The CONUS Quarterly

September 2009

CONUS
Business Consultancy Services

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Editors Note

Welcome to the first edition of The CONUS Quarterly. We hope that you'll find it contains some useful and interesting reading.

Each quarter, following the release of Australian GDP figures, we will be producing The CONUS Quarterly to look at some of the interesting economic topics of the day.

If, in the meantime, we at Conus Business Consultancy Services can help you with information or research on more specific economic requirements, please do not hesitate to contact us to discuss your needs.

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2nd Quarter Australian GDP Data

Second quarter 2009 GDP was released at +0.6% quarter on quarter.
The first quarter was left unrevised at +0.4. This coming after only one quarter of negative GDP growth in the fourth quarter of 2008 (-0.6%).

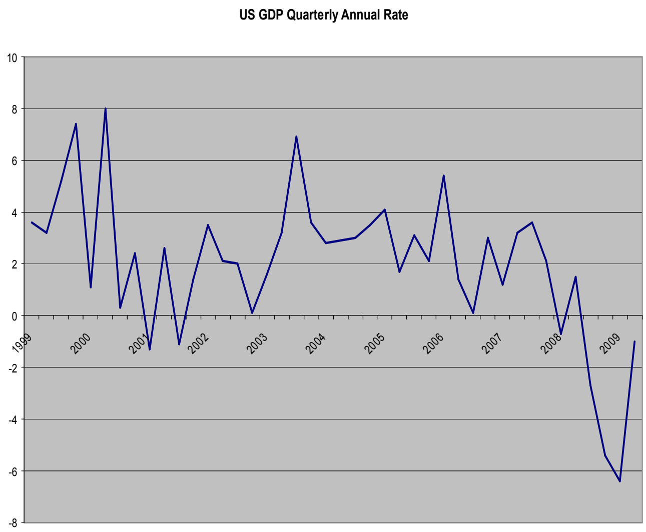
Unlike almost every other developed economy in the world, Australia seems to have ridden out the Global Financial Crisis without slipping into a technical recession (2 consecutive quarters of negative GDP growth).

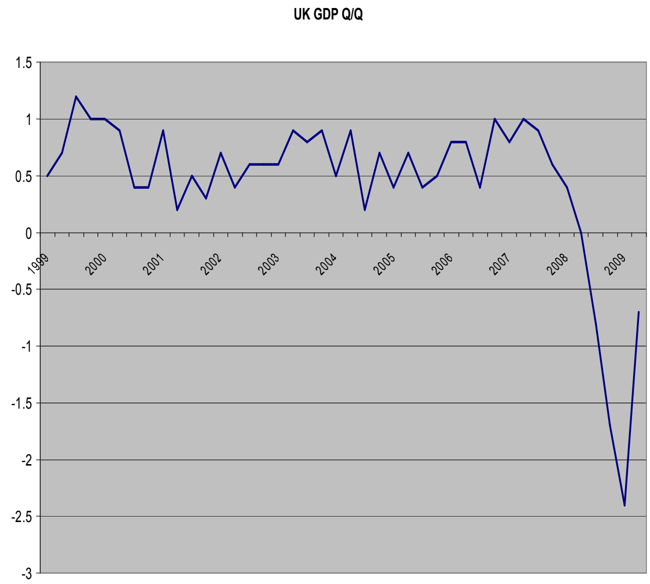
However, the numbers hide a slightly different story and we need to ensure that we don't get too carried away at this stage of the cycle.

A large part of this quarter's growth can be laid fairly and squarely at the door of the government's cash hand-outs earlier in the year. Household spending contributed 0.5% of the GDP growth. This increase in household spending has also had an impact on the country's trade position. Exports were down, despite continued strong commodities demand in China, and imports were strongly up. This has resulted in a significant deterioration in our Trade Balance.

This is a direct result, and the flip-side if you like, of the fact that the Australian economy is doing so much better than most of our trading partners. As this continues to be the case we can expect to see the Trade Balance fall further into deficit. This in itself is a brake on our GDP growth with net exports dragging down second quarter GDP growth by about 0.2%.

So long as our trading partners remain mired in recession, or at best very slow growth, we can expect our exports to struggle. US GDP for the second quarter was still showing a decline (-1%) and is the forth consecutive such fall. In the UK, GDP also fell in the second quarter (-0.7%) and they haven't had a rise in GDP there since the first quarter of last year!





