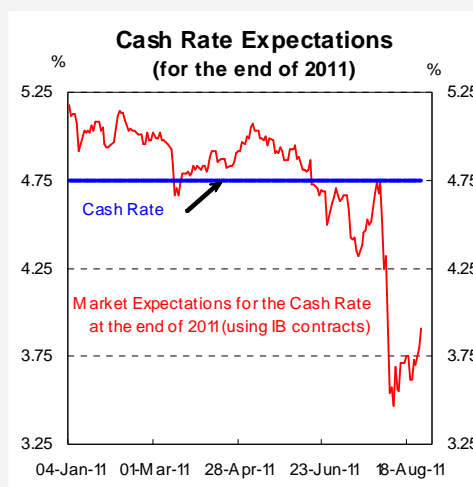
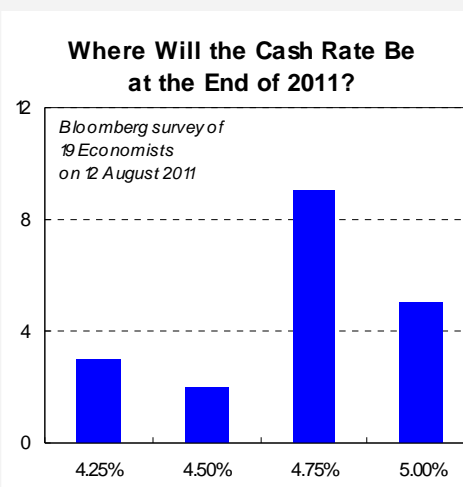


THE CASH RATE OUTLOOK

Glenn Stevens' Testimony to Parliament

Tuesday, 16 August 2011

- There were no big surprises in Glenn Stevens' testimony to Parliament; it maintained a neutral tone consistent with recent RBA commentary.
- The RBA still appears quite concerned about the inflation outlook. It remains worried about rising unit labour costs combined with poor growth in productivity in recent years. At the same time, it recognises the potential downside risk to inflation as a result of recent market turmoil.
- Given the balance of risks, we remain comfortable with our view that rates will remain on hold till the end of the year, with some risk that the next move will be a cut.
- Stevens made comparisons with the recent market volatility and the GFC, and noted that the market turmoil currently was less pronounced. He also said that, "what we have witnessed is best seen not so much as a new crisis, as part of the long aftermath of the 2008 crisis."



There were no big surprises in Glenn Stevens' testimony to Parliament; it maintained a neutral tone consistent with recent RBA commentary. There continued to be recognition of the downside risks facing the global and domestic economy, and Stevens' also highlighted the potential downside risk recent market turmoil will have on growth. However, concerns about inflation remain.

Stevens made comparisons with the recent market volatility and the GFC, and noted that the market turmoil currently was less pronounced. Stevens has said that, "what we have witnessed is best seen not so much as a new crisis, as part of the long aftermath of the 2008 crisis." Credit and money market conditions were also much better. Stevens noted that, "funding costs had if anything declined", although in our opinion, this is also owing to expectations of RBA rate cuts. However, there was also "no abnormal demand for liquidity by financial institutions from the Reserve Bank."

That being said, in regards to the global outlook, "economic recovery would be a drawn out affair" and that "the global growth outlook does not look as strong as it did six months ago, even though it is not necessarily as weak as some of the pessimists fear." In the question and answer section, he mentioned that anxiety over the Euro zone might remain for a few years.

On the Asian economy, the RBA remains positive about growth prospects, including China.

On the domestic front, Stevens again talked about the multi-speed nature of the economy.

The stimulus the high terms of trade was still having a positive impact on incomes, business investment and that it “still has quite some distance to run.” The RBA estimates that about 50-60% of the increase in the terms of trade would be of benefit to the Australian economy through domestic wages, new hires and expenditures.

Stevens however, talked about the weaker areas of the economy such as those sectors that are being weighed down by the high Aussie dollar and also the household sector. Stevens recognised the heightened caution by consumers and that it would be likely to continue given recent financial turmoil. Stevens also said however, “it is important not to overstate the degree of caution,” given that some areas of household spending is growing strongly such as overseas travel.

While the RBA recognises there is greater uncertainty to the outlook, it remains quite positive about Australia’s prospects given the record high terms of trade, low unemployment, strong banking sector, sound currency and enviable sovereign debt position.

Rates Outlook

As in recent commentary, the RBA still appears quite concerned about the inflation outlook. It remains worried about rising unit labour costs combined with poor growth in productivity in recent years. At the same time, it recognises the downside risks facing the economy. Indeed, Stevens talked about downside risks to the RBA’s most recent growth and inflation forecasts published in the August Statement of Monetary Policy, and said that, “It would be reasonable to anticipate that a decline in confidence from recent events internationally may well dampen demand somewhat”. This would in turn, lessen pressure on inflation.

Given the balance of risks, we remain comfortable with our view that rates will remain on hold till the end of the year, with some risk that the next move will be a cut. After Stevens’ testimony, markets are now pricing in less rate cuts from the RBA than previously.

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