Economic overview

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The world economy

Prospects for the world economy in 2009 look, in a word, bleak. Following the global financial crisis of 2008 the world's 'advanced' economies, as a group, are likely to experience their first annual contraction in economic activity since the end of the second world war – by the order of 1 per cent. Of even greater significance to Australia, growth in emerging economies will slow more sharply than seemed likely just two or three months ago – probably to an average of 4 per cent or less. The forecast for growth in the global economy is around 1 per cent – about the same as in 1982, the weakest year for the world economy in the post-war era (Figure 1 and Table 1). And even if the global economic cycle moves into a trough this year, the recovery is likely to be slow and belaboured.

Inflation has started to decelerate sharply around the world, largely reflecting the abrupt decline in the prices of oil and other commodities. However 'core' inflation rates also eased in the closing months of last year. In countries where effective exchange rates have risen since mid-2008 (including the US, Japan, China and the Middle East), a period of outright deflation is distinctly possible in 2009.

In the US and Japan, official interest rates have fallen to almost zero; while in most other advanced economies official rates are at or close to multi-decade lows, and will fall further this year.

However in an environment of very low inflation (or even deflation), when the 'spreads' between official interest rates and the interest rates actually paid by borrowers are unusually wide, and when households and businesses are seeking to reduce leverage, record-low interest rates are likely to prove relatively ineffective in reviving economic activity. Central banks will need to continue to use other, less conventional methods to support economic activity, including expanding their own balance sheets to bypass impaired financial systems.

And in an environment where the effectiveness of monetary policy is likely to be constrained, fiscal policy must, of necessity, play a much greater role in supporting and reviving economic activity than has been customary in recent decades. Most industrialised economies will incur large budget deficits in 2009 and for some years thereafter, as the result of conscious decisions to increase government spending or to cut taxes, as well as due to the operation of so-called 'automatic stabilisers'. Government indebtedness will rise, in some cases sharply.

Although contrary to the prevailing wisdom of the past three decades, these policy responses are, in general, appropriate for the unusual circumstances in which most governments and central banks now find themselves.

Eventually governments and central banks will need to determine when, and how quickly, to unwind these measures, lest they end up resulting in undesirably high inflation or new sources of persistent imbalances. While that will not be an easy task, it will be one for 2010 (or later) rather than for 2009.

Some responses to the global financial crisis will of course be much more enduring than the measures undertaken in response to the downturn in economic activity. More regulation and supervision of banks and other financial institutions will become a permanent feature of the global landscape, as part of a broader reaction to the deregulatory ethos of the past three decades.

It will, however, be crucial to both the short- and longer-term prospects for the global economy that governments resist the pressures, which will undoubtedly emerge as unemployment rises, to adopt measures intended to restrict trade flows (such as increases in tariffs or 'beyond-the-border' trade barriers), or to advantage businesses in their own jurisdictions at the expense of others (such as competitive currency depreciations).

Widespread resort to such measures would not only risk the prospect of an even deeper downturn, it could also threaten the maintenance of peaceful relations among nations.

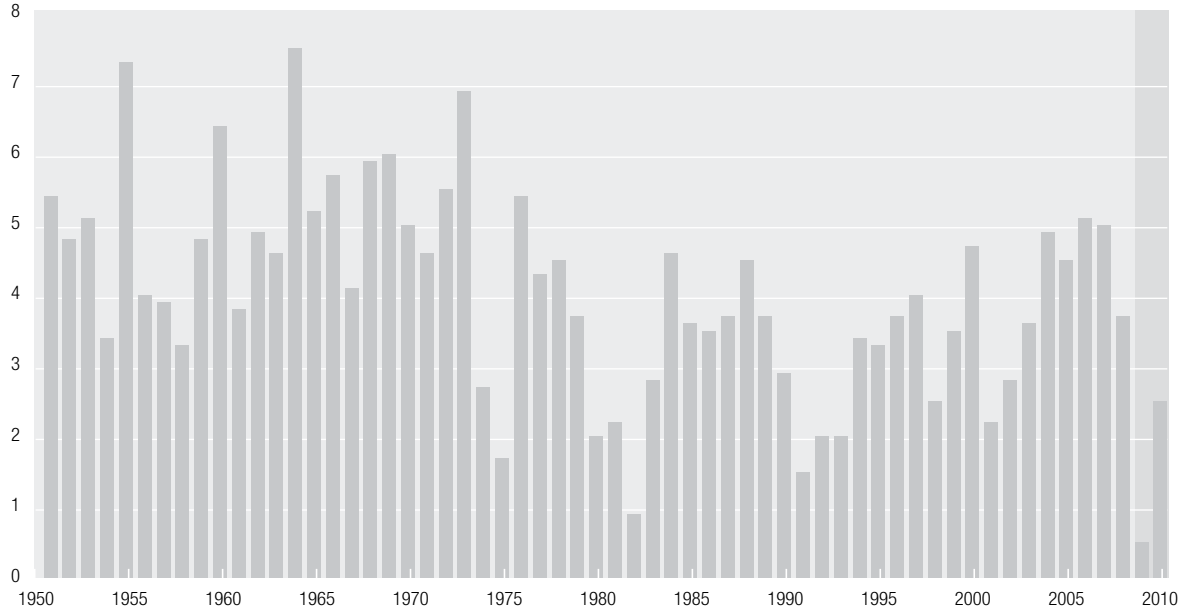
The global financial crisis

The global recession stems largely from the financial crisis which, by most accounts, first came to notice in mid-2007. Its origins were in the meltdown in the US sub-prime mortgage market and it intensified in mid-September 2008 following the US Treasury's decision to allow Lehman Brothers to fail. To the end of 2008 financial institutions had acknowledged losses totalling just over US$1 trillion, of which banks accounted for US$744 billion. (The most recent IMF estimate of the likely losses from loans and securities of all types, made in September last year, is $1,405 billion. Banks were expected to account for US$950–1,110 billion.)

This is easily the largest financial crisis in recorded history measured in nominal dollars, although as a percentage of the GDPs of the affected countries (equivalent to around 3 per cent of US GDP and 2 per cent of EU GDP) the losses remain considerably smaller than those incurred, for example, by Japan in the 1990s (over 15 per cent of GDP) or during the 1998–99 Asian financial crisis (around 35 per cent of GDP).[1]

In response to the losses sustained, banks have raised US$793 billion in fresh capital with US$356 billion of this directly from governments.

Figure 1
World real GDP growth, 1951–2010



Source: The Conference Board, IMF, ANZ.

Table 1
Real GDP growth

	per cent change			
	2007	**2008** (estimate)	**2009** (forecast)	**2010** (forecast)
United States	2.0	1½	–1¾	1
Japan	2.1	¼	–2	½
Euro area	2.5	1	–1½	1
United Kingdom	3.0	¾	–2¼	1
Developed economies	2.3	1	–1¾	1
China	11.6	9½	7½	8½
Other East Asia	5.9	5	2	4½
India	9.3	8	5½	6½
Russia	8.1	7	1	3
Brazil	5.4	4¾	2	3
Emerging economies	8.2	6¾	3½	5
World	4.7	3½	1	2½

Source: IMF, ANZ.

Other entities (mainly insurance companies and the US government-sponsored mortgage insurers Fannie Mae and Freddie Mac) have raised US$129 billion in new capital, US$35 billion of it provided by governments.

The dimensions of the global financial crisis extend beyond the losses directly sustained by banks and other institutions. They include:

- the effective closure of the debt securities markets to the overwhelming majority of non-financial corporate borrowers
- the substantial widening in the 'spreads' between official cash rates or government bond yields and the rates which banks actually pay for funds raised in the wholesale money and longer-term debt markets, as well as much greater difficulty in actually raising funds in those markets
- substantial declines in equity markets which, at their greatest extent (on 20 November 2008), entailed a 56 per cent fall from their global peak and losses totalling almost US$29 trillion (equivalent to 53 per cent of 2008 global GDP).

It is its truly global reach, more perhaps than its numerical dimensions, which differentiates the current financial crisis from previous episodes such as those of the 1990s. Developed country stock markets for the most part continued to advance during the emerging market crises of the 1990s (except for what turned out to be a brief stumble at the time of the collapse of Long Term Capital Management [LTCM] in September–October 2008). The banking systems of the US and Europe were relatively unaffected by those crises, the Japanese banking crisis, or the 'tech wreck' at the beginning of this decade. By contrast, during this crisis there has been almost no place for investors to hide, apart from government bond markets. In particular, although the epicentre of the current crisis has been in the US and Europe, emerging markets have been comprehensively affected by it.

As of early 2009 however, there are some grounds for hoping that the worst of the financial crisis (as distinct, it is important to emphasise, from its broader economic consequences) may have passed.

First, the scale of the carnage appears to be diminishing. Losses and write-downs reported by banks in the December quarter of last year totalled 'only' US$77 billion, compared with between $125 billion and $175 billion in each of the four preceding quarters. There will be more losses to come, in particular on corporate debt securities and loan losses arising from the downturn in economic activity now under way. But there are grounds for hoping they will not be on the same scale as the losses disclosed in the second half of 2007 and during 2008.

Second, some of the key measures of funding strains in the global financial system have lessened appreciably in response to the decisive measures taken by governments and central banks since mid-October (Figure 2).

For example, the spread between the three-month US$ inter-bank borrowing rate (Libor) and the three-month overnight indexed swap (OIS) rate (which represents the purest measure of market expectations regarding the official cash rate over the following three months) narrowed from a peak of over 340 basis points in mid-October to less than 100 basis points in late January. The corresponding spreads for the euro area and the UK narrowed from over 180 and 230 basis points respectively, to around 105 and 180 basis points over the same period. Significantly these spreads did not 'blow out' before the end of the calendar year (the balance date for most US and European banks) as they did at the end of 2007, nor during the most recent bout of concern over the health of US and UK banks.

That said, these spreads remain considerably wider than the 5 to 10 basis points which were typical before the onset of the crisis in July 2007.

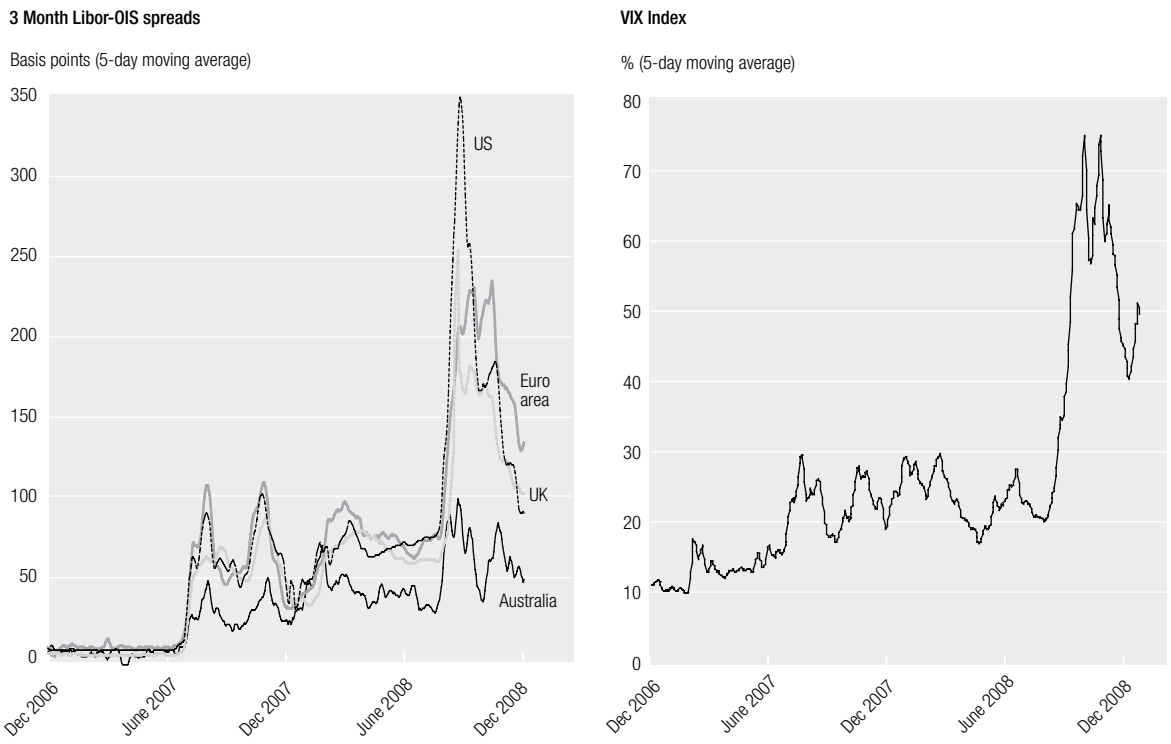
Likewise, longer-term 'swap' spreads between bank and government bond yields have narrowed. US five-year maturities contracted from over 115 basis points in mid-October to around 60 basis points in January, and from over 85 to about 40 basis points for equivalent UK maturities.

