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Economic Update – 5 October 2011
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The Reserve Bank's decision to hold the official cash rate steady at 4.75% per annum following its early October Board meeting means that the rate has been held stable for at least a year, the rate having last been raised in November last year.

The outlook for the official cash rate is for a further period of stability.

There are a number of reasons for this expectation which involve both global and domestic factors with the former having greater impact recently. The long held view that interest rates would be raised over time has recently been challenged by the possibility that a global economic downturn would see rates need to be eased to support a stalling economy. On balance a 'steady as she goes' approach is most likely.

The outlook for global economic growth has worsened considerably in recent weeks. The emergence of further global financial market uncertainty in early August has not abated and there continues to be significant concern regarding the flow on effects of sovereign debt risks in Europe, principally emanating from major concerns regarding Greece and its potential to default on its debt. Not only does the need for fiscal consolidation in many European countries negate the ability to stimulate economic activity but the potential impact on banks that hold sovereign paper, in terms of the need to write down the value of holdings, further exacerbates the situation as banks move to limit their lending. Confidence has fallen significantly and with high levels of unemployment the prospects for European growth look bleak. Monetary policy can do little as well given that interest rates are already low.

Across the Atlantic the U.S. also continues to struggle with low economic growth, high unemployment and similar difficulty in finding effective stimulation measures given its debt position and effectively zero interest rate setting. Global share markets have fallen significantly in the last two months and this has in turn added to weakened confidence through the perception of diminished wealth by people and businesses.

This global backdrop has heightened concerns in Australia. The sheer fact of such significant market instability and the perception of weaker global growth as well as diminished personal wealth has led to much weaker consumer and business confidence. This level of global uncertainty in itself gives the Reserve Bank cause to hold off on monetary policy tightening. The continuance of weaker domestic data adds to this scenario. In particular, retail sales have remained weak over recent months and the housing sector has also been sliding over time as evidenced by ongoing softness in both housing finance and building approvals.

Australians have also been adjusting to higher utility charges which has reduced the amount of money available for discretionary spending. The preference to save or reduce debt is another factor. On top of everything else there has been a recent weakening in the employment markets and this has also contributed to the cautious approach being adopted by consumers. China, India and Asia more generally continue to fuel our export driven mining boom and whilst commodity prices have fallen somewhat in recent weeks the terms of trade remain very strong and the economy is benefitting from strong growth in national income. Unfortunately, this is now offset by broad weakness across the rest of the economy. The strength of the Australian dollar, although it has recently come off its highs, is also working against business, especially in industries such as tourism, manufacturing and education.

Only a few months ago when the June quarter inflation numbers were released in late July there was a heightened expectation that the next interest rate increase was close. Unemployment was at a recent low and underlying inflation was showing signs of challenging the upper end of the Reserve Bank target band toward the end of 2011. At that time also there was a higher expectation that the global recovery was underway. In that climate it was widely anticipated that interest rates would need to be raised again to slow down the economy and avoid the emergence of higher rates of inflation. Today, things look very different and there has been considerable speculation that the Reserve Bank would need to stimulate the economy through lower interest rates. This is unlikely in the short term as the Reserve Bank would not want to create policy stimulus unless it was seen as absolutely essential and certainly not if there was any prospect that it might need to be withdrawn in the short term.

The next inflation print in late October could well show the effect of softer economic growth through a weaker prices change but this of itself would not be enough to prompt a change in policy direction. Rather, the Reserve Bank will be looking for clear signs of the need for policy stimulus which would include both significantly lower inflation expectations and a much weaker employment climate.

The Reserve Bank continues to anticipate solid growth in Australia over the medium term with near-term growth being softer than previously expected. It has also acknowledged that an improved inflation outlook (should it evolve) would provide scope monetary policy support in the event of need.

At the moment there does not appear to be a clear case for a policy shift in either direction. The most likely scenario over the months ahead is for the Reserve Bank to monitor developments in the global economy and financial markets and to further assess the data coming out of the Australian economy. Monetary policy is expected to remain on hold for a period that could eventually extend well into 2012.

A by-product of the current market conditions is that longer term interest rates have fallen sharply. As a consequence fixed rate home loans can be obtained at levels below variable rate loans. Not surprisingly this is stimulating demand for fixed rates.