

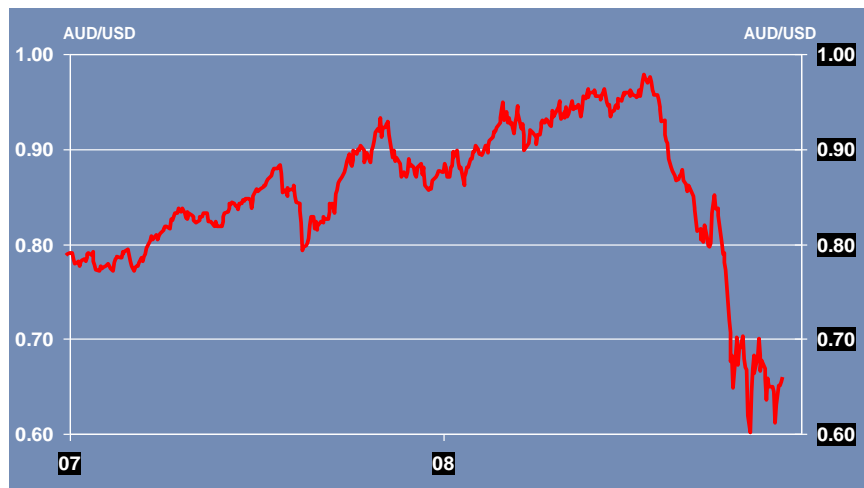
Economics Report

2 December 2008

Ring out the old; ring in the new—a quick look at the state of the world as we enter 2009.

As 2008 draws to a close, there won't be too many people sorry to see the back of it. It's been an awful year for investors, and also for the world economy. It has also been a year of extraordinary market volatility, with the exchange rate and commodity prices, for example, gyrating widely. Over a long run of history, the average daily movement in the Australian dollar has been 0.6 US cents. In October this year, it was 3.7 cents!

The Australian Dollar- lower and more volatile



Source: Datastream

When one writes about the future, there is nothing that is certain. But the closest one can come to certainty is that 2009 will be a better year for investors than 2008 was. The same statement won't be true for the economy, which will clearly get worse before it gets better.

I have outlined before my belief that share markets will **bounce** higher in the short term, and then **trend** higher sometime later when analysts begin to acknowledge that there is another side to the valley; that economic recovery will eventually come. The reason for the short-term bounce is that markets are simply oversold (too cheap). This bounce may already be underway. As I write, the US

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share market has risen by 18% in just four trading days, and that's the biggest four-day move since 1933!

But what of the state of the global and Australian economies? Certainly the world economy is in dire shape! There are recessions almost everywhere, and importantly **they didn't begin after Lehman Brothers went bankrupt**. I estimate that the United States, for example, has been in recession since very early this year. Europe, Japan and the United Kingdom (and let's not forget New Zealand) have already been in recession for many months.

The average recession in the US in the post-war period has lasted 10 months, which means this one is almost into overtime already. Calculating this average over the entire period for which we have data stretches this average to 18 months, which means that we could be about halfway through. I was asked recently at a presentation what meaning one could attach to averages at a time like this, and it's true that they are of limited use: after all, how many people in the entire world have the average number of legs?

But there is something that happens in every bear market and, for that matter, in every economic downturn. At some stage people give up. It is difficult or impossible to see what will lead the market (or the economy) out of it? But something always does. Indeed, markets turn before there is a skerrick of good economic news. But it's too early for a solid sustained "bull market" recovery.

How is the Australian economy faring in all of this? We will know more when we get the September quarter national accounts in early-December. These are likely to show that the economy grew hardly at all in the quarter, and by less than 2% in the past year. If economic growth is reported as negative in the quarter, the media will have a field day. It will be our first negative quarter since late 2000, after the GST was introduced. But slightly negative or slightly positive, the point is the same: the Australian economy has slowed significantly and it will continue to get worse before it gets better.