Another factor impacting on exports is the rapid rise in value of the Aussie Dollar. This makes our exports more expensive and our imports cheaper.

Since the A$ hit lows of about US 62 cents at the peak of the GFC, it has climbed as the markets price in an increase in Australian interest rates in the near future (see our other article on interest rates in this edition) to be currently trading around US 85 cents. Many analysts are now talking (again) about parity with the US$ once Australian rates rise next year.

And it's not just the US Dollar that has seen all the action. The British Pound has weakened from about A$2.50 last year to A$1.91 now. That's almost a 25% fall in less than a year.

These latest GDP numbers have led the Reserve Bank of Australia to change their forecasts for GDP growth looking forward. The RBA now expect modest growth of 0.5% in 2009, picking up to 2.25% in 2010 and 3.75% the year after.

These are the kind of numbers that other Central Bankers and Treasurers can only dream about at the moment and so long as China, and to a lesser extent India, continue to demand our commodities they seem perfectly attainable. However, the financial system globally is still under immense strain and any further unforeseen shocks (such as another major bank failure) could certainly set back Australia's growth prospects. We are not out of the woods yet, but at least we can start to *see* out of the woods.

The outlook for Australian interest rates

The Reserve Bank of Australia (RBA) sets the Cash Rate, which is the overnight money market interest rate. This is used as the basis upon which commercial banks set their lending rates.

Since April 2009 the Cash Rate has been set at 3% (a 49 year low) following declines from 7.25% in Sept 2008.

Comments by Wayne Swan indicate that this rate is seen as an "emergency" rate.

> *"Rates are at emergency levels and at some stage in the future they can be expected to move."*

The last RBA Monetary Policy Statement in August 2009 states,

> *"With the cash rate at an unusually low level and the global economy stabilizing, movement towards a more normal setting of monetary policy could be expected at some point if further signs of a durable recovery emerge."*

Since this last comment Australian GDP for the second quarter of 2009 has been released showing a 0.6% increase. This could be the "signs of a durable recovery" mentioned above.

The ASX quotes prices for 30 day Interbank Cash Rate Futures. The pricing of these instruments gives us some insight into what the market is thinking about the outlook for the Cash Rate over coming months. These prices suggest that the market is currently pricing in increases in the Cash Rate as follows:-

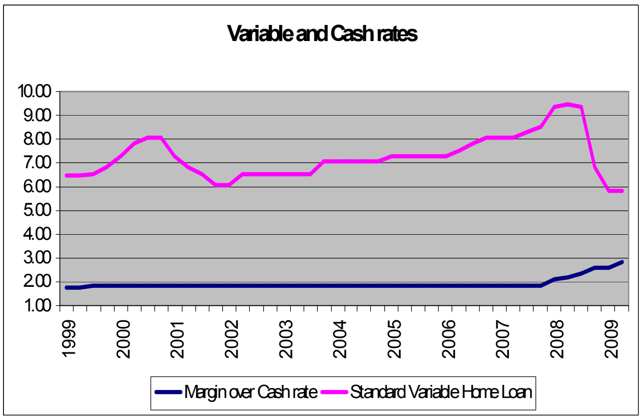
Oct '09	+0.10%
Nov '09	+0.20%
Dec '09	+0.20%
Jan '10	unchanged
Feb '10	+0.25%
Mar '10	+0.25%
Apr '10	+0.20%
May '10	+0.20%

And then further increases of about +0.85% by Feb 2011.

If correct, this would bring the Cash Rate to approx 5.25% by Feb 2011. This might be deemed to be a more "usual" setting of monetary policy by the RBA and would certainly bring the rate back to a level more in line with the historically trend.

Consensus within economists (barring any major unforeseen shock) would appear to be for increases to start in early 2010. However, the futures market and various researchers would suggest rate hikes could start as soon as November 2009.

Of course for many of us the interesting question then becomes, are these increases likely to be reflected fully in the rates charged by the commercial banks?



