

After the global financial crisis – prospects for Australia’s economy

Presentation to an educational briefing for
**Melbourne Credit Union Forum
 and Australasian Mutuals Institute**

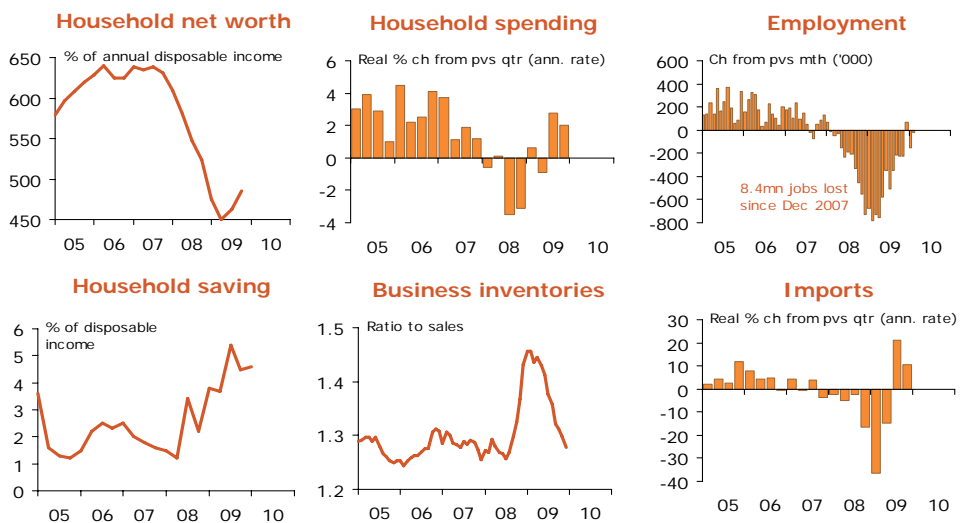
Amora Riverwalk, Richmond
 22nd February 2010

Saul Eslake

Asset price bust and financial market meltdown caused an abrupt and deep US downturn, which bottomed in the second half of last year

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Financial crisis and recession in the US

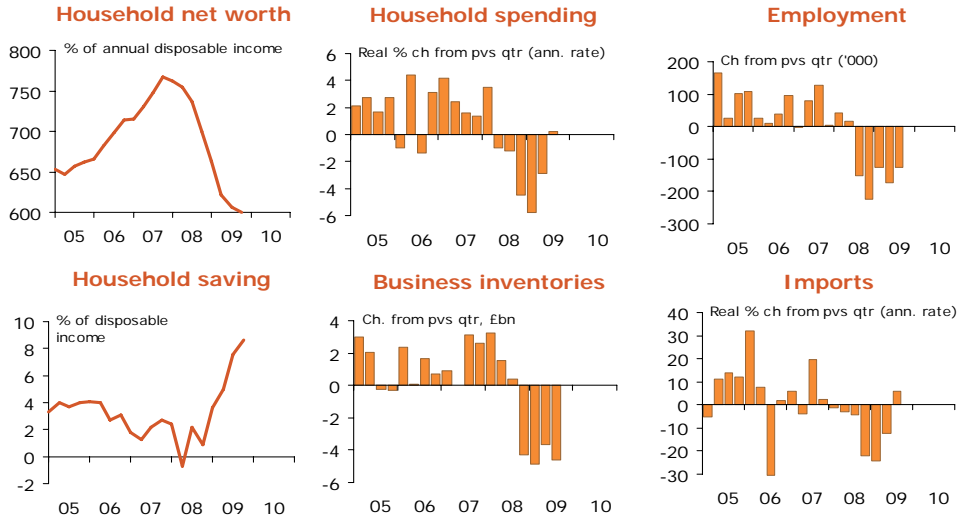


Source: US Bureau of Economic Analysis; US Federal Reserve; US Bureau of Labor Statistics; US Commerce Department

Much the same thing happened in the UK – though more severely and for longer

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Financial crisis and recession in the UK

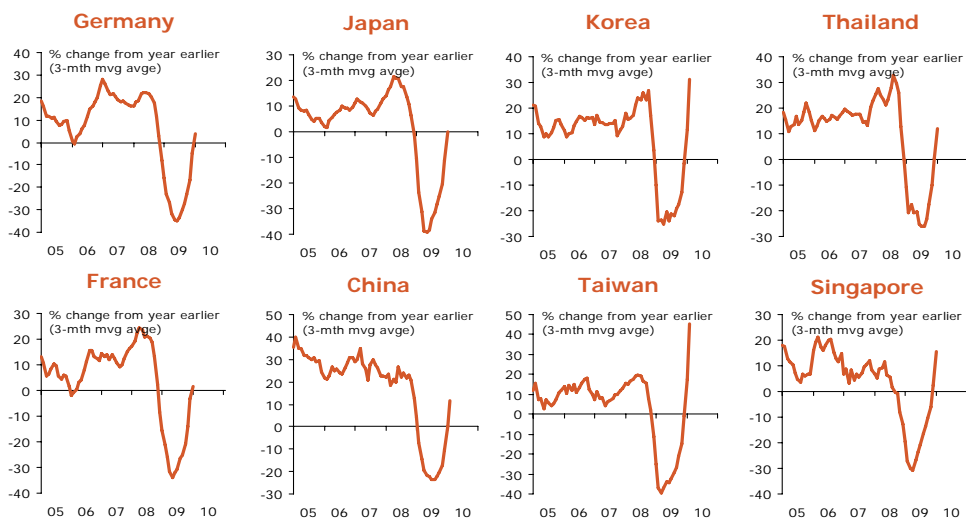


Source: UK Office of National Statistics.

The slump in trade, magnified by 'confidence effects' and disruption of financial flows, spread the downturn around the world

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European and East Asian economies – merchandise exports



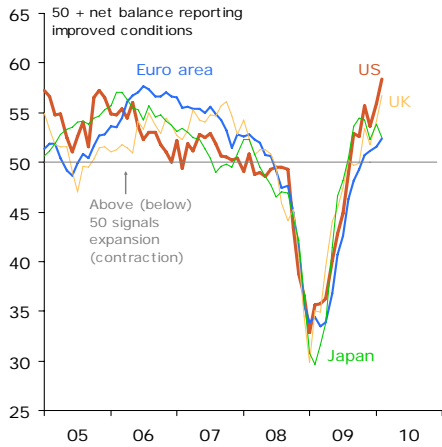
Note: all data in US\$. Sources: National statistical agencies; Datastream.

