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Economic Research note

Australia's economy to stall in 2009; anemic bounce in 2010

- **Australians are experiencing their first recession in 18 years**
- **Household spending and business investment will contract in 2009 as exports collapse**
- **We anticipate a modest improvement in growth in 2010, aided by global recovery**

Australia is in the midst of the first recession since the early 1990s, the ripples of the global economic hurricane belatedly having washed ashore. In fact, we forecast virtually no growth in Australia's economy in 2009, and growth of only 1.7% in 2010. The rebound depends on an anticipated improvement in global growth, which should support Australia's exports. Households currently are in a rare state of retreat, previously upbeat businesses are slashing investment and hiring, and commodity exports are in free-fall. Only a big rise in public spending is taking up some of the slack left by the weakening private side of the economy.

Australia does, however, have a number of advantages that should make this recession mild relative to dire conditions elsewhere. First, Australia exports commodities to China, where growth is holding up better than in most other economies. Second, Australia's authorities retain plenty of policy ammunition, with the central Budget still (officially) in surplus and the cash rate at 4.25%, even though the RBA already has implemented the most aggressive policy easing since the last recession. Third, the 28% plunge in trade-weighted AUD will help cushion the downside for exporters. Finally, largely absent a subprime lending legacy, Australia's banking system is robust and, broadly speaking, corporate balance sheets are healthy.

Australia's first recession since 1990-91

Recession, though, already is baked in Australia's cake. Real GDP most likely contracted in 4Q08, the first fall since 4Q00. We anticipate a second quarterly fall in GDP in 1Q09, which will deliver the first recession since 1990-91. Australia's economy stalled in 3Q08, well before the onset of the worst of the global credit crunch, owing mainly to the impact of interest rates at 12-year highs and soaring energy prices. We anticipate that GDP will expand from 2Q09, albeit at a modest pace. In fact, GDP growth probably will be below potential until 2H10.

Australia: GDP growth forecasts

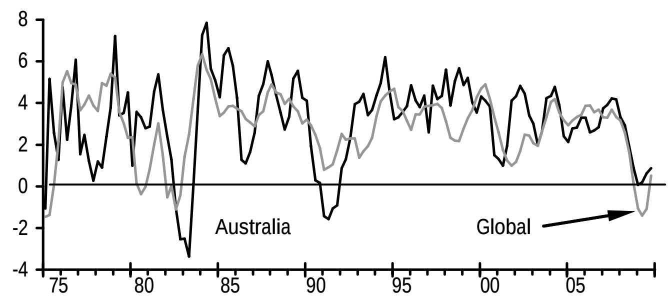
	2008	2009	2010
Household spending	2.0	-0.1	1.4
Business investment	11.4	-5.1	-7.8
Dwelling investment	2.1	2.0	4.6
Public spending	3.9	6.6	5.1
Change in inventories[1]	-0.3	-0.1	-0.2
Exports	5.2	-3.8	1.4
Imports	12.1	-1.2	-0.2
Net exports[1]	-1.7	-0.5	0.3
GDP	2.3	0.2	1.7

Source: JPMorgan

1. Contribution to growth.

GDP growth: Australia and global (incl. JPMorgan forecasts for 2009)

%oya



Virtually all of Australia's economic eggs have been sitting in the export basket. The soaring terms of trade which, until recently, was the highest since the wool price boom of the 1950s, had more than made up for sluggish growth in export volumes, caused by lingering capacity constraints. The resulting substantial boost to national income cushioned growth in the economy against the contractionary effects of falling dwelling investment and public sector austerity.

The investment boom that started in 2002 laid the groundwork for a long-awaited increase in export volumes, provided the global economy remained firm. Unfortunately, however, the slump in global demand for Australia's abundant raw materials means that many exporters now are unable to benefit from the easing of the economy's capacity constraints. Instead, many firms are reassessing their capital spending plans and are trimming their work forces.

Public spending absorbing private slack

At the same time, increasingly pessimistic households, many of whom have seen the value of their investment nest eggs fall by half, are cutting back; in 2008, real retail spending posted consecutive quarterly declines for the first time since 1996. Some of the slack generated in the private side of the economy is being taken up by a huge rise in public spending, particularly in depleted infrastructure. For example, Australia's government has in recent months announced substantial fiscal stimulus packages designed to boost GDP as much as 2% points. Private home construction also is rising, helped by plunging market interest rates and rapid population growth, which has made the existing undersupply of housing even more acute.

