

RBA waits – but will watch

Economic note

2 February 2010

- Defying general market expectations, the Reserve Bank Board decided to leave the cash rate unchanged at 3.75% today.
- Weak demand for business credit and expected within-target inflation were highlighted as key reasons for the pause in the tightening process.
- The RBA also expressed the desire to gather more information on the impact of the previous rate hikes, especially as lending rates have risen further than the cash rate.
- A tightening bias remains in place, but the return to a more neutral monetary policy setting now looks like it will be extended over a longer period.

RBA waits – but will watch:

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to leave the cash rate unchanged at 3.75%. This steady policy outcome came as a surprise to the markets, which had predicted a 25bp tightening.

In announcing today's decision, the RBA highlighted the view that demand for business credit "has continued to fall, as companies have sought to reduce leverage, and lenders have imposed tighter lending standards and in some cases sought to scale back their balance sheets." The RBA also highlighted that "credit conditions remain difficult for many smaller businesses." In addition, the RBA noted that "lenders have generally raised rates a little more than the cash rate over recent months (note: see chart below) and most loan rates have risen by close to a percentage point" (as opposed to the 75bp increase in the cash rate). We would note that this point was made clearly by the RBA Assistant Governor in a speech in late 2009.

The RBA also noted that "inflation is expected to be consistent with the target in 2010." This suggests that the RBA's inflation forecasts of 2.25%-2.5% over 2010-2011 will likely remain unchanged in Friday's *Statement on Monetary Policy*. One risk to this benign inflation view could be, however, that the AUD looks to have stopped rallying, with the currency down more than 1 US cent today to just below \$US0.88.

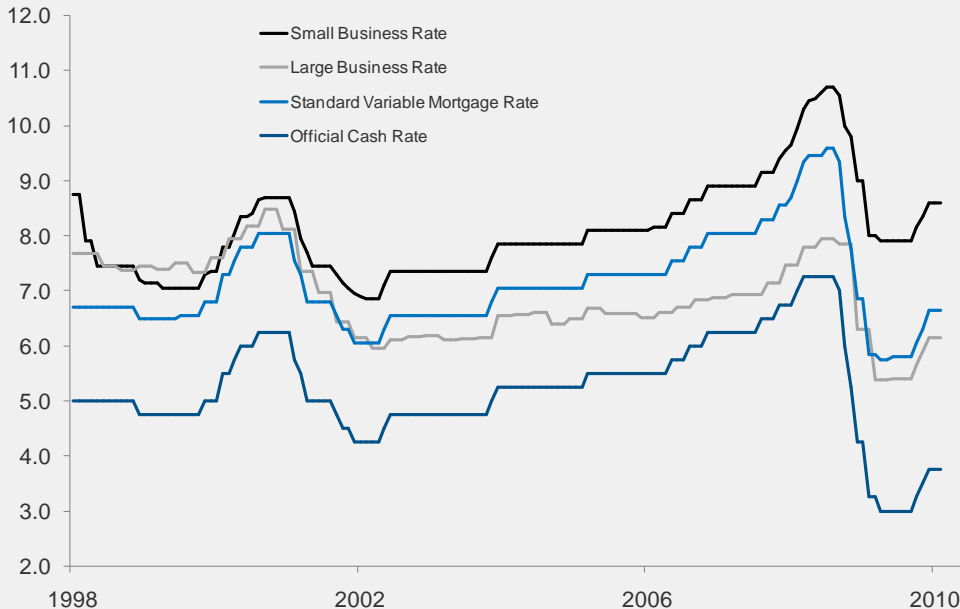
Significantly, the RBA noted that "since information about the early impact of those changes is still limited, the Board judged it appropriate to hold a steady setting of monetary policy for the time being."

The RBA did signal that they still expect to have to tighten policy further, stating that "if economic conditions evolve broadly as expected, the Board considers it likely that monetary policy will, over time, need to be adjusted further in order to ensure inflation remains consistent with the target over the medium term."

However, today's pause clearly sends the signal that the return to a more neutral setting of monetary policy will likely take longer than previously expected and/or be more heavily skewed to the second half of the year, perhaps when the recovery in the global economy looks more assured and both the demand for and supply of business credit has improved.

Financial markets have reduced their expectations for the cash rate at year-end 2010 to around 4.5%, from 4.75%-5.0% previously. However, the risk to the official cash rate would still seem to be towards the 4.75%-5% range, rather than the lower rate priced in today. Nevertheless, markets will now need to factor in a view that encompasses a more cautious RBA than was seen with the three consecutive rate hikes over the final months of 2009.

Australian official cash rate and housing mortgage rates



Source: RBA, data to 2 February 2010

Other highlights from the RBA statement today are as follows:

- “The global economy is growing, and world GDP is expected to rise at close to trend pace in 2010 and 2011. The expansion is still likely to be modest in the major countries, due to the continuing legacy of the financial crisis, resulting in ongoing excess capacity.”
- “In Asia, where financial sectors are not impaired, recovery has been much quicker to date, though the Chinese authorities are now seeking to reduce the degree of stimulus to their economy.”
- “Global financial markets are functioning much better than they were a year ago. Credit conditions nonetheless remain difficult in the major countries as banks continue to face loan losses associated with the period of economic weakness. Concerns regarding some sovereigns have increased.”
- “In Australia, economic conditions have been stronger than expected, after a mild downturn a year ago. The effects of the fiscal stimulus on consumer demand have now faded, but household finances are being supported by strong labour market outcomes and a recovery in net worth.”
- “Public infrastructure spending is now boosting demand, as is an upturn in housing construction. Investment in the resources sector is strong. The rate of unemployment appears to have peaked at a much lower level than earlier expected.”
- “Inflation has, as expected, declined in underlying terms from its peak in 2008, helped by the fall in commodity prices at the end of 2008, a noticeable slowing in private sector labour costs during 2009, the recent rise in the exchange rate and a period of slower growth in demand. CPI inflation has risen somewhat recently as temporary factors that had been holding it down are now abating. Inflation is expected to be consistent with the target in 2010.”
- “Credit for housing has been expanding at a solid pace, and dwelling prices have risen significantly over the past year. Business credit, in contrast, has continued to fall, as companies have sought to reduce leverage, and lenders have imposed tighter lending standards and in some cases sought to scale back their balance sheets. The decline in credit has been concentrated among large firms, which generally have had good access to equity capital and, more recently, to debt markets; credit conditions remain difficult for many smaller businesses.”

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them. This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2010) Colonial First State Group Limited.
All rights reserved.