

BILL EVANS

WEEKEND ECONOMIST: Rate cuts finished

The events of this week have persuaded us that the prospects for further rate cuts in Australia have diminished to the point where we have revised our forecasts to eliminate rate cuts from our view. We now expect that rates have bottomed out and expect that the next move by the RBA will be to increase rates although we do not expect that move until early in 2011.

However, the uncertainties that central banks will be facing in 2010 as they balance potential cyclical upswings in certain sectors; ongoing weakness in others; and major structural constraints on growth make the outlook for 2010 particularly uncertain.

This view that rates have bottomed out is despite the Reserve Bank maintaining a very explicit easing bias. The Governor's Statement following the July 7 board meeting includes the following comment: "The outlook for inflation allows some scope for further easing of monetary policy, if needed."

The events of the last week that motivated this change of view have been:

1) The 9.3 per cent surge in Consumer Sentiment to 109.4. That followed a 12.7 per cent jump in June to register the largest two-month increase in sentiment since the survey began in 1975. As we discussed, this extraordinary increase is reflecting expectations that the economy will avoid recession and the impact of the Government's two fiscal payments of \$8.4 billion in December and \$12.5 billion in March-May.

There will be no more large handouts and it is possible that the June quarter national accounts will print negative growth, thereby reviving speculation of a recession. Accordingly we expect that there will be some retreat in confidence but because the starting point will be so much higher it is expected to settle at much higher levels than previously anticipated. That points to an improvement in the underlying momentum of the consumer.

2) The evidence that the interest rate cuts are working was further emphasised in the housing finance data released for May. The number of loans to owner occupiers grew in annual terms by 23.5 per cent up from 13 per cent in April. In value terms the increases were 36.3 per cent up from 27.8 per cent. Now, we have been aware of the sharp increase in housing lending for the last six months but it appeared to be centred around an unsustainable surge in loans to First Home Buyers. FHB's (number of loans) are up 105 per cent from the August low, but will inevitably slow once the increased grant is phased out from September. However, the evidence is now strong that the recovery in housing is broadening. The number of loans to upgraders is now up by 20 per cent in 2009 while the value of loans to investors increased by 18 per cent in the last three months. Anecdotal evidence is that banks are facing real strains in processing the current surge in loan applications.

Today we are releasing the results of a separate survey which we conducted in conjunction with the Westpac MI Consumer Sentiment survey. In the survey we asked respondents about the outlook for house prices. When we conducted a similar survey in

May we found that 32 per cent of respondents expected house prices to rise, while today's survey indicates a sharp increase in that proportion to 52 per cent.

Of more crucial importance to us were the reactions of those in the 35–54 age bracket (upgraders and investors are concentrated in that group) where in May only 28 per cent expected prices to rise compared to 53 per cent in today's survey. That result is significant in that it indicates that the broadening of the housing recovery from FHB's to upgraders and investors is much more likely if these groups are confident about house prices. Scepticism about the sustainability of the housing surge given the inevitable withdrawal of FHB's has been largely allayed with the recent strengthening of finance approvals and the sharp increase in confidence about prices in the 35-54 age group.

In previous cycles the sector to respond first to rate cuts has been housing. The aggressive cuts in mortgage rates which the banks have implemented (385 basis points in response to the 425 basis point cut in the cash rate) have clearly supported the housing market. The Reserve Bank could reasonably question whether, given this response, there is any need to further stimulate the sector.

Certainly, rate cuts will also lower the bank bill rate and therefore benefit funding costs of business and banks, but we expect that the current contraction in business loans is being driven by widening credit spreads; credit constraints; weak confidence and the income and profit contraction caused by the fall in the terms of trade. A rate cut is unlikely to markedly change that situation and indeed, could adversely affect consumer confidence if households did not benefit from a cut as we saw in April. In fact, given the current momentum in housing, there is even some risk of overstimulating that sector.