Households the economy's Achilles heel

The forecast now anticipates real GDP growth in 2009 of just 0.2%, down from 0.5% previously. If realized, this will be the weakest outcome since 1991, when the economy contracted 1.7%. Of the major components of the economy:

- **Households** are particularly vulnerable. After an extended spending splurge on the back of the mining investment boom and the elevated terms of trade, households embarked on a period of austerity in early 2008. This new-found conservatism owed much to the RBA's rate hikes. Confidence since has collapsed owing to plunging equity prices and the onset of global recession. The main headwind for households currently is rising unemployment: we anticipate a doubling of the jobless rate to 9% by the end of 2010.

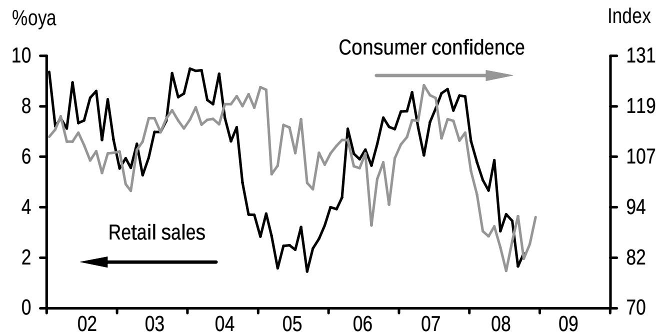
- **Business investment** plans are being scaled back. Projects valued at A$600 billion remain in the investment pipeline, but firms already have trimmed expected growth in spending in the current fiscal year. We expect a fall in private investment spending in 2009, after a 98% rise since 2001, and another decline in 2010.

- **Net exports** are likely to be a drag on the economy until at least 2010. Export volumes are set to fall nearly 4% in 2009 as global demand for commodities, in particular, weakens. A fall in import volumes owing to softer business investment and household spending will, however, limit net exports' subtraction from GDP to 0.5% points. This will be the "best" outcome since 2001.

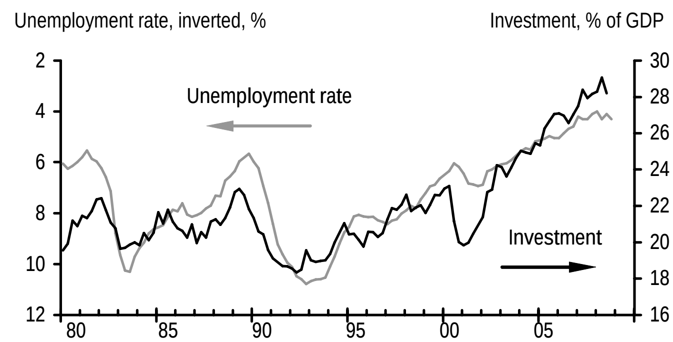
- **Dwelling investment** should rise 2.0% in 2009, owing to the sharp fall in market interest rates, improving home affordability, and worsening undersupply. Australia currently is building close to 20,000 fewer homes than population growth suggests is necessary.

- **Public spending** should rise significantly as Federal and state governments attempt to fill the gap left by faltering private demand. We anticipate a nearly 7% rise in public spending in real terms in 2008 as the central government deploys the surplus which, until recently, measured nearly 2% of GDP. The Commonwealth Budget will be in deficit of up to 4% of GDP by 2010, a similar shortfall to those seen in earlier recessions.

Retail spending and consumer confidence



Private investment and the unemployment rate



RBA's job incomplete as inflation dives

Since early September, the RBA has lowered Australia's cash rate 300bp to 4.25%, which equals the record low target rate set in December 2001. This is the most aggressive policy easing since the recession of the early 1990s, but the role of RBA officials in cushioning the downside for the economy is incomplete. Indeed, we expect a 50bp rate cut in early February (there is no RBA Board meeting scheduled for January, at least not yet) and a final 25bp cut in early March. Even then, however, with global disinflationary forces intensifying, the risk to our forecast for a terminal cash rate of 3.5% is to the downside. A sub-3% cash rate target is possible but unlikely, partly because inflation will remain elevated in the near term.

An anticipated sharp fall in inflation, though, has opened the door for further RBA easing. Our forecast anticipates that headline inflation will fall quickly throughout 2009, partly owing to plunging energy prices, but also because of growing economic slack. In fact, the forecast shows headline inflation at the bottom of the RBA's 2-3% target range in 2H09. Core inflation will be "stickier," but should return to target in early 2010.