Edition #19

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The Australian economy – recession, recovery or both?

Key points

- Australia has so far had a very mild economic downturn compared to other countries and its own history.
- However, it's likely that the economy went backwards in the June quarter and that this will continue into the current quarter. This, along with falling inflation and rising unemployment, is likely to prompt more interest rate cuts over the next 6 months.
- Later this year and through 2010 a sustained recovery is likely to kick in driven by the rebound in China, housing and public investment. In the meantime economic indicators are likely to be a mixed bag.

How does this recession compare?

While the global economy is going through its worst recession in over 70 years, the Australian economy has held up remarkably well, so far at least. The following table compares the current downturn to past recessions.

What happened in past Australian recessions?

Recession	Fall in GDP, %	Length - qtrs	Fall in inflation % points	Rise in unemploy-ment, % points	Fall in cash rate, % points
1960-61	-2.4	4	-5.2	+2.7	NA
1975	-2.1	2 *	-11.2	+3.2	-14.1
1977	-0.6	2	-5.4	+2.3	-2.4
1982-83	-3.8	7	-5.7	+4.9	-12.4
1990-91	-1.7	5	-4.6	+5.2	-13.5
Average	**-2.1**	**4**	**-6.4**	**+3.7**	**-10.6**
2007-so far	-0.2%	NA	-2.5	+1.9	-4.25

* It can be argued that the mid-1970s recession was much longer as GDP peaked in 1973 and spent several quarters just bouncing up and down in a declining trend. Source: ABS, RBA, AMP Capital Investors

GDP has barely fallen from its peak and unemployment is up but not hugely. Several factors have helped Australia including a shortage of houses, the relatively good shape of the financial system, the quick fall in private borrowing rates, the initial fall in the $A which helped exporters, the fact our resource based exports are less sensitive initially to swings in consumer spending in rich countries and far earlier than normal monetary and fiscal stimulus.

Recent data has painted a confused picture

However, recent economic data has been somewhat confusing. March quarter GDP surprisingly rose, housing finance and auction clearance rates have increased, consumer and business confidence readings are well off their lows, retail sales are up 7% year on year and car sales look like they may have bottomed. But business investment looks very weak, the trade balance is deteriorating again, building approvals have fallen back and unemployment is still rising. There is also a concern the monetary and fiscal stimulus is the only reason for the positives and that it will soon fade. So where are we?

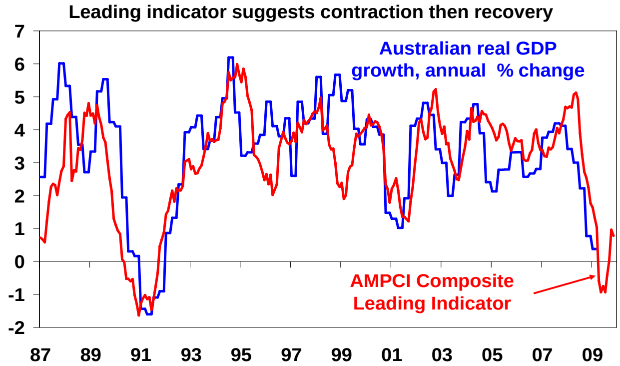
Expect things to get worse in the short term….

There are several reasons to expect economic conditions, as measured by GDP, to contract in the short term:

- Firstly, exports now appear to be starting to weaken. Rural and gold exports, which supported a surprise rise in March quarter export volumes, are reversing and some of the fall in Asian manufactured exports will likely flow through to Australia.
- Secondly, the slump in export prices and hence its flow through to national income is only just getting underway with contract prices for coal and iron ore coming down by 30 to 60%.
- Thirdly, business investment looks set to fall further off the back of the slump in profits, low levels of capacity utilisation and the tougher credit environment with business credit actually now going backwards. The weakness in business investment is highlighted by a 61% fall in the value of non-residential construction approvals from year ago levels.
- Fourthly, while households are being supported by the Governments cash payments, July tax cuts and low interest rates in the short term, this will be offset in the short term by uncertainty about the labour market, as unemployment continues to increase, and the desire to reduce debt in the face of the 15% or so loss of wealth.

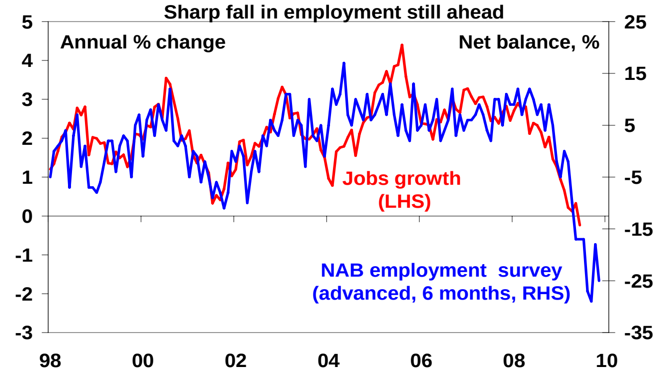
For these reasons GDP is likely to fall in the June and September quarters. Our leading indicator for the Australian economy suggests more weakness in the short term before growth resumes later this year and into 2010.

