Interest rates coming down sooner than previously expected

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Since August last year the Reserve Bank has been quite explicitly and deliberately seeking to induce a slowdown in Australian domestic spending, which through 2007 had grown at an unsustainably rapid pace of almost 6% in real terms, in order to contain and subsequently reverse what was emerging as a worrying upward trend in Australia's inflation rate.

To that end, the Reserve Bank lifted the official cash rate four times, by a total of 1 percentage point, to 7.25%, its highest in a decade; and would have done even more had it not been for the fact that the interest rates actually paid by borrowers rose by a further 0.5-0.9 of a percentage point, as banks passed on some of the higher funding costs flowing from the global 'credit crunch' triggered by the melt-down in the US sub-prime mortgage market.

In recent months it has become increasingly clear that these measures, compounded as they have been by rising fuel prices (which have a similar economic impact to higher interest rates), falling share prices and heightened uncertainty around the outlook for the global economy, have had the effect which the Reserve Bank had intended. Domestic spending has slowed, in some areas quite sharply. Adjusted for price movements, retail sales have fallen in the first half of the year. Motor vehicle sales are slowing. Residential building activity is declining. Real estate prices are no longer rising, and indeed in some cities have actually softened slightly. Households appear to be saving a good deal of the most recent round of income tax cuts, or using some of them to repay debt.

The economic news isn't uniformly bad. Exports are now rising strongly, particularly as a result of the huge increases in coal and iron ore prices negotiated earlier this year, so that Australia is now beginning to run a trade surplus for the first time since 2001. And although the unemployment rate has begun to rise marginally, it remains very low by historical standards, and there is no evidence of the widespread job-shedding that occurred during the early 1990s. Nor is this a likely prospect, given that the business sector as a whole is in a much stronger financial position than it was heading into the last major downturn, and that employers are well aware that the ageing of Australia's population means that labour shortages will remain a key challenge over the medium to long term.

Nevertheless, now that the Reserve Bank has achieved its interim objective of slowing the rate of growth in household spending to something consistent with the available capacity of the Australian economy, it can now be more confident that inflation, though still likely to be uncomfortably high in the near term, will head back towards the 2-3% target range over the next couple of years.

As a result, we can now conclude that interest rates have peaked, and that a downward trend in interest rates will begin very shortly. Indeed, the Reserve Bank has signalled that it will likely lower the cash rate in September – we expect by 0.25 of a percentage point - and that a further reduction can be expected before the end of this year. Assuming, as seems plausible (especially given that oil prices are also declining), that the inflation rate will begin to ease during 2009, interest rates will likely fall by a further 0.75-1.0 percentage point next year.

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