

# Australia: The return to normal...

## ...& a look at the long run

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Banking & Markets**



Commonwealth

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# Our View

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## ■ Severe global recession over and recovery underway

- requirements for market stability now in place – but sentiment fragile;
- fears about fiscal sustainability hurting market confidence;
- global recovery skewed - modest in advanced economies, stronger elsewhere;
- *composition* of global growth evolving in a way favourable to Australia;
- commodity cycle boosting Australian incomes.

## ■ Australia to outperform again

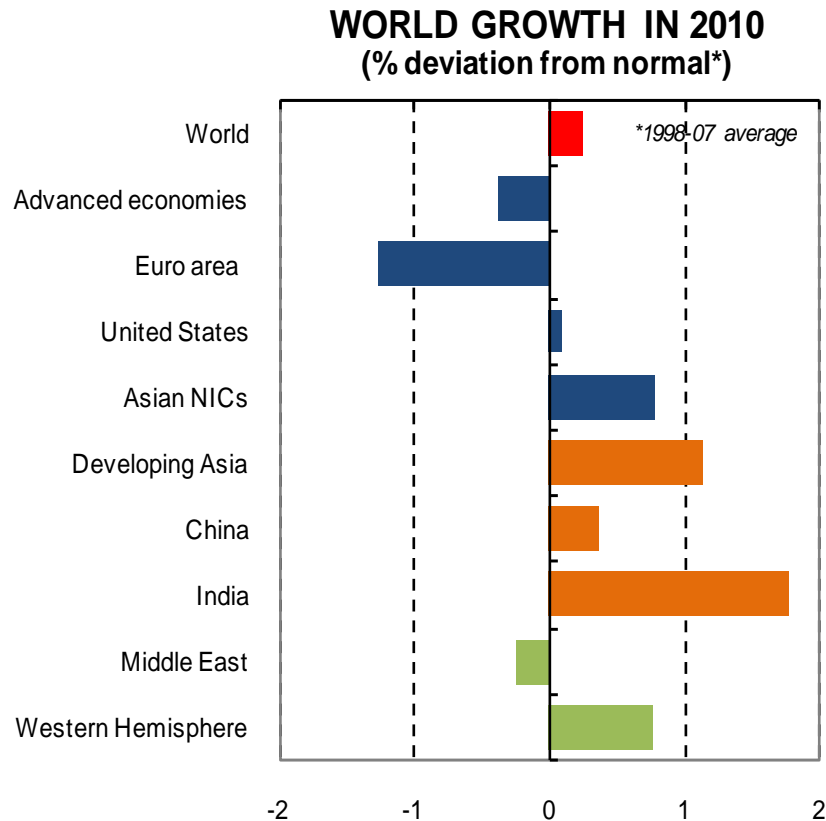
- the framework for a self-sustaining recovery is in place;
- downside risks are less than in 2009 but they are still there;
- risks stem mainly from the sources of the economy's success;
- limited economic slack so inflation risks are tilting up.

## ■ Economic policy

- policy settings need to move into restrictive territory (6% cash by end 2011);
- improving economic backdrop is reducing prospective Budget deficits;
- Budget back to surplus by 2012/13.

# The Elements Of A Self-Sustaining Recovery

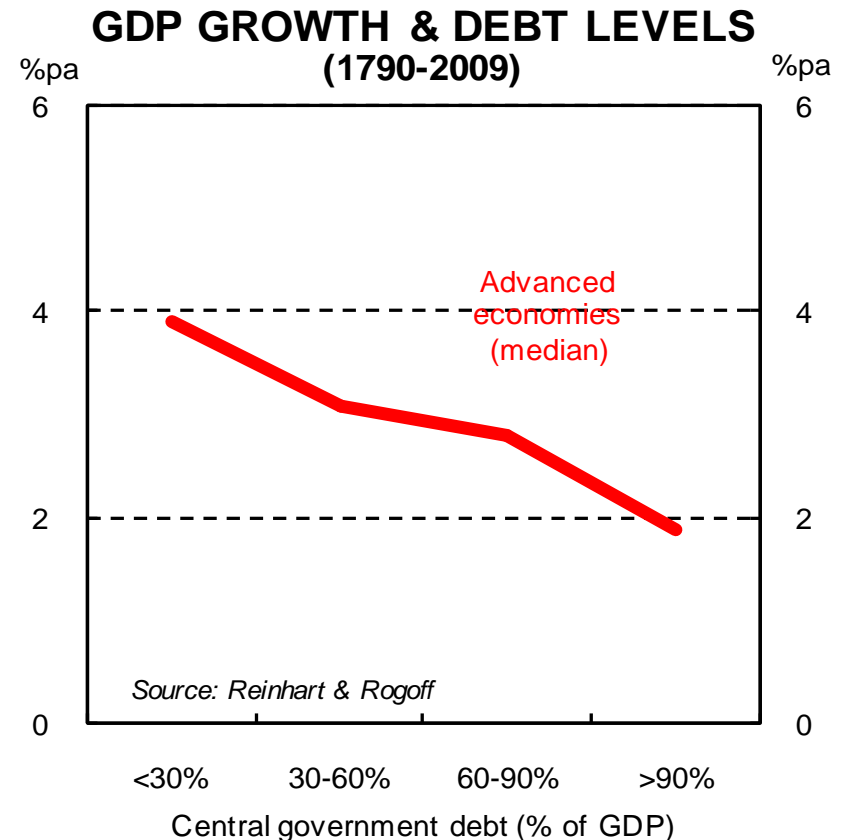
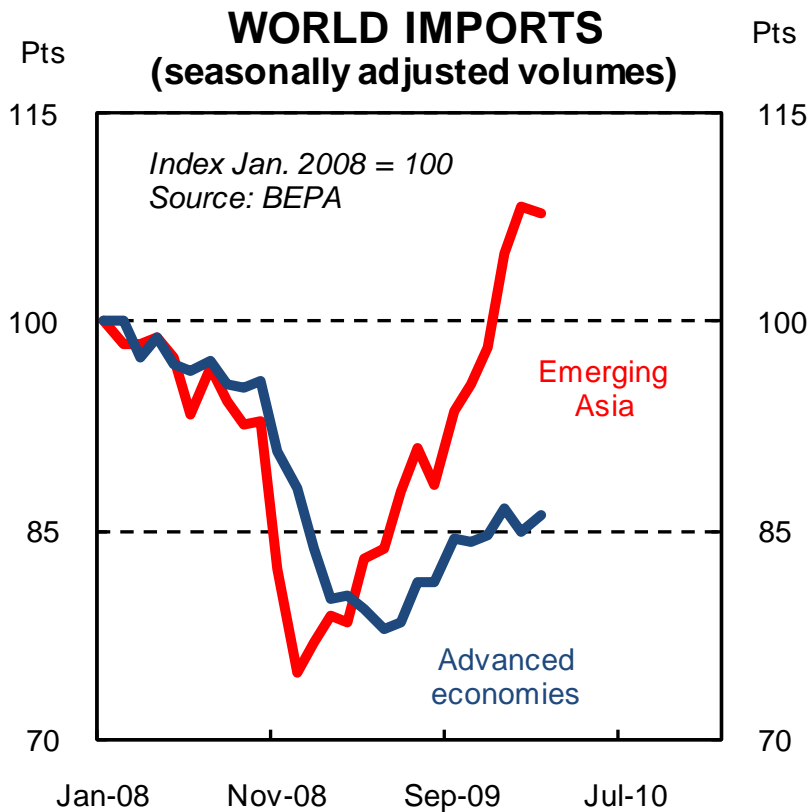
## A global skew