The rebound in advanced economies has been driven by unwinding the inventory cycle and policy stimulus, but 'final demand' remains weak

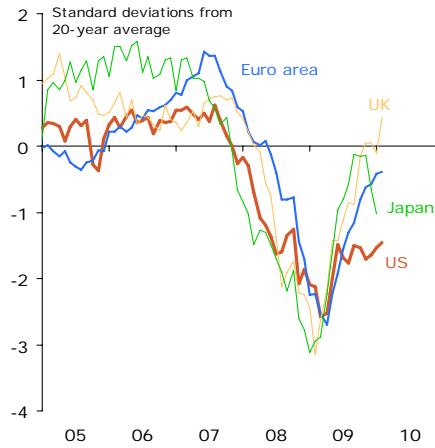
5

'Leading indicators' of major advanced economies

Manufacturing purchasing managers' indices



Consumer confidence



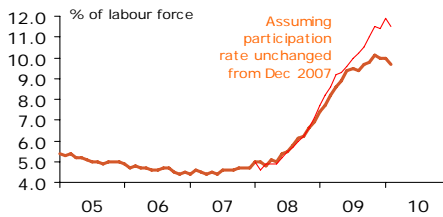
Sources: The Conference Board; Eurostat; Japan Economic & Social Research Institute; US Institute of Supply Management; UK Chartered Institute of Purchasing Management; Markit Economics.

Unemployment has stopped rising in major advanced economies, but is likely to remain at historically high levels for quite some time

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Major advanced economies – unemployment rate

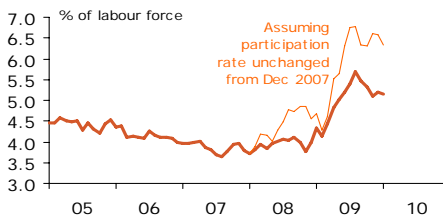
United States



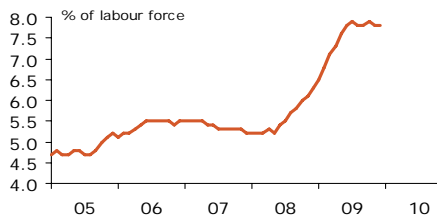
Euro area



Japan



United Kingdom

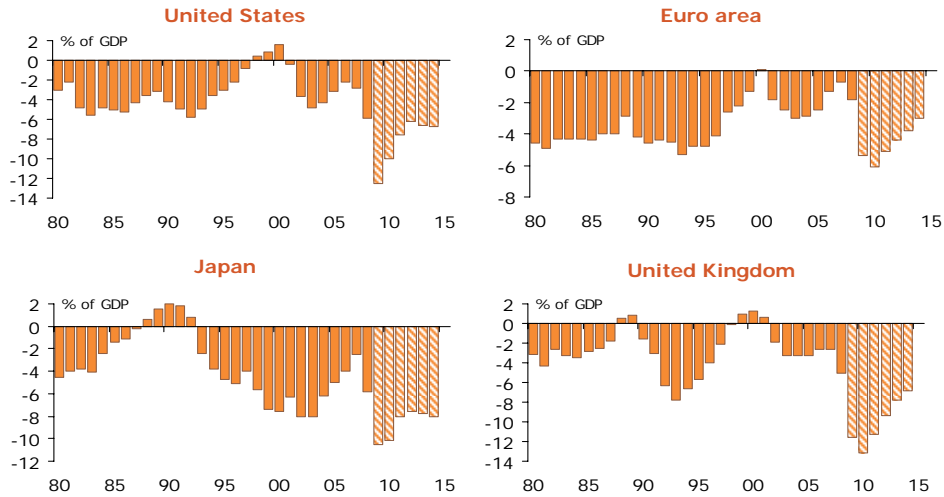


Sources: US Bureau of Labor Statistics; Japan Statistics Bureau; Eurostat; UK Office of National Statistics.

Dealing with the financial crisis and its economic consequences has left major advanced country governments with very large budget deficits ...

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Budget balances – major advanced economies

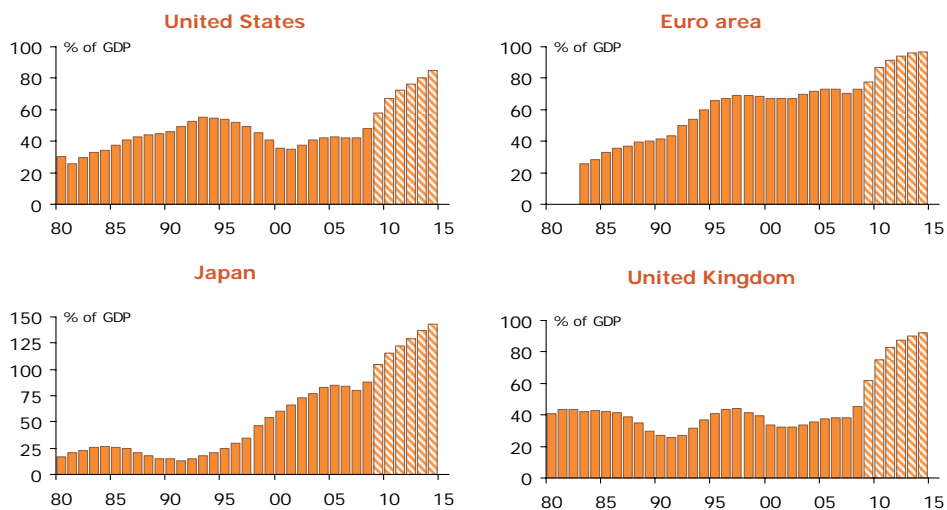


Source: IMF World Economic Outlook database (October 2009).

... and levels of public debt relative to GDP unseen, in most cases, since the end of World War II

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Net public debt – major advanced economies

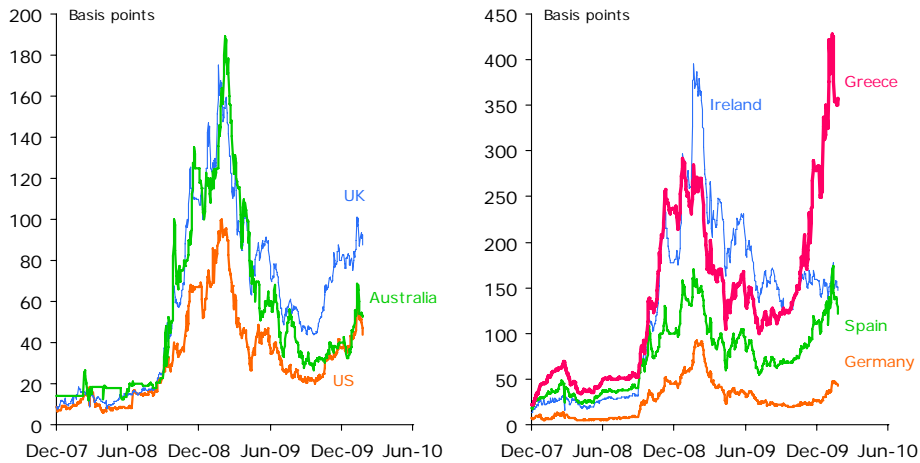


Note: euro area figures are for three largest economies (Germany, France and Italy).
Source: IMF World Economic Outlook database (October 2009).