3) The Governor's Statement following the Reserve Bank's Board meeting showed a significant increase in the Bank's optimism relative to the June Board meeting. On the global economy the Bank noted that "Downside risks to the outlook have diminished"; in referring to the global recovery the June comment was, "slower when it does occur" whereas in July it was, "likely to be slow at first". Economic conditions are described as "not been as weak as expected a few months ago", financial market confidence was no longer described as "fragile". House prices were described as "tending to rise".

In June, China was described as in "turnaround" and in July was described as "strengthened considerably". In that regard we expect that quarterly annualised growth in China for the June quarter will print at around 15 per cent when released next Thursday.

We believe that the Bank may now have a tactical difficulty. Positive rhetoric which precedes a clear easing bias appears a little confusing. But as soon as the Bank removes such an explicit bias markets are likely to rush to price in imminent rate hikes. Accordingly we expect that this bias will be retained for some time.

4) The employment data was in line with our expectations. However, we recently lowered our target peak in the unemployment rate to around 8 per cent in late 2010 from about 9 per cent in early 2011. Our end 2009 forecast level has been reduced from 7.8 per cent to 7.5 per cent. There was nothing in this week's numbers to prompt a further

change but we have clearly lowered our assessment of the intensity of the increase in the unemployment rate over the cycle. The most powerful and still relevant argument supporting more rate cuts is the recognition that the Bank needs to be seen to be acting when the unemployment rate is surging.

However, if housing is responding strongly and underlying momentum amongst consumers has strengthened then the Bank will be comfortable to resist rate cuts given our expected profile for unemployment.

THE OUTLOOK

We now think that the balance of risks favour steady rates despite the explicit easing bias being retained by the Bank for some time. But the forces that make this a fine call are likely to ensure that the case for rate hikes through 2009 and 2010 will remain weak.

There are still risks that the curtailment of the Government's fiscal handout policies (\$21 billion over six months) will have a much larger impact on confidence and spending than we currently expect. The print of negative GDP growth for the June quarter and/or September quarter could revive fears of a recession which would impact consumer confidence.

While the rise in the unemployment rate might be more moderate than previously expected due to labour hoarding, the rise in the "underemployment rate" and the associated contraction in hours worked might sufficiently constrain household income to substantially weaken consumer spending.

While housing is expected to be strengthening the business investment cycle will continue to turn down through 2009 and 2010. The negative income and profit shock from the recent sharp reduction in the terms of trade will continue to constrain business investment and employment. Excess capacity in the capital stock and the labour market will contain any inflation pressures.

The other risks relate to the global economy. The two key factors relate to the US consumer and the state of the global financial system. Both those factors point to a weak global economy in both 2009 and 2010. While the brutal contractions of fourth quarter of 2008 and the first half of 2009 will not be repeated, the world economy is likely to remain weak for an extended period. The US consumer will be faced with further increases in unemployment and little relief on their diminishing wealth.

Deleveraging of balance sheets has much further to run. The implications for banks' balance sheets of the deep recession is yet to surface. Huge further writedowns on consumer loans; commercial property; prime mortgages; and commercial loans are still ahead in both the US and Europe. Availability of credit to finance economic recovery in the US, Europe and Japan will be further complicated by the demands governments will make on global savings.

In 2010 the Reserve Bank will be dealing with those global uncertainties while at the same time coping with a strong cyclical upswing in housing and extended downturn in

business investment and employment. That will create considerable uncertainty on the policy front. The normal timing of rate hikes is likely to be delayed as the Bank grapples with these issues. While the current recovery pace in housing might normally argue for a start to the tightening cycle some time around mid 2010 we expect that there will be considerable delays until these uncertainties clear. Other policies to contain any excesses in housing market are likely to evolve.

With our new expected low point of 3 per cent in the RBA cash rate we continue to expect that the first upward move will not be until early in 2011. While we assess that the balance of risks now favour steady rates in Australia the environment of extreme uncertainty described above points to an extended period of steady rates in Australia with rate hikes being delayed until early 2011 when the RBA will quickly move back to neutral through 2011.

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