**Economic Update – October**

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

The Reserve Bank reduced the official cash rate by 0.25% to 3.25% following the 2 October Board meeting. The rate was last changed in June. This move had been widely anticipated although there were many market participants who felt the change might be made in November instead. To that end there had been almost universal acceptance that the cash rate would be reduced again, at least by 0.25%, during the balance of 2012.

A number of factors both international and domestic were behind the decision.

The outlook for global growth has softened in recent months. In particular, economic activity in Europe has been contracting with unemployment still rising. Some countries, such as Greece and Spain, are struggling with slowing economies and high unemployment with no ability to stimulate activity due to the need to implement debt reduction and fiscal adjustment (austerity) measures. The European Central Bank has indicated its support for the Euro and European sovereign debt, through bond buying commitments. This has assisted in stabilising financial markets which helps remove a measure of instability and concern. The reality is that it will take some time for economic activity to turn around. The U.S. economy continues to experience modest growth with data releases generally presenting a mixed view of the economy. Growth in China has slowed appreciably in recent months, albeit that China is still presenting solid growth levels. The concern is that China, at lower growth rates, can no longer offset the weakness elsewhere. So on balance there is a generally sluggish world economy which has manifested itself more overtly over recent months despite hopes to the contrary.

Against this backdrop key commodity prices, particularly those pertinent to Australia's export performance such as coal and iron ore, have fallen over recent months and remained lower despite some recovery in recent weeks. Accordingly, Australia's terms of trade are lower, albeit still strong in historical terms. This development, though, has taken the edge off the strong growth performance of Australia through the mining export boom and created an environment in which the need for a more balanced growth scenario, across a wider range of sectors, is materialising.

In terms of the local economy, there has been developing weakness in key sectors. Retail sales have been largely flat apart from periods of temporary strength stimulated by government payments. Retailers, as a group, have been strident in calling for interest rate reductions for some time. This sector has been hard hit by the general preference of consumers to pay down debt and save. Business closures and job losses, including those identified in recent State Government announcements, have received significant publicity and this in turn has had a negative effect on consumer confidence. Housing has also been sluggish. The general mood of consumers for improved personal finances has also limited preparedness to invest in housing both in terms of buying a home or investing in a property. This has limited construction activity which has had negative flow on effects to other parts of the economy.

The high Australian dollar, which has remained high despite the commodity price falls, has also continued to depress some sectors of the economy, principally those involved in import competing industries, and has also 'limited' export revenues at a time when export prices are falling in US dollar terms. The domestic tourism market continues to suffer from the high level of the currency as it is more expensive for foreign travellers to come to Australia and on the other hand beneficial for Australians to head to Europe or America.

Summing up these factors, a weakening global economy, a softer mining export sector, a strong currency, sluggish domestic activity in retail and housing and a need to lift confidence, were collectively good reasons for the Reserve Bank to introduce some more stimulus via easier monetary policy. The capacity to do so, due to the continuation of a low inflation outlook, had already been established and the Reserve Bank had indicated that it would be prepared to act if deemed necessary. The weight of evidence had become significant, to the point where inaction by the Reserve Bank could have led to greater negativity. The move this month will have some positive affect on confidence which should lead to increased activity over time.

Where to from here?

There is a school of thought the Reserve Bank will undertake additional easing action in November, that one rate cut of 0.25% on its own will not be sufficient and indeed that there is rarely a 'one-off'  move. There is also the prospect that the full amount of the official rate cut will not be passed on to borrowers which would lessen the effectiveness of the easing, although any 'retention' by banks is expected to be more limited now as funding cost pressures have recently shown signs of mitigating. It should, however, be noted that the Reserve Bank has indicated that policy is already at an accommodative setting with borrowing rates below their medium term averages. In this context and given the other Reserve Bank observation that earlier rate easings are still working their way through the economy, it is quite possible the Reserve Bank will hold off on any further action over the next few months. In the absence of any severe deterioration in global or local economic data in the near term, the first Reserve Bank meeting for the year in February 2013, presents as an appropriate time for further policy assessment.