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Central Bank Outlook

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Australia: Rates Cut, Scope for Further Easing?

Confounding market expectations of a 25 bp rate cut, the RBA decided to reduce the Cash Rate by 50 bp at its meeting in May, ending a run of three straight decisions to hold policy, but all following the two successive 25 bp rate cuts at the end of 2011.

Global Outlook Unchanged…

The statement by Governor Stevens following this meeting showed some notable changes. However, beginning with a largely unchanged assessment of the global economy, the RBA once again noted that growth was likely to continue at a below-trend pace this year but with no sign of a deep downturn occurring. Specifically, while conditions in Europe remains very difficult, the US is showing a continued moderate expansion and the Chinese economy is still expected to remain at a more measured and sustainable pace of growth going forward.

Output Growth Weaker, Inflation Pressures Ease…

In terms of the domestic economy, the RBA noted slower-than-expected output growth over the past year despite the fastest domestic demand growth in four years, dragged down by effects of the high exchange rate and various temporary factors. Diverging performances between sectors were also noted again, with considerable structural changes occurring in the economy once again emphasized, while labor market conditions were seen has having steadied in recent months. In regard to inflation, the RBA noted that recent data showed CPI inflation had been lower than expected, with the underlying rate shown to have been just over 2% over the past year while the headline measure fell to around 1½% in the last quarter from 3½% previously. Both rates are still expected to remain in the 2-3% range going forward.

Borrowing Costs Key…

However, new this month, the Bank devoted nearly two paragraphs to the topic of funding and borrowing costs in the economy. Observing a general improvement in financial market sentiment, the Board noted that, while funding costs have declined in recent months, they remain higher relative to benchmark rates than in mid-2011. This has, in turn, led to some increase in borrowing costs as lenders passed on their higher costs of funding (albeit still being close to their medium-term averages). However, the Board also emphasized that market sentiment remains skittish due to sovereign debt and banking sector problems in Europe and that these remain a potential source of adverse shocks going forward.

Overall, it seems the latest rate cut was, unsurprisingly, motivated by the Board's view that evidence in recent months showed both slower-than-expected growth and inflation, hence providing both rationale and scope for a further easing in monetary policy to support demand. In justifying the size of the latest reduction in rates, the Bank highlighted its desire for financial conditions to be easier now than that in December 2011, and a reduction of 50 bp was seen as necessary to achieve the appropriate level of borrowing rates in the economy. The latter point concerns the fact that the largest banks in the nation had failed to fully pass on the 25 bp CR cut in December to borrowers due to rising funding costs, and with the latest reduction in rates also likely to be only partially passed on.

Scope for Further Easing?

Thus, going forward, recent price data seems to show scope for further policy easing if needed, albeit with any such decision likely to depend on both economic data and developments in borrowing costs in the economy. Insights into any possible further easing may be found from updated growth and inflation projections arriving with the quarterly Statement on Monetary Policy due to be released Friday.