

Reserve Bank of Australia lifts official interest rates

Economic note

6 October 2009

At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to raise the cash rate by 25 basis points to 3.25 per cent, effective 7 October 2009. This was the first rise in the cash rate since March 2008 and followed 425 basis points of cuts since September 2008.

The RBA noted that the cash rate had been lowered very quickly in anticipation of very weak economic conditions and considerable downside risks. In making its decision, the RBA noted “that the basis for such a low interest rate setting has now passed” and “it is now prudent to begin lessening the stimulus provided by monetary policy”.

The RBA chose to raise the cash rate despite continued uncertainty over the characteristics of the global recovery, particularly in developed economies, relatively subdued inflationary pressures and the availability of credit to business. In fact the RBA pointed out it had carefully considered business borrowers and the impact of a higher exchange rate when making its decision.

In its statement accompanying the decision the RBA highlighted a number of comments.

On the global economy

The expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis.

However...

Prospects for Australia’s Asian trading partners appear to be noticeably better. Growth in China has been very strong, which is having a significant impact on other economies in the region and on commodity markets. For Australia’s trading partner group, growth in 2010 is likely to be close to trend.

On inflation

The weaker demand for labour over the past year or so nonetheless has seen a moderation in labour costs. Helped by this and the earlier fall in energy and commodity prices, inflation has been declining, though measures of underlying inflation remained higher than the target on the latest reading. Underlying inflation should continue to moderate in the near term, but now will probably not fall as far as earlier thought.

In addition, the exchange rate has appreciated considerably over the past year, which will dampen pressure on prices and constrain growth in the tradeables sector.

On business credit availability

For many business borrowers, increases in risk margins will still be occurring for some time yet.

Business borrowing has been declining, as companies have sought to reduce leverage in an environment of tighter lending standards. But large firms have had good access to equity capital and access to debt markets appears to be improving, helped by the better-than-expected economic conditions and increased willingness on the part of investors to accept risk.

Despite the risks to the Australian economic outlook and the subdued nature of inflation, the RBA is determined to move interest rates back towards a more normal level. In the statement it indicated it would take a gradual approach; suggesting rate rises of 25bps would occur relatively regularly over the next six months so that the cash rate rests around 4.0% by mid-2010.

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