

RBA rate hikes in November & December - peak to be 7.25% in 2008 H1

We expect there is little doubt that the RBA will announce a 0.25% rate hike at 9:30am on November 7 pushing the overnight cash rate to 6.75%.

Last week we wrote, "Don't dismiss November AND December rate hikes". At the time we flagged the possibility of a follow up December rate hike as a "real probability". At the time markets had the probability of a December follow up move at around zero.

Developments over the last week have now convinced us to adopt the December move as our formal forecast.

We also retain our expectation of a further rate hike in first half of 2008 pushing the rate peak to 7.25%, from our previous forecast peak of 7%

We expect the RBA to signal that follow up move with a very hawkish Statement which will be released at the time of the rate hike announcement. That will be followed up by an equally unambiguous warning in the Statement on Monetary Policy which will be released on November 12.

The reasons we gave last week for the December move were:

- We expect the Bank planned a September "follow up" move to the August rate hike but was cautious in light of the credit crisis. Since then the critical bank bill rate has moved to only around 10bps above a "normal" level compared to 45bps at the height of the crisis in August.
- The adoption of the \$34bn in tax cuts by both political parties (Labour \$31bn with \$2.7bn in other spending) effectively neutralises fiscal policy as a source of economic restraint leaving interest rates as the only policy weapon to slow the economy.
- The Bank appeared to be close to raising rates at the April 2007 meeting but waited for the April 23 CPI announcement, which was only 0.5% removing any justification for the hike at the meeting in May.
- The Deputy Governor recently noted in a speech that it was not at all clear that households had reached their limits on household debt and that interest rates have not reached levels that would "bite" on household debt.

- The inflation read of 0.94% in the September quarter pushed annual core inflation to 3%. With a 0.5% core read "dropping off" in the December quarter, annual core inflation is likely to reach 3.3% for calendar 2007 - a situation that can only be accepted if there is clear evidence of a slowing economy and associated downward pressure on inflation.
- Global growth prospects are strong with accumulating evidence that a strong world economy will "cushion" the downturn in the US economy. The 30-50% expected rise in iron ore/coal prices in early 2008 attests to the continuing stimulus from our terms of trade.
- While politics are clearly not a factor for the RBA, a further move in December will emphasise the urgency of the November decision.

Developments in this last week that have convinced us to adopt the December view as our formal forecast are:

- Dwelling approvals surged in September - up by 6.8%, including a 2.5% jump in private sector house approvals. Housing construction has been the one weak spot in the economy - this result, which follows the apparently ineffective August rate hike, is early evidence that housing may also be turning.
- Retail trade for September surged by 0.8%, with third quarter volumes up by 1.9%. That follows equally strong moves in July and August and a thumping 1.6% jump in June. Once again the impact of the August rate hike appears to have been muted. The strength of consumer spending in the September quarter has contributed to our forecast of a very solid 1.1% - 1.3% GDP growth increase for the quarter.
- We have finalised our preliminary forecast for the December core inflation read, at 0.8%. Following 0.9% and 0.94% and replacing 0.5% from the December quarter in 2006, annual core inflation will be pushed to 3.3%.
- Today's guidance from the US Federal Reserve was balanced with the Fed signalling it had adopted a neutral bias. It also noted that "strains in financial markets have eased somewhat on balance".

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141. Information current as at date above. This information has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs. Westpac's financial services guide can be obtained by calling 132 032, visiting www.westpac.com.au or visiting any Westpac Branch. The information may contain material provided directly by third parties, and while such material is published with permission, Westpac accepts no responsibility for the accuracy or completeness of any such material. Except where contrary to law, Westpac intends by this notice to exclude liability for the information. The information is subject to change without notice and Westpac is under no obligation to update the information or correct any inaccuracy which may become apparent at a later date. Westpac Banking Corporation is regulated for the conduct of investment business in the United Kingdom by the Financial Services Authority. If you wish to be removed from our e-mail, fax or mailing list please send an e-mail to economics@westpac.com.au or fax us on +61 2 8254 6934 or write to Westpac Economics at Level 2, 275 Kent Street, Sydney NSW 2000. Please state your full name, telephone/fax number and company details on all correspondence. © 2007 Westpac Banking Corporation. Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

The major risk to our December call will be the action of the banks following the November 7 rate hike. Opinion is divided as to whether the banks will "pass on" a larger rate increase to reflect a structural increase in funding costs. If the markets deliver effectively more than one hike in early November the Bank may choose to wait for the New Year to assess the impact of, say, a 40bp tightening. However, that would be a calculated gamble given the range of arguments set out above and probably still not enough to convince the Bank that the outcome of "extreme regret" (intractably high inflation) could be averted.

