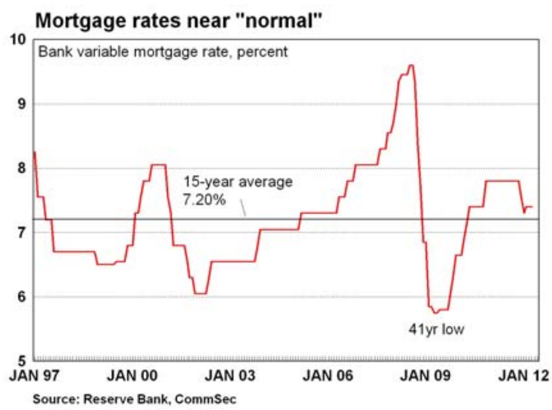
RBA says it's time to muscle up

Reserve Bank Board meeting

- **The Reserve Bank Board cut the official cash rate by 50 basis points (half of a percentage point) to 3.75 per cent. The cash rate is at the lowest level in over two years (March 2010). The next RBA Board meeting is on June 5 2012.**
- **The Reserve Bank has justified the large rate cut in terms of inflation. "*Over the coming one to two years, and abstracting from the effects of the carbon price, inflation will probably be lower than earlier expected, but still in the 2–3 per cent range.*"**

What does it all mean?

- In short, a tremendous decision. Forget the old stereotype of the Reserve Bank being a super-conservative body. This is a courageous decision by the Reserve Bank. Not only will the super-sized rate cut provide real stimulus, but it will also boost much-needed confidence.
- The Australian economy has been a lot like a long distance runner. The long expansion has made the economy lean and mean, but it has lost muscle over time. Now is the time to muscle up – with the Reserve Bank implying that the economy can afford to beef up and confront the challenges that lie ahead.
- Last month the Reserve Bank clearly laid the groundwork for a rate cut. The message was that rates would be cut, provided that inflation remained low. Inflation did its job. And today the Reserve Bank was as good as its word, cutting interest rates by a half a per cent.
- We believe the Reserve Bank will now sit back a few months and assess whether the super-sized rate cut actually works. CommSec is pencilling in another rate cut (quarter of a per cent) in August, should it be necessary.
- The last rate cut of more than a quarter of a per cent was in February 2009 at the height of the global financial crisis when the RBA cut rates by a full percentage point. Apart from that period the Reserve Bank last cut by half a per cent back in April 2001 in response to a weak global economy and a contracting domestic economy.
- Even if the banks pass on half of the rate cut, monetary policy would now be considered stimulatory (below long term averages), albeit slightly stimulatory. In terms of the other financial indicators, home prices are flat; borrowing is weak; the Australian dollar is still historically high;
- Will the rate cut boost the economy? It should, even if banks can't fully pass on the rate cut. The size of the move will clearly boost confidence. But if people don't follow through and spend, it has no impact. Again, if the rate cut doesn't cause people to buy or build more homes or spend, employ or invest then the rate cut is a 'damp squib' – it is akin to pushing on a piece of string. People don't just need interest rates to come down, they also need confidence to act on the easier financial conditions. This rate cut provides confidence.



Interest rate decision and past cycles

- The Reserve Bank Board has cut interest rates for the first time in five months, slashing the cash rate by 50 basis points (half of a percentage point) to 3.75 per cent. The previous rate cuts were in November and December 2011, each by 25 basis

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points. Prior to those moves the Reserve Bank had previously lifted rates seven times from October 2009 to November 2010 – a total of 1.75 percentage points, from 3.00 per cent to 4.75 per cent.

- In the last rate-cutting cycle the cash rate fell to a low of 3.00 per cent in April 2009. In the previous rate-cutting cycle the cash rate fell to 4.25 per cent in December 2001. In the two previous rate-cutting cycles, the cash rate fell to lows of 4.75 per cent.
- 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, slightly above the long-term average or "normal" rate of 7.20 per cent. After today's move, interest rates look to finally become stimulatory.

What are the implications of today's decision?