- Global activity continues to lift.
- The IMF now expects the global economy to expand at “normal” rates (4%pa) in 2010 and 2011.
- But a two speed recovery:
  - advanced economies, especially Euro area, to underperform;
  - Asian advanced economies and emerging economies (esp China and India) to outperform.
- Global backdrop remains favourable for Australian trade and commodity prices.

# The Elements Of A Self-Sustaining Recovery

## Growth divide

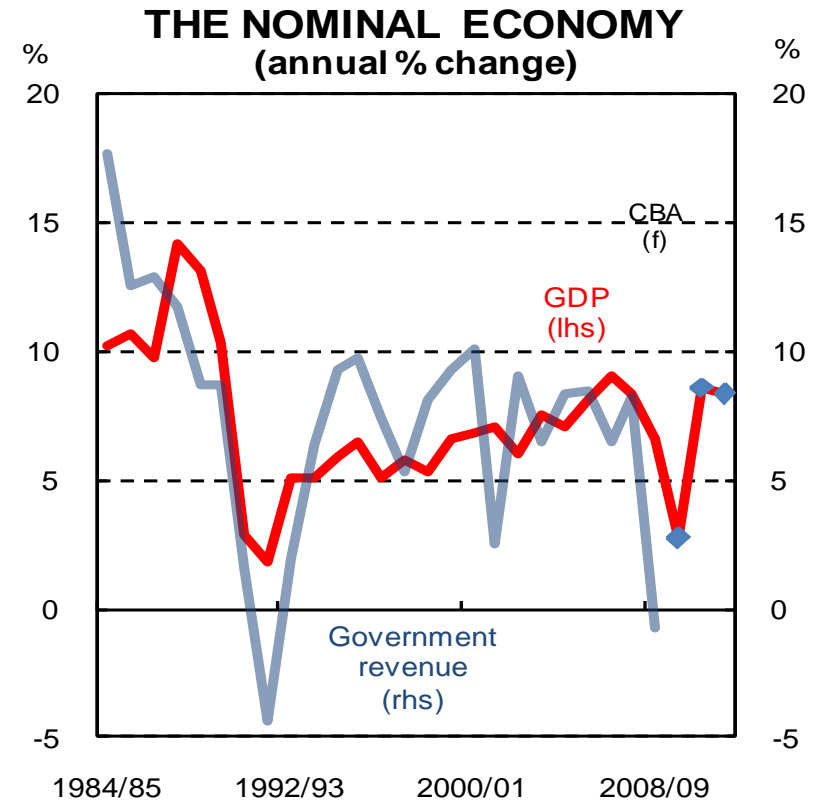
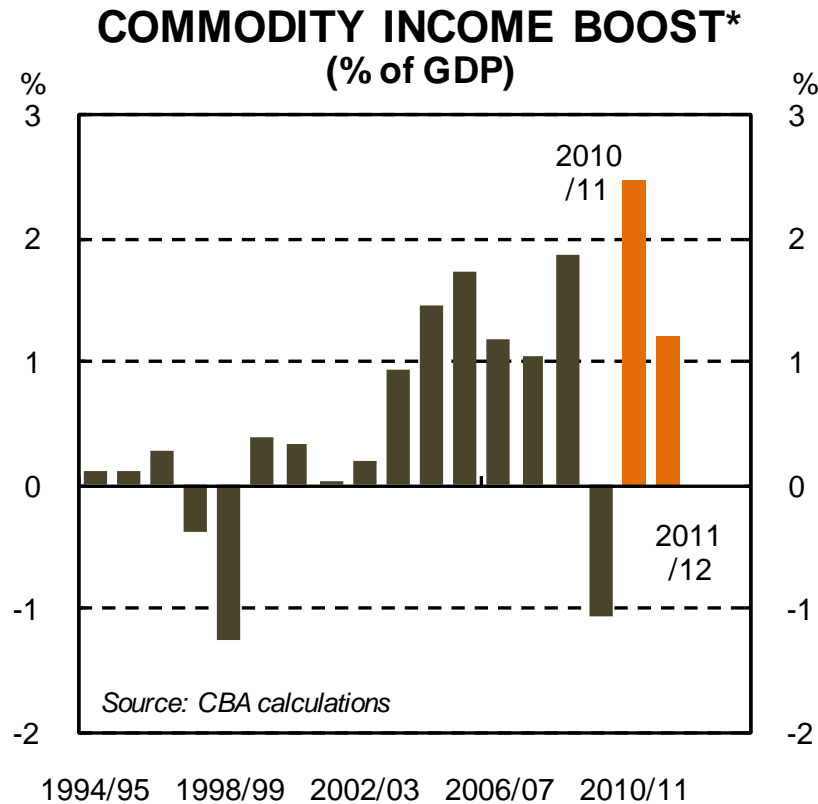


- The Asian growth story is not dependent on a US and European recovery.
- GDP growth rates tend to vary inversely with levels of public debt.