Third, other measures of extreme market distress have eased substantially since late 2008. For example, the measure of implied US equity market volatility derived from options on S&P 500 futures contracts (the so-called VIX index) has declined from a peak of over 80 per cent on two occasions in October and November last year to an average of about 45 per cent in January (Figure 2). Again, this is still well above the pre-crisis levels of (typically) 10–15 per cent (although, arguably, volatility was 'under-priced' during this period) and in line with the level reached during the 1998 LTCM crisis which, until last year, was regarded as 'high'.

The modest rebound in the Australian dollar, and in emerging market currencies, since mid-November can also be viewed in this light.

Finally, it is perhaps significant that most equity markets have remained above their 20 November lows despite the uniformly negative economic data, renewed fears about US and UK banks and revisions to corporate earnings outlooks since then; on average global markets were, by late January, still some 7 per cent above their November lows. This suggests an awful lot of the 'bad news' still to come may have already been 'priced' by investors.

Figure 2
Indicators of financial system stress



Note: Libor is London inter-bank offered rate (or bank bill swap rate for Australia); OIS is the overnight index swap rate; VIX is the implied volatility of options on S&P 500 futures contracts traded in Chicago.
Source: Bloomberg, Datastream (latest data 22 Jan 2009).

None of these points should be taken as a suggestion that the global financial crisis is in any way over. In particular, in no sense can it be said that the global banking system, or the financial system more broadly, has returned to normal functioning, or is even on the cusp of doing so. A coherent 'exit strategy' from the web of guarantees, temporary nationalisations and other ad hoc responses to the crisis is yet to be formulated. And a great deal remains to be done to establish a coherent regulatory regime under which banking systems can resume 'normal' operations, while addressing the manifest inadequacies of previous arrangements.

Moreover as recessions intensify there will inevitably be more loan losses and securities write-downs (including on credit default swaps) resulting from corporate failures, as well as further mortgage-related losses before housing markets bottom. Banks will need to raise still more capital and taxpayers may yet have to provide more of it. Markets remain vulnerable to further shocks, including from any failure to enact foreshadowed fiscal stimulus packages or from premature tightening of monetary policy, let alone any resort to protectionist measures by an internationally relevant government.

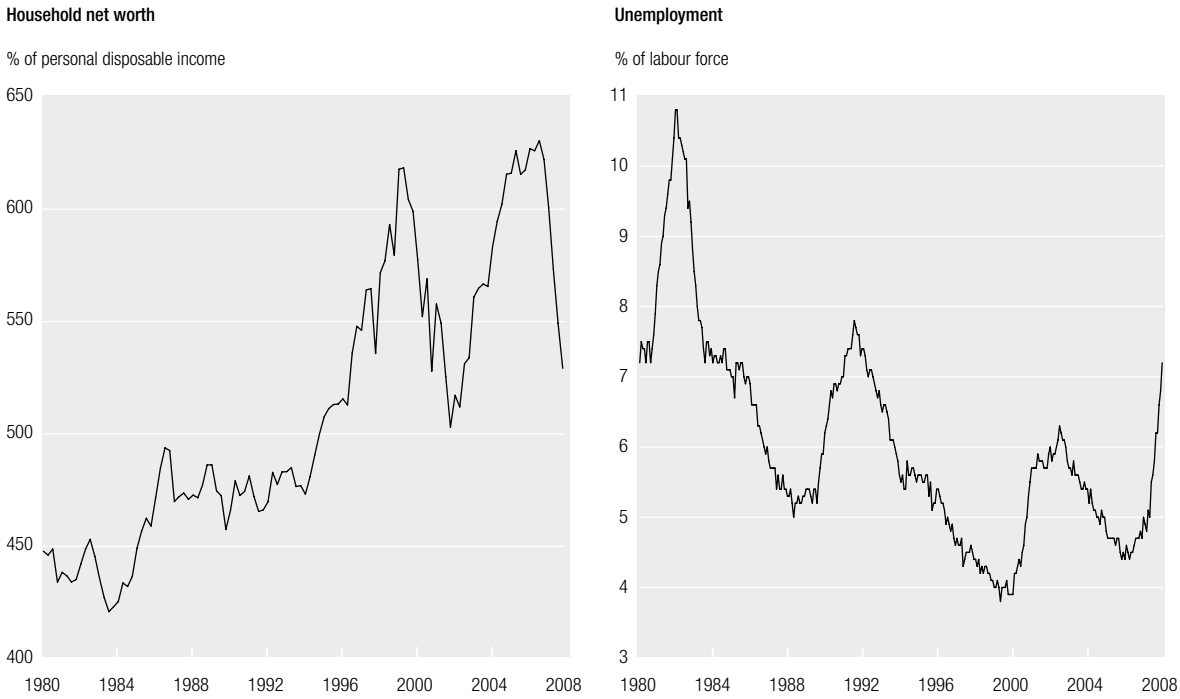
At most, perhaps, we have passed the 'end of the beginning', in Winston Churchill's famous phrasing. We are still some way from seeing the bottom of the economic cycle.

The United States

The US is now well into a recession which is likely to be both long and deep by post-war standards. The ten US recessions since 1945 have lasted an average of 10 months with a peak-to-trough contraction in GDP averaging 1.7 per cent. The current recession is already over 12 months long, having begun (according to the National Bureau of Economic Research's Business Cycle Dating Committee) in December 2007. On the most recent (December) consensus forecasts it will last at least until the end of the June quarter and see real GDP contract by 2.1 per cent.

This latter figure is almost certainly an underestimate. Larger declines were recorded in the recessions of 1981–82 (2.7 per cent), 1973–75 (3.1 per cent) and 1957–58 (3.2 per cent). It would not be surprising if the peak-to-trough contraction in the current recession also exceeded 3 per cent;

Figure 3
Pressures on US households



Source: US Federal Reserve, US Bureau of Labor Statistics, ANZ.

nor if the unemployment rate, having already risen from 5.0 per cent to 7.2 per cent during 2008, peaked at over 9 per cent during 2009.

Post-war US recessions have stemmed typically from efforts by the Federal Reserve to contain inflationary pressures by tightening monetary policy; one inevitable consequence of which has been a squeeze on profit margins. Thus, the typical post-war recession has been brought on by the responses of businesses to pressure on cash flows – cutting payrolls, capital expenditures, and inventories – which then flow to other areas of the economy (including consumer spending), as well as by downturns in housing investment. Recovery has typically been induced by cuts in interest rates and taxes, prompting households to borrow and spend and leading in turn to an eventual recovery in employment and business investment.

The current recession is very different. It was brought on by a sharp (and, in the post-war era, unprecedented) decline in household net worth – initially as a result of falling house prices but more recently also due to falling share prices – after a period when household disposable income was squeezed by rising energy prices. It has since been compounded by a dramatic tightening in the availability of credit to both households and businesses. This onset of recession owes far more than most previous recessions to a downturn in household spending, which is now intensifying as a result of the sharp increase in unemployment. The intensity and duration of the recession will be magnified by the financial crisis (Figure 3).

Given the very different origin and nature of the current recession, it is unlikely that a recovery can be induced by the traditional combination of lower interest rates and tax cuts. Increasingly policy-makers have come to recognise this.

As a result policy responses which, a year ago, would have been characterised as 'unorthodox' are becoming almost *de rigueur*.

Having lowered its cash rate target to, for all practical purposes, zero, the Federal Reserve has been dramatically expanding its balance sheet to provide liquidity to the US and foreign banking systems and shoulder some of the responsibility for intermediating between borrowers and lenders, which the financial system is presently incapable of discharging. For example, the Fed has purchased over US$330 billion of commercial paper since the end of October, and beginning in January will acquire up to $500 billion of mortgage-backed securities.

It is worth emphasising that this expansion (of over 150 per cent in dollar terms, or from about 8 per cent to 20 per cent of GDP) in the Fed's balance sheet since

mid-2008 does not amount to 'printing money' in the same way as in Weimar Germany or, more recently, Robert Mugabe's Zimbabwe. In particular, the Fed is not financing the rapidly expanding US budget deficit. Rather, it is expanding its balance sheet in an attempt to offset the effects of the contraction in the balance sheet of the US banking system.

Although 'base money' (the notes and coin in the hands of the public, and the central bank's liabilities to the banking system) has ballooned since mid-2008, growth in broader monetary aggregates has remained unexceptional because the credit-creation mechanism is impaired. The expansion in the Fed's balance sheet will only lead to inflation if it is not unwound after the credit-creation mechanism has begun to operate normally again. In the meantime US inflation is likely to fall to close to zero (and perhaps even temporarily below zero) as a result of falling energy prices, discounting of goods and services in the face of weak demand, and the impact of the rising US dollar since mid-2008.

Fiscal policy is likely to play a much greater role in ameliorating the current downturn, and in promoting a recovery from it, than has been the case since the mid-1970s (after which the use of fiscal policy for counter-cyclical purposes fell into disfavour). The newly-installed Obama Administration is seeking passage of fiscal stimulus measures totalling around US$825 billion over two years, or nearly 6 per cent of GDP. Depending on timing, these measures could push out the budget deficit for the current fiscal year to almost 9 per cent of GDP, surpassing the 6 per cent of GDP recorded by the Reagan Administration in 1982 (and, for that matter, anything under the Roosevelt Administration until the onset of the second world war). Federal government debt (excluding that held by government agencies) is likely to rise to over 50 per cent of GDP (from 38 per cent in fiscal 2008). However that figure is not appreciably above the levels of the early 1990s, and below those for the decade following the end of the second world war.

Fiscal stimulus on this scale is likely to prompt some recovery in economic activity in the second half of the year. If the housing market can establish a floor by then and the banking system is showing signs of beginning to function more normally, then prospects are good for a sustainable recovery – although even in a 'best case' scenario, recovery will be slow by comparison with previous post-war economic upswings (as financial sector and household balance sheet consolidation will create strong headwinds for the broader economy for some years).

However if the housing market is still declining and the banking system remains severely impaired by the end of the northern summer, the possibility of a renewed and protracted contraction in the US economy cannot be excluded.