But how bad will it be? It's impossible to tell right now. When I forecast by spreadsheet, putting in what I think consumers are going to spend, what business is likely to do etc, I don't get a recession. What I get is a prolonged period of slow growth. But think about it this way: we haven't had a recession in 17 years, and we all know that there will be another one some day. If this is the case it is reasonable to ask: **if the current conditions (weak trading partners, falling commodity prices, loss of wealth, plummeting business and consumer confidence, malfunctioning credit markets) don't put us into recession, what will?**

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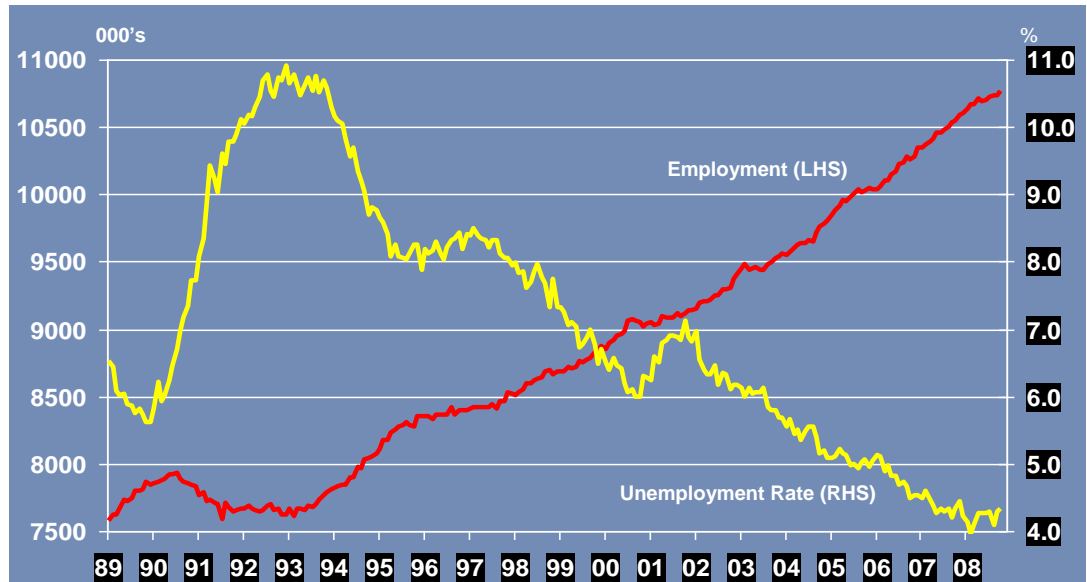
The possibility that Australia can avoid recession relies on the facts that our financial sector is in better shape than most, and that we have the ability to loosen both monetary policy and fiscal policy further. In this respect, I am astonished that there is any debate as to whether a Federal budget deficit is justified in current (and immediate future) circumstances. Bear in mind that the "commitment" in fiscal policy is to balance the Budget "on average over the course of the cycle". Also bear in mind that the economy is not there to serve the purposes of the Budget; the Budget is there, inter alia, to serve the purposes of the economy. **In the current circumstances, it would be the height of economic irresponsibility not to permit the Budget to fall into deficit!**

In any case, whether 2009 turns out to be a year of slow growth or a year of full-fledged recession, one thing is certain. The unemployment rate, currently 4.3%, will rise. If it goes to 5%, we will have done remarkably well. If it hits 6%, that still won't be too bad. The danger is that it goes through 6%. History show fairly convincingly that when unemployment rises, it either goes up by a little or it goes up by a lot. There is little or no middle ground. Hence if it goes through 6%, 8.5% may be more likely than 7%.

