RBA continues the journey … Budget improves slowly

Economic note

3 November 2009

- The RBA Board today announced a further 25bp increase in the cash rate, to 3.5%.
- With this move the RBA continues the journey in returning monetary policy to a more ‘normal’ setting – which is expected to take the cash rate back towards 5% over the next year or so.
- In announcing the rate increase the RBA again highlighted that it was “prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker.”
- In fiscal policy news, yesterday’s MYEFO upgraded the government’s economic growth forecasts to be more consistent with the RBA and market views.
- The improved economic outlook will also lower the projected Budget deficits, but only slowly.
- Australia’s net government debt will, however, be lower than previously expected and substantially lower than other major OECD nations – helping Australia attract much needed global capital inflow.

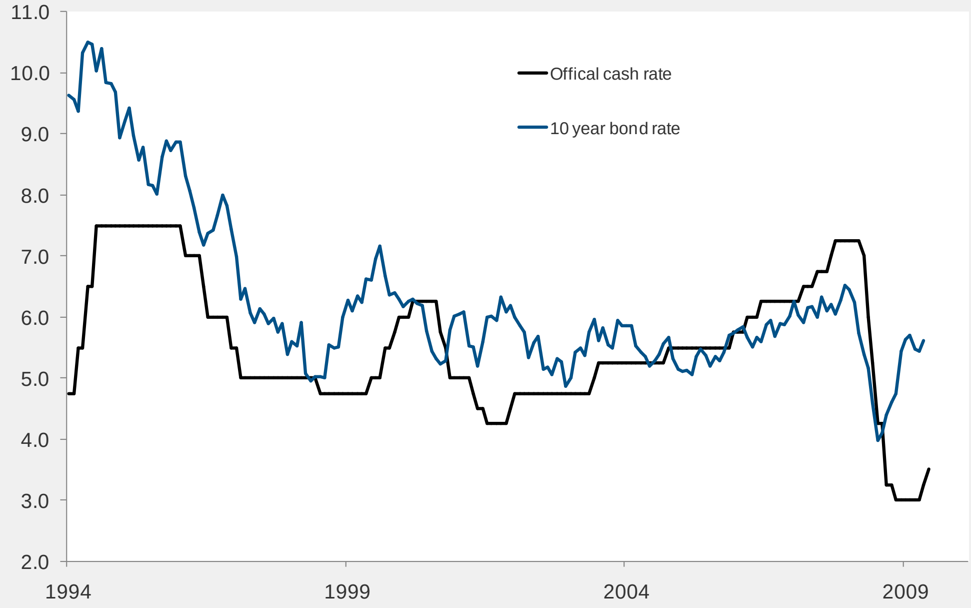
RBA continues the journey
At its meeting today, the Board of the Reserve Bank of Australia (RBA) decided to raise the cash rate by a further 25bp, which following the move last month, takes the cash rate to 3.5%, effective 4 November 2009

In tightening monetary policy again today the RBA stated that while “the Board noted that the rise in the exchange rate is likely to constrain output in the tradeables sector and dampen price pressures …growth is likely to be close to trend over the year ahead and inflation close to target.”

In addition, the RBA noted “with the risk of serious economic contraction in Australia now having passed, the Board’s view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. The adjustments at the October and November meetings will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead.”

While there is limited forward guidance in this statement, it seems clear that further tightening should be expected in the months ahead, as an increase of just 50bp, to 3.5%, is unlikely to be enough of an adjustment in rates to be consistent with an environment where the RBA expects trend economic growth and on-target inflation. However, the market has pulled-back on expectations for the December meeting, with roughly a 50:50 chance of a 25bp move next month now priced in. Into 2010 the market expects a cash rate of around 4.0% by March, 4.5% by June and 5.0% before year-end.

Australian official cash rate and 10-year bond yields



Source: RBA and Iress

Highlights from the RBA statement are as follows:

- "The global economy has resumed growth. With economic policy settings likely to remain expansionary for some time, the recovery is likely to continue during 2010 and forecasts have been revised higher." However, "the expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis."