Except for southern European countries, market pricing of sovereign default risk is less than at this time last year

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Sovereign credit default swap (CDS) spreads



Note: 'credit default swaps' are financial derivatives that provide 'insurance' against default by a borrower. The spread is a measure of the cost of that 'insurance' and hence, implicitly, of the market's view of the probability of default.
Source: Thomson Reuters Datastream.

It's hard to see how the major advanced economies can 'grow' their way out of the debt positions which they now have

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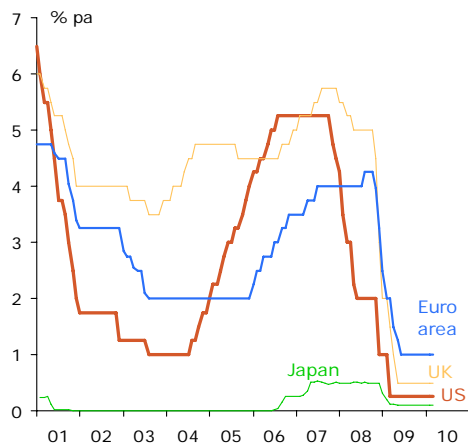
- IMF analysis suggests advanced-economy G20 members' gross government debt will reach an average of 118% of GDP by 2014, up from 78% before the crisis
- To get that figure down to a sustainable 60% of GDP by 2030 will require a turnaround in 'structural primary balances' from deficits averaging 3½% of GDP to surpluses averaging 4½% of GDP by 2020, ie 8 pc points of GDP
- Achieving this would require, for example,
 - non-renewal of existing stimulus measures
 - maintaining growth in health and pensions spending in line with GDP
 - zero real per capita growth in all other areas of spending
 - and revenue measures equivalent to 3% of GDP
- Although 'fiscal consolidations' of this order of magnitude have been achieved before, it's only happened once in the last 40 years in a G7 country (Canada in the 1990s)
 - fiscal consolidation on this scale in large advanced economies would have consequences for global growth as well as for their own
- The circumstances which permitted countries to 'grow' relatively painlessly out of even larger debt-to-GDP ratios at the end of World War II simply don't exist today
 - favourable demographics
 - post-war reconstruction and/or enormous pent-up demand
 - successive waves of pervasive technological innovation
 - greater tolerance of inflation combined with capital controls

Central banks in the major advanced economies are likely to keep monetary policy settings loose for an extended period

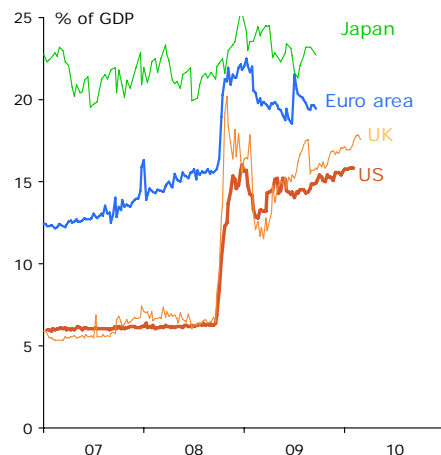
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Monetary policy responses to the financial crisis

Monetary policy interest rates



Central bank balance sheets



Sources: US Federal Reserve; Bank of Japan; European Central Bank; Bank of England; IMF *World Economic Outlook* October 2009; Datastream.

An extended period of 'easy money' increases the risk of asset price bubbles – and adds to pressure for more regulation of the financial system

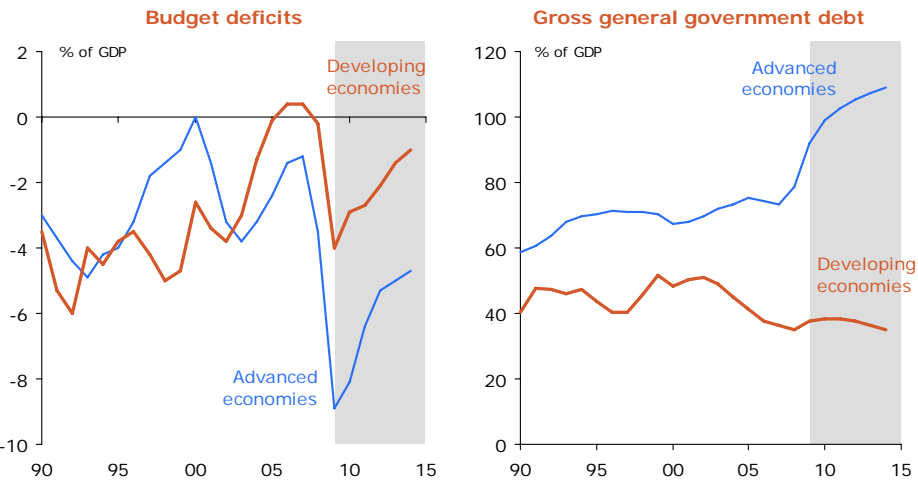
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- In the aftermath of the global financial crisis, governments are moving inexorably towards tighter regulation of banks
- The prospect of official interest rates needing to remain unusually low for an extended period adds to the pressure to use tighter regulation to guard against the re-emergence of asset price bubbles
- Increased regulation is likely to take four main forms -
 - higher capital requirements
 - new liquidity requirements (that institutions hold a prescribed proportion of their assets in cash, central bank deposits or government securities)
 - so-called 'stable funding ratios' intended to reduce reliance on short-term wholesale funding
 - a willingness to vary these requirements in order to 'lean against' the emergence of asset price bubbles or 'excessive' credit growth as an alternative to raising interest rates
- At least some of these new forms of regulation will be introduced in Australia, notwithstanding that Australia's financial system came through the financial crisis in much better shape than those of many other 'advanced' economies
- Some countries are considering other forms of additional regulation
 - restrictions on the types of activities that banks can undertake
 - more detailed oversight of remuneration structures
 - specific taxes on financial institutions

Developing economy public finances are (in general) in much better shape than those in advanced economies ...

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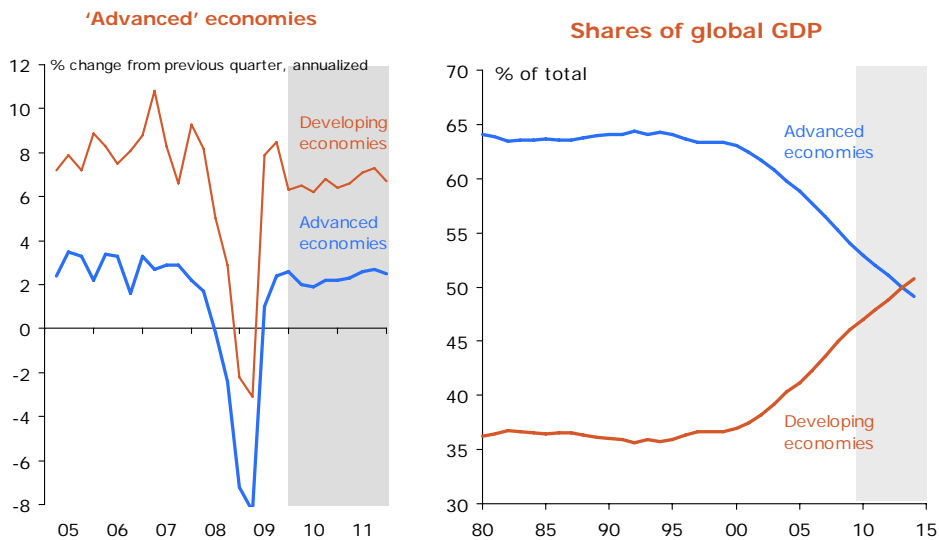
Public finances – advanced and developing economies compared



Source: IMF World Economic Outlook database (October 2009).