Europe

Although the global financial crisis originated in the US, the European economy will nonetheless be severely affected by it. European banks were enthusiastic participants in the housing and securitisation bubbles in which the seeds of the crisis were sown, and have subsequently incurred significant losses. Many European countries experienced housing bubbles; in some cases (the UK, Ireland and Spain) of greater magnitude than that of the US. And European governments and central banks were slower to recognise, and respond to, the crisis than their counterparts on the other side of the Atlantic. Indeed in many cases they initially perceived the financial crisis as a purely 'American' (or 'Anglo-American') problem and in some cases regarded it with a degree of what the Germans call *schadenfraude*.

The euro area economy experienced consecutive contractions in real GDP in the middle quarters of 2008, while the unemployment rate rose by 0.6 percentage points over the last year. Yet the European Central Bank actually raised interest rates in July, and has since cut rates by less than any other major central bank except the Bank of Japan. And euro area governments, paying at least lip service to the strictures of the Maastricht Treaty, have been hesitant to countenance significant fiscal stimuli.

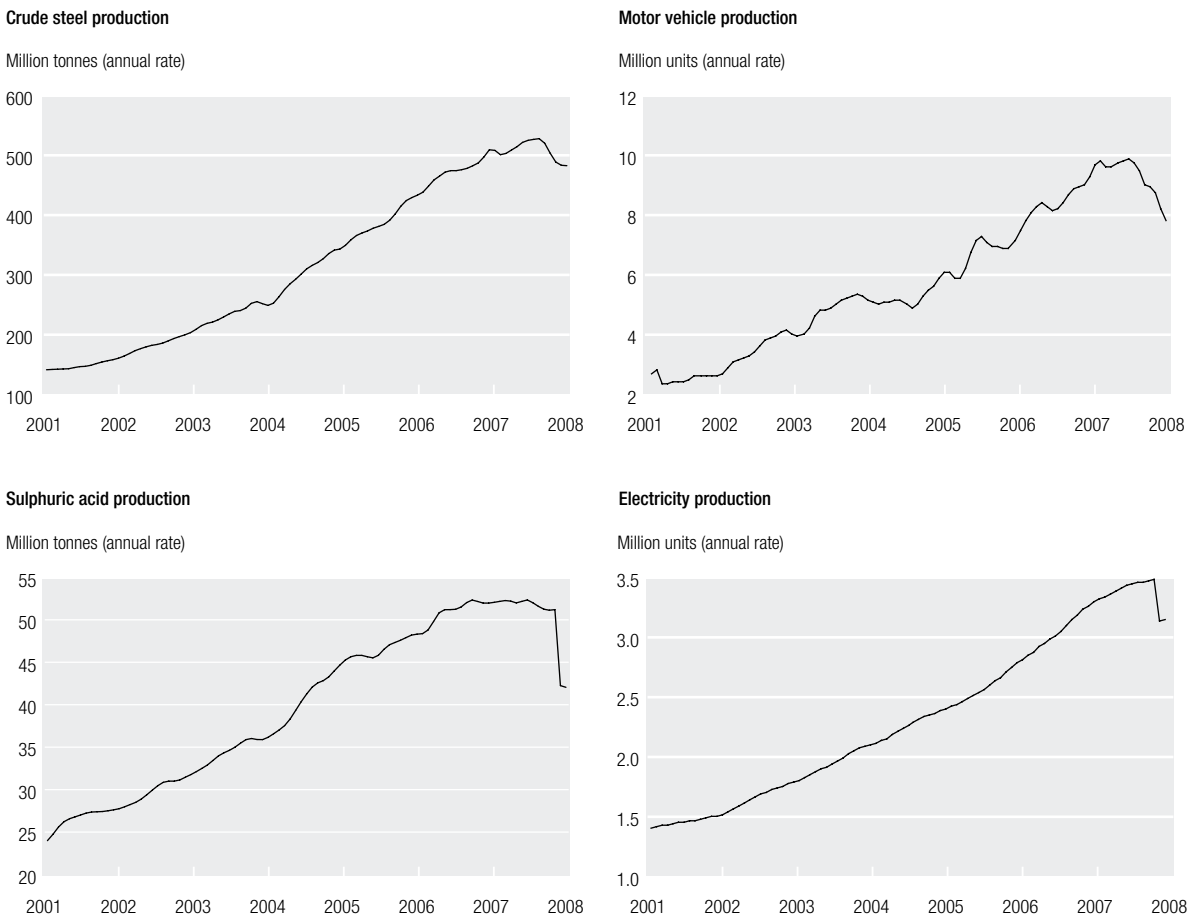
As a result, recession in the euro area may last longer than in the US.

The UK economy shrank by 2.1 per cent over the second half of 2008, while the unemployment rate rose by 1 percentage point. The UK economy is likely to fare worse than the euro area in 2009 given its relatively much larger financial services sector, and its more highly leveraged household sector, even though the Bank of England and the UK Government have responded more aggressively to the downturn than their continental counterparts.

Japan

Japanese banks had very little exposure to securities based on American mortgages – in no small part because when this bubble began developing, they were still recovering from their own crisis of a few years earlier and were in no position to take on large foreign exposure. As a result Japanese banks may be among the eventual 'winners' from the global financial crisis.

Figure 4
Chinese industry data



Note: data presented in 'trend' terms using ABS formulae.
Source: China Steel Industry Association, Petroleum & Chemical Industry Association, Association of Automobile Manufacturers, seasonal adjustment and trend by CEIC and ANZ.

Despite this, Japan may end up experiencing a larger contraction in 2009 than any other large industrialised economy. This stems in large part from Japan's dependence on exports and export-related investment for most of the growth it has been able to eke out during the current decade. The combination of a dramatic plunge in foreign demand for Japanese exports and the sharp rise in the yen during the second half of last year has pushed the Japanese economy into recession. The Bank of Japan has had limited capacity to respond, given its overnight call rate was only 0.5 per cent before the onset of recession (it has since been lowered to 0.2 per cent). And the scope for a significant fiscal policy response is limited by both the poor state of the Japanese Government's finances (net public debt approaching 90 per cent of GDP) and its weak political position (lacking a majority in the Upper House).

China

To the surprise of many observers, China's economy slowed abruptly in the second half of last year. This was only partly due to the impact on China's exports of the sharp slowdown in its principal markets. Although export growth declined dramatically in the final quarter of last year, so did that of imports, implying net exports probably exerted only a small drag on the overall growth rate. Of greater importance has been the slump in construction activity, resulting from strenuous efforts by the People's Bank of China (PBoC) and other authorities (beginning in 2007) to stem what had undoubtedly been a 'bubble' in this sector.

The slowdown in China's economy is more apparent in semi-official data such as that on steel, energy and motor vehicle production (Figure 4) than in GDP and other data which have traditionally been subject

to a degree of 'smoothing'. Nonetheless the published annual growth rate of real GDP declined to 6.8 per cent in the final quarter of last year, below the 8 per cent threshold which is widely regarded as the minimum necessary to ensure unemployment does not begin rising at a pace that would threaten the 'social stability' that is an over-riding priority of the Chinese authorities.

In response to the downturn, Chinese authorities have put 'safeguarding growth' at the top of their agenda for 2009. The Government has announced fiscal stimulus measures totalling Y4 trillion (US$585 billion, equivalent to almost 14 per cent of annual GDP), although this figure includes some proposals foreshadowed previously and others which will be spent over several years. Other authorities have taken specific measures to assist exporters, property developers and motor vehicle purchasers. The sharp falls in commodity prices since mid-2008 will also be of considerable assistance to the Chinese manufacturing sector.

In addition, the PBoC has cut benchmark interest rates by a little over 2 percentage points and lowered commercial banks' reserve requirements by 4 percentage points. The scope for easier monetary policy has been enhanced by a sharp fall in inflation, from a peak of 8.7 per cent in February last year to 1.2 per cent by December. The PBoC has also halted the managed appreciation in the value of the yuan against the US dollar (of some 21 per cent since the fixed exchange rate was abandoned in July 2005), although the yuan has continued to strengthen in trade-weighted terms given the rise in the US dollar against other currencies during the second half of last year.

These measures will take time to have their intended effect, and meanwhile the global recession will continue to affect China's exports adversely. However there should be no mistaking the determination or the ability of the Chinese authorities to ensure growth returns to a rate sufficient to prevent a significant rise in unemployment.

Other Asian economies

The more advanced smaller east Asian economies, for whom exports constitute a substantial proportion of overall economic activity, have been hit hard by the recessions in major Western economies and the abrupt slowdown in China. Singapore and Hong Kong experienced consecutive quarters of negative growth during 2008, and by the time December quarter figures are released, Taiwan may have too. Korea and Taiwan both experienced dramatic slumps in their exports in the December quarter. Both countries have scope to moderate the downturn with fiscal measures, although the timing and pace of recovery (as in Singapore and Hong Kong) will be determined largely by the global economy.

The larger south-east Asian economies have thus far proved more resilient to the global recession. In part this is due to the greater importance of domestic demand to their overall growth in recent years, improvements to their banking systems and public finances following the crisis of a decade ago, and the scope to reduce interest rates significantly provided by the unwinding of the inflationary spikes in the first half of last year. Their growth rates are likely to slow in 2009, but not to the same extent as in north Asia. Political uncertainty will continue to weigh on Thailand's prospects, and could also be a temporary consideration for Indonesia ahead of this year's presidential elections.

India is a relatively closed economy by Asian standards, but its services exports will nonetheless be adversely affected by the contraction in the global financial services sector, and its commodity and manufactured exports to some extent by the downturns in many of its major markets. And as one of the few Asian economies running a persistent current account deficit, the crisis has affected India's ability to finance it. India's already large public sector deficits limit the scope for expansionary fiscal policy. Business and consumer confidence have been affected by the sharp fall in India's share market, by the terrorist attack on Mumbai, and most recently by the Satyam scandal. Nonetheless India's overall growth rate is unlikely to fall below 6 per cent in 2009.

The Australian economy

Australia's economy slowed appreciably during 2008, largely due to the effects of the tightening of monetary policy and successive interest rate increases in February and March, and to the sharp rise in petrol prices, rather than the global financial crisis. Compared with other advanced economies, however, Australia's economy appears to have been remarkably resilient thus far. It is one of a handful of OECD countries not to record any quarterly contractions in real GDP during the first three-quarters of 2008,[2] while unemployment rose by just 0.3 percentage points during the year and remained close to a 33-year low.

Nonetheless the global financial crisis, the abrupt slowdown in the Chinese economy and the ensuing plunge in commodity prices cast a dark shadow over prospects for the Australian economy in 2009.

