

CASH RATE DECISION & OUTLOOK

Tuesday, 7 October 2008

Summary

- **RBA slashed the cash rate by 1% to 6% in an unusual move. Markets were priced for a 50bp easing.**
- **The significant deterioration in global financial market conditions and the global growth outlook primarily drove the size of the cut.**
- **There is scope for further easing by the RBA in coming months.**

In an unexpected move, the Reserve Bank (RBA) eased interest rates by 100bp to take the cash rate to 6.00%. The last time the RBA cut rates by this much in a single move was in the middle of 1992, which was also the time of around the last recession.

Today's rate cut was driven by the significant recent deterioration in both financial market conditions and global growth prospects. These developments pose considerable downside risk to the Australian economy such that the RBA noted in its statement today that there is "now present the risk that demand and output could be significantly weaker than expected". The turn for the worse in financial markets means domestic demand could be slowing too sharply due to the economic impact of difficult financing conditions and share market losses.

We think the size of today's RBA rate cut should be welcomed as it gives greater protection to the domestic economy from the deteriorating global backdrop (both financial and economic). It gives this protection by providing interest-rate relief and propping up confidence. Confidence has been declining with the credit crisis deepening worldwide, causing risk aversion to spike and share market losses to accelerate.

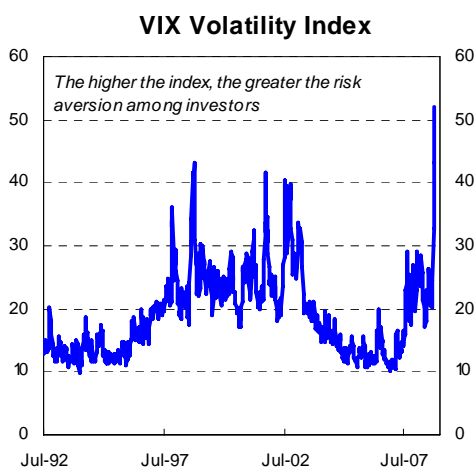
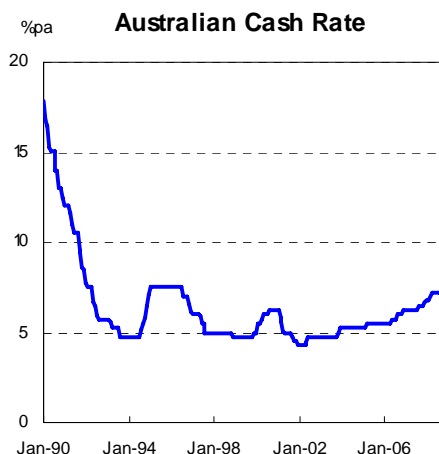
Prior to today's rate cut, inter-bank cash-rate futures were pricing in a little over 100bp worth of tightening before the end of the year (which included an expected 50bp today). So the RBA has effectively front-loaded the expected rate cuts. It has done this in what can be described as both a pro-active and pre-emptive move to try to get in front of the curve. That is, the aggressive nature of today's cut means the RBA is trying to mitigate the downside risks to the economy.

The RBA on the inflation front notes that the next consumer price index reading is likely to show an increase of around 5%pa (up from the latest reading of 4.5%pa on the headline basis), but the growing downside risks to economic growth have clearly shifted the RBA's focus from inflation to growth. Furthermore, the current domestic and global backdrop is likely to help ease inflation pressures. The RBA projects inflation to start easing next year.

The RBA continued to mention the terms of trade (as has become recent practice). However, this time the RBA noted that while the "expansionary effects of the recent surge in Australia's terms of trade are still coming through...some decline in the terms of trade now looks likely over the coming year". Further, the RBA notes accumulating evidence of a "significant moderation in growth in Australia's trading partners".

We also would not dismiss the prospect that today's move by the RBA is part of a global co-ordinated move by central banks. We would therefore not rule out rate cuts from the central banks of the major economies later today.

Going forward, activity data (locally and among our key trading partners) and developments in market conditions will be important in the size of further follow-up moves from the RBA. We think there is scope for the RBA to ease by more in coming months. Indeed, there is a good chance that the RBA eases again in November and/or between meetings if conditions warrant such moves. But the chance that the next easing from the RBA is 1% in size may be small given the RBA stated today that it doesn't see today's movement "as establishing a pattern for future decisions".



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