# The Elements Of A Self-Sustaining Recovery

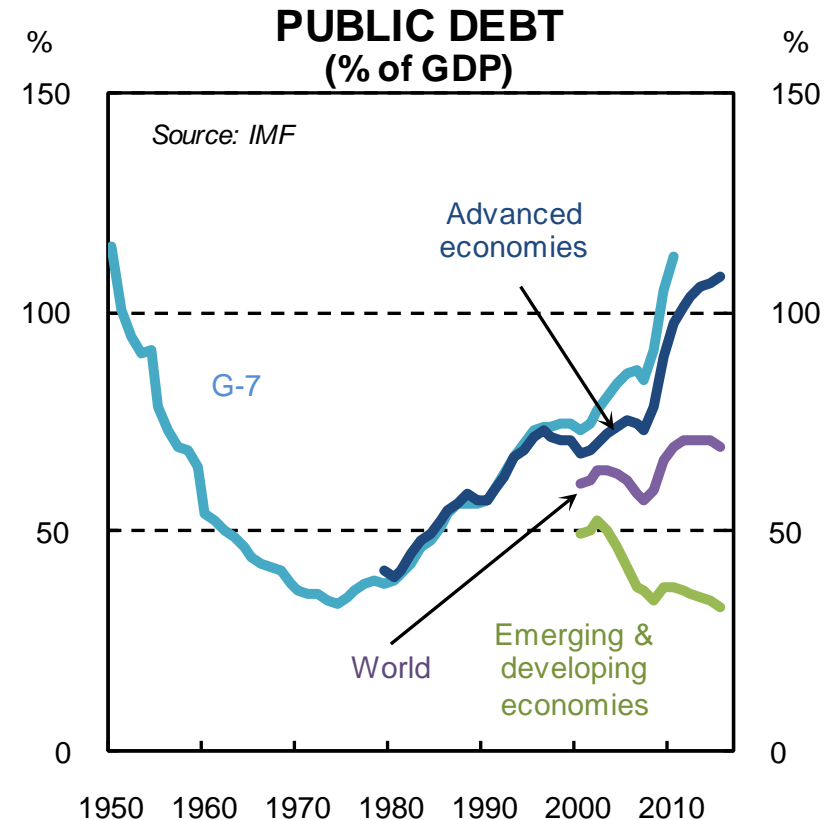
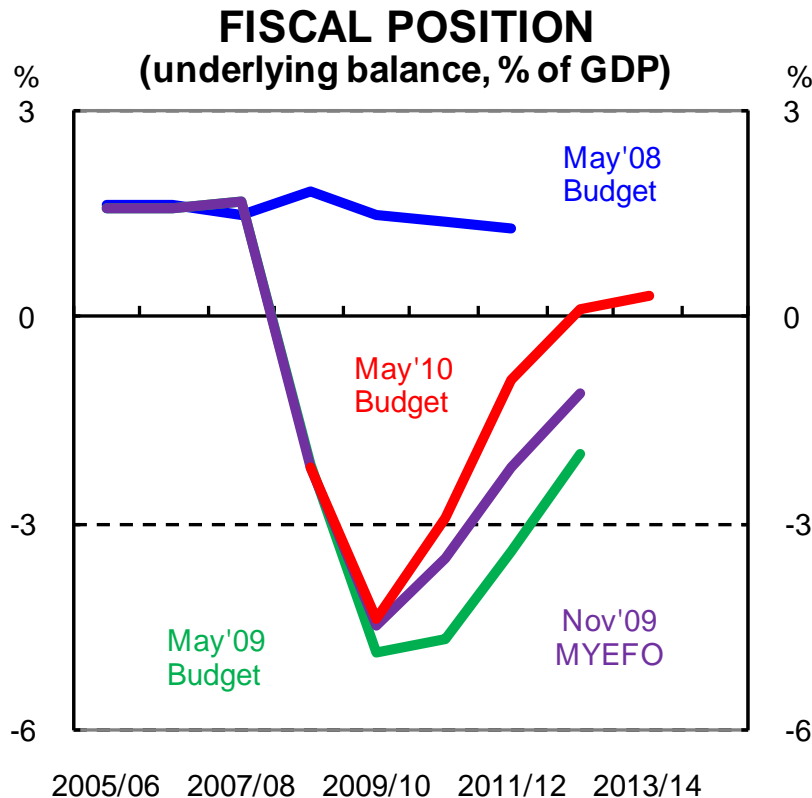
## Asia, commodities & incomes



- Higher commodity prices mean more income and more business capex.
- The *nominal* economy will grow again – a plus for profits and government revenues.

# The Elements Of A Self-Sustaining Recovery

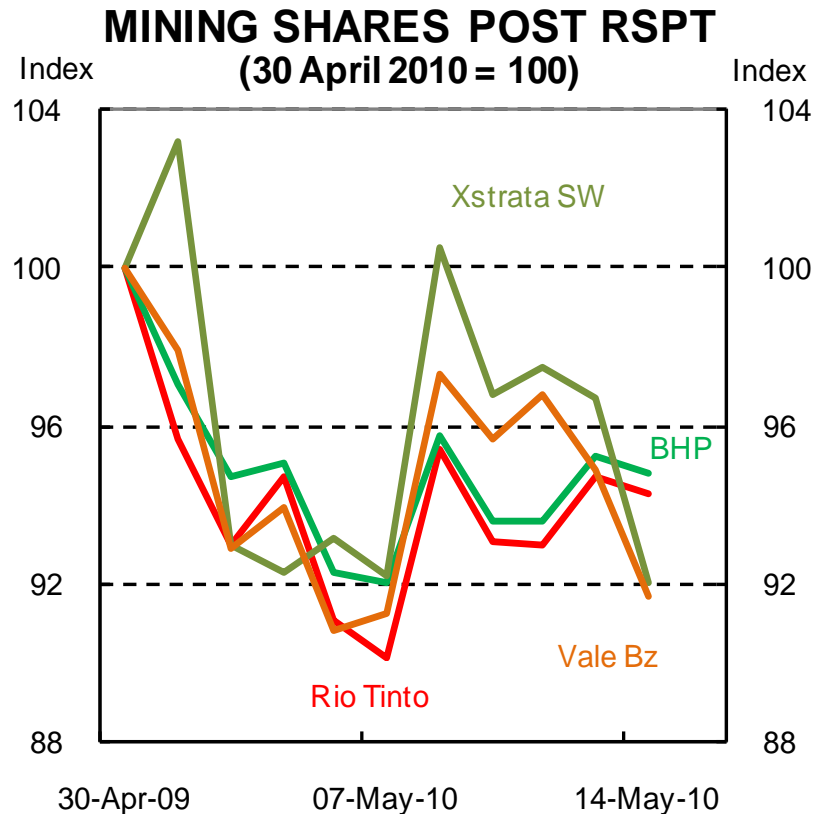
## The *nominal* economy & the Budget



- **Government revenues another beneficiary of the income story.**
- **Fiscal backdrop very good on any global comparison – offers a high degree of protection from global fears about fiscal sustainability.**

