Europe the driver behind *"finely balanced"* rate cut

RBA Board minutes

- **The latest Reserve Bank Board minutes confirms that the decision to cut interest rates in June was *"finely balanced".***
- **The Reserve Bank Board members conceded that the ongoing Euro zone sovereign debt crisis was behind the decision to cut rates. *"Recent domestic data generally had not suggested a significant weakening in conditions compared with the forecasts a month earlier. Moreover, there had not been time to assess the effects of the earlier reductions in the cash rate. However, there was clear evidence suggesting a softening in global conditions, and uncertainty about the future in Europe had increased significantly."***
- **Board members have signalled that further rate cuts may be more circumspect as policymakers attempt to judge the impact from the recent round of rate cuts. *"Members judged that a reduction in the cash rate of 25 basis points, combined with the earlier reductions, would mean that monetary policy would be providing a measure of stimulus that would be expected to flow through to the domestic economy over the coming months".***
- **A low inflation outlook and downside risks to global growth will keep the Reserve Bank on an easing bias. As such CommSec expects the Reserve Bank to cut interest rates by a further 25bps in August.**

What does it all mean?

- The decision to follow up the half a per cent rate cut in May with another quarter of a per cent cut in June was not as clear cut as markets previously thought. The latest Reserve Bank Board minutes highlights that while the case for a rate cut was compelling, it was a *"finely balanced"* decision that was swayed by the ongoing European debt crisis.
- Interestingly the minutes make mention of the general health of the domestic economy, with the recent round of domestic data *"generally had not suggested a significant weakening in conditions"*. The Reserve Bank is well aware of the multi-speed nature of the economy however recent data on retail sales, labour market, mining investment and even business credit implied a *"degree of resilience"* in domestic activity. In fact in recent times policy officials have been at pains to highlight that any inherent weakness is more a confidence issue than as a result of significant structural weakness.
- On the global front the slowdown in China will be closely watched by officials. And while the Chinese economy has shown signs of slowing even further in recent weeks; the stimulatory measures that have been put in place should result in an improvement in activity levels in the latter part of this year.
- The downside risks to global growth were discussed and Europe remains the watching brief. Global growth is below trend levels and sovereign debt concerns emanating from some of the peripheral European economies like Spain seem to be once again gathering pace. The threat of contagion to larger economies across the European Union is a key concern and is another reason that the Reserve Bank would consider providing a further degree of stimulus to the domestic economy
- Importantly given the substantial cuts to the domestic cash rate it is likely that the Reserve Bank will now take a step back and attempt to get a better handle on the impact of the rate cuts across the economy. As such we expect the Reserve Bank to keep rates on hold in early July and then wait on the June quarter inflation data which should confirm that inflationary pressures remain well contained.
- Looking forward the Reserve Bank will continue to maintain an easing bias, allowing the board to once again cut rates by a quarter of one per cent in August. And given the downside risks to global growth the threat of a larger rate cut cannot be ruled out - particularly if the euro zone debt crisis escalates in coming weeks.

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What do the figures show?

Minutes from the June 2012 Reserve Bank Board meeting

Mixed business investment

- *"Surveys of business conditions generally fell in April, to average or below-average levels. Much of the reported strength in business conditions continued to be in mining-related and transport industries, with the weakness concentrated in the retail, construction and manufacturing industries. Members were briefed on the March quarter capital expenditure survey, which suggested a continuation of the very large pipeline of committed mining investment in coming years, notwithstanding recent announcements by some mining companies that they were re-considering the viability of a number of resource projects to which they had not yet committed. The data also showed that non-mining investment intentions remained weak. The pace of business credit had been increasing gradually to an annualised rate of around 4 per cent over the six months to April".*

RBA on the labour market

- *"Some modest strengthening in the labour market over the year to date was apparent, as employment increased by 15,000 in April, the unemployment rate declined to below 5 per cent and the trend measure of average hours worked edged up. However, other indicators and information from liaison continued to suggest that hiring intentions outside mining-related activities remained relatively subdued."*

Weak domestic economy

- *"Members noted that indicators of recent economic activity had been mixed but, on balance, suggested continued moderate growth. Taking the past two months together, ABS data suggested a pick-up in the growth rate of retail sales; nominal retail sales declined by 0.2 per cent in April, but this had followed a strong rise of 1.1 per cent in March. Consumer confidence rose slightly in May, but remained below its long-run average level. In aggregate, housing prices continued to decline and activity in the housing market remained weak, with a sharp fall in dwelling approvals in April partly accentuated by the introduction of new legislative guidelines in Western Australia".*

RBA on inflation

- *"with inflation expected to remain in the lower part of the targeting range over the next year or so, members considered that there was scope for monetary policy to be a little more supportive of domestic activity. Members judged that a reduction in the cash rate of 25 basis points, combined with the earlier reductions, would mean that monetary policy would be providing a measure of stimulus that would be expected to flow through to the domestic economy over the coming months."*

Weak global growth

- *"Members observed that developments in the euro area over the past month had increased the probability of a sharp deterioration in economic conditions in response to ongoing concerns about the sustainability of sovereign debt obligations and stability of banking systems in the periphery of the region. More generally, information received over the past month suggested some weakening in the global outlook in the near term. In addition to indicators of weaker economic activity in Europe, data from China suggested a further slowing in growth, although the Chinese authorities had responded by easing financial and fiscal policies."*

Australian dollar

- *"The Australian dollar had depreciated by around 5 per cent since the previous Board meeting – in contrast to the resilience it had displayed in the period of heightened risk aversion earlier in the year. European, emerging market and other commodity currencies had also depreciated against the US dollar, and by more against the Japanese yen."*

What is the importance of the economic data?

- The **Reserve Bank releases minutes of its monthly Board meeting** a fortnight after the event. The minutes give a guide to Reserve Bank thinking on interest rate settings.

What are the implications for interest rates and investors?

- The recent slide in the Australian dollar will provide an additional degree of stimulus supporting export orientated sectors including agriculture and manufacturing. While the sizeable reduction in petrol prices, coupled with the recent rate cuts should provide households with a healthy improvement in balance sheet conditions.
- CommSec still believes that the Reserve Bank should cut rates again, and we are pencilling the next move to be in August. In short, economic growth is still mixed and inflation is well controlled. The Reserve Bank can inject momentum with few, if any, downsides for the economy.

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