*This ING DIRECT economic analysis draws together recent economic events with forward looking analysis to provide insight to likely future direction of interest rates for both home loan borrowers and savers especially term deposit investors.*

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## Economic Analysis

The past six months have been dominated by financial events in Europe, although this could be viewed as a story in two halves.

During the December quarter the European crisis was perhaps at its most intense, with considerable speculation the EUR currency group would dissolve in a disorderly manner. The March quarter, in contrast, witnessed a number of positive developments that culminated in breaking the negative sentiment which heavily influenced markets during the December quarter.

**In particular**
- The successful completion of negotiations to release further funding assistance to Greece;
- Agreement from bond holders to restructure their Greek debt obligations; and
- Agreement across a number of countries to introduce measures to address fiscal imbalances.

While none of these measures or agreements were new or unexpected, in fact a number had been on the table for several months, the real accomplishment was reaching agreement such that they could be finalised.

A key contributor to the change in sentiment was also the successful 3 year re purchase transaction executed by the European Central bank in December. This effectively alleviated the near term funding pressures facing a number of banks. A further transaction was undertaken at end February. If market conditions require there is scope for a third repo to be executed into the June quarter.

Some commentators argue this assistance, simply, puts off the inevitable for 3 years.

In contrast, we suggest that this provides the markets with a necessary circuit breaker to buy time for the combination of measures to have a positive impact on broader financial markets. While there is a risk it may come to same failed outcome, it was necessary to allow time for the other measures to have an impact.

## Electoral cycle and Implementation risks

The implementation risks on the European rescue and reform packages are formidable.

Across Southern Europe as a whole, nations are being forced to introduce significant fiscal reforms, which have grown out of historical excesses, in a very condensed timeframe. This is leading to social unrest.

Combined with the electoral cycle in these countries, the political landscape is shifting to right wing nationalist parties. If these parties are successful, the implementation risks surrounding these austerity programs will be escalated.

## Broader Global Growth Considerations

In contrast to the bleak growth that appears likely for Southern Europe in particular and Europe more broadly, growth prospects on the other side of the Northern hemisphere have brighten considerably over the past several months.

A wide range of US economic indicators have surprised to the positive over the period. Importantly, it appears employment data has begun to improve, with potential positive flow on effects to consumer sentiment and spending.

Despite these early positive indicators the recovery in the US remains fragile; however, it is gaining momentum at each turn.

Growth in Asian economies has been, to date, little impacted by European events. To ensure their economy remains on a solid platform of 7-9% growth, Chinese officials have eased monetary policy via adjustment to required reserves.

As the rebuilding efforts gather momentum in Japan, the increased activity is expected to be reflected in growth number over the first half of 2012. Despite this improvement recovery in Japan will still be hampered by fiscal imbalances.

Commodities prices, since the beginning of the year, appear to turned and broken a clearly defined downtrend evident from the second quarter of 2011.

## Australian Growth Considerations and Implications

Despite the global volatility over the second half of last year, domestic economic growth remains on track.

Reflecting the weakness in Europe consumer and business confidence eased into year end. Employment was flat over calendar 2012.

Resources and related sectors continued to outperform other sectors of the economy. The number of major new projects, and the quantum of funds invested continues to increase at a solid pace.

Although the retail sector struggled in 2012, broader measures of consumer spending recorded reasonable growth.

Inflation remains well contained and provides scope for the RBA to further adjust rates should domestic demand conditions unexpectedly deteriorate.

Australia will continue to enjoy impressive growth in actual, and especially, comparative terms. While the Europe and the US are expected to grow at below trend levels, Australia will continue to evidence above trend growth driven by ongoing demand from Asia and a recovering US economy.

Clearly, the high level of the exchange rate is impacting those non resource related industries subject to import competition.  This is part of the fundamental shift that is occurring in the economy as the impact of the resources boom and high commodity prices transforms the economy through exchange rate linkages.

## What does this mean for the RBA?

In response to the deterioration in Europe over the December quarter and more importantly prospects for global growth at the time the RBA cut the official cash rate by 25 basis points in both November and December.

Despite higher funding charges banks in the main passed on the full amount of decrease to housing loan interest rates.

At the time the markets feared a deep extended recession in Europe with the potential for a disorderly unravelling of the EUR.

Reflecting these concerns the market was arguing that the RBA would cut rates by around 75 basis points over calendar 2012. This is reflected in implied interest rates derived from the interest rate futures markets.

At its February meeting the RBA noted the combination of the significant improvement in global sentiment and the impact of previous rate cuts paved the way for the Bank to leave rates unchanged at its February meeting. These sentiments were echoed at the March meeting.

Subsequent comments from the Bank have underlined their view that the domestic economy remains strong, although in transition across various sectors. The bank's various comments have seen markets react strongly and almost completely fully discount the prospect of further rate adjustments.

### Australian Interest Rates

## Interest Rate Outlook

In the absence of further destabilisation in Europe and the potential subsequent flow on effects to the domestic economy, the RBA will more than likely be on hold over the next few months.

There is a possibility that the RBA may reduce the cash rate over the June quarter. This would be the low point in this cycle.

Over the second half of the year interest rates are expected to be unchanged, with the risk that as the global and domestic economies strengthen, markets may begin to incorporate higher interest rates into the outlook.

## Impact for Borrowers and Savers

The immediate prospect of further decreases in home lending rates has been put on the back burner.

The combination of significantly higher funding costs and no decrease in the cash rate by the RBA resulted in housing loan rates being increased by about 10 basis points.

The advent of out of cycle adjustment of housing loan rates is a recent development in the market. However, this should be viewed in the context of the continual fine tuning of deposit rates, especially term deposit rates that has been evident over the past several years.

In other words banks have started to align the timing of repricing the asset and the liability sides of their balance sheets.

Savers have benefitted over recent years as banks have built their domestic deposit books, in the face of higher wholesale funding costs in both the domestic and offshore markets.

This market dynamic will continue into the future as term deposits emerge as a newly attractive investment alternative.

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