# The Budget

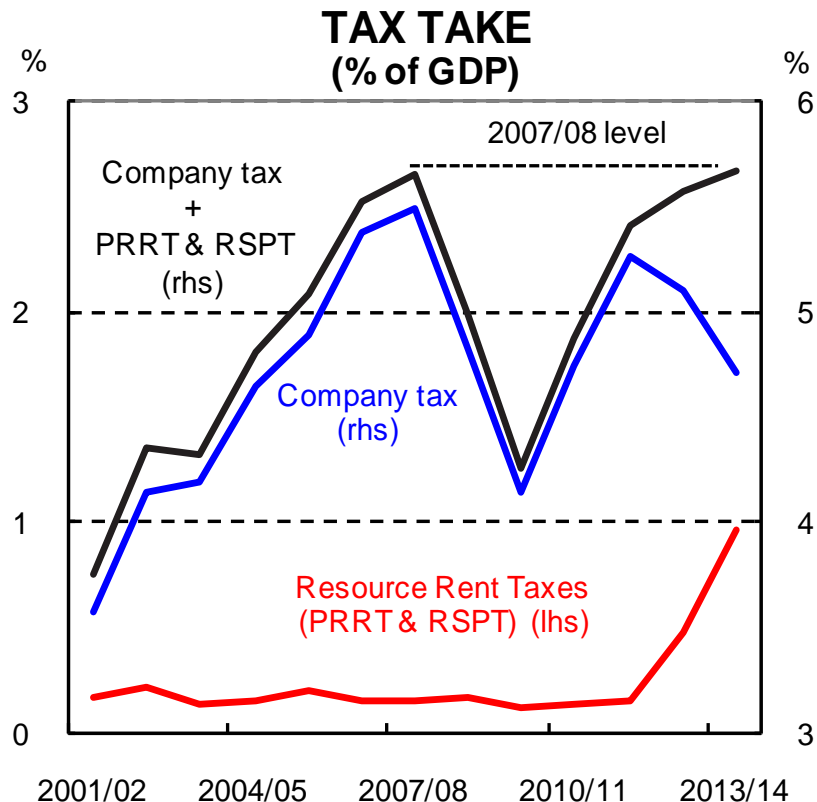
## Resource super profits tax



- **Economics of resource rent taxes mean production and investment decisions unaffected by tax.**
- **Miners receive market price of output.**
- **For any given price, RSPT increases mining output relative to royalties.**
- **Government takes 40% share of economic rents. Government rebates 40% of losses:**
  - **RSPT reduces required return for mining investment;**
  - **post-tax returns smoothed through the commodity price cycle.**

# The Budget

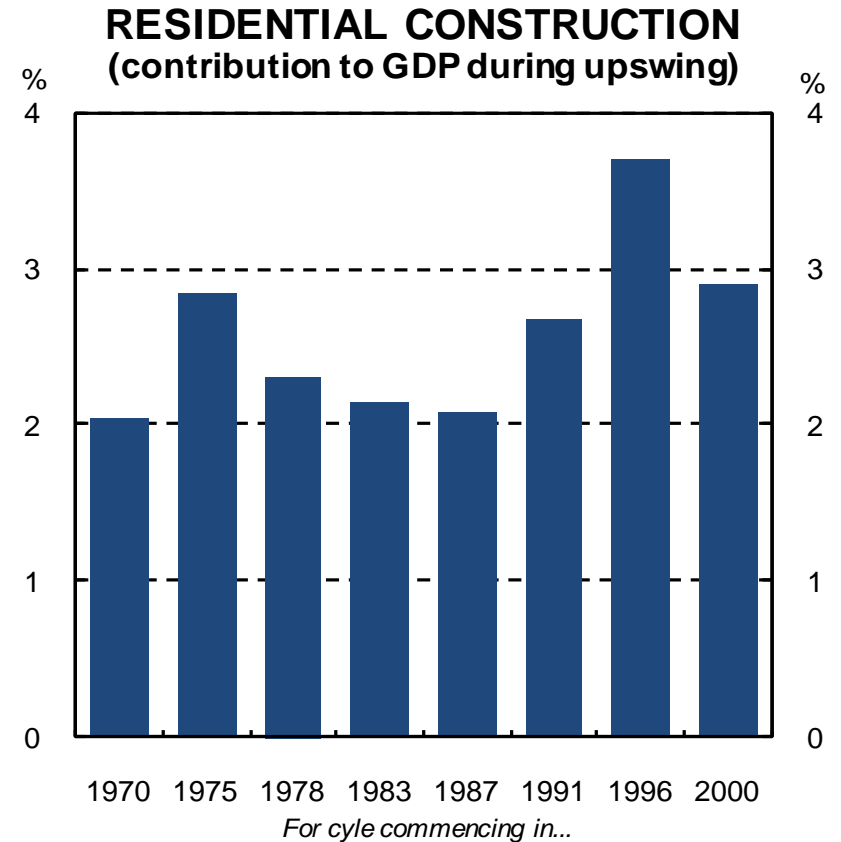
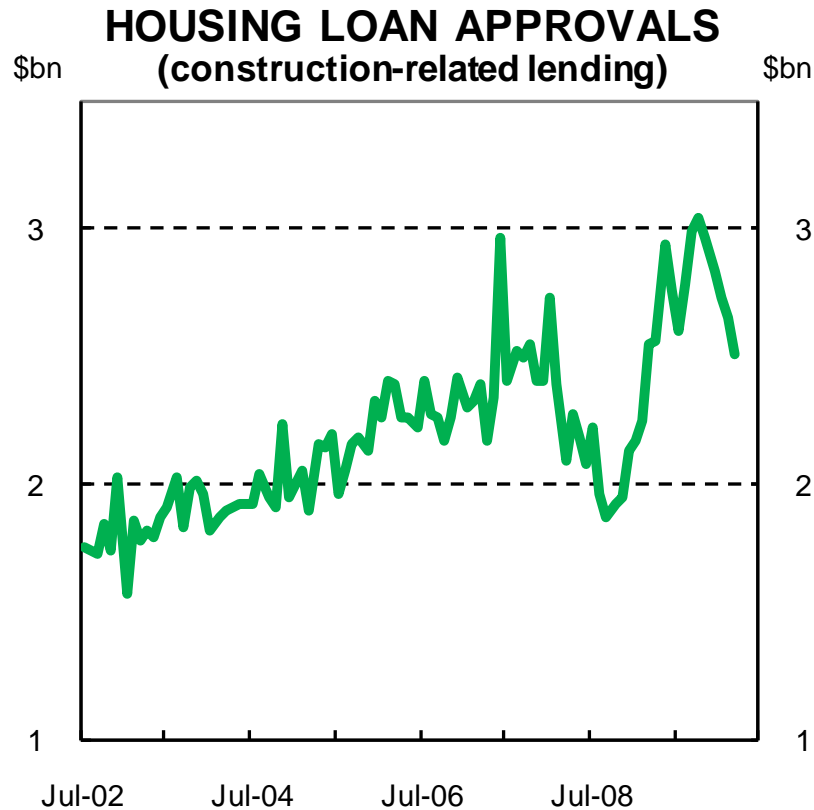
**If it can't move, tax it!**