... one reason why developing countries will come out of the crisis with an even wider growth margin over advanced economies than before

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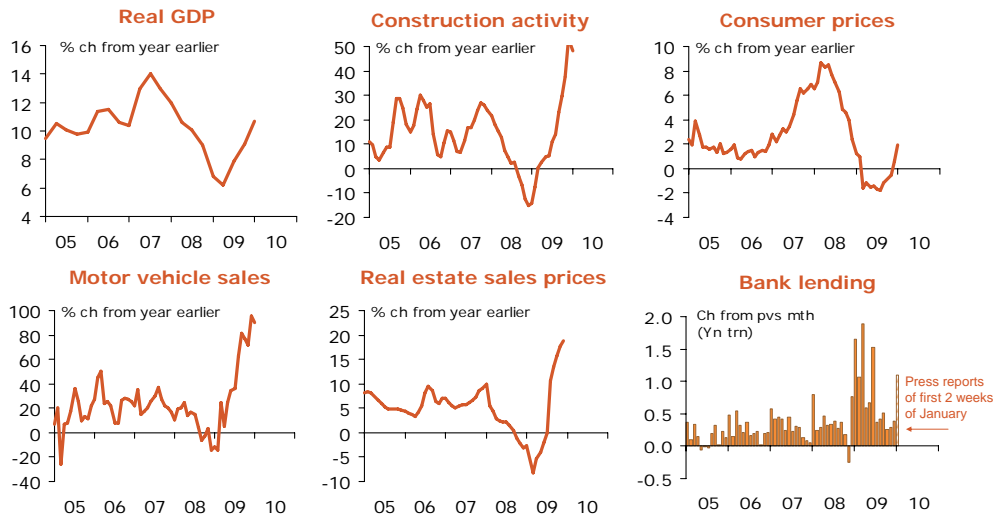


Source: IMF World Economic Outlook Update (26 January 2010) and Database (October 2009).

China has begun to move away from the 'moderately loose' monetary policy of last year

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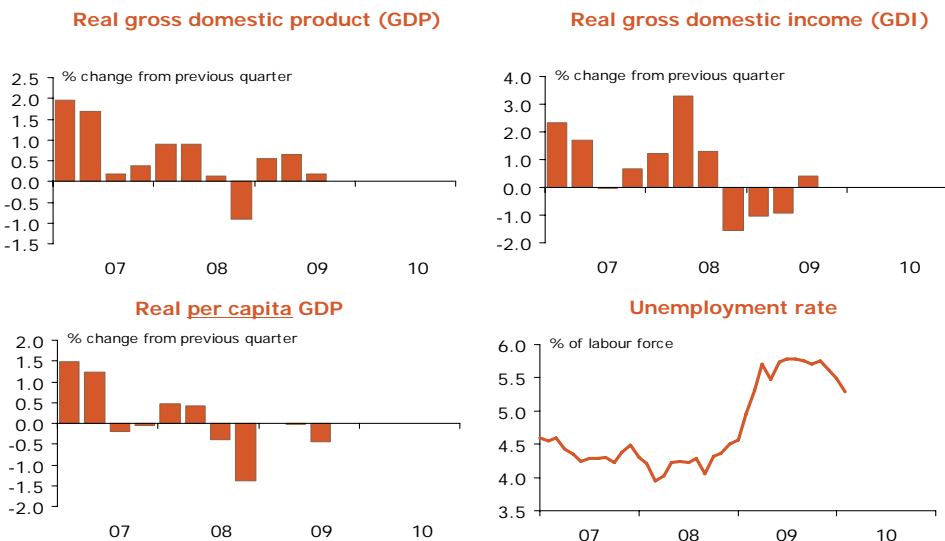
China: selected economic indicators



Sources: China National Bureau of Statistics; UBS Asia; China Association of Automobile Manufacturers; People's Bank of China.

Australia has so far avoided a recession by the most commonly-used definition (although not by all the others)

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Note: Real gross domestic income is real GDP adjusted for changes in the terms of trade (export relative to import prices). Source: ABS.

Why did Australia have such a 'good crisis'?

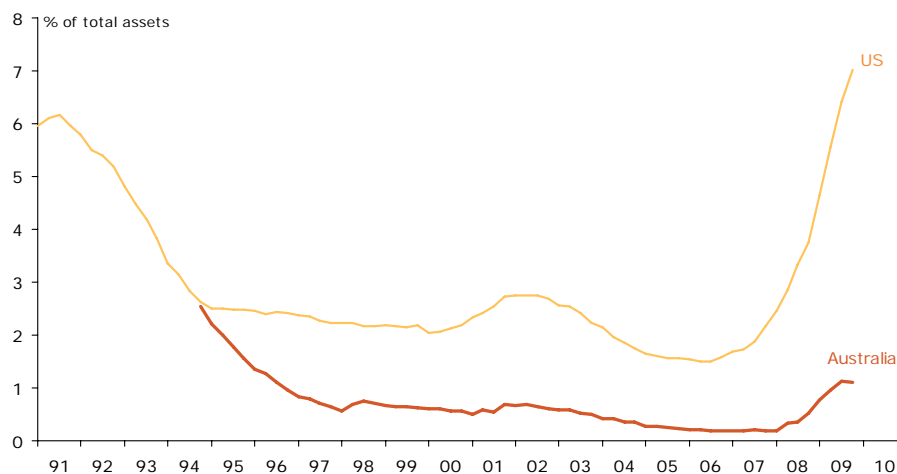
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- Australia had very few of the vulnerabilities which lay at the heart of the crisis in the US and the UK
 - banks had far less exposure to 'toxic assets' and were more closely and diligently supervised
 - elevated house prices the result of fundamental excess of demand over supply, rather than dodgy lending
- Australia has very limited exposure to the contraction in trade triggered by the financial crisis
 - US and Europe account for just 15% of Australia's exports
 - manufactured goods account for only 20% of Australia's exports
 - 70% of Australia's exports go to Asia – and most of that into Asian domestic demand rather than Asian exports
- Australian authorities responded quickly and effectively to the exposures which we did have
 - guarantees of bank overseas borrowings were important
 - substantial cuts in interest rates flowed through quickly to end-borrowers
 - fiscal policy measures were large, timely, explicitly designed to support spending and employment, and didn't raise serious doubts about fiscal sustainability