It now seems probable that Australia will experience a recession in 2009. It is (just) possible that

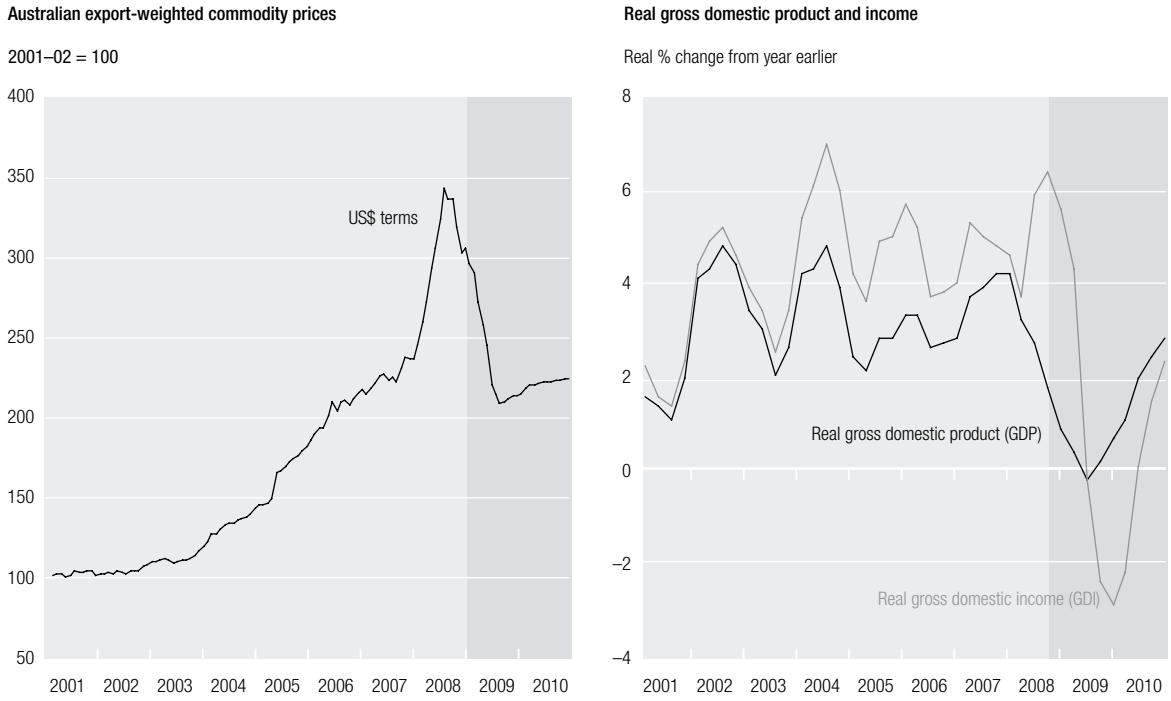
Table 2
The Australian economy in figures

	Year average per cent change (unless otherwise indicated)			
	2007	**2008** (estimate)	**2009** (forecast)	**2010** (forecast)
National expenditure aggregates [(a)]				
Household consumption	4.3	2¼	½	1½
Dwelling investment	2.7	1	–4¼	15
Business investment	12.8	12	–3	–4½
Public spending	3.2	5¾	4	2½
Inventories (contribution to GDP)	0.6	–¼	–¼	0
Domestic demand	6.0	4	–¼	1½
Exports	3.3	4½	–3¼	3
(less) Imports	11.4	11¾	–2½	1¼
Net exports (contribution to GDP)	–1.7	–1¾	0	¼
GDP	4.0	2¼	0	2
Gross domestic income [(b)]	4.9	5½	–¾	¼
Labour market				
Employment	2.8	2.3	0	–¼
Unemployment (per cent, December)	4.3	4.5	6	7
Inflation				
Consumer prices (December qtr)	2.3	4½	2½	3
Wage cost index (December qtr)	4.1	4¼	3½	3½
Balance of payments				
Current account deficit ($ billion)	68	52	67	83
Financial markets				
Cash rate (per cent pa, December)	6.75	4.25	3.00	4.00
10-year bond yield (per cent pa, December)	6.33	4.00	4.40	5.25
A$–US$ (December)	0.88	0.66	0.55	0.59
A$–¥ (December)	98	63	56	65
A$–€ (December)	0.60	0.52	0.50	0.52

(a) Chain volumes
(b) Real GDP adjusted for changes in the terms of trade

Source: Australian Bureau of Statistics, Bloomberg, ANZ.

Figure 5
The commodity boom is over, for now



Note: real GDI is GDP adjusted for changes in the terms of trade. Shaded area denotes forecasts.
Source: RBA, ABS, ANZ.

Australia may avoid recording consecutive quarters of negative real GDP growth that are widely (though somewhat erroneously) taken as the hallmark of a recession (especially if the government times fiscal policy interventions with that objective partly in mind). However with real national income falling sharply, and the unemployment rate likely to rise by at least 1.5 percentage points this year, it will feel like a recession to most people and businesses.

The end of the commodities boom

The commodities boom which did so much to prolong Australia's recent economic expansion has come to an abrupt halt. After peaking last July (some 270 per cent above its mid-1999 low), the Reserve Bank's US$-denominated index of Australian export-weighted commodity prices dropped by 11 per cent over the last five months of 2008.

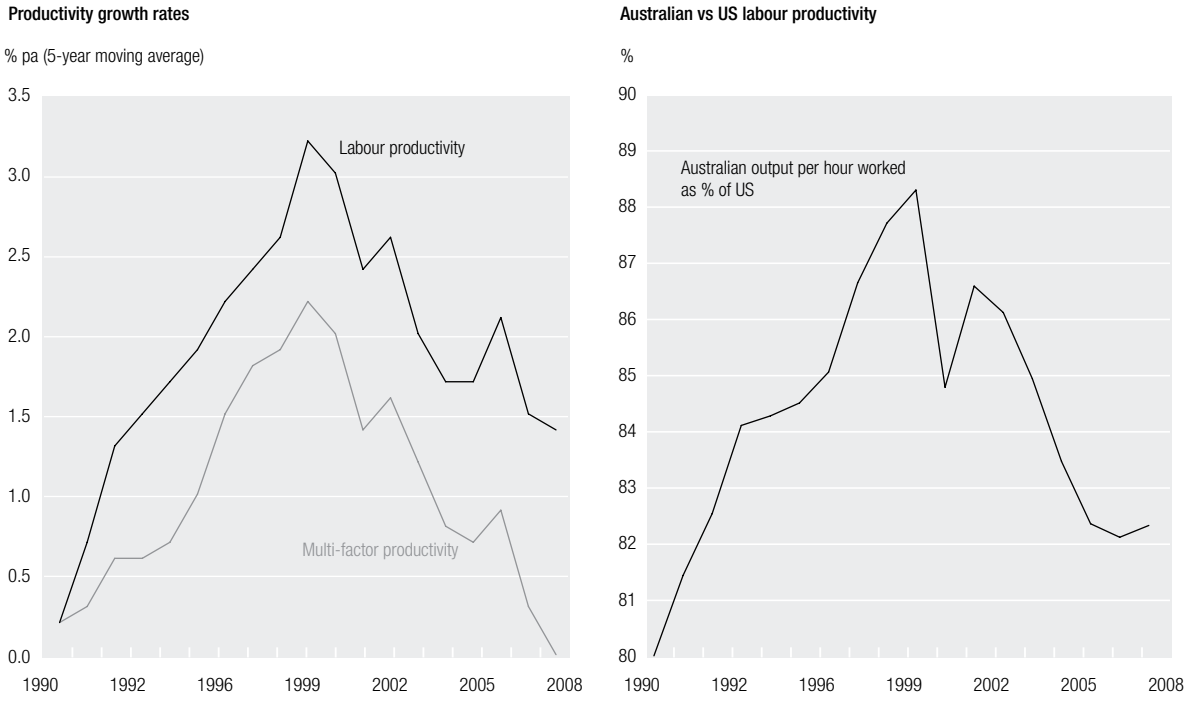
Although this only takes the average level of commodity prices back to where it was last May (and in Australian dollar terms is more than offset by the fall in the A$), further falls are expected this year, especially in April when contract prices for coal and iron ore are re-set. In all, export commodity prices may decline by as much as another 30 per cent this year, taking them back to around mid-2006 levels.

The turnaround in commodity prices adversely affects Australia's economic prospects in four principal ways:

- First, the associated deterioration in Australia's terms of trade (the ratio of export to import prices) – likely to be of the order of 15 per cent over the course of 2009 – directly subtracts from Australia's real income. Whereas terms of trade gains boosted Australia's real income (relative to growth in real output or GDP) by an average of 2 percentage points a year over the five years to December 2008 (and by more than 4 percentage points during 2008), the deterioration in the terms of trade during 2009 will reduce income growth relative to output growth by around 3 percentage points (Figure 5).
- Second, growth in the volume of resources commodity exports – which after many years of falling short of expectations had begun to pick up during 2008 – is likely to slow in 2009 (although it could pick up again in 2010).
- Third, at least some planned investments in the resources sector will be deferred or cancelled altogether, because they are less profitable at lower commodity prices or because of difficulties in securing financing – although of course other projects, especially those undertaken by large companies with very long-term time horizons, will continue to go ahead.

Figure 6

The commodities boom masked a very poor productivity performance



Note: productivity growth rates are adjusted (by ABS) for changes in labour quality.
Source: ABS, The Conference Board Growth & Development Centre, ANZ.

- Finally, production slowdowns and (in some cases) mine closures will inevitably result in job losses, adding to upward pressure on unemployment.

Note that these effects will be concentrated in the resource boom states of Queensland and Western Australia.

It is perhaps now clear that Australia squandered a good deal of the benefits of the resources boom of the past five years. A large proportion of the windfall revenue gains accruing to the Commonwealth government (from enlarged company tax revenues, as well as increased capital gains and other tax revenues from the parallel surge in asset prices) were dissipated in personal income tax cuts and undisciplined government spending – both of which added to inflationary pressures in an increasingly capacity-constrained economy and thus put additional upward pressure on interest rates.

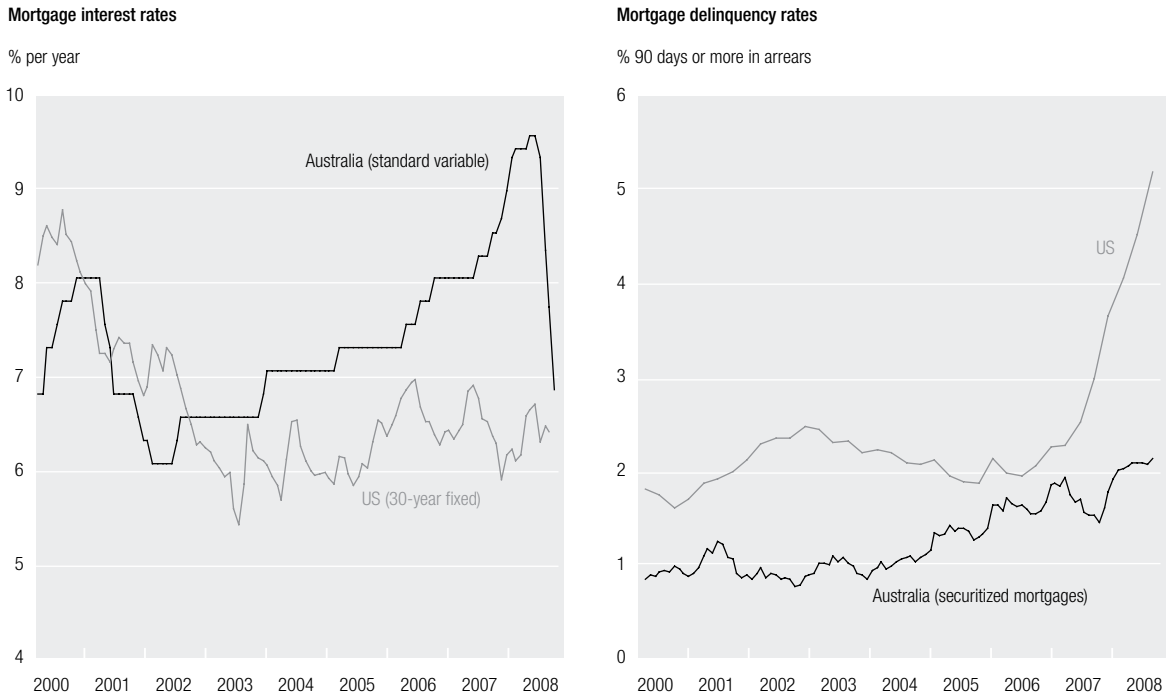
In addition, the commodities boom masked a serious deterioration in Australia's productivity performance (Figure 6). Growth in labour productivity averaged just 1.5 per cent a year over the eight years to 2007–08 (and by just 1.0 per cent a year over the second half of that period), down from an average of 2.5 per cent a year during the 1990s. 'Multi-factor' productivity (which measures the efficiency with which labour and capital are combined to produce output) growth slowed even more, from an average of 1.7 per cent a year during the 1990s to just 0.3 per cent a year over the first eight years of this decade. Australian aggregate labour productivity, relative to the US level, dropped from 88 per cent in 1999 to 82 per cent in 2007, unwinding all of the improvements made between 1992 and 1999.

