

Economics Report

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Caton's Corner November 2009

It was fun while it lasted...and there is probably more fun ahead

Well it had to happen sooner or later. After seven successive monthly gains, share markets gave some ground in October. Over the month, the US S&P500 index fell by 2%, while Australia's ASX200 fell by a little over 2% (and then began November poorly).

Last month I wrote that a short-term correction was possible but not inevitable. It has come despite a surprisingly good earnings season in the United States, and despite confirmation that the US economy began to grow again in the third quarter. It appears that market participants remain jittery about the pace and longevity of the global economic recovery. I continue to believe that the world economy will continue to do better than commonly thought likely for the next twelve months or so.

Incidentally, one side effect of the wavering in equity markets is that the extraordinary rise in the Australian dollar may have come to an end. It began October at 88 cents, and hit a high of 93 cents. Last year, I never joined the crowd saying that it was going to parity with the US dollar (I got a little nervous around 98.5 cents!), and I don't see it happening this time either. The Australian dollar is clearly overvalued at its present level, which doesn't mean that it can't go higher in the short run, since currencies are often driven by momentum. But it does mean that right now the rest of the world is on sale for Australian investors!

On the policy front

The Reserve Bank (RBA) began the process of "deloosening" monetary policy in early October, when it raised the official cash rate from a 49-year low of 3% to 3.25%. It followed this with a further increase of 25 points on 3 November. It is important to point out that the RBA isn't raising rates because there's something wrong with the Australian economy, but rather because the economy is doing so well that it is time to start raising the foot on the monetary accelerator.

In its accompanying Statement, the RBA was non-committal about its next move and a further rate increase in December is an open question right now. The RBA has never before raised rates at three successive meetings, but it had never raised rates before the peak in unemployment prior to this episode. Unprecedented events happen every day.

Either outcome (no change or up 25 basis points) in early December could be described as consistent with "gradual" removal of monetary accommodation. Which way the RBA leans will depend on what we find out between now and then – about the Australian labour market, consumer confidence, the state of the world economy, the exchange rate and financial markets both here and abroad. To name just a few

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considerations! Right now, a position on the fence would seem better than either side of it. But there are more rate rises ahead.

Some ill-informed criticism has suggested that interest rates are now rising because fiscal policy is too loose, and that the two arms of policy are thus in conflict with each other. Nothing could be further from the truth. In both cases, we put the foot flat to the floor to protect the Australian economy against the worst effects of the GFC. The emergency having passed, it is now time to start easing up on both accelerators. The fiscal stimulus was always designed to peak in the June quarter this year, and interest rates are now being raised, although they remain low. The two arms of policy are working in tandem.

The Government released the **Mid-Year Economic and Fiscal Outlook** in early November. While I haven't yet trawled through all 289 pages, the major changes are in line with expectations. Near-term GDP growth forecasts have been raised; the Budget deficit improves faster than expected earlier and the build-up of debt is thus even slower than projected at Budget time. At Budget time, the Government forecast a fall in the economy's output (GDP) of 0.5% this financial year, and a peak unemployment rate of 8.5% or more. Now, GDP is expected to increase by 1.5% this year, and the unemployment rate is expected to peak at no more than 6.75%. This may still be too pessimistic. We got some remarkably good news about the labour market in early October. It was reported that the unemployment rate actually ticked down by a tenth, to 5.7%, which is effectively unchanged from where it was five months ago. There is just a chance that unemployment has already peaked. If this turns out to be the case, it will be a remarkable result.

This, to me, sums it up. The Australian economy is doing so much better than anyone expected six months ago. Let us hope this continues!

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The views expressed herein are those of the author and should not be otherwise attributed.

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