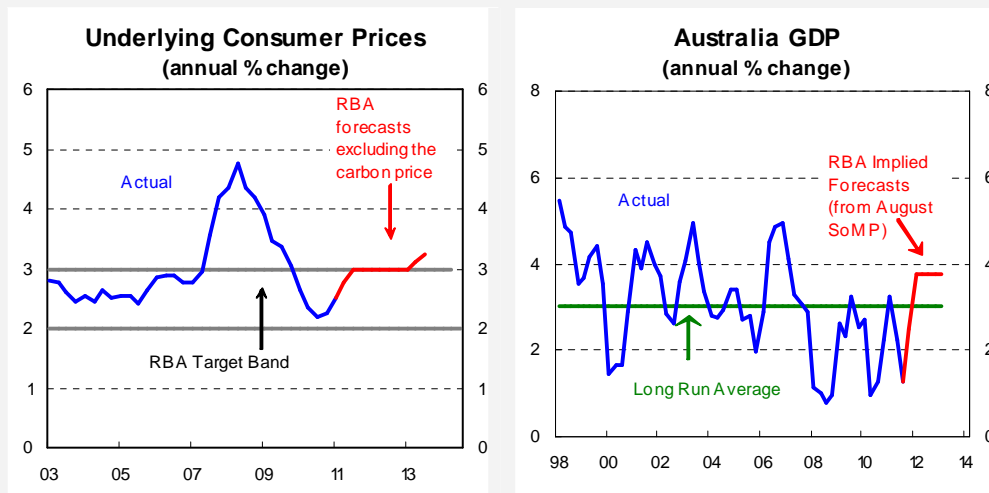


DATA SNAPSHOT

Monetary Policy Statement: Uncertain Times

Friday, 5 August 2011

- The RBA has downgraded its near term economic growth forecasts but the economy is still expected to grow above trend for much of the forecast period.
- The RBA's underlying inflation forecasts to 2013 contain a 3 in front, suggesting little breathing room for inflation. On these forecasts and on considerations of the domestic economy alone, the RBA would be prudent to maintain a tightening bias.
- But uncertainty is gripping financial markets and threatening the global economy. It means the RBA won't be tightening policy any time soon. Indeed, a continuation of the carnage in global markets and a further deterioration in global sentiment could open the door for rate cuts.
- We are maintaining our view that the RBA will keep rates steady this year, but we are monitoring developments in the world economy and financial markets closely.



The flavour of the Statement on Monetary Policy was similar to the Statement published after this week's Reserve Bank (RBA) board meeting. The notable changes were the downgrades to GDP growth and upgrades to inflation in the nearer term. These changes, however, were hinted in previous rhetoric from the Bank.

GDP growth was cut in the near term forecasts while underlying inflation excluding the carbon price was raised. For much of the forecast horizon, GDP growth will be above trend and underlying inflation will have a 3 in front.

On domestic economic conditions alone, these sorts of forecasts suggest a risk of a tightening over the forecast period from the RBA. But the RBA cannot change policy without considering the world economic outlook. The "acute sense of uncertainty in global markets" is making policy decision making harder for the RBA. The RBA notes that it considered tightening rates at its board meeting this week. But the heightened downside risks to global growth contributed to them sitting pat.

Cash Rate Outlook

The RBA notes that downside risks to the world economy continue to increase. Further, the turmoil in financial markets overnight has resulted in sharp moves in financial markets,

which have included deep falls in equity markets.

We think that if the carnage in global markets continues and the concerns about debt in Europe and the US continue to escalate, then these downside risks will result in a slower pace of world growth. The risk then could become of an RBA cutting rates not hiking.

Our view for some time now has been for steady rates for 2011. We continue to hold this view but will be monitoring the world economy and global financial markets closely.

Domestic Economic Conditions – The Detail

On the inflation front, the RBA highlighted the pick up in underlying inflation and stated that, “it appears that the period of disinflation has passed.” The RBA also raised the issue of poor productivity growth and a factor behind the pick up in unit labour costs.

As flagged previously, the forecasts for growth have been downgraded significantly for the year ending June 11 and December 11. The downgrade partly reflect a larger than expected contraction recorded for Q1 GDP. However, the RBA has indicated that the downgraded forecast was also owing to coal production taking longer to recover fully and slower than expected growth in consumption.

The RBA has included two separate inflation forecasts, one that includes the impact of the carbon price and one without. The inflation profile that includes the carbon price has underlying inflation above the RBA’s 2-3% p.a. target band for much of the forecast period.

Reserve Bank Forecasts as at 5 August 2011
(Previous forecasts are in brackets)

	Year Ended, %					
	Jun-11	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13
GDP Growth	(2.50) 1.25	(4.25) 3.25	(4.25) 4.50	(3.75) 3.75	(3.75) 3.75	(3.75) 3.75
HeadlineCPI Excl Carbon Price	(3.50) 3.60	(3.25) 3.50	(2.50) 2.50	(3.00) 3.00	(3.00) 3.00	(3.25) 3.25
Headline CPI Incl Carbon Price	3.60	3.50	2.50	3.50	3.75	3.25
Underlying CPI Excl Carbon Price	(2.50) 2.25	(3.00) 3.25	(3.00) 3.00	(3.00) 3.00	(3.00) 3.00	(3.25) 3.25
Underlying CPI Incl Carbon Price	2.75	3.25	3.00	3.25	3.00	3.25

However, the RBA has stated it would look through any “once-off effects from the introduction of a price on carbon.” This suggests that the RBA will be looking at underlying inflation, which excludes the carbon price impact. When excluding the carbon price, the inflation forecasts remain little changed from the previous Statement on Monetary Policy (published in May), with some slight upward revisions for June and December 2011.

