Favourite home: RBA lifts rates by 25 basis points

Reserve Bank Board meeting

- **The Reserve Bank (RBA) has increased interest rates for the second consecutive month, lifting the cash rate from 3.25 per cent to 3.50 per cent.**
- **The RBA said "it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker."**

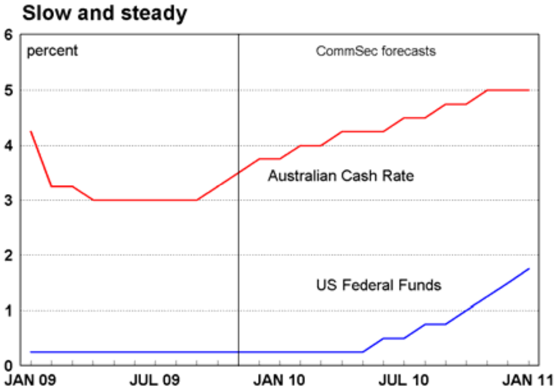
What does it all mean?

- The Reserve Bank certainly hasn't sought to frighten the horses with the latest rate hike. All and sundry had expected a move of 25 basis points and the Reserve Bank didn't disappoint. At this point in the cycle, a move of 25 basis points strikes a nice balance – it edges the cash rate back to more normal levels without threatening the economic recovery. There has been little change in the wording or tone of the statement, suggesting that the RBA will continue to lift rates in 25 basis point increments.
- It is far from certain that rates will rise again in December. The Reserve Bank has never lifted rates for three consecutive months, although it did cut rates five consecutive times late last year and early this year in the midst of the global financial crisis. While the Governor did warn that he wouldn't be timid in removing monetary stimulus, the Reserve Bank has already lifted rates twice at a time when other central banks are solidly on the sidelines. In addition inflation continues to ease, especially once housing is stripped out, and the firmer currency will assist in keeping inflation contained over the next 6-9 months. We expect the next tranche of rate hikes in February and March 2010.
- A year from now the cash rate will most likely be around 4.50 per cent – a level that will make the Reserve Bank much more comfortable. While a cash rate around 5 per cent has been regarded as a 'neutral' monetary policy setting in the past, this may prove too high if the Aussie dollar remains close to, or above, US90 cents. A strong currency not only leads to lower prices of imported goods and lower inflation but makes it tough for exporters and tourism.

Interest rate decision and past cycles

- The Reserve Bank has lifted rates for the second straight month – the first back-to-back rate hike since March 2008. The cash rate was lifted by 25 basis points to 3.50 per cent. Rates had stood at a 49-year low of 3.00 per cent before the decision in October to lift the cash rate.
- The first rate hike in the new cycle occurred six months after rates were last reduced back in April 2009. There were six rate cuts in the last cycle with the cash rate cut from 7.25 per cent to 3.00 per cent. Interestingly the previous tightening cycle in 2002 also began six months after the final rate cut was delivered.
- If banks pass on the interest rate increase in full then repayments on a 25-year $300,000 home loan will increase by $46.21 a month. Even with the rate hike, monetary policy is still clearly expansionary. The Reserve Bank has previously indicated that the "normal" or neutral cash rate is around 5.00 per cent. A neutral cash rate means that monetary policy is neither expansionary nor contractionary.
- The Reserve Bank has now adopted a "tightening" bias. That is, the RBA has indicated that further rate hikes are likely in

Slow and steady



Source: Reserve Bank, Federal Reserve, CommSec

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coming months: "it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker."

Comparing the two most recent statements

- The statement from the October meeting is on the left; the statement from today's November 2009 meeting is on the right. Emphasis has been added to significant changes in wording in the recent statement.

MEDIA RELEASE

No: 2009-23
Date: 6 October 2009
Embargo: For Immediate Release

STATEMENT BY GLENN STEVENS, GOVERNOR MONETARY POLICY

At its meeting today, the Board decided to raise the cash rate by 25 basis points to 3.25 per cent, effective 7 October 2009.

The global economy is resuming growth. With economic policy settings likely to remain expansionary for some time, the recovery will likely continue during 2010 and forecasts are being revised higher. The expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis. 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.

Sentiment in global financial markets has continued to improve. Nonetheless, the state of balance sheets in some major countries remains a potential constraint on their expansion.

