Economic Update – 6 December 2011
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The RBA, at its recent meeting, provided an early Christmas present to the Australian economy.

For the second month in a row the Board adjusted the overnight cash target rate downward to 4.25%, a decrease of 25 basis points. Further, the comments from the RBA Board left the door open for further cuts in the New Year.

Why has the previous staid RBA Board become so generous?
It is not so much what they have done versus what they foresee.

In previous months, the RBA has been sanguine that events in Europe will have limited, if any, impact on the Australian and Asian economies.

However, a reduction in the reserve requirements by the Chinese officials and the increased severity and ongoing complexity of the European mess has clearly shifted the RBA position.

While previously, the Bank was confident Australia and Asia could weather the storm from Europe; this has now changed.

The Bank noted “investment in the resources sector is picking up very strongly, with much more to come (and) some related service sectors are enjoying better than average conditions. In other sectors, changed behaviour by households and the high exchange rate have had a noticeable dampening effect.”

The Bank suggests that the recent weakness in the labour market will temper wages growth in the period ahead, such that the lower inflation path will not be threatened by wages costs.

The combination of these two factors; the impact of Europe and the subdued inflation outlook provided the confidence for the Bank to adjust the cash rate lower.

Reflecting the contagion effect from Europe, the Bank noted the ongoing challenging funding market conditions that Banks around the world are facing.

Indeed, it is noteworthy that none of the major banks immediately announced the extent to which the RBA cut to the cash rate will be passed through to the household mortgage sector. Previously these announcements have been made within minutes of the RBA announcements.

As evidenced by the RBA move, global economic and market developments are being driven by events within Europe.

It appears that Europe is approaching the final solution Mark 4 (or is that 5). It is easy to lose count. On a positive note, it really does appear that Europe is getting close to the final solution.

The key point that has been absent from previous proposals is the concept of fiscal discipline with consequences. Although, within the existing budgetary arrangements the limits on government deficits were available, they were never enforced; at the ultimate cost of the broader European community and, as appears increasingly likely, the global community.

The most recent plan incorporates automatic penalties for breaches of budgetary discipline. In addition, compliance would be measured by an independent adjudicator. While this approach has been endorsed by Germany and France, broader endorsement and acceptance is subject to a meeting at the end of this week. Following this, a process of national endorsement would be required.

To ensure that the European politicians appreciate the implications of the task before them, the Standard and Poor’s rating agency announced that 17 Euro zone countries were on credit watch for a potential downgrade subject to the outcome of the December 8/9 European leaders meetings. France has been identified for a potential two notch downgrade.

In the event that S+P did downgrade the various European sovereigns, the universe of AAA countries would be significantly depleted. Australia stands strong as one of the few AAA rated countries in the world.

Meanwhile in the US, despite the European distraction, economic data has been surprising to the positive side over the past two months. This suggests the US economy will enter 2012 well placed to consolidate on the strengthening economy evident over the final quarter of 2011.

Notwithstanding the improvement in the economy, the stalemate on the US budgetary position is likely to return to the front pages.

As in Europe, the budget issue must be solved; the question is how much damage to the real economy are politicians prepared to inflict on the basis of partisan rhetoric.

Outlook for Interest rates into 2012

Clearly the outlook for Australian interest rates over the first half of 2012 is more heavily dependent upon European events than previously.

Despite previous solutions leaving the markets underwhelmed, there appears a realistic determination that the current proposal can deliver.

The implementation risk remains considerable.

Against this background, it appears likely the RBA has scope to provide further assistance to the domestic economy over the first half of next year. Additional cuts in rates will be designed to cushion the impact on the domestic economy of a further deterioration in Europe.

The next opportunity for the RBA to adjust rates will be at the February meeting when the RBA will have a further reading on inflation.