While aggregate productivity growth in recent years has been adversely affected by differences in the phasing of employment and output growth in the mining and construction sectors, this does not 'explain away' Australia's disappointing productivity performance in recent years: six out of the eleven other major sectors of the Australian economy also experienced slower productivity growth over the past eight years than during the 1990s. Rather, less productivity-enhancing structural reform, productivity-stifling regulation in the name of 'national security' and corporate governance, as well as the generally buoyant economic environment, appears to have stifled the search for continued productivity gains.

The Australian financial system

Australian banks have, in general, been less seriously affected by the global financial crisis than their northern hemisphere counterparts. This at least partly reflects

Figure 7
Australian and US mortgage rates and mortgage delinquencies



Source: Reserve Bank of Australia, US Federal Reserve, Mortgage Bankers Association of Australia, S&P.

that some of the lessons now being painfully learned by banks and regulators in the US and Europe had been learned no less painfully by Australian banks and regulators in the early 1990s.

Australian banks had relatively little (and in some cases no) direct exposure to securities based on American sub-prime mortgages, and have incurred relatively small (by northern hemisphere standards) losses on other derivatives.

Nor had Australian banks engaged in imprudent mortgage lending in the domestic market on anything like the scale of banks in the US and Europe. Sub-prime mortgages represent less than 1 per cent of all Australian mortgages, compared with over 15 per cent of US mortgages; and nearly all of this category of lending has been undertaken by specialist lenders rather than banks or building societies. While mortgage delinquency rates have risen – by late 2008, just over 0.9 per cent of securitised mortgages were 90 days or more past due, up from less than 0.2 per cent in the early years of the decade. These rates are much lower than comparable figure for US mortgages, which by the September quarter of last year exceeded 5 per cent, despite the fact that Australian mortgage interest rates have been considerably higher than US mortgage rates (Figure 7).

As of September 2008, 'non-performing' assets represented 0.8 per cent of Australian banks' total assets, up from a cyclical low of 0.4 per cent two years earlier, but still low by historical standards and well below the peak of over 6 per cent in March 1992.

Australian banks have remained profitable and well-capitalised, with the four major Australian banks among only 21 banks around the world with a credit rating of AA or higher.

Nonetheless Australian banks have experienced much the same difficulties in funding their balance sheets as their counterparts in northern hemisphere financial centres. The spread between three-month market expectations for the official cash rate (captured by the overnight index swap) and the 90-day bank-bill swap rate (as a proxy for the rates banks actually pay for wholesale funds) widened from a pre-crisis norm of less than 10 basis points to an average of 83 basis points in October. It eased (in line with trends overseas) to just over 50 basis points in late January (refer back to Figure 2). The relative cost of longer-term wholesale financing has also increased significantly since mid-2007.

Activity in the Australian debt securities market has remained low since the onset of the crisis, and

"Australian house prices have thus far been more resilient than house prices in comparable markets."

the volume of securitised debt on issue has fallen by some A$50 billion, or more than 20 per cent, since September 2007. Some of this has been taken on to the balance sheets of Australian banks. However with the withdrawal of many foreign banks from the Australian syndicated loan market, the refinancing of up to $75 billion of maturing corporate debt over the next two years may exceed the balance sheet capacity of Australian intermediaries.

Like its counterparts overseas, the Reserve Bank has expanded its balance sheet (from around $90 billion to over $160 billion) to provide additional liquidity to the banking system and securities markets, and to the foreign exchange market (through a swap facility with the US Federal Reserve).

The Australian government has also provided guarantees of Australian banks' wholesale borrowings, and of deposits of up to $1 million, primarily to ensure Australian banks were not at a competitive disadvantage vis-à-vis banks from other jurisdictions whose governments had provided similar guarantees.

As of late January, Australian banks had raised some $45 billion in new debt since the introduction of these guarantees.

Although Australian financial institutions have tightened their lending standards, they have continued to lend: 'on-balance sheet' credit to the private sector grew at an annualised rate of 15.3 per cent over the first ten months of 2008. Moreover, in contrast to the experience in the US and the UK, Australian lending institutions have 'passed on' to their customers the bulk of reductions in official interest rates – although credit risk is continuing to be 'repriced' (upwards), especially for larger borrowers.

In these senses, monetary policy is likely to be more effective in ameliorating some of the contractionary influences on economic activity in Australia than in many other countries.

Household and business finances

The Australian share market fell by 43 per cent in 2008 and has lost more than 50 per cent of its value at its peak at the beginning of November 2007. The Australian market has fallen more than most other markets, partly reflecting its relatively greater weighting towards sectors that have under-performed in all markets, such as financials and, more recently, materials (eg commodities).

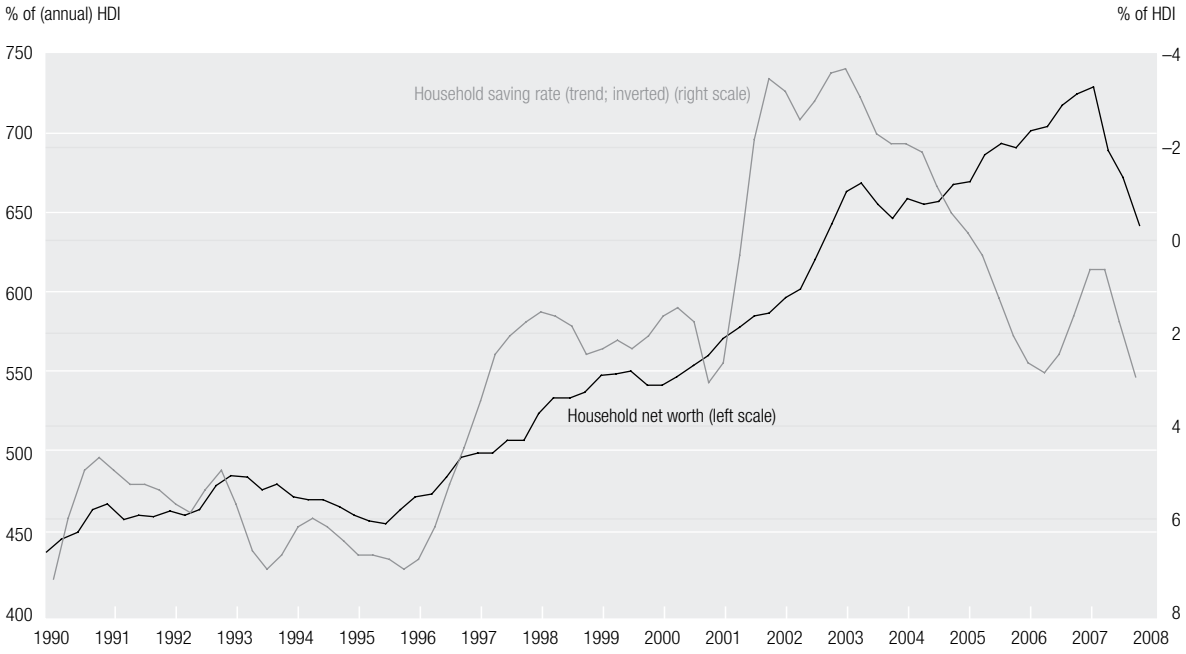
On the other hand Australian house prices have thus far been more resilient than house prices in comparable markets. The ABS measure of Australian capital city house prices has fallen (up to the September quarter last year) by only 2.1 per cent from its peak in the March quarter of last year, compared with falls of 20 to 25 per cent (depending on which measure is used) in the US, 17 to 22 per cent in the UK, 8 to 10 per cent in Ireland and 6 per cent in New Zealand.

Although Australian house prices are undoubtedly high, by both historical and international standards, relative to incomes, that does not mean that they will inevitably decline in sympathy with, or by more than, house prices overseas. Unlike the US, the physical supply of housing has not been boosted (relative to demand) by speculative over-building. Nor, again unlike the US (and to a lesser extent the UK), have house prices come under widespread downward pressure from a rapidly-growing number of 'forced' sellers, unable (or unwilling) to keep up their mortgage repayments (or mortgagees in possession).

Rather, turnover of established dwellings has fallen sharply (by nearly 40 per cent from the peak in 2003), as putative (but 'unforced') sellers have withdrawn from the market rather than accept lower prices. And the substantial decline in mortgage interest rates since last September suggests that (subject to the important proviso that rising unemployment does not trigger a significant increase in forced sales),

Figure 8

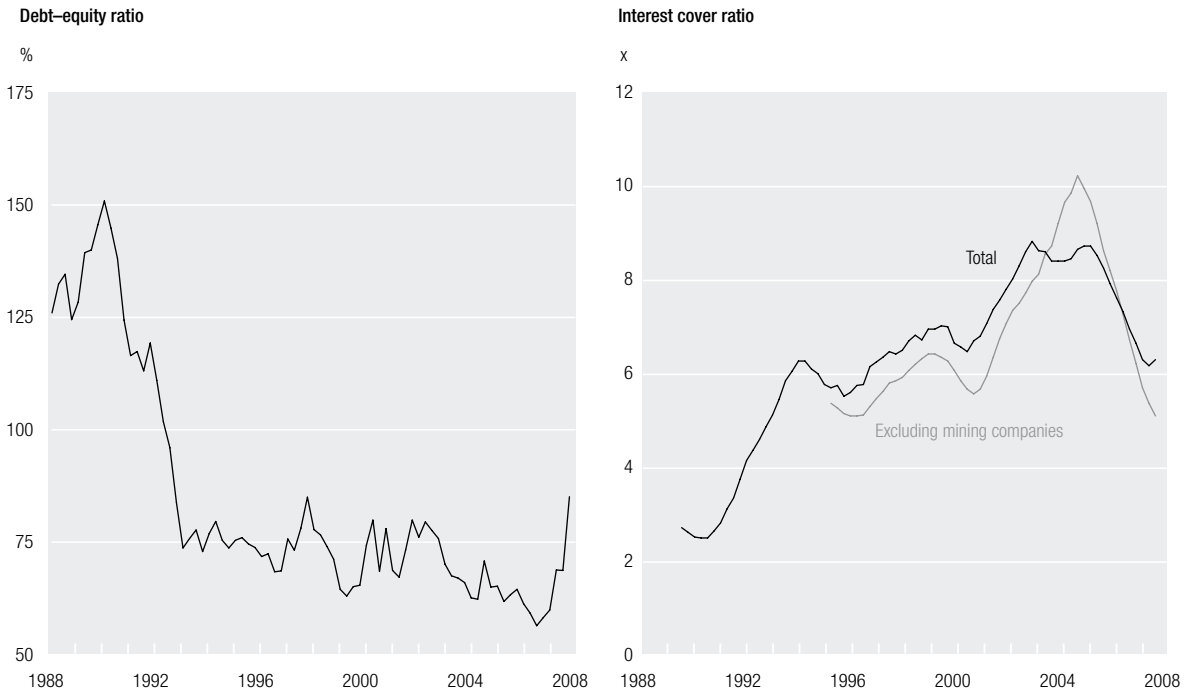
Household net worth and saving



Note: HDI is household disposable income.
Source: ABS, ANZ.