- The Henry Review advocated a change in the burden of taxation.
- Internationally mobile capital to bear lighter tax load.
- Immovable tax bases (like land and non-renewable resources) more likely to generate economic rents.
- RSPT generates extra 0.5% of GDP in revenue in 2013/14.
- But offset by 0.4% of GDP fall in company tax take.
- Tax mix relatively unchanged at 2013/14 from 2007/08 levels.

# The Elements Of A Self-Sustaining Recovery

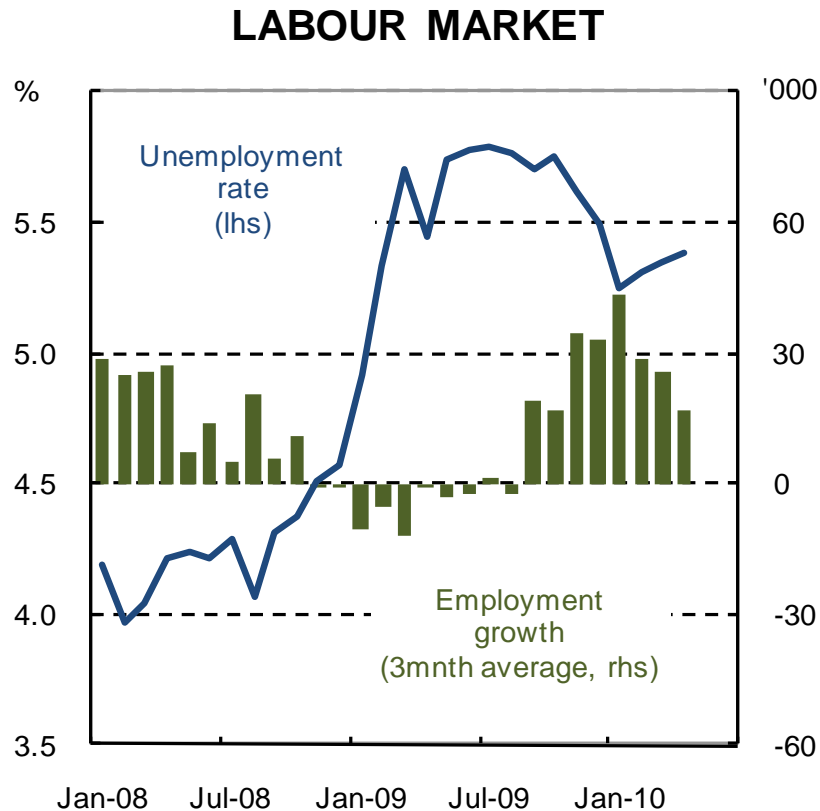
## A housing upturn



- An upturn in residential construction will support economic activity, wealth and spending.

# The Elements Of A Self-Sustaining Recovery

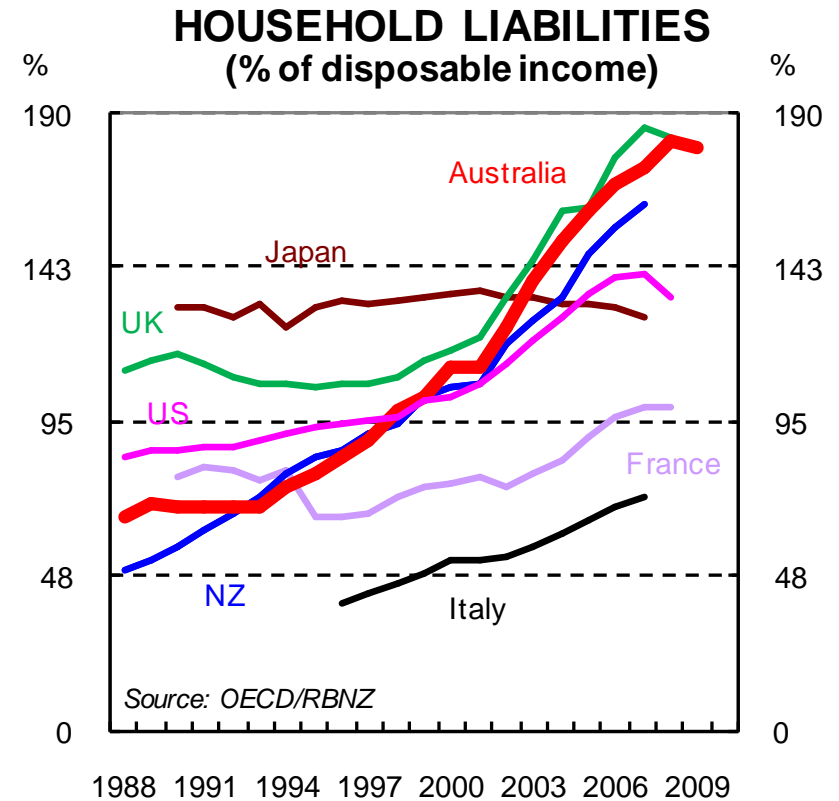
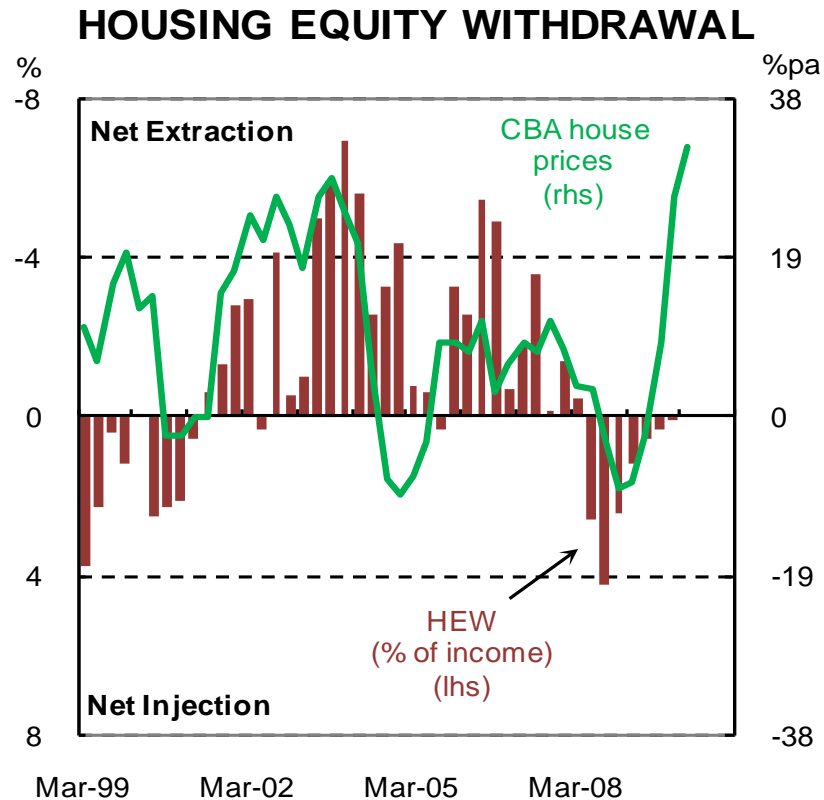
## A positive shock



