

# RBA GOVERNOR'S TESTIMONY

Friday, 14 August 2009

## Summary

- Testimony from the RBA Governor leads us to continue to expect the RBA to start raising rates in early 2010.
- A rate hike this year still can't be fully ruled out; much will depend on the data outcomes in coming months.
- We think the cash rate will be at 4% by the end of June next year; this rate is still stimulatory.

The Reserve Bank Governor Glenn Stevens gave semi-annual testimony to Parliament earlier today. His testimony repeated much the same message that was delivered in last week's Statement on Monetary Policy. Stevens reiterated that conditions "look distinctly better than they did a few months ago". He noted that conditions in international financial markets continue to improve and that while occasional reversals have occurred, each time the improving trend has resumed. Further, Stevens said "really large contractions in major countries' GDP are now behind us and that global output is leveling out". Stevens also continued to highlight the resilience of the Australian economy by describing the economy as "stronger than expected a few months ago".

The questions-and-answers session following the testimony provided newer information. Here are some of the key messages from this session.

- On Australian economic activity, Stevens said it was possible that Australia could record quarterly GDP contractions in the next couple of quarters. But he still sees a good prospect of recovery toward the end of this year.
- As for the exact timing of future cash rate moves, the RBA did not give a lot away. Stevens said that he did not want to give a particular steer on when any change of policy might happen. Stevens told parliament that "on the timing of when we adjust policy, that's an issue about which one keeps an open mind at this point".
- But clues on the outlook for the cash rate were given when Stevens said the current cash rate setting is the lowest in 40 years and was put in place in anticipation that the economy "would be seriously weak, and that there were very real risks to the downside". Stevens went on to say that "as the set of risks that you think face start to shift...at some point you are going to have to make a response to move away from the emergency setting". We think the risks facing the Australian economy are changing; they certainly have changed significantly over the last six months with the Australian economy performing better than expected by the RBA and the economics fraternity.
- The 'neutral' or 'normal' rate of policy came up again today. The neutral rate is the cash rate that neither applies brakes or stimulus to the economy. The Governor said that he prefers not to give a point estimate for the neutral rate. But he did say that normal policy is a "good deal north" of where the cash rate is now (at 3%). We at St.George think the neutral rate is somewhere in the region of 5.25-5.50%, although it can move around.
- On employment, the Governor said that the peak in the unemployment rate was likely to be noticeably lower than the federal budget's estimate of 8.5%. We at St.George think the peak will be closer to 7.5%; when the global credit crisis first began we thought the peak may be 8-9%, but it has increasingly become clearer that greater labour market flexibility and a more resilient economy is helping temper the rise in the unemployment rate.

Overall, today's testimony and remarks from the Governor did little to deter financial markets or us from expecting the next move in the cash rate to be higher. The fact that the Governor did little to dispel market expectations for a rate hike suggests to us that the RBA is preparing for a rate hike, but waiting for the best appropriate time to start hiking rates. We think this time will be early next year. While the Governor continued to show cautious optimism for the Australian economic outlook, he also outlined some risks in the next few quarters. For example, he did not rule out contractions occurring in Australian economic activity for the next few quarters. So we think the most likely timing remains early next year unless the flow of economic data in coming months firms up the case for a rate hike later this year. We think the cash rate will be at 4% by the end of June next year and the at least 5% by the end of next year.

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