The RBA continued to talk about the multi-speed nature of the domestic economy as in much of their recent commentary.

The strengths in the economy include the mining sector, which is benefiting from the high terms of trade, and a number of service industries. The large amount of expected investment in the mining sector was beginning to transpire with construction having already commenced or due to commence this year for many LNG projects. Strong growth in import volumes for capital and intermediate goods were reflecting the pick up in mining investment.

The outlook for the farming sector was also favourable. Higher than average rainfall has seen crops improve for winter crops and summer crop production is “estimated to have risen to the highest level in almost a decade.”

The RBA however also mentions those areas of the economy that are not faring so well. The main risk factor for the RBA within the domestic economy is the household sector. Indeed, it appears to be one of the two major factors for the downgrade in its near-term growth forecasts, suggesting that the caution in consumer spending is much greater than expected. The RBA, however, expects consumption growth to “strengthen gradually over the forecast

period”.

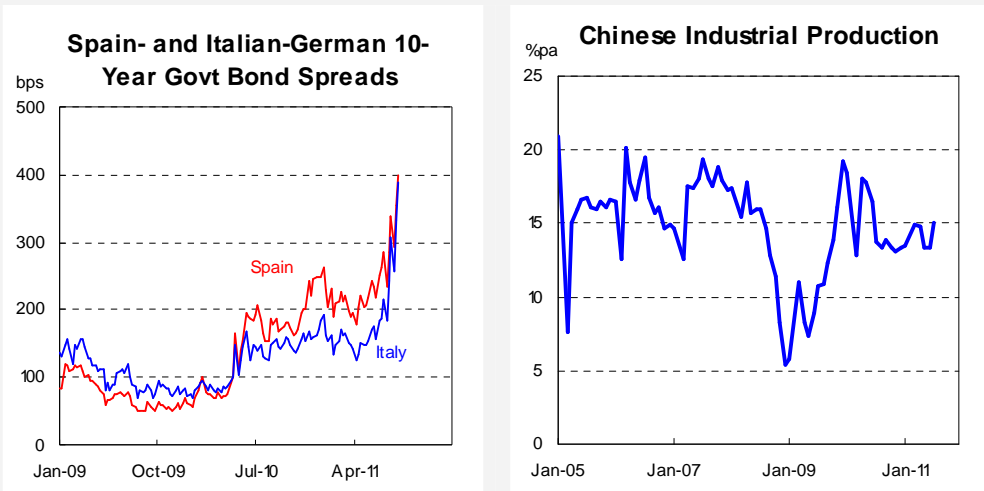
The high AUD was also impacting negatively on manufacturing, tourism and education.

The RBA has noted the slowdown in employment growth from the rapid pace seen throughout 2010, but that jobs growth remained firm. The RBA continues to expect moderate growth in employment, as suggested by leading indicators.

Labour cost growth was firm and consistent with a relatively tight labour market. Private-sector wage growth was above average, although public-sector wages had slowed and was likely to slow further. The strongest wage growth was experienced in Western Australia, and by industry, in mining and professional, scientific and technical services industries.

International Economic Conditions – The Detail

The RBA notes that the global economy is continuing to expand, but the pace of growth has slowed. Conditions also vary significantly across the regions. However, the RBA notes that the downside risks to world growth are “prominent”. Concerns about sovereign debt in the US and Europe continue to weigh on global sentiment. We cannot be certain that the turmoil overnight was incorporated in today’s Statement on Monetary Policy. So these downside risks flagged by the RBA could be more considerable than reflected in the Statement.



These concerns have caused risk aversion among investors to spike to its highest level since mid 2010. The heightened risk aversion has led to turmoil in global markets of a nature not seen for some time. This turmoil has included significant falls across global share markets. The Australian share market has followed suit, falling by nearly 4% to a two-year low in trade at the time of writing. The concerns have also caused deep falls in government bond yields and commodities ex gold. Further, there have also been sharp shifts in currencies globally.

Spreads in the peripheral economies of Europe that are at the height of the worries have also blown out. Among the big economies, Europe’s weakest link is Italy. Anxieties over Italy’s economic future have led many to consider what a possible default in Italy would mean for Europe and beyond. The European Union, the IMF and the European rescue fund do not have enough money to bail Italy out. The risk is of a domino effect to other countries and the banking sector. Borrowing costs in Italy have risen sharply to post-euro highs.

The RBA sees growth in Asia as “robust”, particularly in China. A global slowdown, however, would not leave Asia or Australia immune, but Asia and Australia are in an envious position and are likely to be cushioned from the worst of it.

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