- A recovery in the labour market will support consumer incomes and confidence.

# The Elements Of A Self-Sustaining Recovery

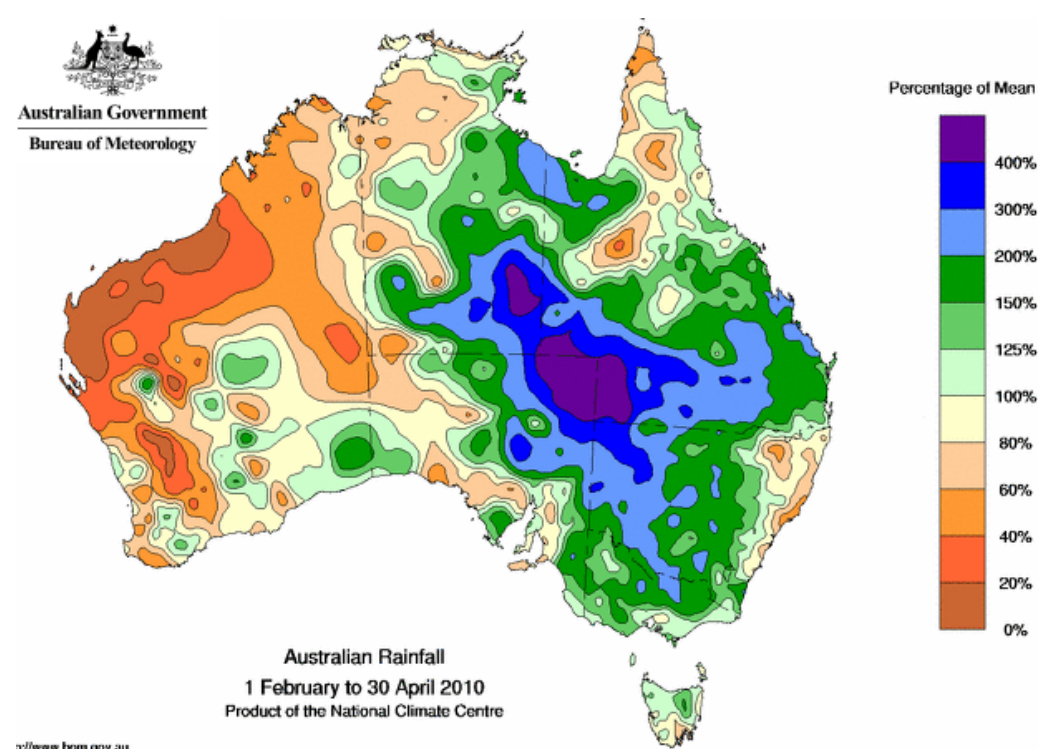
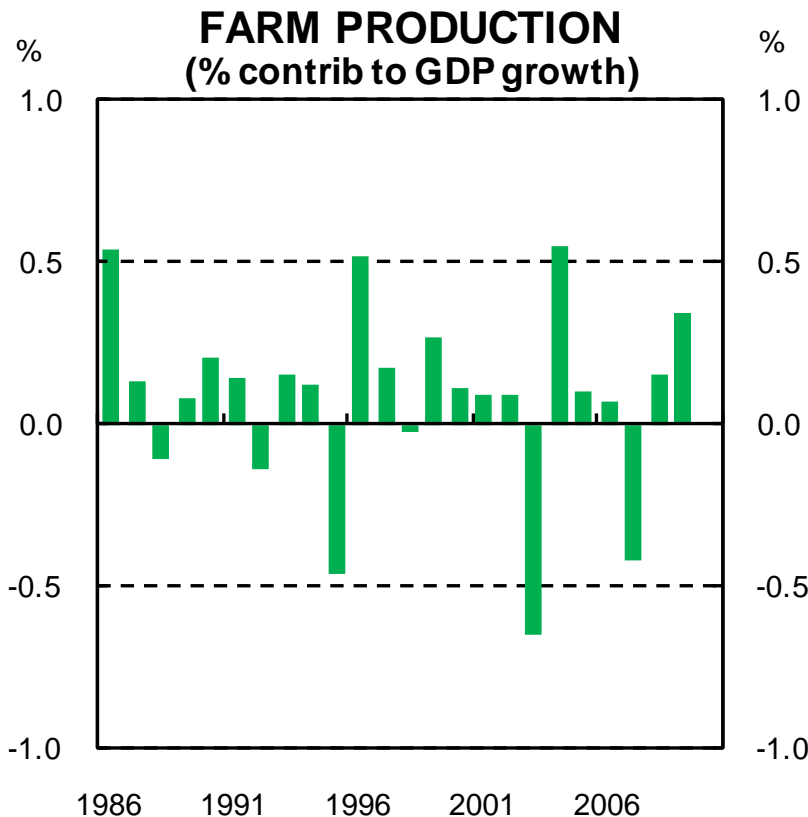
## Temptation returns?



- Household desire for balance sheet repair is weakening.
- Australian households carry high levels of debt relative to income.

