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Flash Notes

Australia: RBA hikes for the third consecutive time

The Reserve Bank of Australia raised its benchmark interest rate by 25bps to 3.75% on Tuesday. In fact, it made history as yesterday was the first time the Bank had lifted interest rates for three successive months since rates were first announced in 1990.

In its monetary statement, RBA Governor Glenn Stevens highlighted that "In Australia, the downturn was relatively mild, and measures of confidence and business conditions suggest that the economy is in a gradual recovery". Although it was acknowledged that the effects of government stimulus were beginning to fade, Stevens added that public infrastructure spending was stoking demand and prospects for business investment were strengthening.

On unemployment, he said that "the rate of unemployment is now likely to peak at a considerably lower level than earlier expected". Recent jobs data in Australia have indicated that total employment rose by 24,500 to 10.832 million in October, seasonally adjusted, after it shot up by 40,600 in September. The unemployment rate has hovered around 5.8% in recent months and even briefly dipped to 5.7% in September. The Treasury has revised its forecasts for the jobless rate to hit 6.7% by late 2010. Earlier this year in May, the Treasury had forecasted unemployment rate to hit a peak of 8.5%.

Australia's economy is indeed growing faster and generating more jobs than the government and the RBA had forecast earlier in the year, helped by Stevens's decision to slash borrowing costs by a record 4.25 percentage points between September 2008 and April to a half-century low of 3 percent. Growth was also boosted in the first half of this year by more than A$20 billion in cash handouts to households from Prime Minister Kevin Rudd's government. Another A$22 billion is being spent on roads, ports and schools. In response to the rate hike yesterday, Australia's Treasurer Wayne Swan said it was "unsurprising" that the bank had again lifted rates. Swan said that "The Australian economy is performing better than just about every other advanced economy, with lower debt, lower deficit and lower unemployment" and that "the consequence of that is rates will rise gradually over time".

The decision by the RBA to raise rates for the third time now comes at a time when major developed nations are emphasizing that interest rates at their side will stay at record lows for some time to come. And whilst a handful in the market were having doubts (prior to the decision) as to whether the RBA would raise rates given the recent Dubai debt crisis which sent both currency and stock markets in a flurry, Australian authorities seemed to be quite unfazed by these problems. In the statement, Stevens said that "Financial markets have improved considerably during 2009, notwithstanding periodic setbacks, and capital flows into Asia and other emerging market regions have been picking up".

Besides, Stevens had repeatedly stated that he only slashed rates to historic-lows for fear of an economic crisis; and since the Australian economy averted a recession and there are signs that conditions have been better-than-expected, such stimulus is no longer needed. These were in similar vein to the concluding paragraph of the statement whereby "With the risk of serious economic contraction in Australia having passed, the Board has moved... to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker".

Yet, the hawkish comments that accompanied the decision sent the Australian dollar lower. Post-RBA saw the AUD/USD trading to lows of 0.9105 yesterday, perhaps because the outcome was in line with expectations and had prompted some profit-taking. Speculation that the RBA may slow its pace of tightening when it comes back next year, were also seen weighing on the currency pair. The board does not meet in January and the next meeting is scheduled for February 2.

A "material adjustment" was what the RBA had described the three rate hikes so far. In spite of this, it offered no guidance for further moves. And we did not seem to get any sense of urgency from its statement that it is in a hurry to move rates upwards. After all, a break in January would mean that the RBA could take the time to access the impact of the three rate hikes on the economy. Furthermore, Stevens had also signaled that gains in the Australian currency would dampen prices for goods and services, implying that Australian policymakers are certainly not worried (for now) that inflation is getting out of control, and are confident that "growth in 2010 is likely to be close to trend and inflation close to target". Consequently, we are looking at rates to be around 4.50% by the first half of 2010. On the Australian currency, we look for the AUD/USD to head higher, trading comfortably above the 0.940-levels by mid-2010, supported by the diverging outlook for policy at home and abroad.

	End Q4-09	**End Q1-10**	**End Q2-10**
Overnight Cash Rate	3.75	4.00	4.50
AUD/USD	0.920	0.935	0.945

* Source: UOB