Australian banks have had much less exposure to 'toxic assets' and other write-downs than US banks

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Australian and US banks – impaired or delinquent assets

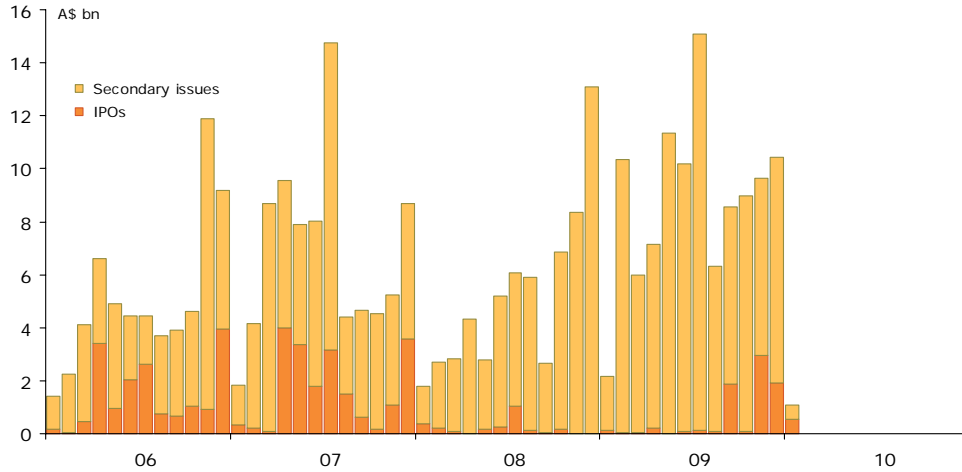


Sources: Australian Prudential Regulation Authority; US Federal Reserve Board.

Australian listed companies have raised A\$135bn of equity capital since the collapse of Lehman Brothers in September 2008 ...

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Capital raisings by Australian listed companies

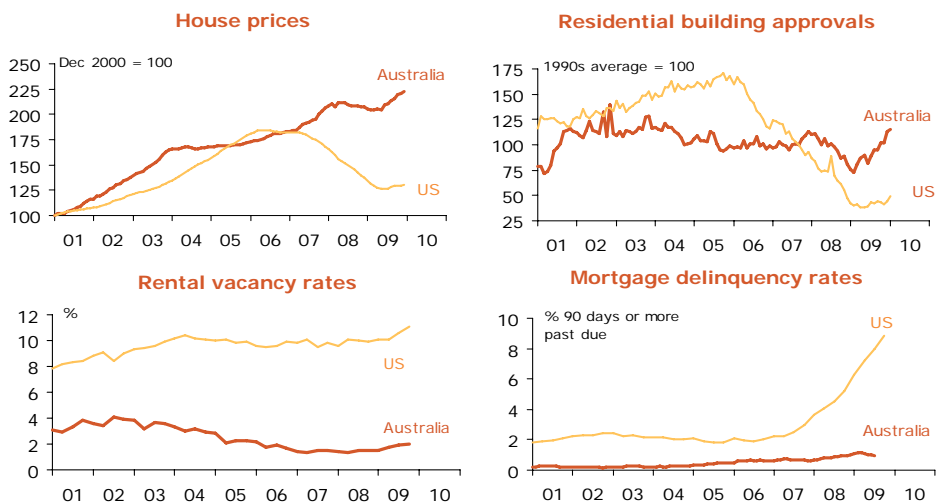


Source: ASX.

Australia has not had a housing 'bust' – reflecting a persistent shortfall of supply relative to demand and an absence of 'forced sellers'

20

Australian and US housing markets

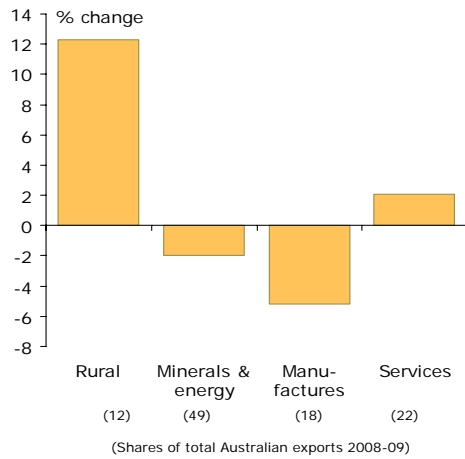


Note: Australian mortgage delinquencies are for securitized mortgages only. Sources: Residex; S&P; Real Estate Institute of Australia; Mortgage Bankers' Association of America; ABS; US Commerce Department; US National Realtors' Association.

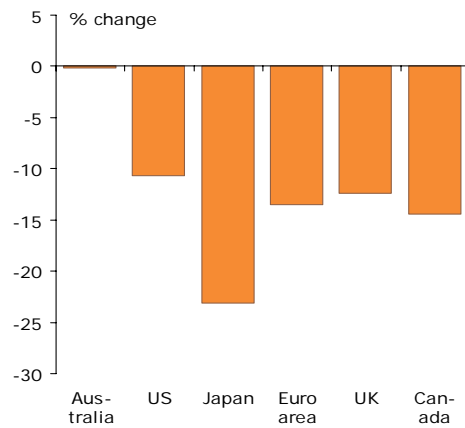
Australia's exports weren't much affected by the collapse in global trade in manufactured goods

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Change in the volume of Australian exports, year to June quarter 2009



Change in the volume of total exports, year to June quarter 2009

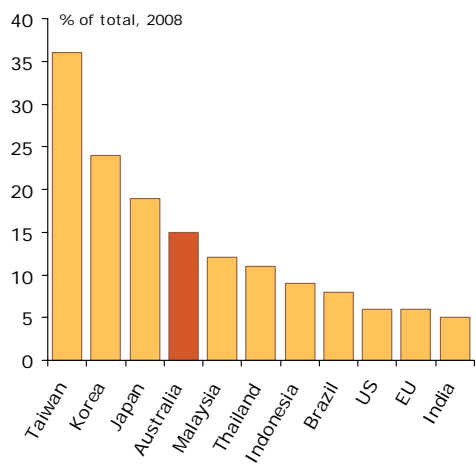


Sources: ABS; equivalent national statistical agencies in other countries.