# The Elements Of A Self-Sustaining Recovery

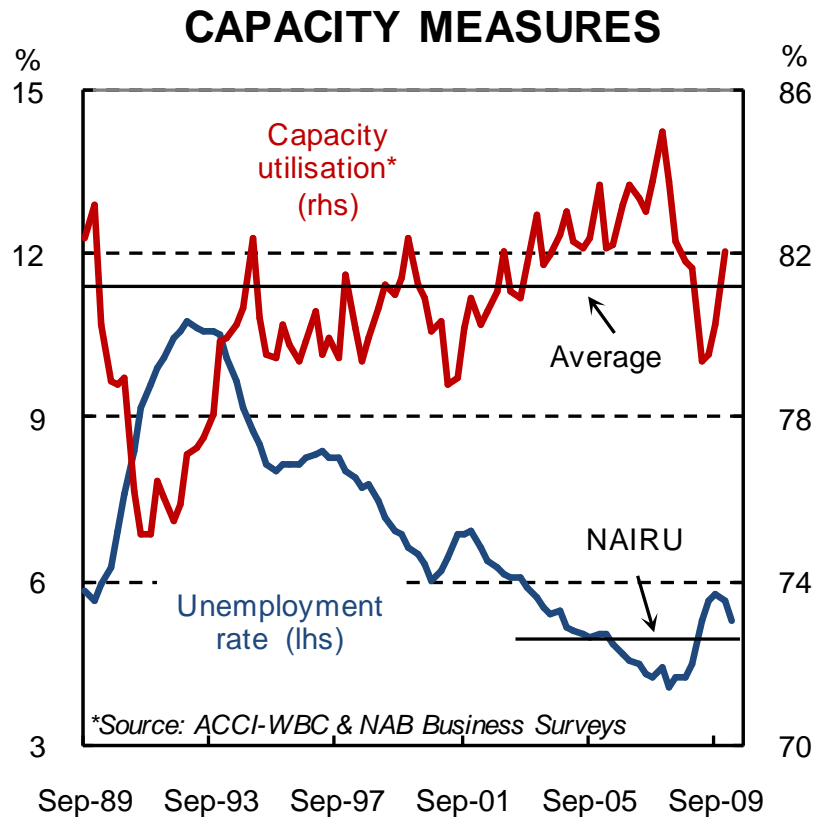
## The lucky country



- Widespread rains have sharply improved the outlook for farm production.
- Potentially a significant boost to economic activity.

# A Price To Pay – The Risks In Success

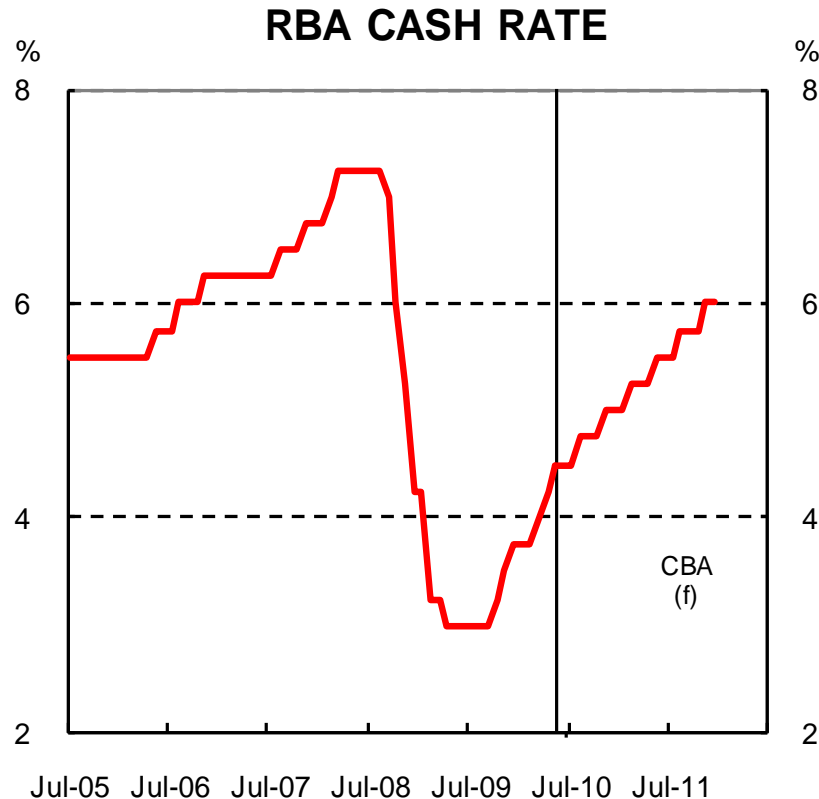
**Activity: too much of a good thing?**



- The spare capacity in product and labour markets is limited.
- Inflation outcomes benign in 2010 but risks tilting up in 2011.

# A Price To Pay – The Risks In Success

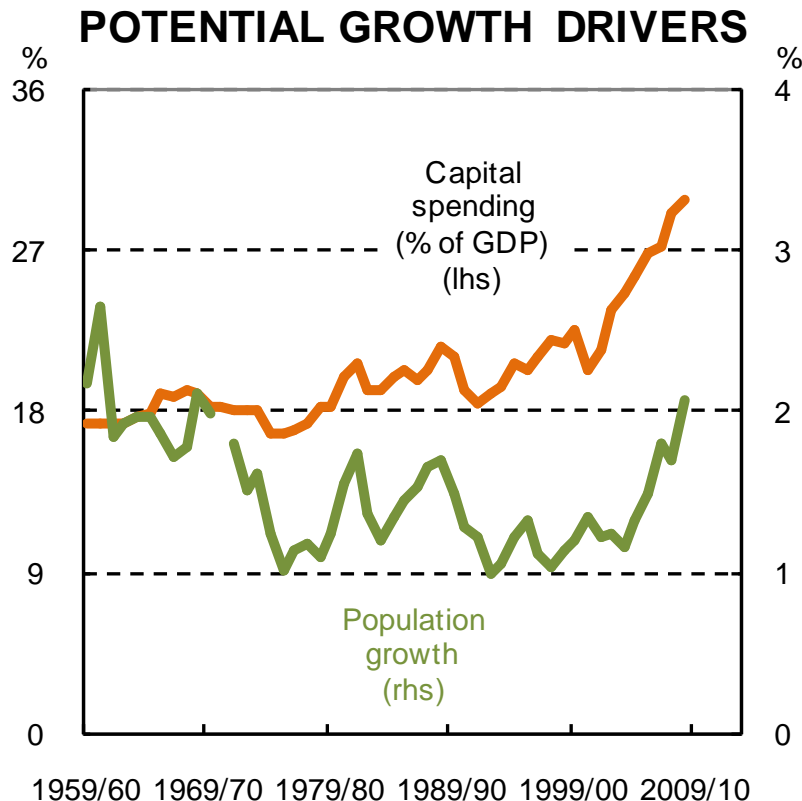
## The consumer: the squeeze returns?



