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Economic Research note

Further growth downgrades to Antipodean economies

- **GDP in Australia and NZ will contract in 2009, by 0.5% and 0.7%, respectively**
- **Export volumes will collapse owing to weaker trading partner growth, particularly in Asia**
- **Significant policy stimulus to cushion the downside; expect huge budget deficits and more rate cuts**

We have been forecasting recession in Australia since last October, but the latest dire news on the global economy means that we are even more confident in this view than before. Our global team again has marked down the forecast for 2009 global GDP "growth" to -1.6%. Deteriorating conditions offshore and the worsening credit crunch point to a deeper Australian recession than previously forecast. We now look for Australia's economy to contract 0.5% in 2009, a marked change from our previous forecast of a weak 0.2% expansion.

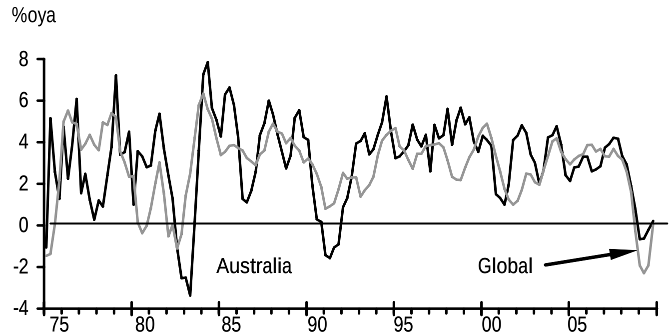
The New Zealand economy also will likely be weaker than previously forecast. A contraction in GDP in Australia, New Zealand's largest trading partner, will be a major headwind. In our revised forecast, the small, open, exporting Kiwi economy will shrink 0.7% in 2009 as export volumes collapse and private consumption stalls.

Asian trading partners outlook a key drag

The dismal outlook for the global economy means there are tough times ahead for Antipodean exporters. A major concern will be the marked deterioration in conditions in Australia and New Zealand's dominant trading partners in Asia, which receive more than half total exports. In Japan, for example, which is Australia's number one export destination and New Zealand's 3rd, GDP now is expected to contract 5% in 2009. There also have been further downgrades to J.P.Morgan's 2009 growth forecast for China, the second largest export partner for Australia and the 4th largest for New Zealand, to 7.2% from 7.8% previously.

Australia's export volumes, therefore, are poised to tumble. On our forecasts, export volumes will fall 8% in 2009 as global demand, particularly for commodities, weakens. Also, the dive in most commodity prices means the end of the long boom in national income. In response, many firms are reassessing their capital spending plans. 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 private investment spending to fall 7% in 2009, after rising 98% since 2001.

GDP growth: Australia and global (incl. J.P.Morgan forecasts for 2009)



Australia: GDP growth forecasts

	2008	2009	2010
Household spending	2.0	-0.4	1.9
Business investment	11.4	-7.4	-8.1
Dwelling investment	2.1	0.6	3.0
Public spending	3.9	6.6	4.9
Change in inventories[1]	-0.3	-0.1	-0.2
Exports	5.2	-8.3	-2.2
Imports	11.7	-4.4	-1.9
GDP	2.3	-0.5	1.5

Source: JPMorgan
1. Contribution to growth.

Aussie consumers in rare state of retreat

Previously upbeat Aussie businesses are slashing investment and trimming their work forces, reaffirming our view that the unemployment rate will reach 9% by the end of 2010, double the current rate. Leading indicators of employment have collapsed and more contemporary industry anecdotes, such as the deep job cuts announced throughout January in sectors as diverse as mining, retailing, and telecommunications, signal that labor market conditions will deteriorate further. We forecast a deep labor market adjustment that will result in employment falling at least 1% during the current recession.

Increased anxiety about job security will be a heavy burden for consumers in 2009. Not surprisingly, most consumers remain pessimistic—the WMI consumer confidence index read 89.9 in January, well below the neutral level of 100 for the twelfth straight month. Lower confidence and the massive wealth destruction occurring in the highly leveraged Aussie household sector already have fuelled a rise in precautionary saving and driven many households laden with debt to make additional repayments. Household spending probably will fall 0.4% in 2009.

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Public spending absorbing private slack

Some of the slack in 2009 generated on the private side of Australia's economy should be taken up by a huge rise in public spending. The government has in recent months announced substantial fiscal stimulus packages designed to boost GDP as much as 2% points. We anticipate a 7% rise in public spending as the central government deploys the surplus, via increased spending on public infrastructure and more tax relief for households.