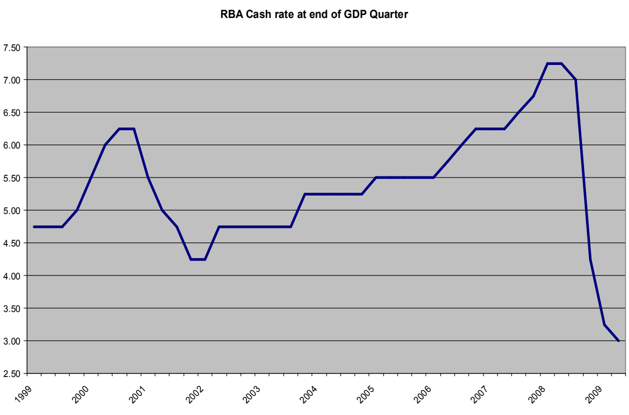
What the chart above shows us is that as rates were slashed quickly at the end of 2008 and into 2009, the fall in variable standard home loan rates was not as fast. Indeed it would appear that variable home loan rates are currently about 1% higher than the usual 1.8% margin over the Cash Rate would suggest they should be.

Why might this be? Well, we can see that as the Global Financial Crisis took hold through 2008 the banks began charging a higher margin over the Cash Rate than previously. Simply put, this was because the GFC increased the cost of funds to commercial banks as the credit markets froze up. This increase in cost was passed along to their customers in the form of higher lending rates.

What this might suggest is that as the problems in the credit markets caused by the GFC start to disappear (they haven't gone yet), we could hope to see the commercial banks return their variable rate margins back towards the historic average of about 1.8% from the current 2.85%.

In other words, if the Cash Rate rises next year, and as the global financial markets become more stable, it is possible that the full (predicted) 2.25% of rate increases might NOT be passed on to bank borrowers.

But knowing the banks as we do, I wouldn't hold my breath.



Government Debt. What's the real picture?

The Australian Government, in line with virtually all other major economies, has instigated a package of fiscal stimulus measures in a bid to alleviate the negative impacts of the Global Financial Crisis.

These fiscal stimulus's have ranged from simple cash hand-outs to tax payers, massive infrastructure spending (much of it now coming under intense scrutiny as it becomes clear that some of the money has gone to , at best, questionable projects!), and tax breaks for businesses who have invested in capital goods.

As all this spending has been going on, the slowdown in the economy has also reduced government revenues accordingly.

The Federal Budget has moved heavily into deficit and the inevitable consequence of this has been an increase in government borrowing and a higher level of net debt.

However, much of the comment in the press and from politicians regarding this position has been inflammatory and often without regard to the actual position.

To put this in some kind of perspective it's important that we look at the level of this debt in terms of its size relative to the nation's size (i.e. as a percentage of GDP). After all, we all take out larger mortgages, for example, to buy our homes than we did 20 years ago, but that is because we earn much more than we did 20 years ago! The bare figures of government debt don't really tell us anything useful; we need to look deeper.

On the last available measure (for 2008), government debt was 5.9% of GDP in Australia.

Forecasts suggest a peak level of debt at about 16.6% of GDP in the year 2014. This may sound like a lot (and indeed it is), but we must also bear in mind that as recently as 1996 and 1997 government debt stood at around 22% of GDP. By 2004 it had already fallen to only 8% of GDP.

Putting this into some kind of international context it is perhaps useful to look at these debt levels for other major economies. The following are the IMF forecasts for Government debt as a percentage of GDP in some other economies by 2014:-

US	**106.7%**
UK	**87.8%**
Japan	**234.2%**
France	**89.7%**
Germany	**91.0%**
Avg. Advanced G20 countries	**114.1%**

Of course I am not suggesting for a minute that we should become blasé about the debt mountain that is building up. Fiscal stimulus must, and will, begin to be eased as the economy continues to recover from the impacts of the GFC.

However, the recent G20 Summit in London made it very clear that the major economies are in no mood to start cutting back on stimulus just yet. And although Australia is in an enviable position compared to many G20 nations, Wayne Swan made it known that the announced stimulus in Australia would continue as planned.

Of course, as the economy improves and returns to more normal growth, then government revenues will once again grow and this should allow the government to return to a more fiscally conservative position.

For the foreseeable future we can expect to see the government and Reserve Bank working together; the Reserve Bank slowly unwinding its accommodative monetary policy with rate increases in coming months, and the government continuing on with the stimulus spending already announced.

As far as Australia is concerned, with a growing economy, this level of debt is far from unsustainable and we should therefore not expect to see the government starting to roll-back stimulus any time soon.