

## Australia: Our thoughts on the RBA's 25bps hike

In a move that surprised many, the RBA lifted interest rates by 25bps to 3.25%. Tuesday's rate hike - the first move since April, when rates were reduced to a 49-year low of 3.00%, and the first increase since March 2008 - is a sign that the local economy is on the mend, making Australia the first G20 nation to increase interest rates since the onset of the global financial crisis.

In its statement, RBA governor Glenn Stevens said that "economic conditions in Australia have been stronger than expected and measures of confidence have recovered". He ended the statement saying that "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". The remarks by Stevens mark a significant change from the middle of the year, when he raised the possibility of further rate cuts following each board meeting.

As highlighted in our latest quarterly, Australia has indeed proven to be more resilient, suffering from only one negative quarter of growth (in the final quarter of 2008). The country's avoidance of a technical recession and recent improvements in economic activity has given us strong confidence that the RBA would take the lead in moving policy rates upwards. As such, had the official cash rate not been increased at the meeting on Tuesday, it would have been expected to go up early next year or even by the end of this year. Whilst speculation has now turned to whether the RBA is going to move higher on Melbourne Cup Day (November 3), the more interesting question is, why did the RBA move earlier-than-expected?

First and foremost, the 3.00% level was one that the central bank had previously described as an "emergency setting"; and in recent months, the RBA had been giving strong indications that the "emergency interest rate setting" will no longer be appropriate as the economic crisis abates and a recovery gathers pace. For this reason, we feel that the rate hike is merely a shift out of the "emergency monetary policy setting" and that the more important message the RBA would like to convey is for markets to shake off the gloom and to focus on the economic recovery.

Furthermore, the RBA may be seeking to lower the risk of having to move aggressively in the future. Reversing current monetary conditions in a gradual approach would mean that there is less of a need to play "catch-up" when the need to tighten monetary policy arises. Besides, 25 basis points is just right an amount to "test" markets and still give the central bank sufficient room to adjust accordingly in either direction, given that market confidence is still skittish.

In addition, authorities may be increasingly concerned about the stimulatory effect low interest rates are having on housing prices, with first time buyers taking on record levels of debt and becoming more vulnerable to the inevitable rate rises as the RBA returns to more "normal settings" over the next few years. Stevens had highlighted in his statement that "housing credit growth has been solid and dwelling prices have risen appreciably over the past six months." As such, while the RBA fears derailing an economic recovery by hiking rates too fast, it also knows it cannot keep rates too low for too long while inflation runs above official targets.

Latest unemployment figures showed that Australia's jobless rate had fallen for the first time in five months to 5.7% in September from 5.8% previously, vindicating the RBA's decision to start raising interest rates this week. The report showed that the number of full-time jobs gained 35,400 and part-time employment rose by 5,200 in the month. The latest figures echoed the October 6 statement in which Stevens' had pointed out that "unemployment has not risen as far as had been expected".

Nevertheless, we expect that the RBA, going forward, would be keeping a close watch on how households cope after the expiration of the fiscal stimulus and whether the labour market holds up. We also believe that policymakers in Australia would be wary about "premature tightening", especially given that the rest of the world is still either in a recession or that the sustainability of recovery in many economies including itself is still very much in question. The RBA would therefore continue to look out for clearer prospects of recovery in the global front, and at the same time, for a more sustained pickup in growth at home, before it decides to move interest rates aggressively upwards. With that, our projection is for the RBA to hike by another 25bps by the end of this year and subsequently, moving the official rate up "gradually" to 4.00% by the end of the second quarter next year.

	<b>End Q4-09</b>	<b>End Q1-10</b>	<b>End Q2-10</b>
<b>Overnight Cash Rate</b>	3.50	3.75	4.00
<b>AUD/USD</b>	0.90	0.91	0.92

Source: UOB

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