- "Prospects for Australia's Asian trading partners appear to be noticeably better. Growth in China has been very strong, which is having a significant impact on other economies in the region and on commodity markets. For Australia's trading partner group, growth in 2010 is likely to be close to trend."

- "Sentiment in global financial markets is much better than earlier in the year. Nonetheless, the state of balance sheets in some major countries remains a potential constraint on their expansion."

- "Economic conditions in Australia have been stronger than expected and measures of confidence have recovered. Some spending has probably been brought forward by the various policy initiatives. With those effects now diminishing, these areas of demand may soften somewhat."

- "Some types of capital spending are likely to be held back for a while by financing constraints, but it now appears that private investment will not be as weak as earlier expected. Medium-term prospects for investment appear, moreover, to be strengthening."

- "Higher dwelling activity and public infrastructure spending are also starting to provide more support to spending. There have been some early signs of an improvement in labour market conditions. The rate of unemployment is now likely to peak at a considerably lower level than earlier expected"

- "Inflation has been declining for the past year. In underlying terms, inflation should continue to moderate in the near term, but now will probably not fall as far as earlier thought. Headline CPI inflation on a year-ended basis has been unusually low because of temporary factors, and will probably rise somewhat over the coming year. Both CPI and underlying inflation are expected to be consistent with the target in 2010."

- "Housing credit growth has been solid and dwelling prices have risen appreciably this year. Business borrowing has been declining as companies have sought to reduce leverage in an environment of tighter lending standards. For many business borrowers, increases in risk margins are still coming through. The decline in credit has been concentrated among large firms, which have had good access to equity capital and, more recently, to debt markets. Share markets have recovered significant ground."

MYEFO economic forecasts stronger, but Budget improving only slowly

In the Commonwealth's Mid-Year Economic and Fiscal Outlook (MYEFO), released yesterday, the government has, as widely expected, significantly revised its economic growth forecast for both 2009/10 and 2010/11. The better economic outlook, which brings the government into line with the RBA and market forecasts, has also led to an improvement in the Budget bottom-line.

The government's MYEFO estimates also highlight that the fiscal stimulus to the economy will be withdrawn by around 1% point of GDP each year (i.e. after adding 1% point to growth in 2008/09 and 1.5% points in 2009/10, fiscal policy will subtract a little over 1% point from GDP growth each year from 2010/11 onwards). This is clearly also consistent with the RBA's desire to return monetary policy to a more neutral setting, as highlighted in today's monetary policy decision.

For Australia, therefore, after monetary and fiscal policy both made significant contributions to growth for 2008/09 and 2009/10, they will both be subtracting from growth in the years ahead.

The Treasurers press release states that the MYEFO "forecasts lower unemployment, higher growth, lower deficits and lower debt than expected at Budget, and underscores Australia's position as the strongest performing advanced economy in the world." Notwithstanding the political hyperbole, this statement actually rings true, with the Australian economy now expected to record positive economic growth in 2009/10 (new forecast +1.5%, previous -0.5%), an unemployment rate now forecast to peak at 6.75% at June 2010 (previous forecast 8.5%) and net debt peaking at just 10% of GDP by June 2014 ($A153.2bn) against the previous estimate of 13.8% (an improvement of around $A50bn) and an average of 93% for the major OECD nations.

With better-than-expected growth in the near-term, the economic growth forecasts for both 2011/12 and 2012/13 have been lowered marginally to 4.0% from 4.5%. The economy is now expected, however, to return to its potential growth path in 2014/15 – two years earlier than previously expected.

Major economic parameters

	Forecasts		Projections	
	2009-10	2010-11	2011-12	2012-13
Real GDP Growth	1.5	2.75	4.0	4.0
Employment growth	0.25	1.5	2.25	2.0
Unemployment rate	6.75	6.5	6.0	5.75
Headline inflation	2.25	2.25	2.25	2.25
Nominal GDP growth	1.25	5.5	6.25	6.25

Source: Commonwealth Treasury

Even with this better-than-expected fundamental environment, nominal GDP is still expected to experience its weakest performance in almost 50 years and it is this weak nominal GDP outcome that is expected to continue to weigh on the Budget position in the current year.