Figure 9

Corporate finances in better shape than before last recession



Note: 'debt' excludes accounts payable.
Source: ABS, ANZ.

Australian residential property prices are unlikely to begin falling significantly during 2009.

The combination of modest declines in house prices and more substantial falls in share prices, together with ongoing increases in household borrowing has, however, resulted in household net worth falling by nearly $380 billion over the first three-quarters of 2008,[3] and probably by around $500 billion over 2008 as a whole. By a wide margin this is the largest drop in household net worth in the 20 years for which data are available.

Australian households have begun to respond to this decline in their net worth, in text-book fashion, by increasing their saving and cutting back borrowing (Figure 8). The ratio of household saving to disposable income, which was negative for three years earlier this decade, climbed to almost 4 per cent in the September quarter last year as households saved a large proportion of the latest round of personal income tax cuts.

Non-housing personal borrowing has fallen by over 5 per cent since June 2008, due to repayments of margin loans and more cautious use of credit cards. The personal saving rate seems likely to rise further during 2009.

Business sector balance sheets are, in aggregate, in much better shape than they were ahead of the last recession in the early 1990s (see Figure 9). The sharp fall in share prices pushed the debt-to-equity ratio of the non-financial corporate sector up to 82 per cent by the September quarter of last year (and presumably higher since then) from a low of 55 per cent in mid-2007.[4] However this compares with a peak of almost 135 per cent ahead of the 1990–91 recession (and higher levels during it). By comparison, business cash flows have been much less crimped by high interest rates than prior to the onset of previous recessions. The 'interest cover' ratio for the non-financial corporate sector averaged just under five times in the June quarter of last year (latest available data), compared with less than two times ahead of the 1990–91 recession.

Pre-tax profit margins were also at healthy levels in mid-2008: profits of non-mining companies covered by the ABS business survey were equivalent to over 6 per cent of sales for the first three-quarters of last year, up from less than 4 per cent at the beginning of this series in 2001; while for those sectors for which a longer run of data is available (manufacturing and wholesaling), pre-tax profit margins were some 2 percentage points larger, on average, than in 1990.

In addition, and in marked contrast to the periods leading up to each of Australia's three major downturns over the last three decades, employers have not had to contend with surging labour costs over the past year. Indeed real unit labour costs (that is, labour costs per unit of output produced, adjusted for changes in output prices) declined by 3 per cent over the year to September 2008, to a near-record low.

Although there are some sectors where sharp falls in product prices and/or falling activity levels imply that job losses are inevitable, across the business sector as a whole there does not (yet) appear to be a strong objective case for the sort of mass retrenchments that have been a feature of previous recessions.

Indeed, perhaps mindful of recent shortages of skilled labour, many employers appear to be trying to avoid large layoffs if at all possible.

Household spending

As noted earlier, consumer spending slowed appreciably over the course of 2008 despite continued strong growth in income, as households responded initially to rising interest rates and fuel prices and subsequently to falling wealth by increasing saving and borrowing less. The 1.7 per cent real increase in household consumption expenditure over the year to the September quarter was the smallest in 15 years.

Perhaps surprisingly, in contrast to other countries, consumer confidence recovered somewhat over the final three months of last year, assisted by falling interest rates and petrol prices. These developments, together with the government's $8.4 billion hand-out to pensioners, carers and 'working' families in the first half of December, appear to have resulted in pre- and post-Christmas retail sales holding up better than expected (and considerably better than in many other countries).

Nonetheless it seems likely that the willingness of Australian households to spend most of, or more than, what they earn underwent a fundamental change during 2008. And with unemployment likely to be trending upwards through the coming year, although (even on a worst-case scenario) more than 90 per cent of households who keep their jobs will be better off (due to falling interest rates, lower fuel prices and discounting by retailers), consumers will remain cautious, the saving rate will rise further and consumer spending will remain subdued.

Dwelling investment

Leading indicators of residential building activity declined markedly during 2008, accelerating in the closing months of the year (despite falling interest rates) to levels typically associated with troughs in the housing cycle.

During the second half of 2008 residential building approvals fell sharply, partly due to tougher financing

"Falling commodity prices, especially once coal and iron ore prices are renegotiated downwards after April, will see a deficit re-emerge by the second half of this year…"

conditions for builders and developers. Softer buyer demand, the ongoing financial crisis and previously higher interest rates also contributed to the decline. Indeed housing finance commitments (which can be taken as a proxy for housing demand) showed signs of improving in the closing months of last year, in response to falling interest rates and increased government assistance to first home-buyers.

While housing construction activity will inevitably decline further in the first half of 2009, this will exacerbate the already considerable gap between the housing supply and demand (driven largely by high levels of immigration). As noted earlier, this is one of the key differences between the housing market in Australia and that of many other countries, in particular the US. As soon as financial conditions allow (probably not until mid-2009 at the earliest), housing activity should begin responding to this persistent demand and could rebound strongly in 2010.

Business investment

Business investment intentions have remained remarkably strong, despite the dramatic deterioration in business sentiment over the course of 2008. Taken at face value, the ABS survey of capital expenditure expectations undertaken in October and November last year (that is, when the global financial crisis was at its most intense), points to a 27 per cent lift in the (nominal) value of business investment spending in the current financial year, assuming that these intentions are realised to the same extent on average as over the preceding five years. Even if one uses the lowest 'realisation ratio' in the last two decades (that for 1990–91) the survey still suggests an increase in business investment of more than 12 per cent in 2008–09.

Nearly all of this projected growth in business investment is in the resources sector, and as noted earlier, the deteriorating outlook for commodity prices implies that many planned or committed projects may be deferred or cancelled either for that reason or for want of financing. Investment expectations in other sectors of the economy also seem likely to be scaled back.

Business investment spending will almost certainly decline in 2009, and the extent to which it does may be a key determinant of the extent to which economic activity as a whole contracts in the coming year.

Trade and the balance of payments

Australia's balance of trade in goods and services finally swung into surplus in the second half of 2008, for the first time since 2001 (and only the fifth time in the last three decades).

The move was almost entirely attributable to higher prices for coal and iron`ore exports. Although growth in export volumes picked up a little, it was more than outweighed by continued, accelerating growth in imports.

This rare period of black ink on Australia's trade accounts is likely to prove as ephemeral as its predecessors. Falling commodity prices, especially once

coal and iron ore prices are renegotiated downwards after April, will see a deficit re-emerge by the second half of this year, even though import volumes are also likely to be declining by then.

The emergence of a surplus on the trade balance and declining interest rates on Australia's foreign debt in the second-half of last year led to a narrowing in Australia's current account deficit to its smallest as a proportion of GDP in more than six years. As with the trade account, however, this improvement in the current account balance is likely to prove temporary, and the deficit will widen again to over 5.5 per cent of GDP in the second half of 2009.

The relative ease with which Australia has been able to finance quite large current account deficits over the past decade may be another casualty of the global financial crisis. With equity investment abroad by Australian companies and superannuation funds exceeding foreign equity investment into Australia, and in the absence of any requirement for overseas borrowing by Australian governments, Australia's current account deficits have hitherto been financed overwhelmingly by the overseas borrowings of Australian banks. The global financial crisis has made that more problematic.

Financing the current account deficit, especially if it widens in the second half of next year as seems probable, will be a point of potential vulnerability for the Australian economy. It could be a source of further volatility in the exchange rate; and in the event of renewed global financial instability, rendering the financing of the deficit much more difficult, could provide an additional source of contractionary pressure on the Australian economy.

Regional divergences

The past few years have seen a heightened focus on apparent divergences in economic performance among Australia's states and territories, particularly on account of the commodities boom.

Such divergences are in fact not unusual. The difference between the fastest and slowest annual growth rates of gross state product (GSP) among the six states has averaged 3.9 percentage points since 1990–91, and this average has been exceeded only once in the past three financial years; indeed the 2.5 percentage point gap between the fastest- and slowest-growing states in 2007–08 was the smallest in a decade.

What has been unusual has been the persistently poor performance of Australia's largest state, New South Wales. NSW has ranked last among the states in terms of real GSP growth in four of the past seven years (and second last in two more), after having never once ranked last in the preceding ten years. State Treasury forecasts in the most recent mid-year budget reviews suggest NSW will rank last among the states on this score again in 2008–09. For the past four years NSW's unemployment rate has been above the national average, something which has not occurred for any sustained period of time since the 1980s.

However the divergence among the economic growth rates of Australia's states is likely to narrow in 2009 as the end of the commodities boom brings Queensland and Western Australia 'back to the pack', at least temporarily. Western Australia's Treasury still expects 6 per cent growth in its economy in 2008–09, but has lowered its forecast for 2009–10 from 6.25 per cent to just 1.5 per cent. Queensland Treasury lowered its 2008–09 forecast growth rate from 4.25 per cent to 3 per cent.

Victoria, South Australia and Tasmania, the states which gained least from the commodities boom (although South Australia experienced a surge in mineral exploration activity) and were most adversely affected by the steady rise in the A$ which accompanied it, have proved surprisingly resilient. Victoria and, to a lesser extent, South Australia have benefited from an increase in population growth, partly at the expense of NSW. Tasmania has enjoyed a broadly-based improvement in economic performance such that, in the second half of 2008, its unemployment rate was below the national average for the first time in nearly two decades.

Employment and unemployment

Employment growth slowed during 2008, in line with the broader slowdown in economic activity. Net job gains, at around 134,000, were the smallest since 2001, and underlying growth in full-time employment had come to a halt by the December quarter. Anecdotal evidence of job shedding increased towards the end of the year and intensified sharply in January, while leading indicators of the demand for labour, including job advertisements and the employment intentions components of business surveys, slumped sharply.

It seems inevitable that unemployment will rise noticeably during 2009, as a result of insufficient new job creation to absorb new entrants to the labour force (including from a still-high rate of immigration) and the loss of existing jobs through retrenchments. This is despite the fact that, as noted earlier, business finances do not appear to be in anywhere near as parlous a state as they have been immediately ahead of previous episodes of major job-shedding, and growth in labour costs has been much more subdued

than in the lead-up to previous periods of widespread retrenchments.

The extent to which the unemployment rate rises during 2009 will depend significantly on the extent to which employers choose to reduce their work forces 'pre-emptively'. It is possible that a fall in the labour force participation rate from its record high of over 65 per cent during 2008 could mask some of the rise in unemployment; however it is equally possible that the sharp fall in the value of older workers' superannuation savings could prompt at least some of them to defer retirement, keeping a floor under the participation rate.

Accordingly, unemployment can be expected to rise from 4.5 per cent at the end of last year (up from the February 2008 trough of 3.9 per cent, the lowest in 34 years) to at least 6 per cent by the end of 2009, an increase in the unemployment rate of 1.5 percentage points. A rise in unemployment of this magnitude (or greater) over a 12-month interval is usually considered sufficient to constitute a recession.

