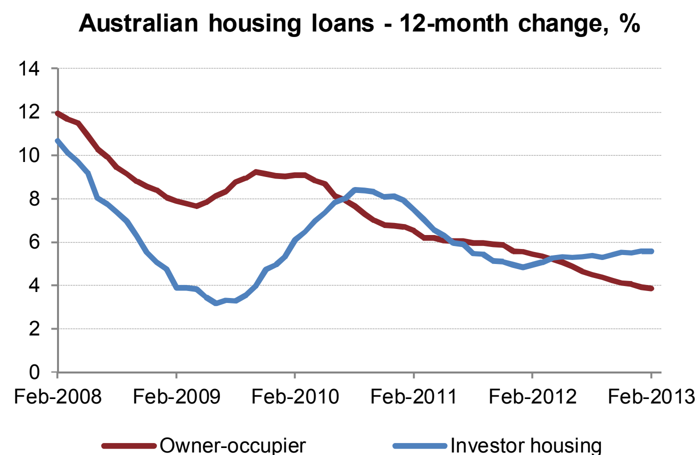
STEIN BROTHERS
LONDON-STOCKHOLM

Aussie to remain strong

- **RBA now unlikely to cut rates again**
- **Public sector deficit to remain**
- **Interest rate differential, safe haven status, favour Aussie dollar**

The RBA left interest rates unchanged in April, but again noted that there remains scope to cut if circumstances so warrant. Given that the cash rate at 3% is one of the highest among developed economies that is somewhat of an understatement. The issue therefore becomes, *do* circumstances so warrant?

Probably not – and if they do, it would only be one more cut. The arguments in favour of further monetary policy easing are above all based on the weaker housing market. Both housing loans and building approvals fell in both December and January; and although housing loan growth seems to have stabilised, this is at 0.3-0.4% per month, ie in the 3½-4½% range on an annual basis, low by past standards. However, loans for investor housing – ie, buy to let – are growing faster, implying that it is not the unwillingness to find somewhere to live, as much as the unwillingness to go into debt that is the constraint. This fits in with the fact that Australian households are building up their savings (according to the RBA, households have repaid some 20 months' worth of mortgages ahead of time). Moreover, building approvals rose strongly (3.1%) in February. And finally, there is anecdotal evidence – eg, an increase in high density building at the expense of detached – that at least hints that the Australian housing market may be looking more at rental than in the past.



The arguments *against* further cash rate cuts are equally strong. The Australian labour market is very buoyant. Even if the addition of 71,500 jobs in February (the highest number in a decade) was a statistical fluke, unemployment is at a healthy 5.4% and February job vacancies were at a three-year low. While Q4 household spending was subdued (rising by 0.2%, the same rate as in Q3), overall growth remained good

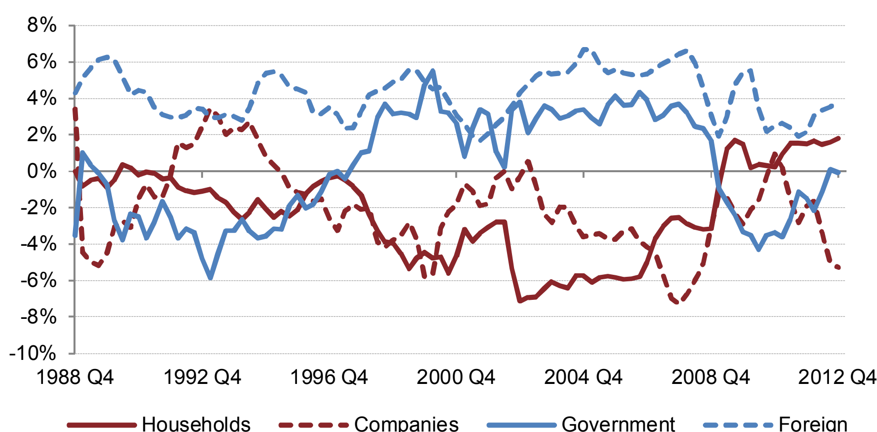
Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.

by international standards (0.6% after 0.7% in Q3) if not perhaps by Australian. Moreover, retail sales rose strongly in January and February, hinting at a recovery in household spending in Q1 2013. Perhaps most importantly, the rest of the world is improving, notably those parts that are of most relevance to Australia – China and Hong Kong (the destination for close to 35% of Australian exports); Japan (close to 20%); and the United States, which admittedly only takes less than 3% of Australian exports but which has an indirect effect through its impact on exports from and activity in East Asia.

A stronger economy has the usual effect on Australia – a weaker trade balance. Whatever is achieved through stronger exports and higher commodity prices tends to be outweighed by stronger imports. This has another consequence. The Australian government for many years ran a budget surplus. In 2008, this turned into a deficit; but the government still hopes to return to a surplus. That is easier said than done. Since Australia runs a current account deficit, a government surplus is contingent on one or both of the two domestic private sectors running a financial deficit in excess or of the current account deficit. Although the corporate sector is obliging – the consequence of continued strong GCFC, notably in the resources sector – the household sector has swung decisively into surplus and is not indicating any willingness to return to deficit. As a result, the public sector is unlikely to be able to move back into surplus unless the corporate sector saves less/invests more – again, an unlikely near-term development; the near future is rather one of less corporate cap-ex – or the foreign sector surplus (ie, the Australian current account deficit) narrows. But that is also unlikely in an improving economy. Expect, therefore, the deficit in Australian public sector finances to remain – although far smaller and less important than those of selected euro area countries.[1]



The RBA could choose to cut interest rates further, in the hope that this would weaken the dollar and boost exports. But that risks further inflating localised housing bubbles, eg, in Sydney. Moreover, it is

[1] These developments were foreshadowed in my comment *Look beyond the RBA rate cut*, 2nd October 2012

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

highly unlikely to be more than one more cut of 25bps; and that, in turn is not going have much more effect on stimulating demand that has not already been stimulated by the previous 175bp cuts since December 2011.

Alternatively, it could hold fire and continue to gauge national and international developments. The risk here is that Aussie dollar strength will continue, partly because of the interest rate differential, partly because of its safe haven status. However, the aggregate effects of the stronger dollar may be less than generally perceived. While the exchange rate obviously is not the only factor affecting exports, average monthly export growth in the 27 months since December 2010 (when the Aussie dollar moved above parity with the US dollar) has been 0.2%. Average monthly export growth in the 27 months preceding that date was also 0.2%. This would tend to confirm that what matters right now is more the state of the world economy and demand elsewhere, than the strength of the currency.

With this in mind, judging by the RBA's past behaviour and subject to no sudden deterioration in economic prospects, no further cut in the cash rate is now the more likely development. This also means that in a world where most countries are trying to weaken their exchange rates, the Aussie dollar should join the US dollar at the table of the strongest developed market currencies in 2013 and 2014.

Gabriel Stein 2013-04-04
gabriel.stein@steinbrothers.co.uk

Gabriel Stein is Managing Director of Stein Brothers (UK) Ltd and Chief Economic Advisor to OMFIF. The views expressed are his own.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.