For 2009/10 the Budget deficit (underlying cash balance) estimate is virtually unchanged at $A57.7bn or 4.7% of GDP (previous estimate $A57.6bn, 4.9%). However, improvement comes in 2010/11 with a deficit estimate of $A46.6bn, 3.6% of GDP, down $A10.5bn from the previous estimate. For 2011/12 the deficit is estimated at $A31.2bn, 2.3% of GDP (down $A13.3bn) and then to $A15.9bn, 1.1% of GDP in 2012/13 (down $A12.3bn).

These estimates imply an improvement of an average of 1% of GDP in the Budget deficits for each of the forecast years. However, the government still does not expect a return to Budget surplus until the 2015/16 year.

These estimates still seem to be very conservative and it could be expected that further improvement in the Budget bottom-line would be included in the May 2010 Budget.

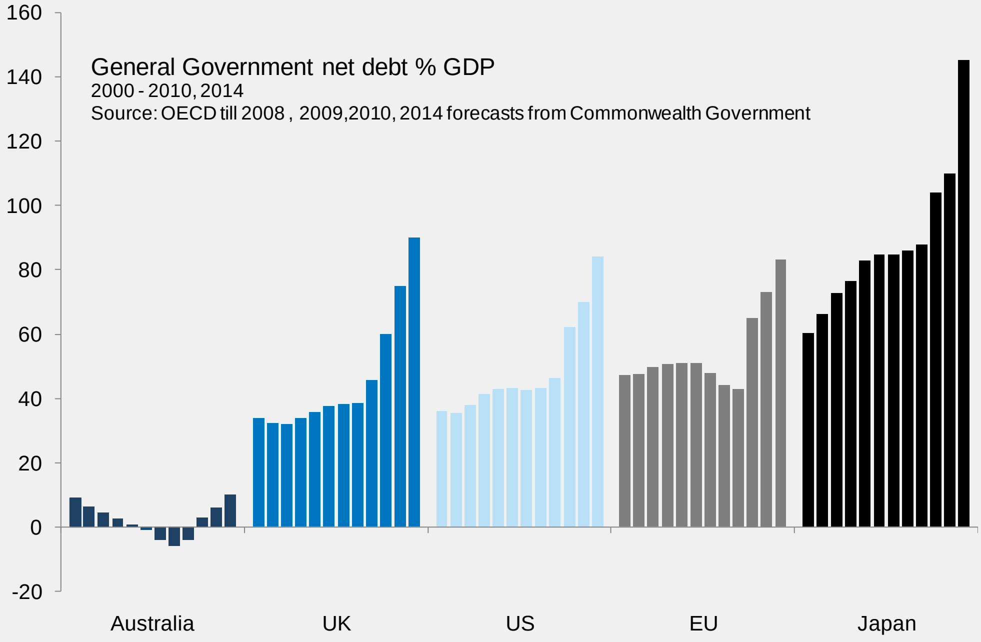
Summary of budget aggregates

	Estimates			
	2009-10		2010-11	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance ($Abn)	-57.6	-57.7	-57.1	-46.6
Per cent of GDP	-4.9	-4.7	-4.7	-3.6
	Projections			
	2011-12		2012-13	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance ($Abn)	-44.5	-31.2	-28.2	-15.9
Per cent of GDP	-3.4	-2.3	-2.0	-1.1

Source: Commonwealth Treasury

As noted above, the government now expects net debt to peak at just 10% of GDP at 30 June 2014. At an estimated $A153.2bn, this is around $A50bn less than the previous estimate of 13.8% of GDP or $A203.1bn. As detailed in the chart below, this net debt level is very small compared with the projected OECD average of 93% of GDP and is a key factor in attracting much needed global capital inflow into to the Australian economy.

General government net debt: Australia and major OECD nations



Source: Commonwealth Treasury and OECD

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