

CASH RATE OUTLOOK

RBA Board Minutes: RBA in the Chess Game of Europe 15 Nov, 2011

- It is clear the two overwhelming factors in the Reserve Bank's recent rate cut decision were the lower inflation outlook and the increased downside risks to the global economy from European developments. The combination meant the RBA determined a more neutral stance was warranted for the cash rate, which paved the way for the rate cut on Melbourne Cup day.
- The language of the minutes did not shout out that the recent rate cut is the start of a long series of rate cuts or a deep cutting cycle. But nor can we rule it fully out if Europe implodes under its own weight.
- Our core view remains that the RBA will follow up with another rate cut in February next year and then keep rates steady thereafter, but as Europe continues to deteriorate the risks will grow for a deeper or longer easing cycle from the RBA, which could include a rate cut being brought forward to December.
- Much of the rate outlook depends on developments in Europe and the knock-on impact to the rest of the world economy, particularly Asia. Forecasting Europe is subject to considerable variability, given much of the forecasting involves politics. But one thing is clear – downside risks continue to dominate.

The two overwhelming factors in the Reserve Bank's rate cut decision on November 1 were the lower inflation outlook and the increased downside risks to the global economy. The combination meant the RBA determined a more neutral stance was warranted for the cash rate, which paved the way for the rate cut on Melbourne Cup day.

On inflation, the introduction of the new CPI series (with new seasonal factors and weights) meant inflation was lower than expected. The lower starting point together with (modest) downward revisions to output growth meant underlying inflation was expected to be consistent with the inflation target (replacing previous forecasts that expected underlying inflation to breach the inflation target for much of the forecast horizon).

The RBA state that the general outlook for inflation – of one which is expected to be consistent with the target – is conditional on aggregate wages growth remaining at around its current pace and a pick-up in productivity growth. The latter is tenuous and suggests unless Europe continues to deteriorate, a deep easing cycle are long odds.

On Europe, the RBA note that the presence of funding pressures with short-term funding costs characterised as relatively high and unsecured borrowing in euros closed for most borrowers. And perhaps more importantly for the RBA's agenda, there are "some early signs that the slowing in some advanced economies was having an impact" on the Asian region, most evident in exports.

The RBA characterises the risks to the global economy as "predominantly on the downside". This view is largely because it sees economic conditions in Europe weakening further over the period ahead, "given the effects of the recent turmoil on confidence, likely tightness of the credit supply and the need for further fiscal consolidation". The RBA notes the marked downward revision to the OECD's growth forecasts for the euro area in 2012 from 2% down to 0.3%.

Our core view remains that the RBA will follow up with another rate cut in February next year and then keep rates steady thereafter. The Board leaves the door open for further rate cuts by not describing the policy stance as now neutral but as being at "a more neutral setting". It won't take much more easing to get to neutral. But as Europe continues to deteriorate the risks will grow for a deeper or longer easing cycle from the RBA, which could include a rate cut brought

forward to December.

Much of the rate outlook depends on developments in Europe and the knock-on impact to the rest of the world economy, particularly Asia. Forecasting Europe is subject to considerable variability, given much of the forecasting involves politics. But one thing is clear – downside risks continue to dominate. So another rate cut remains on the agenda.

Besa Deda, Chief Economist

Ph: (02) 9320-5854

Contact Listing

Chief Economist	Besa Deda	dedab@stgeorge.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@stgeorge.com.au	(02) 9320 5751
Economist	Janu Chan	chanj@stgeorge.com.au	(02) 9320 5892
State Manager SA	Mark Goldsmith	goldsmithm@banksa.com.au	(08) 8424 5597

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