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Economic Update – 7 March 2012
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The Reserve Bank maintained the official cash rate at 4.25% per annum on Tuesday following the March Board meeting. This was consistent with market thinking and the general signal provided in February following its decision last month to hold the rate steady.

While the Reserve Bank started to lower the rate at the end of 2011 with 0.25% cuts in both November and December it has since signalled a 'steady as she goes' outlook and is unlikely to move the rate again for some months, unless of course there is a significant deterioration in the current outlook. The statement accompanying today's decision is very similar to the last one and clearly shows that the Bank is comfortable with the current monetary policy settings.

The reasoning behind the rate reductions in late 2011 was largely based on the persistent problems in Europe with sovereign debts concerns generating severely deteriorated financial market conditions which included dramatically higher funding costs for banks due to the significant flow on effects of sovereign debt concerns on the stability and financial performance of many European banks. The start of 2012 has seen a softening in the European crisis through the development of a rescue package for Greece to hopefully save it from defaulting on its debt, general fiscal consolidation measures and more recently additional support being made available to banks through low cost funding provided by the ECB.

The Reserve Bank had seen these European problems as potentially having an adverse effect on global growth which would ultimately lead to softness in Australia's own economic growth rate. At the same time the Reserve Bank was already observing weakness in some sectors of the local economy, namely retail spending and housing in particular, and employment growth stalling after a long period of strong growth with an associated upturn in the unemployment rate. Consumer and business confidence had also fallen, largely on the back of the European and global market disruptions. Within this scenario, inflation (in underlying terms) was sitting comfortably toward the bottom of the Reserve Bank's target range of 2% to 3%. This, in particular, in concert with the other weakening signals in the economy gave the Reserve Bank scope to ease rates to stimulate activity. While there were no immediate signs of an adverse impact on Australia from global factors, the Reserve Bank was effectively seeing sufficient potential for this and eased rates as a form of insurance at a time when it had the capacity to do so.

Another factor in easing policy was the strength of the Australian dollar which had constrained (and continues to constrain) activity in some sectors such as tourism, generally dampened revenues for exporting manufacturers and intensified competition for import competing businesses.

Whilst the 2011 rate moves did produce positive responses, the market expected a continuation of monetary policy easing would take place into 2012 to support the economy.

The Reserve Bank is now presenting a picture of Australia that does not, in its view, necessitate any further policy action.

Europe is no longer seen as being in a downward spiral. It is surely far from being 'out of the woods' but conditions there are seen as stabilising and financial markets are also more stable with funding conditions for banks on the improve. Further, data coming out of the U.S. indicates an improving economy with, importantly, employment starting to make steady gains. Additionally, Asian economies continue to produce sound growth led by India and China, albeit that growth rates are moderating from their previous high levels with China in particular focused on a slightly softer but more sustainable growth path. The global picture is now seen as more supportive of Australia than was potentially the case a few months ago. Having said this, there is still scope for a weaker global scenario to detract from the local growth outlook and this will remain a factor in assessing monetary policy settings going forward. For now things are looking brighter though.

Locally, inflation (in underlying terms) continues to remain benign with the more recent reading for Q4 2011, released in late January, reaffirming that underlying inflation remains in the middle of the target band. The Reserve Bank's published outlook is for an acceptable inflation position to persist for some time, in fact into 2014. At that time though underlying inflation is forecast to have moved toward the top of the Reserve Bank target band.

Whilst some sectors remain relatively weak the mining boom, backed by high commodity prices and historically strong terms of trade, continues to see significant investment in mining and related activities. Flow on effects from this investment are anticipated across the wider economy. The influence of the policy easing of 2011 is still working its way through the economy. In particular, consumer and business confidence are showing early signs of improvement, although this appears to have been halted by the cessation of the anticipated further policy easing along with the subsequent increase in lending rates by banks in response to higher funding costs, an outcome of 2011 conditions in global markets. The lower interest rates are expected to positively influence consumption and borrowing over time if conditions in global markets remain steady and concerns about a global crisis dissipate. The Reserve Bank's expectation is that growth in the economy, although varying across sectors, is returning to trend levels of around 3% to 3.5%. In this context it does not see a need to add any further stimulus.

As indicated, the Reserve Bank is comfortable with the current interest rate settings, particularly in terms of its view that rates for borrowers 'remain close to their medium term average'. It expects the economy to grow at a steady rate under current policy settings. It is still mindful of potential downside risks to growth should the situation in Europe deteriorate again. In this event it has the comfort of a low inflation environment and a cash rate at a level that allows plenty of room to move to create stimulus. It is a position that would be the envy of many a central bank.

No change is expected to the official cash rate for some months unless things turn sour in the near term. In the longer term (and that's probably a fair way off) as global conditions improve and economic growth builds there may be a need to raise rates again.