**Economic Update – April 2011**

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The Reserve Bank Board again opted for stable interest rates when it left the official cash rate unchanged at 4.75% at its April meeting. This is the fourth meeting in a row at which it has maintained a steady cash rate.

The immediate outlook for interest rates is for a continuation of a 'no change' approach by the Reserve Bank. As we move deeper into 2011, however, it is expected that developments in the economy will necessitate a return to a mild tightening of monetary policy that would see interest rates raised again in the latter part of the year in order to contain the emergence of a higher level of inflation.

For some time now there has been a general consensus view of the prospects for the Australian economy over 2011. That view has been based around a softness in demand in the first half of the year with consumer spending, in particular, remaining weak and then a higher level of economic activity coming through in the second half of the year fed by high levels of investment in the mining sector stimulating the broader economy, especially through increased employment.

It is very clear that the consumer has been conservative over recent times and this is expected to continue for a little while. People are generally more cautious in the current environment and are preferring to save more or repay debt rather than spend. This condition has been heightened by concerns over increased utility charges which could be further exacerbated by the proposed introduction of a carbon price, unless there is clearly communicated compensation. The floods and other natural disasters in the early part of the year have further dampened sentiment and disrupted activity. The tragic events in Japan and the spike in the oil price due to unrest in the Middle East and North Africa have also acted to dampen the global economic outlook which has in turn added to the conservative attitude to spending. The generally weak tone in the economy and offshore uncertainties have certainly influenced the Reserve Bank to leave interest rates on a more accommodative setting.

Economic activity is not going to stay soft. The current conditions will progressively give way to a stronger rate of activity. This will be influenced by a number of factors. Firstly, the many events both overseas and at home that have lowered confidence will reduce in terms of the intensity of their effect and the initial negative impact on economic activity will give way to improved levels as concerns wane and conditions generally return to normal. Secondly, the underlying performance of the global economy is showing clear signs of improvement with advances in the developed economies (particularly the US and Europe) adding to the already robust growth coming out of the Asian region and China in particular. This will provide further support to the Australian economy which is already the beneficiary of historically strong terms of trade due to record commodity prices. In this improving climate the increased investment that is going into mining and related industries will produce increased activity across the economy and stimulate employment growth which is already strong as evidenced by a low unemployment rate of 5% that is expected to continue to fall, albeit at a more moderate pace.

Inflation has been low in recent readings and is likely to remain within the Reserve Bank target band of 2% to 3% for some months yet with the strength of the Australian dollar offsetting some potentially concerning price influences such as a rising world oil price which is expressed in US dollars. This also supports a 'no change' rate setting over coming months. The longer term prospect is though that as we move deeper into 2011 the higher level of economic activity against a background of an already tight labour market will generate wages pressures. Rebuilding efforts in flood and other disaster affected areas will also add to demand. As this scenario unfolds there will be a general build up of broader inflationary pressures in the economy.

In response to rising inflation in the latter part of 2011 the Reserve Bank is expected to need to increase the general level of interest rates by raising the official cash rate to ensure the economy does not grow too rapidly and generate even higher levels of inflation that could have damaging longer term consequences if not brought under control early. Increases of the order of 0.5% in the official cash rate (by way of two 0.25% moves) are likely over the final months over 2011. This adjustment will potentially start around August with a second change in the final few months and would see the official cash rate end 2011 at 5.25%.