Economic conditions in Australia have been stronger than expected and measures of confidence have recovered. Some spending has probably been brought forward by the various policy initiatives. As those effects diminish, these areas of demand may soften somewhat. Some types of capital spending are likely to be held back for a while by financing constraints, but it now appears that private investment will not be as weak as earlier expected. Medium-term prospects for investment appear, moreover, to be strengthening. Higher dwelling activity and public infrastructure spending is also starting to provide more support to spending. **Overall, growth through 2010 looks likely to be close to trend.**

Unemployment has not risen as far as had been expected. 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**.

Housing credit growth has been solid and dwelling prices have risen appreciably over the past six months. 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. Share markets have recovered significant ground.

Interest rates facing prospective borrowers on fixed-rate loans have already risen to some extent, as markets have anticipated a higher level of the cash rate. For many business borrowers, increases in risk margins will still be occurring for some time yet. 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. These factors have been carefully considered by the Board.

In late 2008 and early 2009, the cash rate was lowered quickly, to a very low level, in expectation of very weak economic conditions and a recognition that considerable downside risks existed. **That basis for such a low interest rate setting has now passed, however. With growth likely to be close to trend over the year ahead, inflation close to target** and the risk of serious economic contraction in Australia now having passed, the Board's view is that **it is now prudent to begin gradually lessening the stimulus provided by monetary policy**. This will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead.

MEDIA RELEASE

No: 2009-25
Date: 3 November 2009
Embargo: For Immediate Release

STATEMENT BY GLENN STEVENS, GOVERNOR MONETARY POLICY

At its meeting today, the Board decided to raise the cash rate by 25 basis points to 3.5 per cent, effective 4 November 2009.

The global economy has resumed growth. With economic policy settings likely to remain expansionary for some time, the recovery is likely to continue during 2010 and forecasts have been revised higher. The expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis. 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.

Sentiment in global financial markets is much better than earlier in the year. Nonetheless, the state of balance sheets in some major countries remains a potential constraint on their expansion.

Economic conditions in Australia have been stronger than expected and measures of confidence have recovered. **Some spending has probably been brought forward by the various policy initiatives. With those effects now diminishing, these areas of demand may soften somewhat**. Some types of capital spending are likely to be held back for a while by financing constraints, but it now appears that private investment will not be as weak as earlier expected. Medium-term prospects for investment appear, moreover, to be strengthening. Higher dwelling activity and public infrastructure spending are also starting to provide more support to spending. There have been some early signs of an improvement in labour market conditions. The rate of unemployment is now likely to peak at a considerably lower level than earlier expected.

Inflation has been declining for the past year. In underlying terms, inflation should continue to moderate in the near term, but now will probably not fall as far as earlier thought. Headline CPI inflation on a year-ended basis has been unusually low because of temporary factors, and will probably rise somewhat over the coming year. Both CPI and underlying inflation are expected to be consistent with the target in 2010.

Housing credit growth has been solid and dwelling prices have risen appreciably this year. Business borrowing has been declining as companies have sought to reduce leverage in an environment of tighter lending standards. For many business borrowers, increases in risk margins are still coming through. The decline in credit has been concentrated among large firms, which have had good access to equity capital and, more recently, to debt markets. Share markets have recovered significant ground.

The Board noted that the rise in the exchange rate is likely to constrain output in the tradeables sector and dampen price pressures. Nonetheless, growth is likely to be close to trend over the year ahead and inflation close to target. With the risk of serious economic contraction in Australia now having passed, the Board's view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. The adjustments at the October and November meetings will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead.

What are the implications for interest rates and investors?

- Around a third of people rent, a third of people own their homes outright and a third of people are buying homes. But over time, the proportion of home owners with a mortgage has been rising. So the community is far more interest rate sensitive. Still, when rates were coming down in 2008, many home buyers elected not to cut their loan repayments. So with interest rates still historically low, there will be negligible effects on the economy. But the Reserve Bank must be careful when lifting rates in 2010 – arguably it went too far with rate hikes in 2007 and early 2008.
- The Reserve Bank will continue to 'normalise' rate settings over 2010 – that is, lift rates to more 'normal' levels in line with more 'normal' economic conditions.
- Apart from Australia, only Israel and Norway have lifted interest rates. The longer that Australia effectively 'goes on its own' in lifting rates (at least compared with major economies) the higher the Australian dollar is likely to go, constraining earnings for globally-focussed companies. The Reserve Bank has continued to highlight that the Aussie dollar will act as a dampening influence on tourism and export sectors and constrain inflation.

