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Economic Update – 2 May 2012
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The Reserve Bank acted decisively following the 1 May Board meeting by reducing the official cash rate by 0.5% to 3.75%. The size of the cut was regarded as surprising by the market.

Expectations were high that the Reserve Bank would cut the rate by 0.25% especially given the comments made after the April Board meeting that indicated that if the first quarter inflation numbers (released in late April) remained low there was room to ease monetary policy if warranted. This was widely interpreted in the market that the central bank was close to lowering rates but just wanted to sight the latest inflation data before acting.

The step away from the usual 0.25% adjustment was not so widely anticipated. In hindsight though the decision makes sense.

There were two views of the likely outcome for May. Most economists and market participants felt that the Reserve Bank would move by 0.25% but there was a small group thinking they should do more. Many business leaders were urging for a larger move. The general concern about a larger move and the reason most commentators settled on a 0.25% drop was the potential for a larger cut to be seen as alarmist, sending a signal that the economy was in a poorer state than previously thought. This was seen as potentially a negative for sentiment; a further downward influence on the economy. After all, rates could be lowered by a series of moves and there was no obvious need to move more aggressively.

So why did the Reserve Bank move by 0.5%?

The answer lies in the shift in approach. The Reserve Bank has for some months now referred to the level of lending rates in the market (especially the very publicly sensitive home mortgage rate) as the key factor, not purely the level of the cash rate itself. The Reserve Bank has recognised that the nexus between the cash rate and lending rates has been broken due to the major shift in funding costs for banks that are no longer strongly correlated to the official rate.

Wholesale market funding costs have risen sharply over recent years and remained high, the result of concerns regarding banks emanating from the global financial crisis and the subsequent European debt crisis. Interest rates on deposits have risen sharply also and increased as a proportion of bank funding, a direct response to high wholesale market costs and attempts to reduce reliance on that source. Term deposits in particular have become an interest rate battleground with margins above the official cash rate moving significantly above historic averages. These changes in funding behaviours and costs have also been stimulated by regulatory change as banks are being encouraged to access more term funding and reduce short term funding exposure in order to build stronger, more liquid balance sheets which in turn would guard against any future market shocks.

Now, since the Reserve Bank last eased the cash rate in December, the costs of funds pressure on banks brought about increases in lending rates in the market during February. Further, in the lead up to the May meeting, market speculation that banks would need to repeat this adjustment and again raise lending rates, or not pass on the full amount of any potential Reserve Bank easing, was high. So in this context and with a strong predilection to target lending rates as opposed to the cash rate itself, the Reserve Bank saw a need to move the official cash rate by a larger amount. By doing this, and after taking into account the prospect of the cash rate change not being fully passed on to borrowers via lending rates, the net outcome would still produce a desired level of monetary stimulus to the economy.

The above discussion clarifies why the Reserve Bank moved by a larger than usual amount. Behind this though is the basic reason for moving at all, for creating stimulus. In its statement the Reserve Bank acknowledged that economic growth had been weaker than previously expected and the long awaited inflation April numbers showed that inflation had actually fallen. Forward forecasts were reduced for both economic growth and inflation, raising the case for action to stimulate the economy. Whilst no reference was made to it, there is also probably a background picture developing around a

tight fiscal position, commencing with the coming Federal Budget which is expected to turn a large deficit into a surplus, that would produce subdued growth outcomes.

We should not forget that the global economy is still impacted adversely by the European circumstances. China has moved to a lower more sustainable growth rate. The U.S. is generally recovering but employment remains sluggish. So the general global setting remains uncertain and whilst on an improving track, is generally soft in terms of growth. This adds to the need to ensure that the local economy is not adversely affected by global challenges.

The other major factor to consider is the general level of confidence, particularly that of consumers. Spending has been conservative and saving and debt reduction have been predominant among households. In an environment of economic and political uncertainty consumers are also faced with rising costs for essential services such as electricity and are yet to see the impact of the forthcoming carbon tax. Confidence is therefore down and the propensity to spend was at risk of diminishing further. The interest rate adjustments should have a positive impact on sentiment and lift spending. In time there is also likely to be a positive flow on to the housing market through lower mortgage rates. This will also alleviate pressure on household budgets.

Where to from here?

The Reserve Bank has acted strongly to inject some stimulus into the economy. It can be expected to observe the impact of this move over coming months before taking any further action. It is quite possible, though, that this latest easing, whilst reasonably sizeable of itself, will not be sufficient to lift the economy significantly back toward a higher growth rate, particularly given the potentially adverse effect of tight fiscal policy and a limited flow on to lending rates. Given the low inflation climate we are in, there will be room to do more. A further cut in the official cash rate is higher likely in coming months.