**Economic Update – September**

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

The Reserve Bank maintained stable monetary policy for the third month leaving the official cash rate unchanged at 3.5% following the September Board meeting. This outcome was broadly in line with market expectations.

There is, however, a stronger view developing in the market that the Reserve Bank will need to ease the benchmark interest rate again over coming months.

What is driving that view and, if there is a case building for further monetary policy easing, why didn't the Reserve Bank act this month?

With respect to this month's decision to hold current policy settings, as was the case last month, it is probably based on the absence of any immediate urgency with respect to a need to act. Over recent months the Reserve Bank has been taking a 'glass half full' view of the Australian economy. Whilst it has been recognising the potential downside risks to future growth, mainly emanating from ongoing European debt concerns and the flow-on effects on the global economy, the Reserve Bank has adopted a monitoring stance. In particular, it has acknowledged that given the low level of underlying inflation in the local economy there is capacity to act in the event of need. The need has until now been characterised by a significant deterioration in the European debt crisis. Without this need, the Reserve Bank has been content to observe developments. In this context also, the Reserve Bank has indicated that significant monetary stimulus had been generated through a series of interest rate cuts (that lowered the official cash rate by 1.25% over the period since November 2011) and that borrowing rates were generally below average, therefore being on an 'accommodative' footing.

In recent weeks, however, data releases have been painting a less buoyant picture and the Reserve Bank has begun shifting its language concerning developments in the global and local economy.

Firstly, the Reserve Bank is now observing a general weakening in global growth, with increased risk to the downside, following a more upbeat start to 2012. In particular, it has observed that activity in Europe is contracting and that the U.S. continues to struggle to generate anything better than modest growth numbers.

Closer to home, growth in China and Asia more generally has also softened in response to the generally weaker performance of the major economies that has lowered demand for exports. These developments have fed directly into the outlook for Australia. Commodity prices have fallen, particularly with respect to iron ore and coal which have been major components of our export driven economy. Australia's terms of trade, whilst still high by historic measures, have fallen from their peak of approximately a year ago and this shift is placing increased doubts around the ability of the mining boom to be sustained and to continue to drive the overall level of growth in the local economy. In this context, we have seen a number of mining projects either stopped or deferred which has generally fed this questioning about the sustainability (or more specifically the depth and longevity) of the mining boom.

With respect to the financial markets, the concerns over Europe and global market conditions have moderated somewhat due to repeating utterings by central bank officials in both Europe and the U.S. that action would be taken in the event of need to stabilise the Euro and to inject liquidity into markets to support and stimulate the economies. The statements have created a calmer market environment but there is a high expectation building that action, such as more bond purchasing by central banks, will be taken shortly to counter flagging growth. Should this not occur in the near term it is highly likely that market instability will return. This would place additional risk on economic growth.

Turning to local factors, the recent retail sales figures were much weaker than expected and again raised questions about the robustness of consumption spending, albeit that it had demonstrated reasonable strength over the earlier part of 2012. The assistance packages provided by the government around June appear to have boosted sales for a period but this effect has now dissipated and consumers appear to be returning to a more cautious behaviour. Whilst official employment numbers continue to point to modest growth in employment and a relatively stable unemployment rate (around 5.2%) there are repeated examples of job losses across a variety of industries receiving publicity.

This serves to keep consumer confidence subdued as people continue to observe negatives in the economy and opt to defer spending decisions. On the positive side, the Reserve Bank points to the fact that business credit has picked up over the course of this year and more recently dwelling prices have 'firmed a little'.

The overriding view, however, remains one of uncertainty, whether it be the product of ongoing global weakness and market instability or concerns about the future of Australian economic growth and job security. In addition, the strength of the Australian dollar continues to inhibit economic performance. It has softened export revenues (on top of lower commodity price effects) and continues to negatively impact import competing industries. Whilst the Reserve bank is unlikely to intervene in markets to bring about a fall in the value of the currency, interest rate settings at current levels are certainly helping to hold up its value. In the event that the Reserve Bank finds it necessary to lower interest rates in the months ahead, a positive by-product of such action is likely to be a lower Australian dollar.

So, whilst Australia is currently seen as maintaining a growth rate close to trend, the outlook is most likely for the various factors noted to contribute to a weakening in activity over months ahead. As observed risks are clearly biased to the downside. In this scenario the question is more about the timing of the Reserve Bank's next move on interest rates rather than whether or not it will act to reduce the official cash rate again. Future meetings of the Reserve Bank Board should be viewed as 'live' with respect to potential rate cuts. It is expected that the official cash rate will be reduced by a further 0.25% before the end of 2012, most likely in November. There could be further action in 2013 depending on developments with respect to global and local economic activity, although it is quite possible that the next reduction could see the end of this easing cycle with policy then stable for some time.