

Reserve Bank to increase the cash rate twice



The RBA core inflation measure for the September quarter has just been announced at 0.95%.

Our forecast has been that a 0.9%qtr rise in the core measure would be enough to trigger a rate hike on November 7. We have forecast that the November move would not be the end of the cycle, with another 25bp by March 2008. Indeed, we felt that even a 0.8% core result would have been enough to lead to a November hike. Today's number confirms our forecast and we are not changing our view that there is another rate hike to follow the November move.

In fact we think that on balance the risks favour rates going even further than our central forecast of two hikes. Certainly I anticipate that after the expected second hike the market will be looking for higher rather than lower rates..

Because this number was a little higher than we expected, with the weighted median pushing the average to 0.94%qtr (vs f/c 0.90%) we believe that the real issue now is not whether we can expect a second rate hike after November, but whether indeed it could come as early as December. Recall that the very hawkish August Statement on Monetary Policy signalled that the Bank was prepared to follow the August rate hike with one in September. The credit turmoil intervened, and the prudent policy was to wait until the impact of that turmoil was clearer. We now see that the higher funding cost faced by banks and represented by the 90 day bank bill rate's margin over the 'normal' level has contracted from 40bp to 10-15bp. That may not be enough to see the banks pass on a higher rate hike than the 25bp which will come from the RBA in November. Liquidity in the domestic market is now very strong indeed which is assisting those regional banks and non-bank lenders to gain finance at improving levels.

A possible follow up in December.

The other key issue which will affect the Bank's thinking is the global environment. It is becoming very clear that the downturn in the US economy is not spilling over into the developing economies, which are the most important for Australia. We are now forecasting a rise in the terms of trade in 2008, mainly as a result of the expected 30-50% rise in iron ore export contract prices and 25% increase in coal prices. The RBA will look at this prospect as effectively eliminating the most likely external source that could be relied upon to slow demand in Australia, and free up capacity.

We have also seen both political parties adopt a fiscal strategy that will negate the cyclical role of fiscal policy to provide some drag on the economy when growth is excessive. The RBA will now see interest rates as the only weapon to slow the economy in 2008 and take the necessary pressure of inflation. The issue now is really one of whether in view of the fact that the Board does not meet in January, the Bank can wait until February before it moves for a second time on rates.

We at this stage are taking the conservative position that the Bank will wait until February/March given the uncertainties that will dog the US economy. However, customers should give a real probability to a follow up move in December, particularly if the US economy avoids recessionary signals in the next six weeks, as we expect to be the case, particularly after the Fed cuts rates on October 31.

Credit Issues

We do not expect a damaging credit crunch in the Australian housing market. The rebalancing of housing credit supply away from the non-bank securitisation vehicles to the banks is likely to be gradual and smooth. Securitisers are likely to have adequate short term funding; markets are already reopening and secondary market trading indicates that the securitisers can still earn positive margins on their new loans.

Bank bill rates are unlikely to fall much further. Currently they stand around 10ps above "normal" levels. Banks and other lending institutions are looking less likely to pass on these higher funding costs to household and business borrowers.

Customers should be aware that this outlook is not fully priced into the yield curve. Westpac's advisors are available to discuss ways of managing these ongoing interest rate risks.

Bill Evans, Chief Economist ph: (+61 2) 8254 8531