**Economic Update**

**By Glenn Baker, CFO, ING DIRECT**

The Reserve Bank left the official cash rate unchanged at 3.5% for a second month following its August Board meeting. The decision was largely anticipated by the market.

In recent months, though, there had been considerable expectation that interest rates needed to be lowered further to stimulate the local economy, particularly given the re-emergence of sovereign and bank debt concerns in Europe and the negative flow on effect this has had on global economic growth forecasts. In addition, evidence of slowing activity in China, the driver of regional growth and a major contributor to Australian growth through purchases of our iron ore and coal, raised concern about future activity levels. Adding to calls for a policy easing was the high value of the Australian dollar which has been making things difficult for exporters and import competing businesses. Perversely, the decision to hold interest rates added further strength to the currency.

The release of the June quarter inflation data in late July gave a boost to the prospect of easier monetary policy. Underlying inflation fell further over the quarter to an annual reading at the bottom end of the RBA target range viz. close to 2%.

The combination of low inflation and resurgent global growth concerns certainly provided scope for the RBA to act to lower rates. So why didn't it?

The answer probably lies in two areas. Firstly, it may be a question of timing. Secondly, the case for action may not be as strong as first thought.

In relation to timing, the Reserve Bank did not see a compelling case to act immediately. Over the course of the last nine months the official cash rate has been eased by 1.25%, from 4.75% to 3.50%, the bulk of which occurred in May and June this year. With this level of stimulus already in place the Reserve Bank appears to have wanted to observe the effect of the current policy settings before adding any further interest rate support. Additionally, there is an argument that suggests that while European concerns have re-emerged there is not an immediate crisis to deal with. Preserving some 'firepower' in relation to the capacity to ease interest rates may well be a more prudent approach. So, today's decision could represent a pause in monetary policy easing. The benign inflation environment certainly gives the Reserve Bank lots of scope to act if required, if economic growth weakens considerably or if there is further financial market turmoil that threatens confidence and future growth expectations.

With respect to the case for easing, the evidence started shifting in recent weeks. Firstly, GDP data for Q1 2012 indicated that the economy was operated at an above trend rate. Whilst this data was for the first quarter of the year it had surprised on the upside and at least cautioned that the notion of a slowing economy might need to be evidenced through the next quarter's figures. Additionally, recent data has indicated that areas of prior weakness such as retail sales and housing have performed more strongly. In the case of retail sales it is evident that the cash payments being made to households by the Government as compensation for the expected impact of the recently introduced carbon price was fuelling increased consumption spending. It remains to be seen if this improvement in retail sales is only a short term boost generated by this cash injection or whether there is a more fundamental shift taking place. Retailers certainly fear that activity will slide over coming months and have been calling for further interest rate cuts to maintain momentum. Employment growth has slowed to a moderate level over the course of 2012 and the unemployment rate has stabilised at around 5.2%.

Publicity surrounding job shedding in some industries, notably retail and car manufacturing, has added to calls for further stimulus but in general labour market conditions have proven to be sufficiently resilient to not be an immediate factor in policy deliberations. The Reserve Bank pointed to a pick up business credit growth as another recent indicator of an improving economy. On balance there is insufficient evidence at present to suggest that the economy needs further - and more to the point - immediate stimulus. That is not to say that there won't be adverse developments over coming months but rather that the current picture indicates an economy that is in reasonably good shape.

In the accompanying statement to its rate decision announcement the Reserve Bank played down the significance of the current inflation readings. Instead it pointed to its medium term view that inflation would be 'consistent with the target over the next one or two years'. It added that maintaining low inflation over the longer term would require domestic cost rises to be contained as the positive effects of earlier exchange rate appreciations wane. This would be compounded by any fall in the value of the Australian dollar. So the Reserve Bank is not as focused on today's inflation levels as the market is and appears to be discounting this as a driver of policy in the short term.

It was also very pertinent that in communicating its current 'on hold' position the Reserve Bank also pointed to the fact that past decisions had brought the general level of interest rates for borrowers to 'a little below their medium term averages'. This added to the notion that the Reserve Bank wanted to observe the impact of the series of easings already undertaken and that it considered policy to be already in the 'accommodative' mode.

Summing up the situation it is clearly evident that the Reserve Bank's view of the economy is relatively upbeat. This contrasts somewhat with views in the market place particularly those expressed in some quarters such as retailers who are concerned about future sales prospects and industry in general, particularly those sectors battling with the strong currency - exporters and import competing companies. The Reserve Bank has the capacity to do more to lower rates but does not see any urgency, preferring to observe developments for the time being. In particular, it can respond to any adverse developments on the world stage such as a revival of European debt concerns and a deterioration in global growth that in turn lowers Australian activity levels.

So the Reserve Bank is well positioned to respond to any adverse developments but it is signalling that its current view of the economic outlook and its current interest rate settings do not require any further action at present. Looking ahead, while the Reserve Bank has effectively removed any indication of a policy bias it is more likely that the official cash rate could need to be reduced further (but modestly, by say only another 0.25%) before we see the end of the current cycle.