- **Part I of the RBA’s exit strategy involved removing the “emergency component” of rate settings:**
  - RBA lifted cash rate from 3% to 4%.
- **Part II involved returning rate settings to “normal” as the economy normalises:**
  - RBA lifted cash rate to 4½% and got lending rates back to “average”.
- **Part III may be that policy settings are pushed to the restrictive side in 2011:**
  - CBA forecast: RBA cash rate to 5% be end 2010 and 6% by end 2011.

# A Look At The Long Run

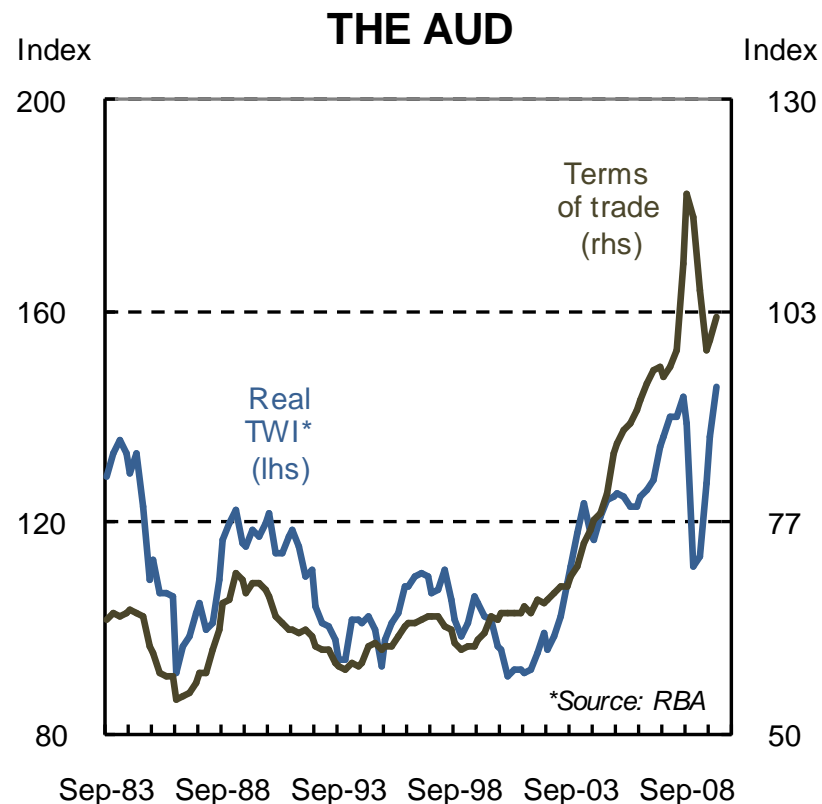
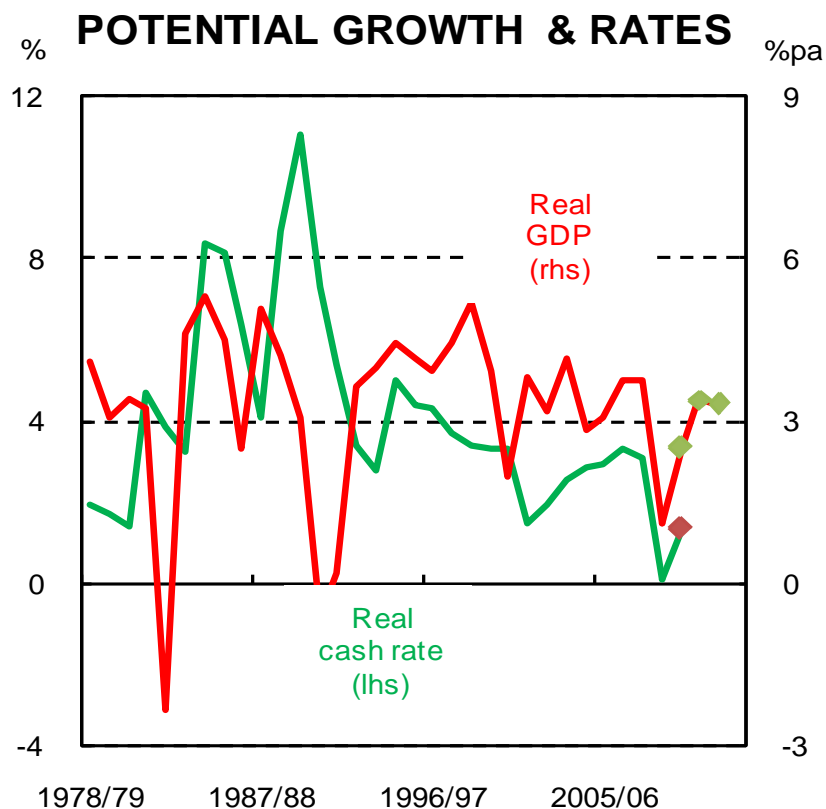
**More capital + more labour = higher potential growth**



- Capital stock and labour supply growing at multi-decade highs.
- Potential GDP growth rates set to step up from 3% to 3.75%.
- The Australian economy by mid century will be around AUD3.2trillion in size (2.5 times current size).
- Implies ongoing large infrastructure requirements.

# Implications

**Higher potential growth = higher rates. Higher terms of trade = a stronger AUD.**



- Higher potential growth rates mean that the “neutral” policy rate will rise.
- The terms-of-trade a proxy for the fundamentals that drive the AUD over time.

# CBA Forecasts

| <b>Economy</b>            | <b>2008/09<br/>(a)</b> | <b>2009/10<br/>(f)</b> | <b>2010/11<br/>(f)</b> | <b>2011/12<br/>(f)</b> | <b>2012/13<br/>(f)</b> |
|---------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
| GDP (% ch)                | 1.3                    | 2.4                    | 3.6                    | 3.4                    | 3.7                    |
| Unemployment (%)          | 4.9                    | 5.5                    | 5.4                    | 4.9                    | 4.8                    |
| CPI (% ch)                | 3.1                    | 2.4                    | 3.1                    | 3.1                    | 2.8                    |
| Current A/c (% of GDP)    | -3.0                   | -4.5                   | -3.5                   | -4.5                   | -5.2                   |
|                           |                        |                        |                        |                        |                        |
| <b>Policy</b>             |                        |                        |                        |                        |                        |
| RBA cash rate (June, %)   | 3                      | 4½                     | 5½                     | 6                      | 6                      |
| Budget balance (% of GDP) | -2.2                   | -4.4                   | -2.9                   | -0.9                   | 0.1                    |

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