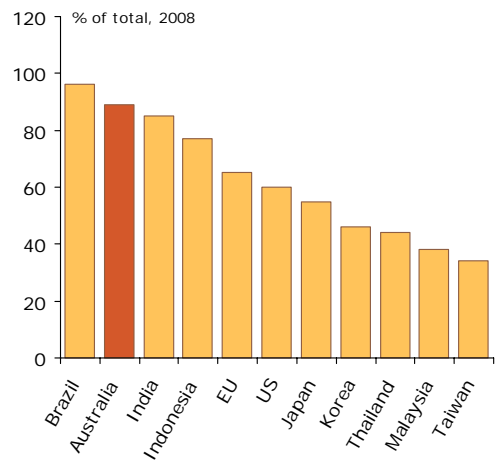
Australia is better placed than most countries to benefit from a domestic demand-led rebound in China's growth

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Exports to China as a share of total exports



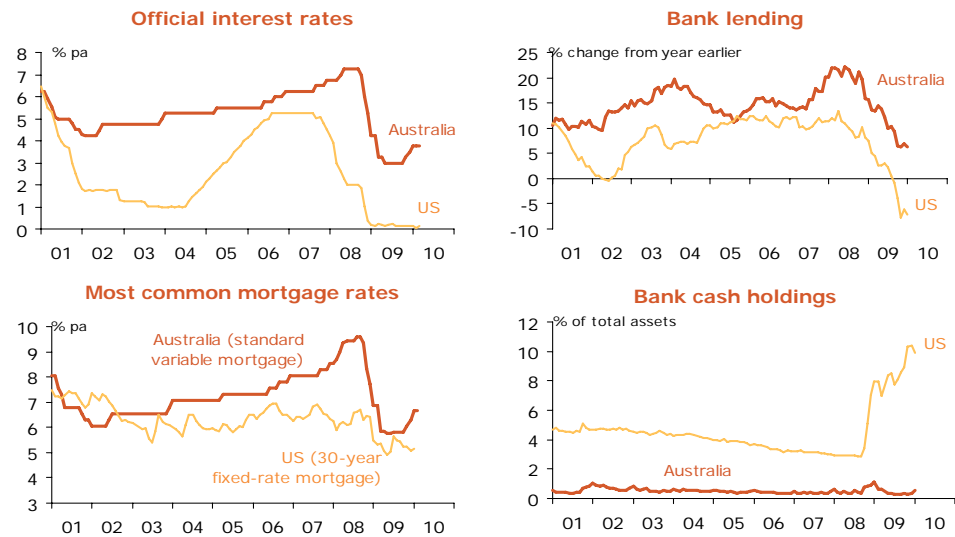
Share of exports to China that are for China's 'domestic' use



Source: Tao Wang, 'Who benefits the most from China's growth recovery', UBS Investment Research, 20 August 2009.

Monetary policy has worked more effectively in Australia than in the US and other countries

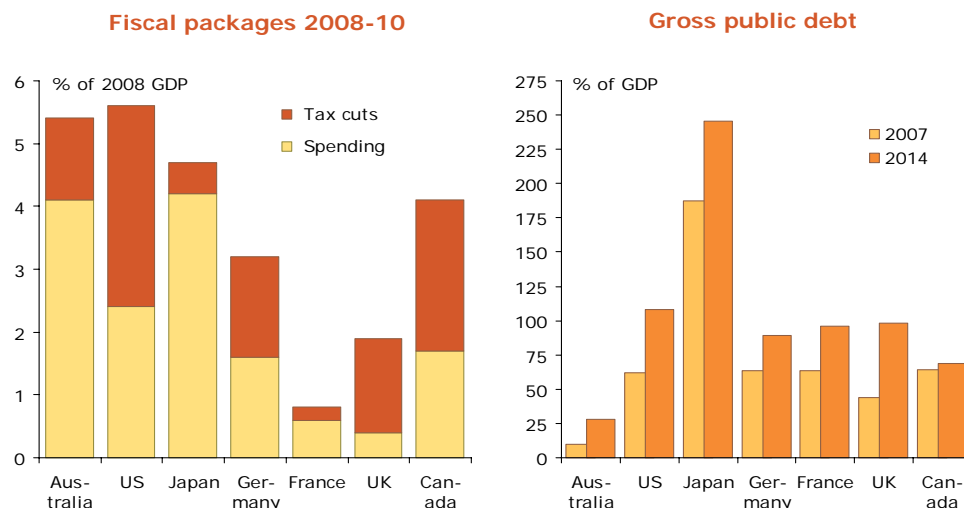
23



Note: 'Cash' includes deposits with the central bank. US banks are subject to required to hold cash reserves against their transactions account balances and thus typically hold a higher proportion of their assets in cash than Australian banks which are no longer subject to such requirements. Sources: RBA; US Federal Reserve; Datastream.

Australia has been able to apply a relatively large fiscal stimulus while leaving its public finances in relatively good shape

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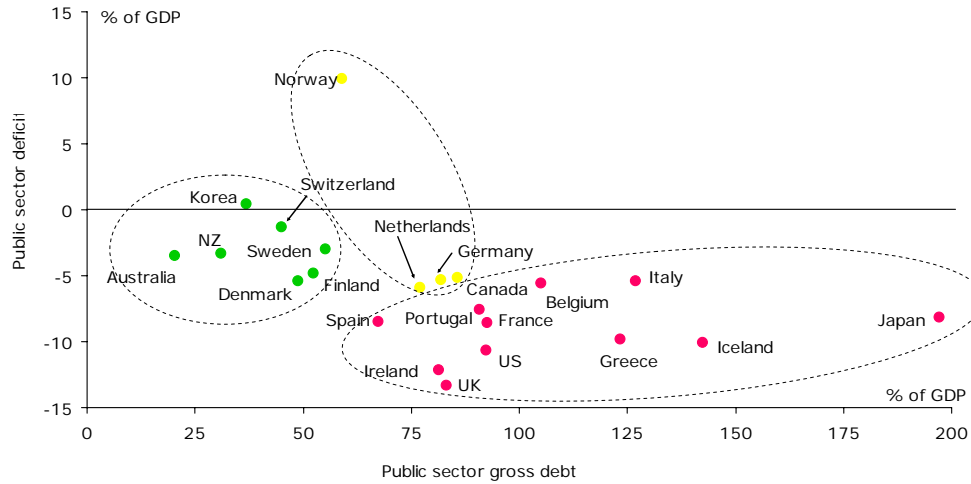


Sources: OECD, *Economic Outlook* No. 85, June 2009; IMF, *The State of Public Finances Cross-Country Fiscal Monitor*, November 2009

Australia's public finances look sounder than those of almost any other OECD economy

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Public sector deficits and gross debt, 2010

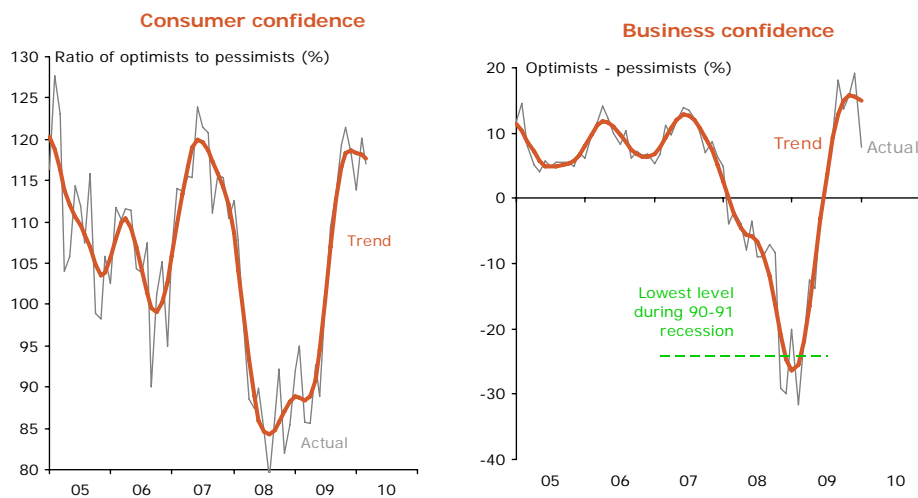


Source: OECD Economic Outlook No. 85 (December 2009); based on a similar chart in Bill Gross, 'The Ring of Fire', PIMCO Investment Outlook (February 2010).

