

Australia Central Bank Says Room to Cut Interest Rate **(Update1)**

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Aug. 11 (Bloomberg) -- Australia's central bank says it will have more room to cut interest rates because a "significant moderation" in domestic demand will slow inflation, cut economic growth by half and drive up unemployment.

"Economic growth will be fairly slow in the period ahead," the Reserve Bank of Australia said in its quarterly policy statement released in Sydney today. Gross domestic product will probably expand 2 percent this year compared with 4.3 percent in 2007 and less than the 2.25 percent forecast in May.

Today's statement suggests Governor Glenn Stevens will ignore a spike in the inflation rate to prop up an economy buffeted by weaker domestic spending and falling house prices. Stevens, who left the benchmark rate unchanged at a 12-year high 7.25 percent last week, says consumer prices will peak in the fourth quarter, before falling below 3 percent by mid-2010.

"It confirms there's scope for an easing cycle to begin, most likely in September," said Su-Lin Ong, senior economist at RBC Capital Markets Ltd. in Sydney. "I don't think there's anything in there that suggests a more aggressive move.

"Part of the reason there isn't a green light for a 50-basis point cut is that the inflation forecast numbers have been revised up for the near term."

The Australian dollar dropped to 88.65 U.S. cents at 1:02 p.m. in Sydney from 88.72 cents before the statement was released. The two-year government bond yield fell 2 basis points, or 0.02 percentage point, to 5.92 percent.

Scope to Cut

The currency has declined 10 percent against its U.S. counterpart since reaching a 25-year high of 98.49 cents on July 16 on speculation the Reserve Bank will cut borrowing costs as soon as next month.

"On the assumption that the subdued demand conditions are likely to continue, scope to move to a less restrictive monetary policy stance in the period ahead is increasing," the bank said today. Stevens expects a "significant reduction in inflation over time."

Inflation is forecast by the bank to peak at 5 percent in the fourth quarter, compared with the 4.5 percent predicted in the May statement, before slowing to 2.75 percent in 2010.

The bank aims to keep annual gains in consumer prices between 2 percent and 3 percent on average. They rose 4.5 percent in the second quarter.

Today's statement said "demand pressures in the economy now appear to be easing" and it expects a "significant period" of slower growth.

Bank's Dilemma

"The Reserve Bank is grappling with high inflation and weakening growth," said Tom Kenny, chief economist at Nomura Australia Ltd. in Sydney. "Growth is slowing a bit faster than they anticipated three months ago."

There are risks to the bank's inflation forecasts "in both directions," today's statement said.

While the second-quarter consumer prices index report suggested "quite tentative" evidence inflation pressures may no longer be rising, income from Australia's trade boom could stimulate domestic spending and leave "inflation expectations entrenched at unacceptably high levels," the statement said.

Demand for coal and iron ore from China has boosted Australia's terms of trade, a measure of export income, by 20 percent this year, taking the increase in the past five years to 65 percent, the bank said. "The income gains from this source continue to represent a significant stimulus to the economy."

Policy makers raised the benchmark interest rate in March, February, November and last August amid concern the lowest unemployment in more than three decades would drive up wages and inflation.

Consumer Confidence

Stevens and his board will cut the overnight cash rate target by at least 25 basis points to 7 percent when they meet on Sept. 2, according to 18 of 25 economists surveyed by Bloomberg last week. Five predict a 50 basis point reduction and seven expect no change.

The economy will probably grow 2.5 percent in 2009 and 2.75 percent in 2010, today's statement predicts. It expanded 0.6 percent in the first quarter, the slowest quarterly pace in almost two years. Second-quarter gross domestic product figures will be released on Sept. 3.

Consumer confidence slumped in July to the weakest level in 16 years and home-loan approvals tumbled in June to a four-year low.

The bank also said "any further deterioration in the outlook for global growth would present a significant downside risk" to Australia, "particularly if it led to a marked slowing in growth in China and India."

Market Turmoil

“In addition, the ongoing turmoil in capital markets could exacerbate the slowing in domestic growth by further reducing the availability of credit to households and businesses,” it said.

The Reserve Bank said investment in the housing market is “expected to contract over the next year.”

House prices fell in the second quarter for the first time in almost three years.

Demand for labor will continue to ease, the bank said. Australia's jobless rate was 4.3 percent in July, up from 3.9 percent in February, which was the lowest since 1974.

Source: Jacob Greber