Inflation

Inflation accelerated sharply through 2008, reaching an annual rate of 5.0 per cent in the September quarter. As in many other countries rising petrol and food prices contributed to the pick-up in 'headline' inflation (in Australia's case, a total of 1.6 percentage points), while the widening spread between deposit and loan interest rates contributed a further 0.7 percentage points to the acceleration in inflation over the year to September.

Unlike most other countries, however, Australia also experienced a significant acceleration in 'core' or 'underlying' as well as in 'headline' inflation. A simple average of the Reserve Bank's two 'statistical' measures of the annual rate of 'underlying' inflation breached the upper band of the RBA's 2 to 3 per cent target range in the December quarter of 2007, and remained above it throughout 2008. This was the longest period of above-target inflation since the adoption of 'inflation targeting' in the early 1990s – peaking at 4.7 per cent in the September quarter.

This acceleration in 'underlying' inflation was an almost inevitable result of persistently faster growth in demand in an increasingly capacity-constrained economy (as a result of growing shortages of skilled labour, infrastructure bottlenecks and declining productivity growth).

In contrast to most other episodes of rising inflation over the past four decades, the most recent owed very little to rising labour costs. Indeed considering the tightness of the labour market up until the end of 2008, growth in labour costs was remarkably subdued by historical standards, except in the mining and construction sectors where labour shortages were especially acute. But, reflecting the significant institutional changes in wage-setting arrangements over the past two decades, the faster growth in mining and construction sector wages did not 'flow on' to other sectors.

Household, business and market inflation expectations have all fallen sharply since the onset of the most serious phase of the global financial crisis in September–October last year. By contrast, the Reserve Bank has actually raised its forecasts for 'underlying' inflation in 2009 and 2010 by 0.25 percentage points a year, and pushed back the horizon over which it expects 'underlying' inflation to return to within its 2 to 3 per cent target band by about six months, from the second half of 2010 to the first half of 2011. This largely reflects its assessment of the consequences for the prices of imported goods and services of the sharp depreciation of the A$ since July. (Figure 10)

In practice, importers and/or retailers may encounter some difficulty in fully passing on currency-related cost or price increases in the face of weak consumer demand. And although out-sized price increases will continue in some areas such as utilities, rents and health insurance premiums, there is likely to be more widespread discounting in other areas. Combined with sharper falls in petrol and other commodity prices than assumed by the Reserve Bank in its November forecast, 'underlying' inflation may be down to 3 per cent by the end of 2009 and back within the Reserve's target range by the first half of 2010.

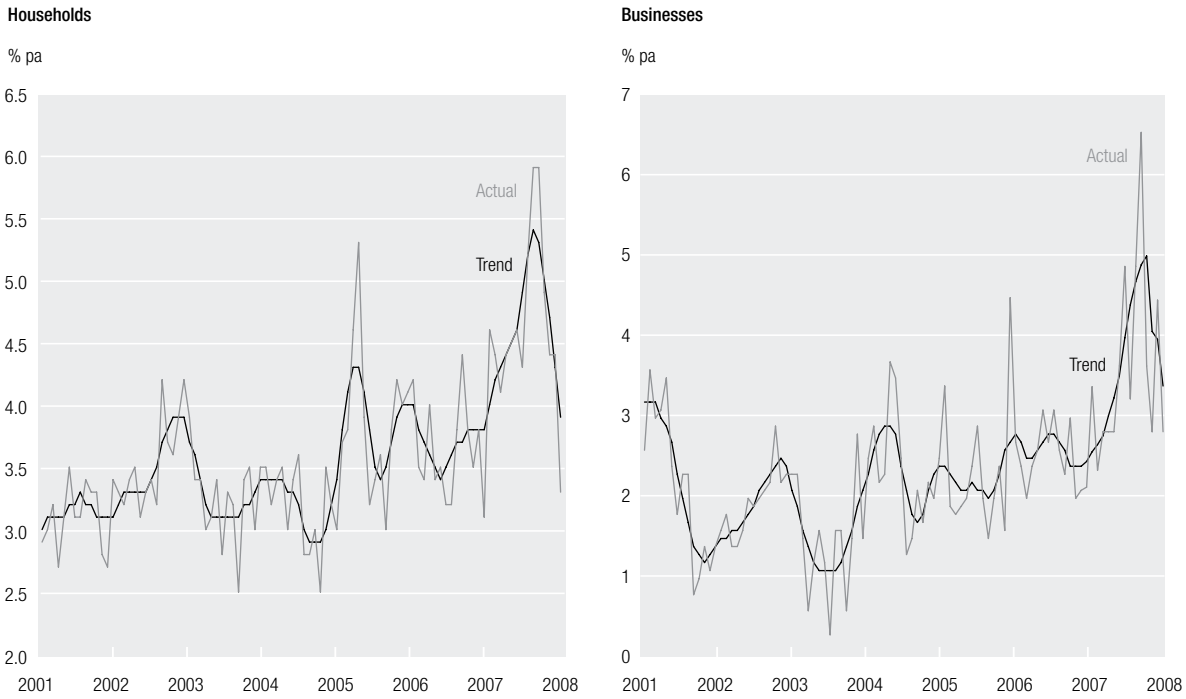
Fiscal policy

Australian political discourse over the past decade has tended to equate 'responsible economic management' with the maintenance of budget surpluses at the Commonwealth level of around 1 per cent of GDP, almost irrespective of the context. However this notion has never had any sound basis in economic theory or history.

Most economists support the proposition that the 'automatic stabilisers' inherent in the financial arrangements of contemporary governments – in particular, the tendency of tax revenues to rise and fall more than proportionately with the level of economic activity (or with movements in asset and commodity prices), and the equivalent tendency of certain components of government spending (in particular unemployment benefits) to move in the opposite direction – should be allowed to operate. These tendencies should result in endogenous, counter-cyclical fluctuations in

Figure 10

Inflation expectations have turned around sharply



Note: Business series is selling price expectations for next three months, converted to annualized rate.
Source: Westpac-Melbourne Institute, NAB, ANZ.

the budget balance and reduce the need for other policy actions.

The elevation of a particular budgetary outcome (such as a surplus of 1 per cent of GDP) to the status of a target in its own right has forced fiscal policy to become 'pro-cyclical' in recent years.

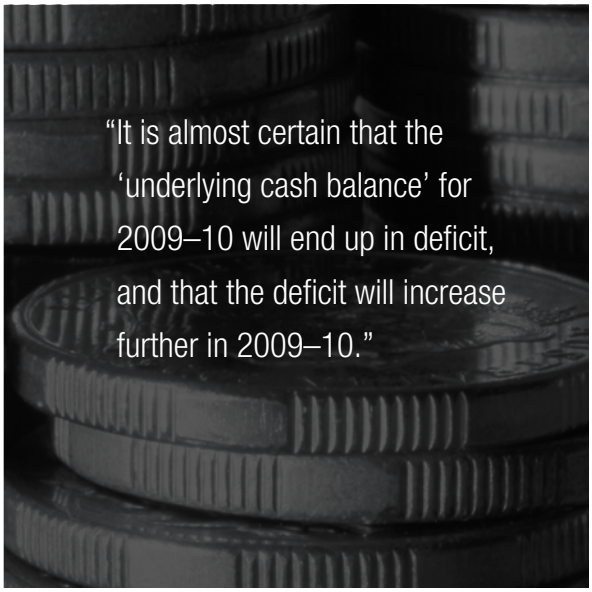
Thus, the Howard government in its last two terms felt obliged to cut taxes and increase government spending in circumstances where surging revenues would otherwise have resulted in a budget surplus of well in excess of 1 per cent of GDP. In consequence, monetary policy was obliged to take on more of the burden of bringing the rate of demand growth into line with that of potential supply.

Now that the global financial crisis and the end of the commodities boom has resulted in a pronounced turn in the economic cycle, the continued pursuit of a budget surplus in the face of declining revenues would require the government to increase taxes or cut spending in ways that would inevitably exacerbate the downturn in private sector economic activity.

There is no economic logic to support this course of action – especially in circumstances where the ability of monetary policy to carry the primary responsibility for ameliorating the downturn in economic activity is likely to be impaired by the global financial crisis and by fundamental changes in the attitudes of households and businesses towards increasing their levels of borrowing.

Rather, most mainstream economists tend to support the view that in circumstances such as those likely to prevail this year, national governments should consider running budget deficits temporarily, not only as a result of the 'automatic stabilisers', but also as a result of 'policy decisions' to cut taxes and/or increase government spending to reduce the effects of the downturn in private sector activity and to induce an eventual recovery. Most economists would also agree that these actions should be unwound (or offset by other measures) once a sustainable recovery has become established.

Beyond that, there will be differences among economists (and others) as to the exact measures that should be adopted, for example: tax cuts as against increased government spending; whether any tax cuts should be portrayed as temporary or permanent; whether additional spending on infrastructure (which produces lasting benefits but usually involve considerable planning and implementation lags) is preferable to (for example) increased support for household incomes and spending (which can be implemented more quickly but which may be politically



more difficult to reverse after the need for them has passed). Such differences reflect divergent perspectives on the response of households and businesses, as well as ideological differences.

For its part the Rudd government has been willing to allow the 'automatic stabilisers' to operate. In addition it provided a discretionary fiscal stimulus of over $10 billion (1 per cent of annual GDP), the vast bulk of it directed towards supporting household income and spending in the lead-up to and immediately after Christmas, and the remainder towards supporting housing demand. However it has been noticeably cautious about allowing, let alone explicitly pushing, the budget into deficit.

According to the government's Mid-Year Economic and Fiscal Outlook (MYEFO), released in November last year, 'parameter variations' (that is, revisions to estimates of revenue and expenditures arising from changes in economic and other assumptions) since the May Budget have reduced the underlying cash surplus in prospect for the current financial year by $5 billion and that for 2009–10 by $14.4 billion. 'Policy decisions' have further reduced the prospective surplus for 2008–09 by $11.1 billion (most of that stemming from the Economic Security Strategy announced in October) and that for 2009–10 by $1.6 billion.

Further policy announcements since early November (the largest of which are increased payments to state and territory governments agreed at December's COAG meeting) will reduce the surplus for 2008–09 to less than $1 billion, and that for 2009–10 to a little over $3 billion, on unchanged economic and other assumptions.