- Interest rates have been slashed, so those investors that have been content just to leave the money in the bank may need to make some choices. Figures from RP Data – Rismark show that rental yields on apartments across capital cities are around 5 per cent – in fact as high as 5.7 per cent in Darwin. And these attractive yields are on top of potential increases in capital values in coming years. On the sharemarket, Telstra is paying a fully-franked dividend yield of around 8 per cent with the major banks paying dividends of around 6-7 per cent. In comparison, term deposit rates are just over 5 per cent with interest returns taxable in the hands of the investor.
- Ordinarily a rate cut would be positive for retailers and other consumer-dependent businesses. But if home-buyers elect to pay off their home loans quicker, then extra spending power won't be released into the economy. And savers may feel that the rate cut actually reduces their spending power. The hope for retailers is that businesses are more confident to take on more workers because a stronger job market is a greater guarantee of increased spending than an interest rate cut.
- Smart home-buyers – whether they be those looking to live in the homes or those investing in property – are already trolling for bargains. The interest rate cut will bring more people into the housing market, serving to boost home prices and new construction.
- There have been two rate cuts, but so far the impact on the economy appears negligible. This super-size rate cut should have a far bigger impact. If not, the RBA will cut again.

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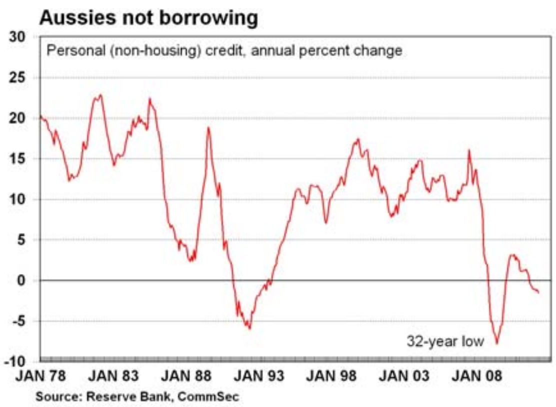

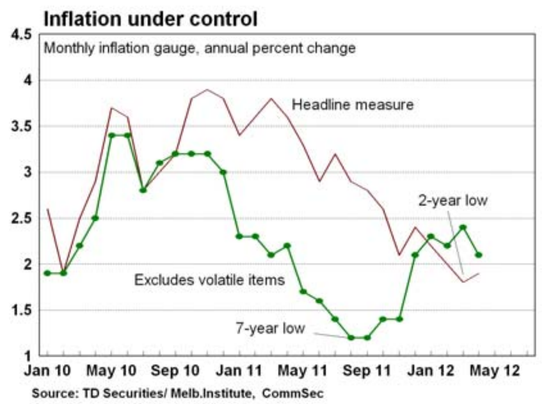

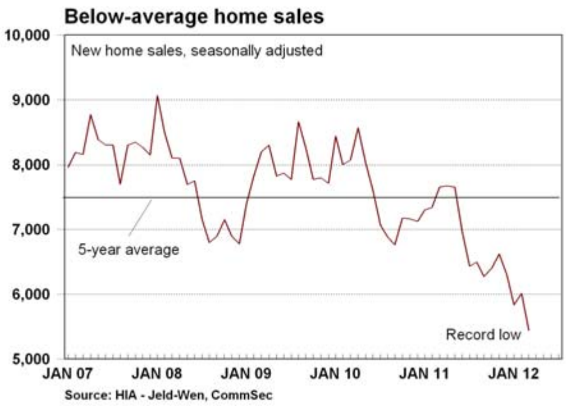

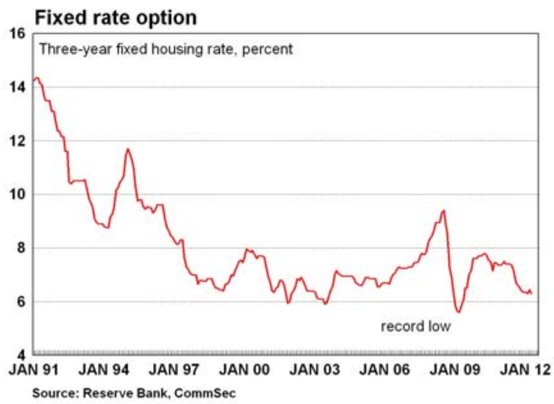

Comparing the two most recent statements

- The statement from the April meeting is on the left; the statement from today's May 2012 meeting is on the right. Emphasis has been added to significant changes in wording in the recent statement.