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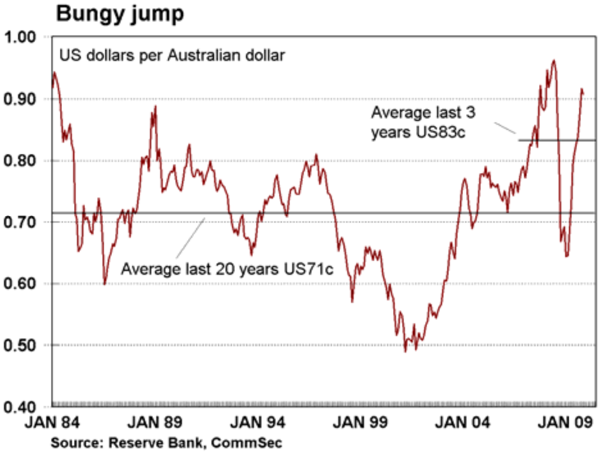

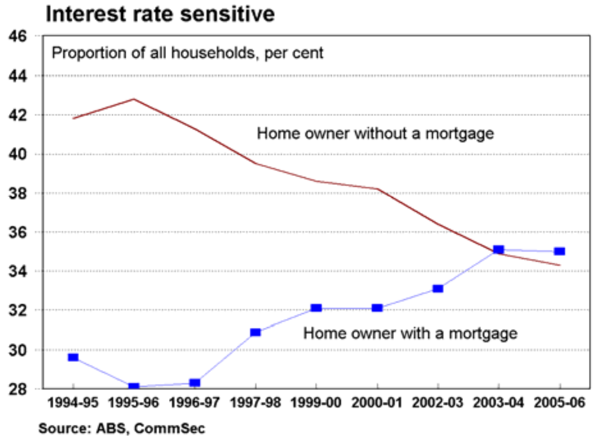

MORTGAGE CALCULATOR (Monthly repayments, 25 years)

Mortgage	Change in Interest Rates						
		+0.25%	+0.50%	+0.75%	+1.00%	+1.25%	+1.50%
	6.05	6.30	6.55	6.80	7.05	7.30	7.55
$100,000	$647.36	$662.76	$678.33	$694.07	$709.97	$726.03	$742.25
$150,000	$971.04	$994.15	$1,017.50	$1,041.11	$1,064.96	$1,089.05	$1,113.37
$200,000	$1,294.72	$1,325.53	$1,356.67	$1,388.14	$1,419.94	$1,452.06	$1,484.49
$250,000	$1,618.40	$1,656.91	$1,695.84	$1,735.18	$1,774.93	$1,815.08	$1,855.62
$300,000	$1,942.08	$1,988.29	$2,035.00	$2,082.22	$2,129.92	$2,178.09	$2,226.74
$350,000	$2,265.76	$2,319.67	$2,374.17	$2,429.25	$2,484.90	$2,541.11	$2,597.86
$400,000	$2,589.45	$2,651.05	$2,713.34	$2,776.29	$2,839.89	$2,904.13	$2,968.99
$450,000	$2,913.13	$2,982.44	$3,052.51	$3,123.32	$3,194.87	$3,267.14	$3,340.11
$500,000	$3,236.81	$3,313.82	$3,391.67	$3,470.36	$3,549.86	$3,630.16	$3,711.23
		Change in repayments per month					
$100,000		$15.40	$30.97	$46.71	$62.61	$78.67	$94.89
$150,000		$23.10	$46.46	$70.07	$93.92	$118.01	$142.33
$200,000		$30.80	$61.95	$93.42	$125.22	$157.34	$189.77
$250,000		$38.51	$77.43	$116.78	$156.53	$196.68	$237.21
$300,000		$46.21	$92.92	$140.13	$187.83	$236.01	$284.66
$350,000		$53.91	$108.41	$163.49	$219.14	$275.35	$332.10
$400,000		$61.61	$123.89	$186.84	$250.44	$314.68	$379.54
$450,000		$69.31	$139.38	$210.20	$281.75	$354.02	$426.98
$500,000		$77.01	$154.87	$233.55	$313.05	$393.35	$474.43

Source: CommSec