

RBA Stevens comfortable with slowing growth

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RBA Governor Glenn Stevens today made his semi-annual appearance before the Parliamentary Committee on Economics, Finance and Public Administration. This includes a prepared opening statement and an extended Q & A session. Key points to note are below.

Monetary policy

- Stevens confirmed that if banks had not moved rates independently of the RBA, then the official cash rate would now be higher than it currently sits.
- Stevens comments were consistent with our view that the official cash rate has peaked in the current cycle. Stevens believes that domestic demand is moderating, and we received more evidence of this in today's weak retail sales figures for February.
- However, Stevens also warned that he couldn't promise that the official cash rate would not rise again and that he could not give any indication of when rates would start to come down.
- Together with comments that it would take some time for inflation to come down (see below), this suggests that current market pricing for a rate cut by the end of 2008 is a little premature.

Inflation and economic growth

- Stevens acknowledged that inflation will be even higher in the March quarter at around 4%.
- However, this is unlikely to trigger a rate hike in the near term. Upon questioning Stevens stated that inflation is "not out of control" Moreover, Stevens now more definitively believes "*demand growth in Australia is now in the process of moderating*" due to a combination of "*a tightening in financial conditions, lower share prices and heightened concerns over the global financial problems*" This will help to put downward pressure on inflation over time.
- In addition, the RBA's inflation (and growth) forecasts are likely to be revised down from those published in the February *Statement on Monetary Policy* as these did not incorporate the February nor the March rate hikes.
- That said, Stevens also warned that the forecast slowdown in inflation (and growth) will be gradual and take some time. He could not "credibly say" that inflation would ease quickly. This is consistent with our forecasts, which suggest that inflation will not return to within the target band until around mid 2009.
- Upon questioning, Stevens stated that a slowdown in economic growth will not necessarily lead to a sharp rise in the unemployment rate, although this depends to some extent on the flexibility of the labour market. This is consistent with our view that the rise in the unemployment rate will be gradual, particularly in the presence of labour hoarding.

Global economic outlook

- Growth in Australia's trading partners is likely to be below average in 2008. Stevens believes the "international environment remains very difficult" with growth in the US and to a lesser extent in

Europe and Japan likely to be weak. Growth is likely to slow more moderately in the developing world, with economic conditions to date "quite solid".

- However, Australia will continue benefiting from higher contract prices for iron ore and coal. The RBA expects this to boost Australia's terms of trade by 15% although this seems to be a conservative forecast.
- The Australian economy therefore is caught between two powerful cross-currents: *"the biggest terms of trade boom for 50 years is coinciding with one of the most serious malfunctions in developed country capital markets for a long time."*

Higher bank funding costs

- The Governor was comfortable with banks recouping their higher funding costs by raising rates to end borrowers as it ensures that credit is still accessible through the banking system: *"this outcome is preferable to the alternative of lending drying up."* While Stevens did say that *"the Board is also conscious that some non-price tightening of credit conditions is probably occurring at the margin"*, this does not seem to be of particular concern at this stage.
- Deregulation of the banking system is thus a better model than one in which bank lending rates are controlled or capped; in this situation, higher funding costs would simply have prompted banks to stop lending.
- Stevens also reminded us that while margins above the cash rate have now increased, this has followed an extended period in which margins had been squeezed.

Fiscal policy

- Stevens said very little about the outlook for fiscal policy, other than to say that well-calibrated fiscal policy seems a difficult task in his opinion.

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