MEDIA RELEASE

No: 2012-09
Date: 3 April 2012
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 4.25 per cent.

Recent information is consistent with the expectation that the world economy will grow at a below-trend pace this year, but does not suggest that a deep downturn is occurring. Several countries in Europe will record very weak outcomes, but the US economy is continuing a moderate expansion. Growth in China has moderated, as was intended, and is likely to remain at a more measured and sustainable pace in the future. Conditions around other parts of Asia softened in 2011, partly due to natural disasters, but are not showing signs of further deterioration. Some moderation in inflation has allowed policymakers in the region to ease monetary policies somewhat. Commodity prices declined for a few months last year and are noticeably off their peaks, but have been relatively stable for a while now, at quite high levels. **Australia's terms of trade have peaked, though they remain high**.

Financial market sentiment has generally continued to improve in recent weeks and capital markets are supplying funding to corporations and well-rated banks. **At the margin, wholesale funding costs are tending to decline**, though they remain higher, relative to benchmark rates, than in mid 2011. But the task of putting European banks and sovereigns onto a sound footing for the longer term remains large and Europe will remain a potential source of adverse shocks for some time yet.

In Australia, growth in domestic demand ran at its fastest for four years in 2011, driven by private spending. Nonetheless the balance of recent information suggests that output growth was somewhat below trend over the year. There are differences in performance between sectors, and considerable structural change is occurring. Labour market conditions softened during 2011, though the rate of unemployment has been little changed for some time.

Interest rates for borrowers remain close to their medium-term average. Credit growth remains modest. Housing prices have shown some signs of stabilising recently, after having declined for most of 2011, but generally the housing market remains soft. The exchange rate has remained high over recent months, even though the terms of trade have declined somewhat.

In underlying terms, inflation was around 2½ per cent in 2011. CPI inflation was higher than that but will fall over the next quarter or two. It is currently expected that inflation will be in the 2–3 per cent range over the coming one to two years. This forecast abstracts from the effects of the carbon price and also embodies an assumption that productivity growth in the economy increases somewhat as a result of the structural change now occurring. At its next meeting, the Board will have the opportunity to reassess the outlook for inflation, taking into account not only data on demand and output but also forthcoming information on prices

The Board eased monetary policy late in 2011. Since then, its judgement has been that, with growth expected to be close to trend, inflation close to target and lending rates close to average, the setting of monetary policy was appropriate. The Board's view was also that, were demand conditions to weaken materially, the inflation outlook would provide scope for easier monetary policy. **At today's meeting, the Board judged the pace of output growth to be somewhat lower than earlier estimated, but also thought it prudent to see forthcoming key data on prices to reassess its outlook for inflation**, before considering a further step to ease monetary policy.

MEDIA RELEASE

No: 2012-10
Date: 1 May 2012
Embargo: For Immediate Release

STATEMENT BY GLENN STEVENS, GOVERNOR MONETARY POLICY

At its meeting today, the Board decided to lower the cash rate by 50 basis points to 3.75 per cent, effective 2 May 2012. This decision is based on information received over the past few months that suggests that economic conditions have been somewhat weaker than expected, while inflation has moderated.

Growth in the world economy slowed in the second half of 2011, and is likely to continue at a below-trend pace this year. A deep downturn is not occurring at this stage, however, and in fact some forecasters have recently revised upwards their global growth outlook. Growth in China has moderated, as was intended, and is likely to remain at a more measured and sustainable pace in the future. Conditions in other parts of Asia softened in 2011, partly due to natural disasters, but have recently shown some tentative signs of improving. Among the major countries, conditions in Europe remain very difficult, while the United States continues to grow at a moderate pace. Commodity prices have been little changed, at levels below recent peaks but which are nonetheless still quite high. Australia's terms of trade similarly peaked about six months ago, though they too remain high.

Financial market sentiment has generally improved this year, and capital markets are supplying funding to corporations and well-rated banks. At the margin, wholesale funding costs have declined over recent months, though they remain higher, relative to benchmark rates, than in mid 2011. Market sentiment remains skittish, however, and the tasks of putting European banks and sovereigns onto a sound footing for the longer term, and of improving Europe's growth prospects, remain large. Hence Europe will remain a potential source of adverse shocks for some time yet.