Leading indicator suggests contraction then recovery



The leading indicator is based on consumer and business confidence, building approvals, money supply growth and the yield curve. Source: Thomson Financial. AMP Capital Investors

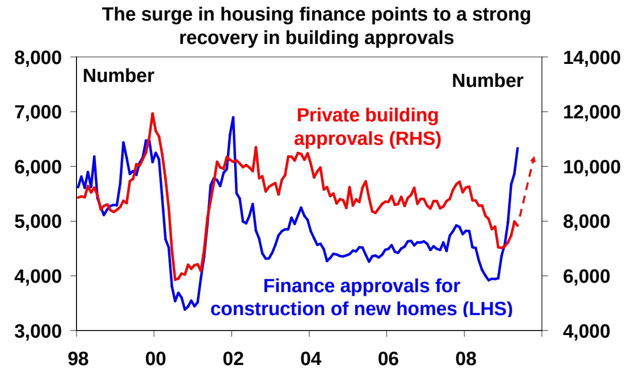
In terms of the labour market, it's worth stressing that it always lags the economic cycle as it takes a while for businesses to swing from hiring to firing (and vice versa). So the slump in growth over the past year is yet to fully impact employment and this (combined with a contraction in activity in the near term) is likely to push unemployment up to around 7% by year end and probably up to a peak of 8% next year. While June employment data still indicated a relatively modest rate of deterioration in employment, **the 50% slump in ANZ job ads over the last year and the sharp fall in business hiring plans, as evident for example in the National Australia Bank's business survey, point to a sharp fall in employment still to come**. See the next chart.



Source: Thomson Financial, AMP Capital Investors

… before they get better

However, while we see a lurch back into negative growth in the June and September quarters - which should really be seen as the continuation of the recession that commenced in the December quarter last year - we remain of the view that the economy is on track for a sustained recovery from later this year. Firstly, thanks to the kick start from the first home owner's boost and more fundamentally from lower mortgage rates, the housing construction cycle is likely to turn up from later this year. Sure, the first home owners boost will tail off as we go through next year. However, with mortgage rates remaining low and with pent up demand having built up after years of housing commencements running below underlying demand it's likely that the housing construction upswing will continue through next year into 2011. There is a danger in reading too much in the slump in building approvals in May as it was largely driven by a 43% fall in normally volatile approvals for apartments. Housing finance commitments for the purchase or construction of new homes is still rising solidly and this normally leads housing approvals. See next chart.

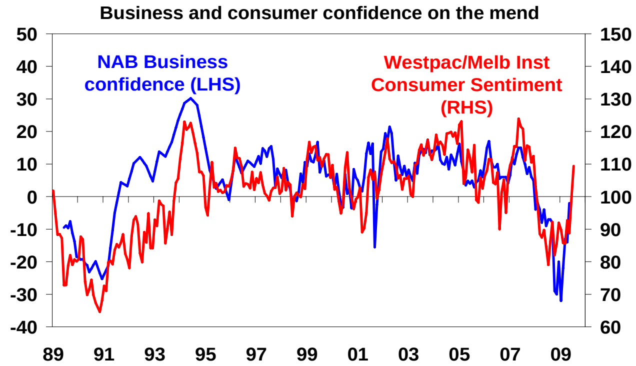


Source: Thomson Financial, AMP Capital Investors

Secondly, a range of business surveys point to a recovery in global economic activity from later this year. At the forefront of this is a solid upswing now getting underway in China. This should help drive a recovery in exports.

Thirdly, stronger public spending particularly on infrastructure will start to kick in from later this year and this will provide an offset to weak business investment.

This is all consistent with the rise in business and consumer confidence that we have seen over the last six months which normally feeds through to growth with a lag.



Source: Thomson Financial, AMP Capital Investors

During recessions there is always a concern that any boost provided by fiscal stimulus will be temporary. But historically it has always been successful, along with interest rates which remain low well into any recovery, in sparking a pick up in private sector demand. This time around the problems of excessive household debt are much greater, but against this the fiscal stimulus has also been greater than normal.

Implications for interest rates

With unemployment likely to rise well into next year serving to push wages growth down and excess capacity in the economy continuing to expand, it's likely that inflation will fall well below the RBA's 2 to 3% inflation target over the year ahead. In fact June quarter inflation data to be published later this month is likely to show inflation at 1.7%. **With inflation falling below target, unemployment drifting steadily higher and worries that the fiscal stimulus to consumer spending may wear off it's likely that the RBA will want to drip feed more good news into the economy in the form of further interest rate cuts over the next six months or so**. As a consequence, we remain of the view that the cash rate can - and will - fall further to around 2.25 or 2.5% by year end.

Concluding comments

We are now in the stage of the economic cycle where economic indicators paint a confusing picture. Some indicators are still signalling weakness such as the rise in unemployment but others are pointing towards an eventual economic recovery from later this year. The cross currents in economic indicators also reflect the constraints around high debt levels on the one hand and massive monetary and fiscal stimulus on the other. Unfortunately this confused picture is likely to remain for a while. But the key is that even though the June and September quarter GDP readings will likely be negative, the economy remains on track for a recovery from later this year.

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