

Economics Report

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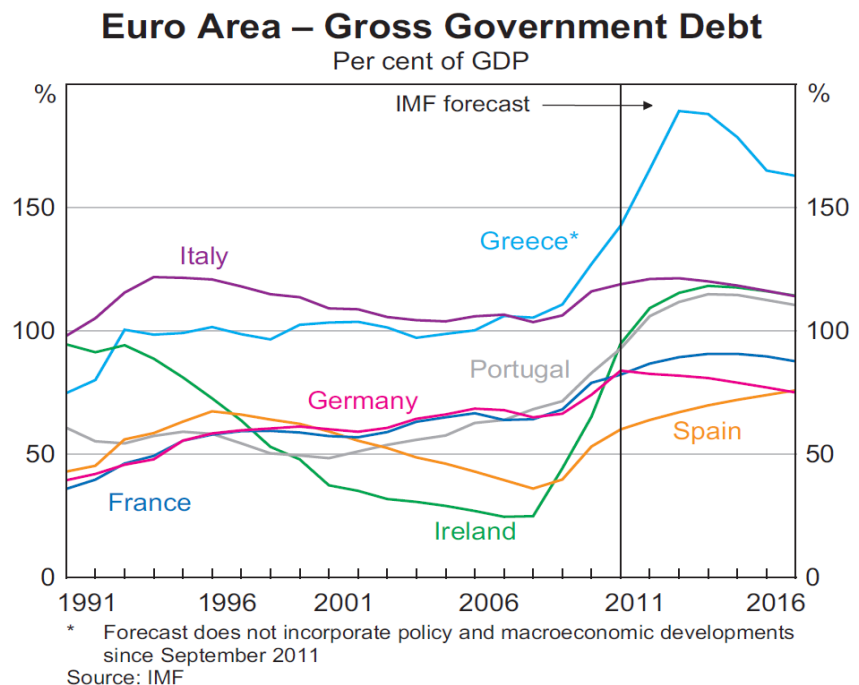
Caton's Corner December 2011

November was another difficult month for investors. Plagued by ongoing concerns about Europe, share markets struggled once again. For the month, the S&P500 index fell by 0.5%, while the Australian share market, as measured by the ASX200 index, declined by 4.1%. This was the seventh negative month in the past eight. The main reason why the Australian market underperformed the US is that the latter rose by more than 3% on the last day of the month; this will, at least, get the Australian market off to a good start in December.

The Focus Remains on Europe

The European debt crisis clearly worsened in the month, in that it “spread” to Italy. So long as the issue was confined to Greece, Ireland and Portugal, it was relatively inconsequential, given the small size of those economies. But the Italian economy is almost three times the size of the others in total, and the eighth largest economy in the world.

Last month, I suggested that Italy did not really have a debt problem—their debt/GDP ratio is high, but it has been close to stable for 20 years—but that would change the day that markets decided that it *did* have a problem.



In November, the Italian long bond rate rose to its highest level in 14 years, piercing the 7% “ceiling” that is considered to be consistent with debt spiralling out of control. When rates get that high, financing new

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debt or refinancing maturing debt obviously becomes more costly. This financing cost itself adds to the debt, and the debt-to-GDP ratio tends to rise, which further concerns markets. I also suggested that the most likely way that any such sell-off and subsequent spiral could be avoided was for the European Central Bank (the ECB) to act as a buyer of last resort of government bonds. I stand by that prescription.

Were the ECB to pursue this policy aggressively, markets would tend to stabilise and the problem would (slowly) alleviate. The problem is that Germany, in particular, does not see this as part of the ECB's responsibility. But if the latter is not responsible for doing whatever is necessary to ensure European economic stability, what exactly is its function?

This is not all that needs to be done of course. Austerity does not to be practiced in those countries, particularly Greece, whose public finances are out of control. But trying to solve the whole problem by austerity measures in the individual countries is effectively trying to shrink one's way out. It would appear far better to try to grow one's way out! If your debt-to-GDP ratio is too high, then wouldn't it make sense to try to raise the denominator as well as reduce the numerator? The affected countries can't simply set the sails for growth, but the strong economies—particularly Germany and, to a lesser extent, France—can. A stronger Germany will demand more exports from its neighbours, and hence drag them along. In addition, the European "cash rate" stands at 1.5%. Why can't it be cut to zero?

What I am arguing is that Europe has (admittedly unconventional) weapons that it hasn't even tried yet. My assessment is use of these could at least stabilise the situation and thus allow for gradual improvement. There seems to be only one way to find out!

Elsewhere

The other two international issues are still with us. In late-November, it was reported that a Chinese purchasing managers' index fell to its lowest level in some 32 months. This is, at worst, an indication of some light slowing. But it was enough to knock close to 2% off the Australian share market in one day, and to increase the speculation that commodity prices have already peaked (they probably have!). In the US, the "Super Committee" tasked with coming up with a long-term deficit reduction plan failed miserably, but is anyone really surprised? The economic data from the US continue to suggest that it is not about to lurch back into recession, something that I have long contended is unlikely to happen. But it remains a risk. In the year to the September quarter, real US GDP grew by 1.51%. In the post-war period, whenever this statistic has dipped below 1.5%, a recession has followed in short order. Watch this space!

Back in Oz

Earlier this week, the Federal Government released the Mid-Year Economic and Fiscal Outlook (MYEFO) as it does every year. This one differed from its predecessors, however, in that it morphed into a mini-Budget, with a number of new initiatives announced. The *raison d'être* for these initiatives was the desire by the Government to continue to forecast a surplus for the coming fiscal year, 2012/13. The measures announced ranged from things that needed to be done all the way through to picayune. The forecast surplus still exists, but the biggest reason is that some measures were moved into 2011/12 (post-flood reconstruction spending, for example), thus increasing the forecast deficit in that year (it now stands at \$37.1 billion, up massively from \$22.6 billion at Budget time six months ago). This is the accounting equivalent

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of a shell game; the forecast surplus has been maintained with very little genuine fiscal tightening.

The good news is that this isn't so bad. In the current global environment, there is simply no good economic reason to set out to achieve a surplus no matter what. And it probably won't happen anyway. First, the turnaround from large deficit in 2011/12 to small surplus in 2012/13 would be the largest on record. Second, the global economy in general, and the possibility of a substantial fall in commodity prices, may wreak havoc with any forecast surplus that is, in any case, less than rounding error!

On the monetary policy front, as I type, financial markets are expecting the cash rate to fall by a further 1.25 percent in the next six months. While there will certainly be one or two more cuts, this seems to me to incorporate an overly gloomy view of both the Australian and global economies.

Chris Caton

Chief Economist

The views expressed in this article are the author's alone. They should not be otherwise attributed. This being the last Caton's Corner for 2011, I would like to take the opportunity to wish both readers a Merry Christmas and a Happy New Year.

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