The monetary and fiscal stimulus had a substantial positive impact on business and consumer confidence

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Survey measures of consumer and business confidence

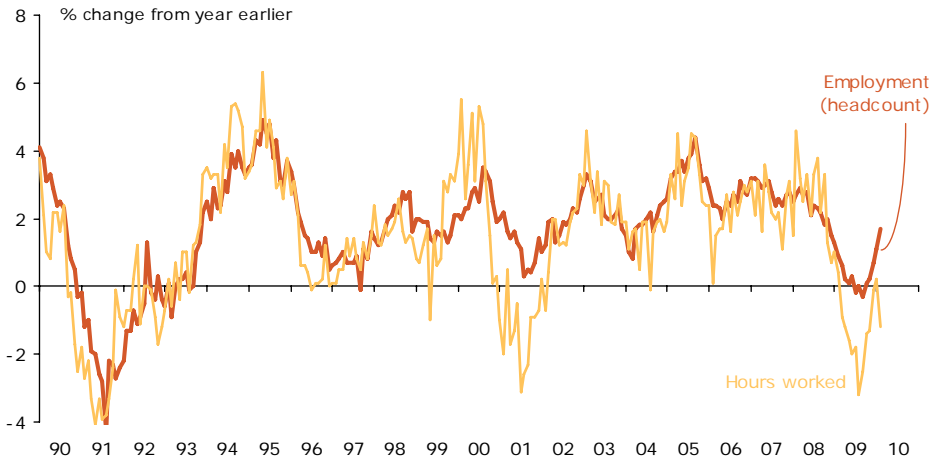


Sources: Westpac-Melbourne Institute; National Australia Bank.

It encouraged employers to believe the downturn would be mild, thus making them willing to 'hoard labour', keeping unemployment down

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Headcount and hours worked

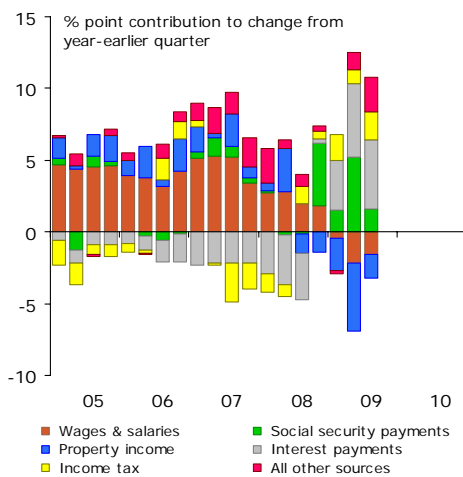


Source: ABS.

Household spending is losing some impetus as stimulus measures fade but will still be supported by job gains and high levels of confidence

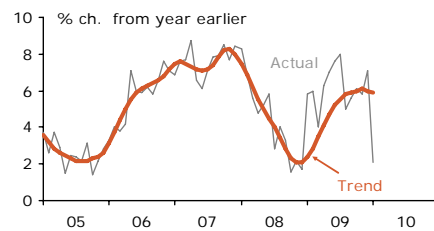
28

Sources of growth in real personal disposable income

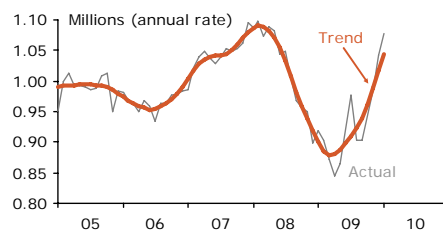


Sources: ABS

Retail sales



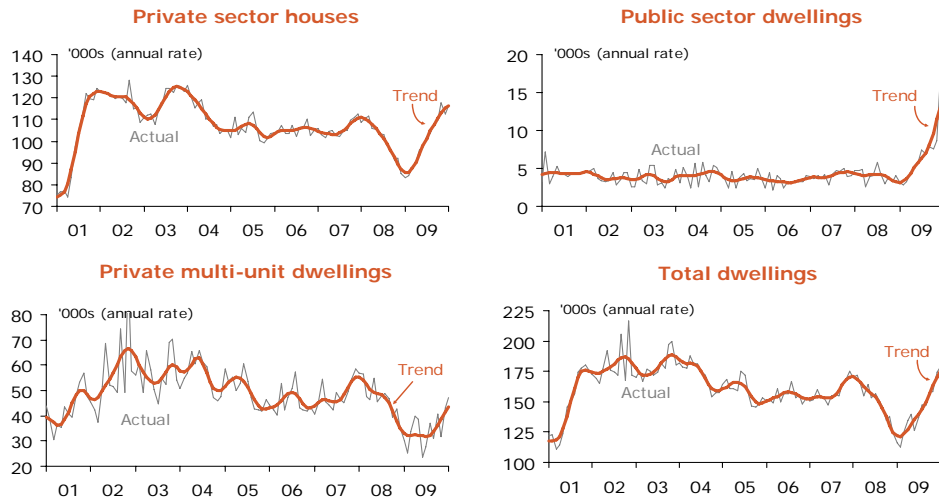
Motor vehicle sales



Housing activity will strengthen significantly this year, despite somewhat higher interest rates

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Residential building approvals



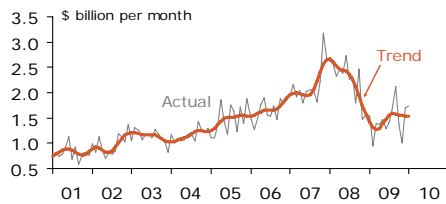
Source: ABS.

Non-residential building activity will be weak (except for schools projects) but engineering construction should remain strong

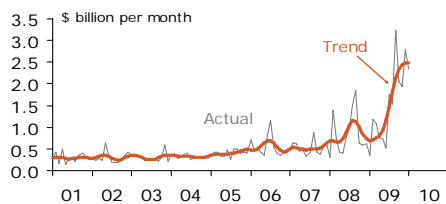
30

Non-residential building approvals

Private sector



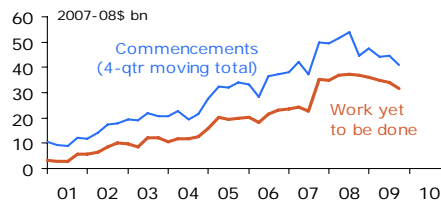
Public sector



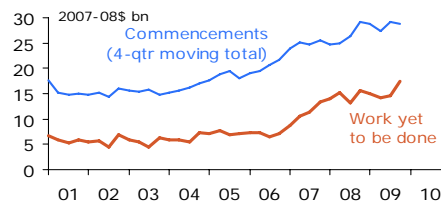
Source: ABS; author's calculations.