Readers will note that we still expect a further move in the first half of 2008. Our judgement of global and domestic momentum is such that even two consecutive moves will not be enough to settle the Bank's concerns. Certainly, if we are correct with our "early" December quarter CPI call and our global view the Bank will continue to be unsettled when the January 23 inflation measure prints.

This interest rate call has implications for the Australian dollar. Due to markets not expecting the December move further stimulus to the AUD can be expected. Off the current base of US93¢ we would expect the AUD to be boosted to US96¢ in March. That "peak" can be expected to be sustained through early 2008 with steady US rates giving the US dollar some stability.

Bill Evans, Chief Economist

Economic & financial forecasts

Interest rate forecasts

	Latest (Nov 1)	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
Cash	6.50	7.00	7.25	7.25	7.25	7.25
90 Day Bill	7.04	7.45	7.40	7.40	7.40	7.35
3 Year Bond	6.79	6.90	7.10	7.10	6.90	6.80
10 Year Bond	6.26	6.50	6.60	6.60	6.50	6.40
10 Year Spread to US (bps)	167	180	200	190	170	150

International

Fed Funds	4.75	4.50	4.50	4.50	4.50	4.75
US 10 Year Bond	4.49	4.70	4.70	4.70	4.80	4.90
ECB Repo Rate	4.00	4.00	4.00	4.00	4.00	4.00

New Zealand

Cash	8.25	8.25	8.50	8.75	8.75	8.75
90 day bill	8.62	8.65	8.75	9.00	9.00	8.95
10 year bond	6.37	6.40	6.25	6.30	6.50	6.60
10 year spread to US	200	170	155	160	170	170

Exchange rate forecasts

	Latest (Nov 1)	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
AUD/USD	0.93	0.95	0.96	0.93	0.92	0.91
NZD/USD	0.7641	0.78	0.80	0.81	0.81	0.79
USD/JPY	114.26	115	114	113	112	110
EUR/USD	1.4338	1.44	1.46	1.44	1.43	1.42
AUD/NZD	1.20	1.21	1.20	1.15	1.14	1.15

Australian economic growth forecasts

% change	2006		2007		2008			Calendar years			
	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	2005	2006	2007f	2008f
GDP	1.1	1.6	0.9	1.1	1.1	1.1	1.1	2.8	2.7	4.5	4.5
Annual chg	3.0	3.8	4.3	4.9	4.8	4.3	4.5	-	-	-	-
Current Account AUDbn	-15.4	-15.5	-16.0	-16.8	-17.0	-16.7	-16.1	-54.0	-55.1	-65.5	-63.0
Unemployment Rate	4.6	4.5	4.3	4.1	4.2	4.2	4.2	5.1	4.8	4.3	4.1
CPI Headline	-0.1	0.1	1.2	0.7	0.5	0.6	1.1	-	-	-	-
Annual chg (yr end)	3.3	2.4	2.1	1.9	2.5	3.1	2.9	2.8	3.3	2.5	3.0

New Zealand economic growth forecasts

	2007				March financial years			Calendar years		
	Q1	Q2	Q3e	Q4f	05/06	06/07	07/08f	2006	2007f	2008f
GDP % qtr	1.2	0.7	0.7	0.6	-	-	-	-	-	-
Annual avg change	1.7	2.2	2.8	3.1	2.7	1.7	3.3	1.7	3.1	3.4
Unemployment rate %	3.7	3.6	3.5	3.4	3.9	3.7	3.2	3.7	3.4	3.0
CPI % qtr	0.5	1.0	0.5	0.8	-	-	-	-	-	-
Annual change	2.5	2.0	1.8	2.8	3.3	2.5	3.3	2.6	2.8	2.9

Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.