In Australia, output growth was somewhat below trend over the past year, notwithstanding that growth in domestic demand ran at its fastest pace for four years. Output growth was affected in part by temporary factors, but also by the persistently high exchange rate. Considerable structural change is also occurring in the economy. Labour market conditions softened during 2011, though the rate of unemployment has so far remained little changed at a low level.

Recent data for inflation show that after a pick-up in the first half of last year, underlying inflation has declined again, and was a little over 2 per cent over the latest four quarters. CPI inflation has also declined, from about 3½ per cent to a little over 1½ per cent at the latest reading, as the weather-driven rises in food prices in the first half of last year have, as expected, now been fully reversed. **Over the coming one to two years, and abstracting from the effects of the carbon price, inflation will probably be lower than earlier expected, but still in the 2–3 per cent range.**

As a result of changes to monetary policy late last year, interest rates for borrowers have been close to their medium-term averages over recent months, albeit tending to increase a little as lenders passed on the higher costs of funding their books. Credit growth remains modest overall. Housing prices have shown some signs of stabilising recently, after having declined for most of 2011, but generally the housing market remains subdued. The exchange rate remains high even though the terms of trade have declined somewhat.

Since it last changed the cash rate in December, the Board has maintained the view that the setting of policy was appropriate for the time being, but that the inflation outlook would provide scope for easier monetary policy, if needed, to support demand. The accretion of evidence over recent months suggests that it is now appropriate for a further step in that direction.

In considering the appropriate size of adjustment to the cash rate at today's meeting, the Board judged it desirable that financial conditions now be easier than those which had prevailed in December. A reduction of 50 basis points in the cash rate was, in this instance, therefore judged to be necessary in order to deliver the appropriate level of borrowing rates. .

Implications for home buyers

- If the rate cut is passed on, the following table highlights the impact on mortgages.

MORTGAGE CALCULATOR (Monthly repayments, 25 years)

Mortgage		Change in Interest Rates					
		-0.25%	-0.50%	-0.75%	-1.00%	-1.25%	-1.50%
	7.40	7.15	6.90	6.65	6.40	6.15	5.90
$100,000	$732.50	$716.38	$700.41	$684.61	$668.97	$653.50	$638.20
$150,000	$1,098.75	$1,074.57	$1,050.62	$1,026.91	$1,003.46	$980.25	$957.30
$200,000	$1,465.00	$1,432.75	$1,400.83	$1,369.22	$1,337.94	$1,307.00	$1,276.40
$250,000	$1,831.25	$1,790.94	$1,751.03	$1,711.52	$1,672.43	$1,633.75	$1,595.51
$300,000	$2,197.50	$2,149.13	$2,101.24	$2,053.83	$2,006.92	$1,960.50	$1,914.61
$350,000	$2,563.75	$2,507.32	$2,451.44	$2,396.13	$2,341.40	$2,287.26	$2,233.71
$400,000	$2,930.00	$2,865.51	$2,801.65	$2,738.44	$2,675.89	$2,614.01	$2,552.81
$450,000	$3,296.24	$3,223.70	$3,151.86	$3,080.74	$3,010.37	$2,940.76	$2,871.91
$500,000	$3,662.49	$3,581.88	$3,502.06	$3,423.05	$3,344.86	$3,267.51	$3,191.01
		Change in repayments per month					
$100,000		-$16.12	-$32.09	-$47.89	-$63.53	-$79.00	-$94.30
$150,000		-$24.18	-$48.13	-$71.83	-$95.29	-$118.50	-$141.44
$200,000		-$32.24	-$64.17	-$95.78	-$127.05	-$157.99	-$188.59
$250,000		-$40.31	-$80.22	-$119.72	-$158.82	-$197.49	-$235.74
$300,000		-$48.37	-$96.26	-$143.67	-$190.58	-$236.99	-$282.89
$350,000		-$56.43	-$112.30	-$167.61	-$222.34	-$276.49	-$330.04
$400,000		-$64.49	-$128.34	-$191.56	-$254.11	-$315.99	-$377.19
$450,000		-$72.55	-$144.39	-$215.50	-$285.87	-$355.49	-$424.33
$500,000		-$80.61	-$160.43	-$239.44	-$317.63	-$394.99	-$471.48

Source: CommSec