Engineering construction commencements and pipeline

For private sector



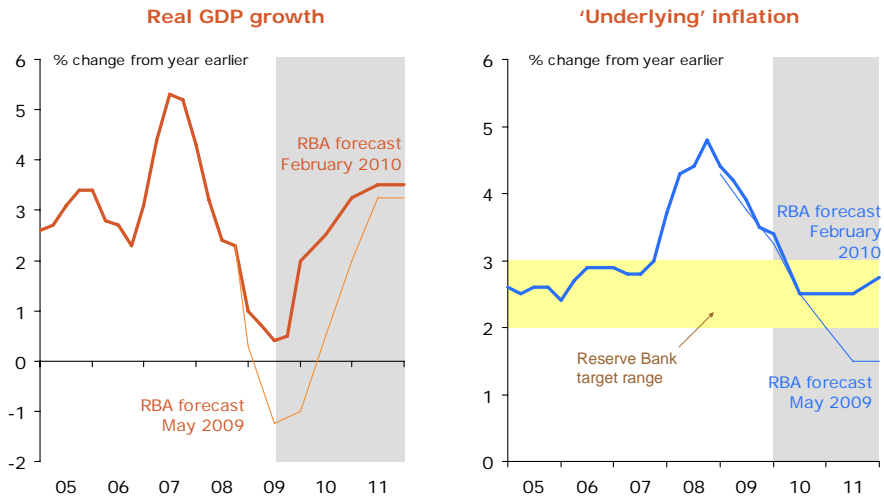
For public sector



The Reserve Bank now expects significantly stronger growth and moderately higher inflation than it did when it had rates at 50-year lows

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Australian economic growth and inflation outlook

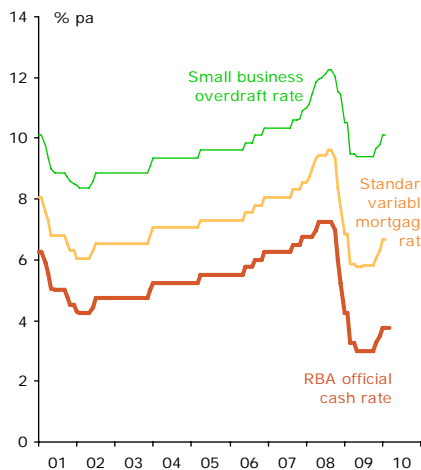


Sources: Australian Bureau of Statistics; Reserve Bank of Australia *Statements on Monetary Policy*.

Interest rates will rise some more – but probably not a lot more

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Australian interest rates



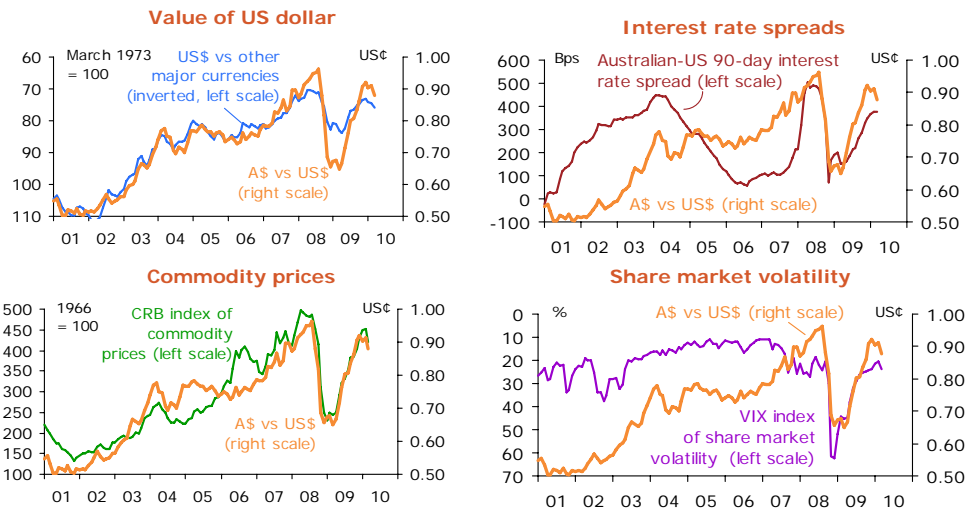
Source: RBA.

- The RBA's aggressive rate cuts of 2008-09 were based on forecasts that the economy would contract and that underlying inflation would drop below the 2-3% target range
- Those rate cuts helped forestall those outcomes – but now that growth appears to be heading back towards trend, and inflation bottoming in the mid-point of the target range, the stance of monetary policy is heading back towards 'neutral'
- The margin between the RBA's cash rate and the rates which borrowers actually pay has widened by 110-225 basis points since the onset of the financial crisis
- So the level of the cash rate consistent with 'neutral' monetary policy settings is arguably at least 1 pc point lower than it was before the onset of the financial crisis – ie if it was ~5½% before mid-2007 it's now ~4½%
- The cash rate is likely to increase another two or three times this year but not more

The A\$ will remain strong by historical standards but now seems less likely to attain parity with the US\$

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Key influences on A\$-US\$ exchange rate



Sources: Thomson Reuters Datastream; Reserve Bank of Australia; US Federal Reserve.

Summary

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- The worst of the financial crisis and the ensuing global recession is over, but its effects will linger for a long time yet
 - self-sustaining recoveries in private sector spending and in employment are not yet established in the major advanced economies
 - most of the major advanced economies face enormously challenging 'fiscal consolidation' tasks – default is unlikely but economic growth will significantly be constrained
 - by contrast most major developing economies are returning to close to trend growth
- Interest rates in the major advanced economies will remain low for a long time
 - which won't lead inevitably to higher inflation
 - but does increase the risk of more asset price 'bubbles' and adds to the impetus for 're-regulation' of financial systems
- Australia has come through the crisis much better than anticipated
 - reflecting the absence of much of the imprudent lending & borrowing evident in the 'North Atlantic economies', fortuitous trade exposures, and timely & effective policy responses
- Growth in the Australian economy should pick up through 2010
 - led by a recovery in housing demand and continued strong growth in resources-related and public sector investment, with consumer spending more subdued as the effects of previous stimulus fade
- Australian interest rates will rise some more
 - however the Reserve Bank is unlikely to move monetary policy settings beyond 'neutral'
 - and the cash rate consistent with 'neutral' is lower than it was before the financial crisis
- The A\$ will likely remain relatively strong by historical standards
 - although it probably won't reach (or sustain) parity with the US\$

Important information

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Why did Australia have such a 'good crisis'?

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