Officials will push the Budget into a deep deficit of around 4% of GDP by 2010, a similar shortfall to those seen in earlier recessions. This week, the government hinted that another round of personal tax relief could be in the pipeline, in addition to big increases in public spending.

Terminal cash rate of 2.75% forecast

Deteriorating conditions offshore and rapidly accumulating evidence that Australia is not immune to global recession solidify the case for assertive RBA easing. We forecast another 100bp cut in the cash rate at the February 3 Board meeting. In our view, RBA officials would rather risk overdoing the policy easing by moving early and aggressively, than moving too little too late. Being overly cautious risks the economy dropping into a destructive, deflationary spiral of even more aggressive job cuts and collapsing activity; this argues strongly in favor of the RBA frontloading the policy easing.

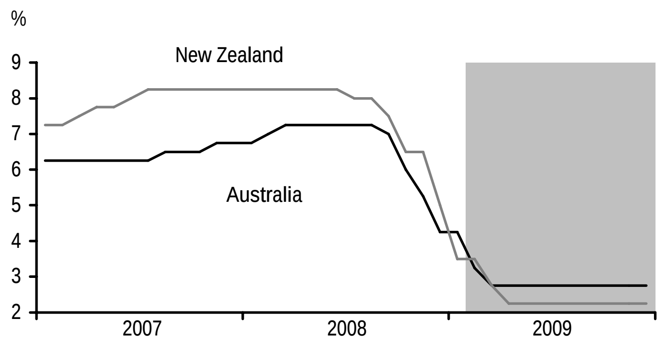
Our forecast for the terminal cash rate is 2.75% by March. By then, having delivered a mammoth 450bp of rate cuts in just seven months, the most aggressive policy easing since the 1990-91 recession, RBA officials will likely sit back and let the policy stimulus do its stuff. An important consideration will be how the monetary boost interacts with a further significant loosening of the fiscal purse strings.

Aussie downgrade bad news for NZ

Across "the ditch" in the Shaky Isles, the Kiwi economy already was in a home-grown recession before the recent international troubles unfolded. The threat of even weaker export demand, particularly from Australia, is the main reason for our latest activity downgrade. Even though the end of the drought should boost agricultural activity, export volumes probably will fall 3% this year.

Household spending probably will fall in 2009—the forthcoming tax cuts to be delivered in April will prevent a larger decline than the 0.2% currently forecast. Consumers are becoming increasingly reluctant to spend amid wide-

Record low terminal cash rates in Australia and NZ



New Zealand: GDP growth forecasts

	2008	2009	2010
Household spending	0.1	-0.2	2.3
Government spending	4.1	7.3	-2.9
Fixed investment	-3.8	-5.5	4.9
Change in inventories[1]	0.6	-0.4	-0.5
Exports	-1.0	-3.0	3.8
Imports	3.4	-2.4	3.4
GDP	0.4	-0.7	1.4

Source: J.P. Morgan
1. Contribution to growth.

spread recession fears, still-elevated market interest rates, falling asset prices, and rising unemployment. On our forecasts, the unemployment rate will rise from the current five-year high of 4.2% to nearly 7.0% by year end.

Private consumption also will be under pressure following dairy cooperative Fonterra's decision this week to lower payouts to farmers. Fonterra—which accounts for 35% of global dairy output and is a major driver of income in New Zealand—announced that falling commodity prices and fluctuations in NZD have reduced its estimated payout for the period ending May 31, 2009. The company cut the payout forecast to NZ$5.10/kg of milk solids from NZ$6/kg. We estimate that the payout cut will remove some NZ$1.5bn from the economy.

Two positives: lower rates and tax relief

The prolonged recession in New Zealand, coupled with the rising prospect that inflation soon will fall to within the RBNZ's 2-3% target range, point to further assertive policy easing. Our forecast calls for a terminal cash rate of 2.25%, a stark contrast to the 8.25% peak recorded in 2008. The forthcoming fiscal stimulus is a key factor preventing even larger cuts to the OCR. The government plans to inject about NZ$7bn (4% of GDP) into the economy over the next two years. Significant personal income tax relief, targeted spending on public infrastructure, and higher welfare payments will push the Budget into significant deficit.