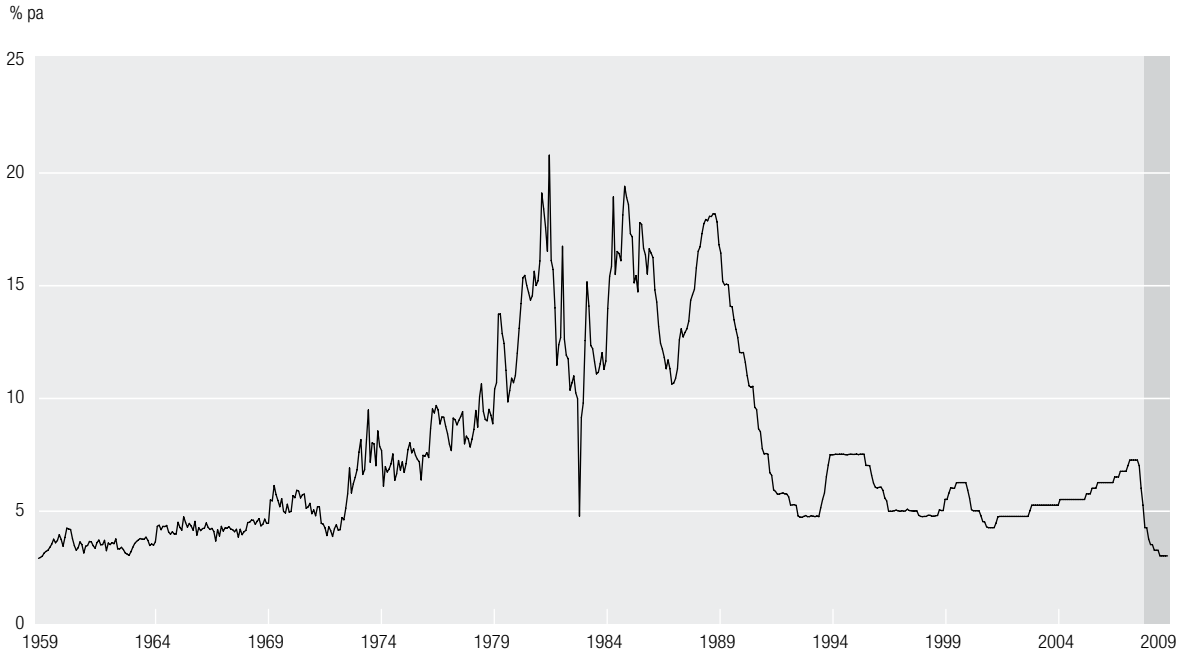
The assumptions underlying the MYEFO estimates (including real GDP growth of 2 per cent in 2008–09 and 2.25 per cent in 2009–10) were widely regarded as optimistic and the outlook has deteriorated since then. It is almost certain that the 'underlying cash balance' for 2009–10 will end up in deficit, and that the deficit will increase further in 2009–10.

As noted above, it is entirely appropriate that the budget be in deficit in current circumstances; indeed, it seems desirable that the government implement measures with the incidental effect of increasing the deficit in the short term, provided these measures are well targeted and do not increase the deficit on a permanent basis.

State and territory government budgets are also under pressure from sharp declines in revenue from taxes on property transactions, and will be adversely affected by weaker payroll tax collections as the labour market deteriorates. The New South Wales and Queensland governments have raised some

Figure 11

The cash rate could fall to a 40-year low this year



Note: Shaded area at right denotes forecasts.
Source: Reserve Bank of Australia, ANZ.

state taxes, while some other states have foreshadowed expenditure-saving measures.

In general, state and territory governments should not run 'operating' deficits (that is, spend more on recurrent services than they receive by way of revenues from their own sources and from Commonwealth grants). They are not responsible for counter-cyclical economic management. Their economies are too integrated to prevent any general stimulus from 'spilling over' into other regions; and their revenue base is too narrow to provide much assurance that any 'operating' deficit will prove temporary.

On the other hand, there is nothing wrong with state or territory government borrowing for capital expenditures (in accrual accounting language, incurring 'fiscal deficits'), provided the capital expenditures are justified on their merits and the borrowings undertaken to finance them can be serviced without pushing the 'operating' budget into deficit.

Monetary policy and interest rates

As noted earlier, Australia faced a serious inflation problem throughout much of 2008, and on the Reserve Bank's most recent forecasts (which envisage above-target inflation until the end of 2010), it still does. By last August, however, the Bank had concluded that the inflation risk was outweighed by the deteriorating global economic outlook, a view which solidified as it became increasingly apparent that China's economy was slowing rapidly with unavoidable implications for Australia.

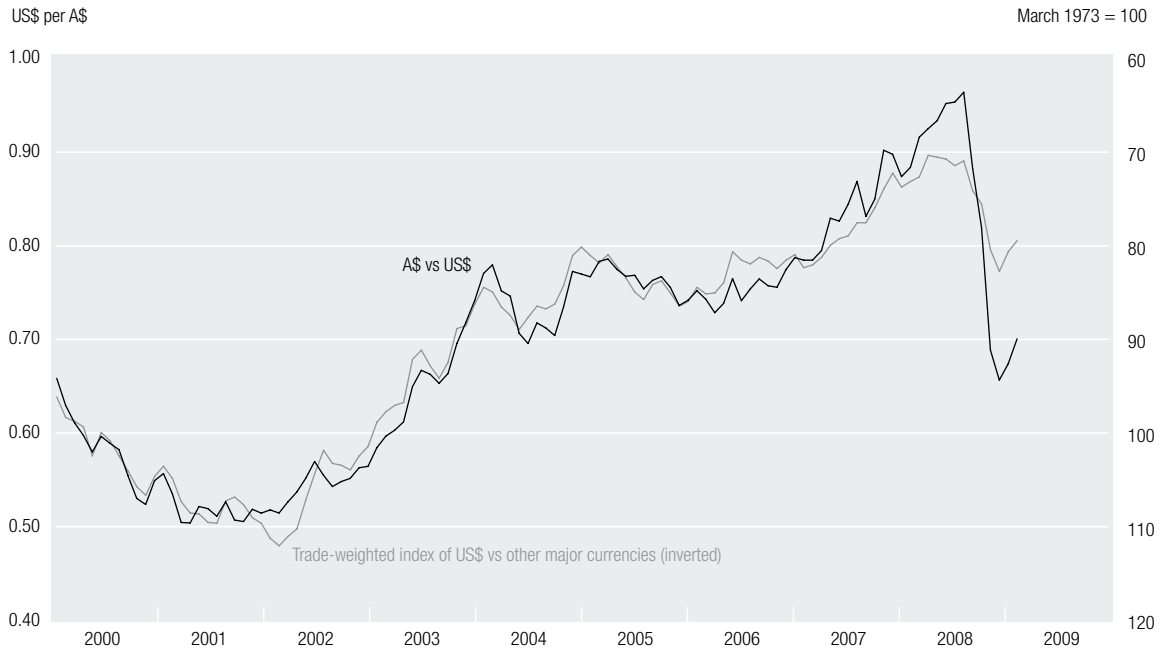
The Reserve Bank then made one of the most abrupt u-turns in its history, cutting its cash rate from 7.25 per cent to 4.25 per cent. This decline of 300 basis points in four months reversed an increase of the same order of magnitude over the preceding six-and-a-half years.

The magnitude of the reductions reflected the Bank's determination to indicate forcefully the extent to which it was willing and able to respond to the deteriorating outlook (as a result of its previous tightening); a determination to ensure that the reductions in the cash rate actually led to significant reductions in the interest rates paid by household and business borrowers (rather than being absorbed by banks); and what appeared to be a desire not to disappoint market expectations.

At 4.25 per cent the cash rate is – as the Reserve Bank Board explicitly intends – well below the range regarded as consistent with a 'neutral' stance of monetary policy. That range has traditionally been seen as indicated by a cash rate in the range of 5 to 6 per cent. However with the spread between

Figure 12

The Australian dollar's movements – partly, though not totally, driven by US$



Source: RBA, US Federal Reserve, Thomson Financial Datastream.

the cash rate and the interest rates actually paid by end-borrowers widening by some 60 to 80 basis points last year, the range for the cash rate consistent with 'neutral' monetary policy has shifted down, at least for the time being, to 4.25 to 5.25 per cent or thereabouts.

It could be argued that monetary policy settings are only marginally on the 'easy' side of 'neutral', at a time when the Australian economy may be on the cusp of recession, and that there is both the scope and the necessity for monetary policy to be eased further in the months immediately ahead, albeit perhaps not as rapidly as during the final months of last year. The cash rate could fall to 3 per cent – its lowest level since 1960 (when the cash rate did not serve the purposes it does today) – by or shortly after Easter; and could even go lower if Australia finds itself experiencing a serious economic contraction (Figure 11).

The elevated spreads between the cash rate and mortgage rates will probably not widen further, but nor are they likely to begin narrowing any time soon. Although banks' marginal cost of funds is now falling, their average cost of funds will decline more slowly (and more slowly than the official cash rate) as maturing longer-term debt raised before the onset of the global financial crisis is 'rolled over' at wider spreads.

The Australian dollar

After almost reaching parity with the US dollar (and a 22.5-year high in trade-weighted terms) in mid-July, the Australian dollar fell sharply over the second half of 2008, touching a low of just over US61¢ on 20 November (the day which, thus far, also represents the trough for the Australian and global share markets). It came close to its September 2001 low of ¥57.2 against the Japanese yen, losing almost 30 per cent of its value in trade-weighted terms. Since then, the A$ recovered by almost 10 per cent in trade-weighted terms and to just over US70¢ as of mid-January, before falling back to the mid-60s against the US$ in the second half of January.

The sharp decline in the value of the A$ over the second half of last year was in part due to strong rises in the US$ and Japanese yen against almost all other currencies.

The rise in the US$ was surprising to many, given the US was the epicentre of the global financial crisis and that interest rates on US financial instruments fell to record or near-record lows during this period. It was largely attributable to the hoarding of US dollars by US and other banks (creating a 'scarcity' premium), to the scramble on the part of highly-leveraged investors to repay loans denominated in

US$, to a perception that the US authorities were responding more aggressively to the financial crisis than their European counterparts, and to a lingering belief that (whatever its other failings) the US remained a 'safe haven' in a crisis. The even greater appreciation of the yen resulted largely from the abrupt end to the 'yen carry trade' (the funding of speculative positions, including by Japanese retail investors, in the Japanese currency).

Other factors weighing on the A$ included the decline in commodity prices, and the narrowing in the interest rate differentials between Australia and other financial centres (Figure 12).

Although it is easy to construct bearish scenarios for the US dollar in 2009 (based on the prospect of a deep US recession, an extended period of near-zero interest rates, and deteriorating US public finances), it is far from clear what other major currency or currencies should appreciate against it. Despite its rally over the second half of last year, the US$ is still 25 per cent below its peak against other major currencies earlier this decade. The euro's fundamentals hardly inspire greater confidence than the dollar's, except that the euro area has considerably less net foreign debt than the US. Appreciation by any other plausible candidates, most obviously the Chinese yuan, is likely to encounter strong political resistance.

The US dollar could prove surprisingly stable almost by default.

The Australian dollar almost certainly has more downside ahead of it in 2009, given the likelihood of further falls in commodity prices and declines in Australian interest rates relative to those in other financial centres (in many of which interest rates are already close to zero).

Depending on the extent to which the US$ strengthens further, the A$ could fall below US60¢. However it is difficult to envisage the A$ revisiting its 2001 lows of US47¢ given that the US$ is most unlikely to be as strong against all currencies as it was then. Even with a further fall of more than 30 per cent from end-2008 levels, commodity prices (in US$ terms) will still be more than double their 2001 levels. It is almost impossible to envisage Australian interest rates being below US interest rates, as they were for a time around the turn of the decade.

The A$ is likely to be reasonably stable against the euro and sterling, but may strike new lows against Asian currencies (including the yen and the yuan) during 2009.

The views in this article are those of the author and should not be attributed otherwise.

Endnotes

1 These latter figures will almost certainly be exceeded by Iceland, where the cost of bailing out the banking system is by some estimates likely to exceed 75 per cent of annual GDP.

2 The others being Austria, Belgium, the Czech Republic, Finland, Greece, Korea, the Netherlands, Poland, Slovakia and Switzerland.

3 Proportionately this represents a decline of 7.6 per cent, compared with a decline in US household net worth (from a peak one-quarter earlier) of 11.1 per cent.

4 Rio Tinto's debt-funded acquisition of Alcan in 2007 also boosted this ratio by 12 percentage points.