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Unemployment is set to rise



Source: ABS

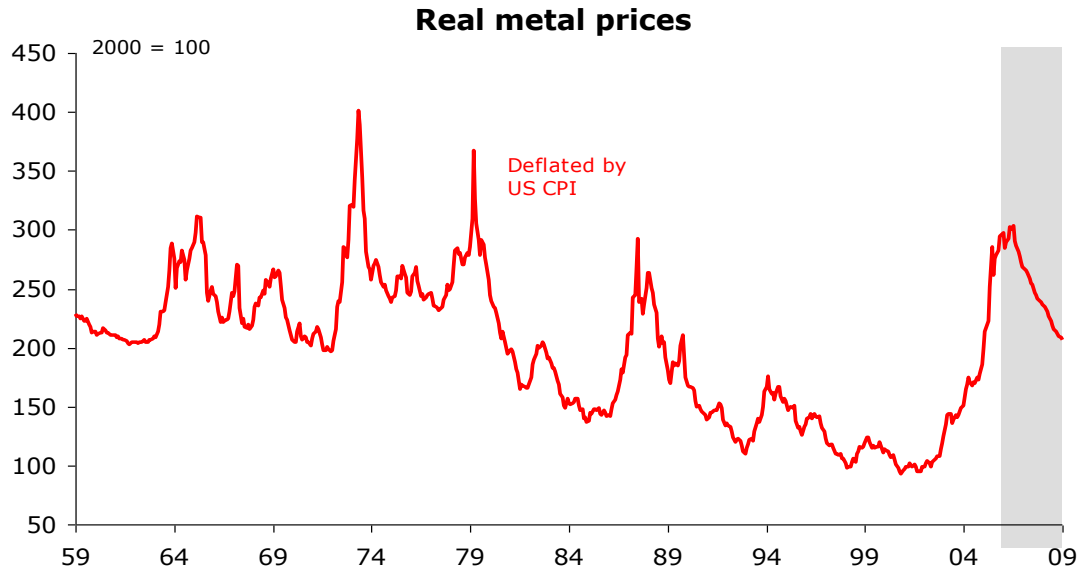
But whatever the final figure, Australians are not used to rising unemployment. It hasn't happened for seven years, and the mere prospect of bad times ahead is already causing both businesses and consumers to cut back on discretionary spending. This is how slowdowns feed upon themselves!

The big uncertainty about the slowdown in Australia is the effect of falling commodity prices. In the five years to the June quarter 2008, the commodity price boom meant that the ratio of Australia's export prices to our import prices rose by an astonishing 65%. There isn't another developed country in the world that experienced that degree of largesse. Since we export about a fifth of GDP, this relative price rise meant a 13% real income gain for Australians on average. Of course, if you live in Western Australia, you did even better than this on average, but all of Australia benefitted. The commodity price boom led to a huge surge in company tax receipts, which was used as the biggest single source of finance for the six-in-a-row individual income tax cuts.

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Commodity prices are finally falling



Sources: IMF International Financial Statistics; US Bureau of Labor Statistics; Economics@ANZ.

The boom was a tremendous source of economic growth, and the decline in commodity prices will inhibit growth. In particular, mining investment will slow significantly.

The fall in commodity prices was always going to happen one day. The China-India story is still there, and bodes well for the long-term outlook for commodity prices, but the fall currently being experienced reflects the fact that prices were so far ahead of any sustainable long-term trend. It was a big mistake to think that Australia would be shielded from a weak world economy because of our relationship with China. Early in 2008, it was fashionable to believe that China and the rest of Asia would be relatively immune from a world economic slowdown because, *inter alia*, China could quickly switch from exports to middle-class consumer spending and thus maintain its double-digit growth rate. No-one believes this "decoupling" view anymore. Indeed, in the most recent quarter, astonishingly, Chinese industrial production has actually fallen. As the chart shows, no-one should be surprised by occasional sharp falls in commodity prices!

The Bottom Line

The Australian economy will get worse yet, but markets don't have to. They have already factored in a lot of the bad news

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still to come. And somewhere in (the first half of?) 2009 there should be a solid market rise as economic recovery appears on the horizon.

So what if anything does this mean for local governments?

I'm no expert on this topic. Tough economic times are tough for everybody, particularly for those local government units who inadvertently bought themselves exposure to the US sub-prime problem.

But we all know what every cloud has, and in this case the silver lining may be that the Federal government has already displayed a willingness to loosen the purse strings and to finance worthwhile local-government spending projects. So make sure you keep one in your briefcase for those visits to Canberra!

Chris Caton

Chief Economist

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