

# We have revised our growth and rate forecasts

- **Australian economy to contract by 0.7% through 2009.**
- **Australian economy to outperform G7 in 2009 due to greater policy flexibility.**
- **Unemployment rate to rise to 7.0% by end 2010.**
- **RBA's cash rate to reach 2% by June Quarter; 100 bp rate cut on February 3.**
- **Global recovery will be slow keeping global rates very low through 2009 and 2010.**

The events of the last 18 months, particularly the last few months, have convinced us that the corporate sectors of the US; UK; Europe and Japan have or are very likely to enter into balance sheet recessions. Balance sheet recessions are rare but the evidence we have from the 1930's and Japan in the 1990's suggest they are drawn out and very painful. A balance sheet recession can result when economic entities encounter violent falls in asset prices. In the case of the corporate sectors the collapse in equity and commercial property prices and the implications which these prices have for other unlisted assets on their balance sheets have and will continue to spur the corporates to hoard cash and/or pay down debt.

Debt reduction and cash hoarding has replaced profit maximisation as the key corporate objective. Due to excessive gearing and poor risk management policies, the worst affected balance sheets have been those of the financial sector entities. The combination of limited supply of credit (as financials seek to restore their balance sheets) and weak demand for funds (as corporates pay down debt and hoard cash) will constrain economic growth prospects for a considerable period – well beyond 2009.

The depth and timing of these recessions will be heavily affected by the responses of the authorities.

Monetary policy has little impact in these circumstances because the demand for funds is not driven by price rather the need to restore balance sheets. However monetary policy should certainly not exacerbate the problems by adopting policy settings associated with targeting inflation which are appropriate for a "profit maximisation world". Interest rates should be reduced to extremely low levels very quickly and held there for a considerable time. Hence monetary policy's role has to be to "get out of the way" while corporates are operating in this way. In time, when it becomes clear that the balance sheet affect is no longer driving economic decisions then monetary policy needs to be activated quickly to mop up excess liquidity and manage the spending recovery.

Even quantitative easing has a limited impact since both lenders and borrowers are more concerned with restoring balance sheet health than making or receiving more loans. Such an environment will mean continuing contraction in corporate spending and employment plans.

In those countries like US; UK; and parts of Europe the collapse in house prices has had a comparable impact on the household sector's demand for funds while the collapse of asset quality in the financial sector's balance sheets has constrained supply of funds

to the household sector. Household spending will be affected by the households' balance sheet concerns; the financial sectors' risk aversion and the reduced employment opportunities as the corporate sector reacts to its own balance sheet problems.

The most important policy response must come from the fiscal authorities. Total spending in the economy can only be sustained if the public sector spending largely fills the gap created by the reduced spending from the private sector. When we saw a similar response from both corporate and household sectors in the aftermath of the share market collapse in 1929 the 4 year delay in an appropriate fiscal response exacerbated the Great Depression and allowed deflation to take hold. The fiscal authorities must also act to restore the functioning of the financial system through guarantees; capital injections; and assistance in restoring the balance sheet quality of the banks. While the central bank may be used as the agent of these initiatives these are really aspects of fiscal policy.

The general fiscal stimulus needs to be focussed on spending rather than tax cuts since corporates and possibly, households which are still in the "balance sheet recession" mode are likely to save much of any tax cut.

Fiscal policy should be used aggressively to ensure that total spending and the money supply do not contract as we saw in the period in the US between 1929 and 1933 particularly to manage the risk associated with entrenching deflation and deflationary expectations.

This environment points to an extended period of weak global growth with the contractions/anaemic growth in the G7 through 2009 and 2010. At this stage the fiscal responses of these major economies remain underwhelming given the enormity of the problems although the lessons of the 1929 – 1933 period have been partly heeded.

## What Does This Mean for Australia?

It is likely that the Australian corporate sector is also entering a period where balance sheet health overrides profit maximisation. While trends prior to the RBA's recent aggressive rate cuts pointed to the household sector adopting a more conservative approach to debt, (see Figure 1) there is early encouraging evidence that the demand for funds has picked up in response to the recent aggressive rate cuts by the RBA and the efficient pass through of those cuts to borrowers.

While the collapse in equity and commercial property prices will focus the attention of the corporate sector on balance sheet issues, house prices, which are the key asset price for households, have been relatively stable. Policy needs to be aimed at avoiding a balance sheet recession for the household sector. With Australia's household sector holding record debt levels the risk of a balance sheet recession for the household sector cannot be ignored.

Monetary policy is still effective in Australia with banks being in a position to pass rate cuts through to borrowers and households likely to continue to respond positively to those cuts. There is considerable scope for monetary policy to be used in this way and that policy

option must be taken. Nevertheless, households will inevitably be adversely affected by the employment decisions of the corporate sector so aggressive rate cuts are important to assist the cash flow positions of the household sector; encourage more borrowing and investment in housing and avoid a balance sheet recession in the household sector.

