.5
-1
Dec-06
Dec-07
Dec-08
Dec-09
Source: RP Data-Rismark, CommSec