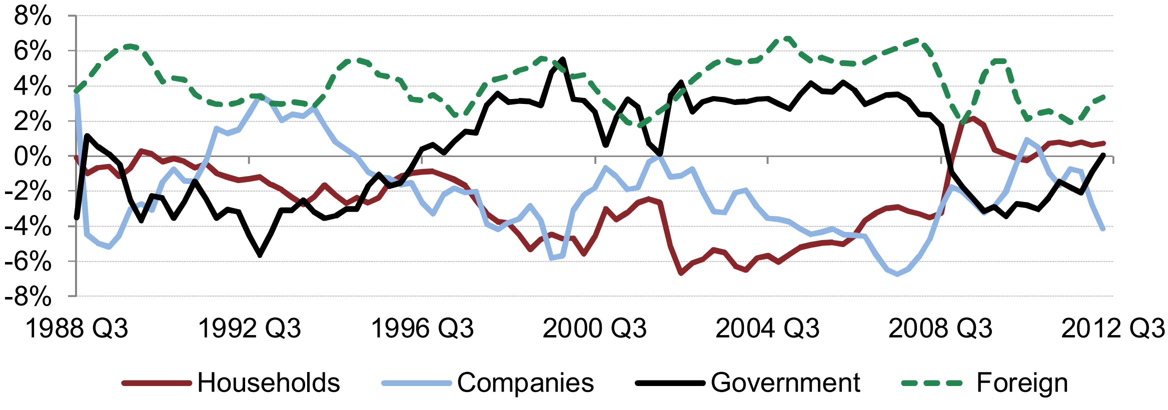
Look beyond RBA rate cut

Key sentence is "the peak in resource investment is likely to occur next year, and may be at a lower level than earlier expected."

For a change, markets were genuinely uncertain whether the Reserve Bank of Australia (RBA) would change its cash rate today or not. In the end, the Bank did, taking it from 3.5% to 3.25%. The cut was motivated by the softer outlook for world growth and lower commodity prices, with risks on the downside. That is a correct assessment of the world situation. But for Australian, there is another point to make of more medium-term relevance. This is the government's aim to return to a budget surplus this financial year (July 2012-June 2013), most recently reiterated by Treasurer Wayne Swan in late September.

The Australian government is unusual among advanced country economies in that it ran a consistent budget surplus from mid-1996 to the end of 2008.This provided it with the firepower to implement a fiscal stimulus when the Great Recession hit the world, helping the country to avoid a technical recession (GDP contracted in Q4 2008 and in Q1 2011, but only for one quarter each time). However, this surplus was only possible because the private sector – households and companies – was running a deficit. The sum of financial balances for the four sectors in an economy – public, household, corporate and foreign, where 'foreign' is the current account with a reversed sign – must as a matter of accounting identity add up to zero. So, for the Australian government to run a financial surplus, *either* the foreign sector must run a deficit (ie, Australia run a current account surplus), *or* the domestic private sectors (households and companies) must run a deficit of savings over investment; or, of course, a combination of those.

Australian sectoral financial balances, % of GDP



But, as the chart shows, Australia as a rule does not run a current account surplus. In fact, since Q3 1959, Australia has only seen a current account surplus in 16 quarters (out of a total of 212), none of them since 1975. Even in the recent commodity prices boom, arguably the biggest in world history, the

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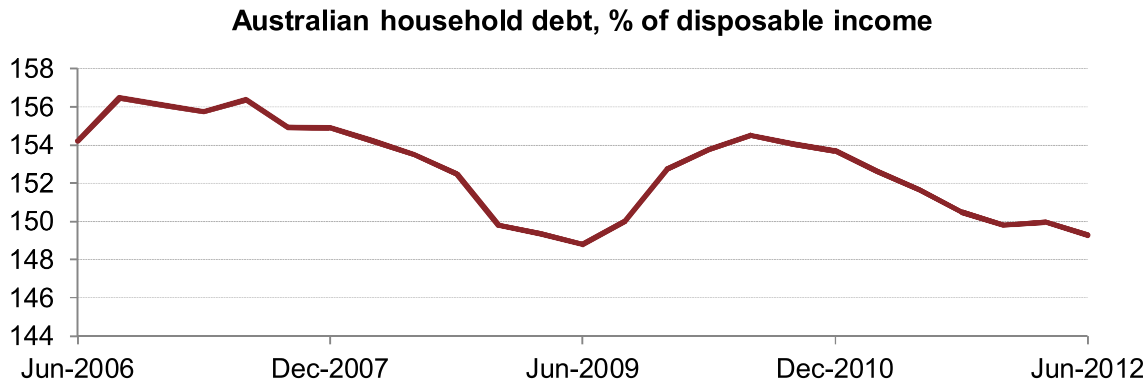
current account deficit never slipped below 2% of GDP. So, a public sector surplus is dependent on the private sector running a deficit. But what is currently happening in Australia? The heavily indebted household sector is busy trying to deleverage; household debt has fallen from 156.5% of disposable income in Q3 2006 to 149.3% in Q2 2012. The household sector has been running a financial surplus since Q4 2008 and – judging by monetary and housing data – is still intent on doing so.



This leaves the corporate sector as the main possible counterpart to an improved public sector balance. But, look again at the chart on the first page. The Australian corporate sector has just massively widened its financial deficit to around 4% of GDP, roughly where it was during the boom years of the mid-2000s, primarily due to strong investment growth. Yet recently all we hear is about investment plans being curtailed, notably in the resources sector. Now go back to the RBA's statement following today's rate cut decision. The key sentence is in the fourth paragraph: "Looking ahead, the peak in resource investment is likely to occur next year, and may be at a lower level than earlier expected." In other words, the main driver of corporate behaviour *and hence of the corporate sector's financial balance* is going to disappear or at least diminish. Given that corporate investment has contributed half Australia's output growth over the past five years, it implies weaker activity ahead. But, it also means that while the government's plans for a financial surplus may possibly be realised this year, we are highly unlikely to see a return to the consistent surpluses that have characterised the past 16 years. This has obvious implications for the attraction of Australian government bonds; and for the Aussie dollar.

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