However, the most important policy option needs to be fiscal policy. The Australian government is already showing positive signs of accepting its responsibility to ensure the stability of the financial system. There is more work to be done in sustaining demand in the face of the inevitable weakness in private sector spending. As with the US and others, direct spending needs to be favoured over tax cuts to ensure maximum support to demand.

### These Observations have Significant Implications for our Financial and Macro Forecasts.

1. In previous global recessions Australia has underperformed the average G7. Because this global recession is different there is a respectable case for Australia's growth profile to exceed average G7. Australia has more policy flexibility to deal with current problems and, in particular, these policy options should allow the household sector to avoid a balance sheet recession. However, we emphasise that an aggressive mix of monetary and fiscal policy will be required to achieve this desirable outcome.
2. Despite this relatively favourable outcome we still expect that the Australian economy will contract in 2009 by 0.5%. With appropriate policy that low point should be followed by positive but anaemic growth of around 1.8% through 2010.
3. The RBA will cut rates even more aggressively than we previously expected reaching a low point in the cash rate of 2% (from the current 4.25%) by June quarter 2009 (our previous forecast low was 2.75%). Risks on this low point are to the downside because the essential role for the RBA in 2009 will be to manage interest rates to a level where rates are providing the maximum possible boost to the household sector. Hopefully, the Bank is quickly accepting that inflation targeting is not appropriate in the current environment and minimisation of the impact of the global balance sheet recessions on the real economy is the central policy objective.
4. With the corporate balance sheet issues remaining a constraint for some years both globally and locally there will be insufficient evidence for the RBA to see the need to return policy to a more "normal" policy stance before 2011 – expect these low rates to be sustained throughout 2010.
5. The Australian corporate sector will not only be adversely affected by deteriorating balance sheets but those in the resource sector and those companies that service the resource sector will also have to deal with a massive reversal in Australia's terms of trade – the resulting impact on cash flows will complement the balance sheet issues in constraining capital and labour expenditure. Our view of the world economy is not consistent with any major revival in commodity prices over the next two years.
6. Business investment, employment and exports will be much softer than previously expected, reflecting the likely weakness in corporate spending plans. We expect business investment to contract 13% in 2009 and a further 8% in 2010. The unemployment rate is likely to reach 6% by end 2009 and 7.5% by the end of 2010. Export growth will fall from 6% in 2008 to -1.0% in 2009.

### Growth: Aust vs G7

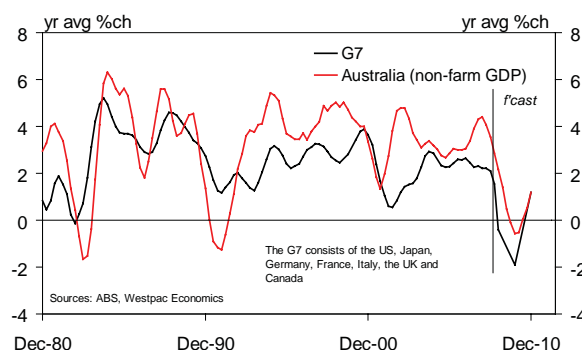


Figure: 1

7. While our policy expectations envisage that the household sector will avoid a balance sheet recession household spending will be constrained for longer due to the conservative approach taken by the business sector both in Australia and globally. Consumer spending will grow by only 1% in 2009 and 1.7% in 2010. That anaemic growth while well below par is still contingent on aggressive fiscal and monetary policy responses.
8. The authorities will embrace a much more aggressive fiscal policy than previously expected and the stimulus will need to last longer than one year. Expect continuing additional stimulus policies to be enacted in both 2009 and 2010. With the starting position being "no net debt" the Australian authorities have considerable scope to use fiscal policy effectively. We note that the latest fiscal package being considered by the new US president is around 8% of GDP – so far Australian's fiscal stimulus have been only around 1.5% of GDP. We expect more stimulus packages mainly centred on public works and other spending policies. Our current growth forecasts for 2009 and 2010 assume further fiscal initiatives while recognising that our preferred policy emphasis of public works and direct expenditure will have the major impact in 2010.
9. With the global economies realising the urgent need for stimulatory fiscal policies those economies with below par growth and running trade surpluses should rely exclusively on domestic policies to stimulate growth- we are encouraged by announced intentions of both China and Japan in this regard. Those economies with below par growth and trade deficits should be able to expect some growth "assistance" from external factors. That implies appreciation of surplus currencies and depreciation of deficit currencies. USD and AUD fit into that deficit framework while RMB; JPY; and EURO fit the surplus model.
10. With global risk concerns likely to be sustained for some time; its fiscal stimulus policies lagging the US and the interest rate differential closing by 225 ppts the AUD is likely to depreciate against USD in the near term. However we expect that in the medium term Australia will be more successful than US in stimulating its economy particularly due to a much healthier financial and household sectors. That points to eventual strength of AUD against USD although the surplus countries are likely to continue to outperform (on the assumption of an absence of official intervention).

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