

RESEARCH REPORT

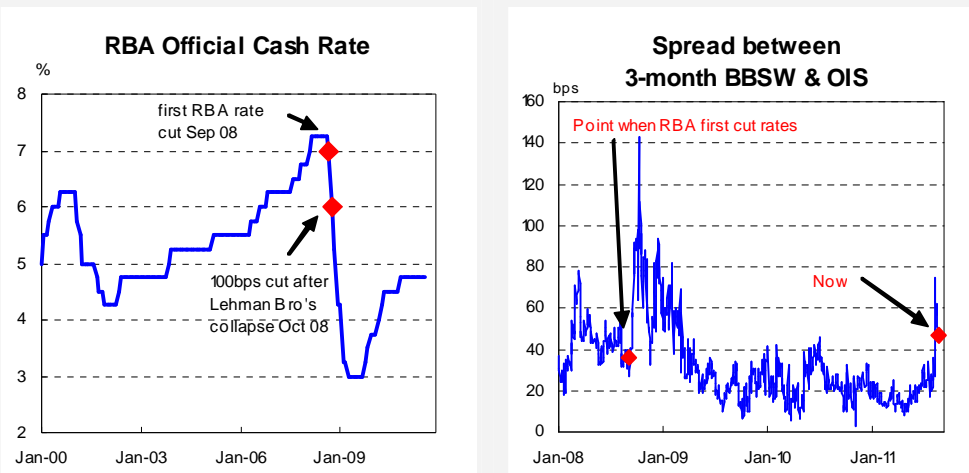
Déjà Vu' - Another Crisis?

Thursday, 18 August 2011

- In the past few months, concerns about the sovereign debt situations in Europe and the US have escalated to the point where market turmoil and uncertainty in financial markets have led some to compare the current situation to the GFC (Global Financial Crisis).
- The volatility in financial markets certainly gives one a sense of déjà vu, and is reminiscent of the days of the GFC. Money markets were however, dysfunctional for a long period leading up to and during the GFC. In contrast, money market conditions are currently less difficult and are only showing possible signs of tension.
- Some economic conditions are similar. Building inflationary pressures, high commodity prices boosting incomes and business investment combined with prospects of weakening global growth were also common themes facing the domestic economy.
- There are, however, some differences. Current forecasts from the RBA appear much more optimistic about the outlook, than just before the height of the GFC. But the uncertainty regarding the sovereign debt issues in Europe poses downside risks to global growth. In our opinion, there are also more downside risks emanating domestically, particularly from the household sector.

Concerns about the sovereign debt situations in Europe and the US have escalated to the point where market turmoil and uncertainty in financial markets have led some to compare the current situation to the GFC Global Financial Crisis (GFC). Indeed, there are many similarities although there are also many differences in economic and financial conditions globally and domestically. In both scenarios, we saw extreme volatility in financial markets and an escalating of downside risks to global growth.

We analyse these conditions that characterised the Global Financial Crisis and provide a comparison to current conditions and assess the wider implications for monetary policy.



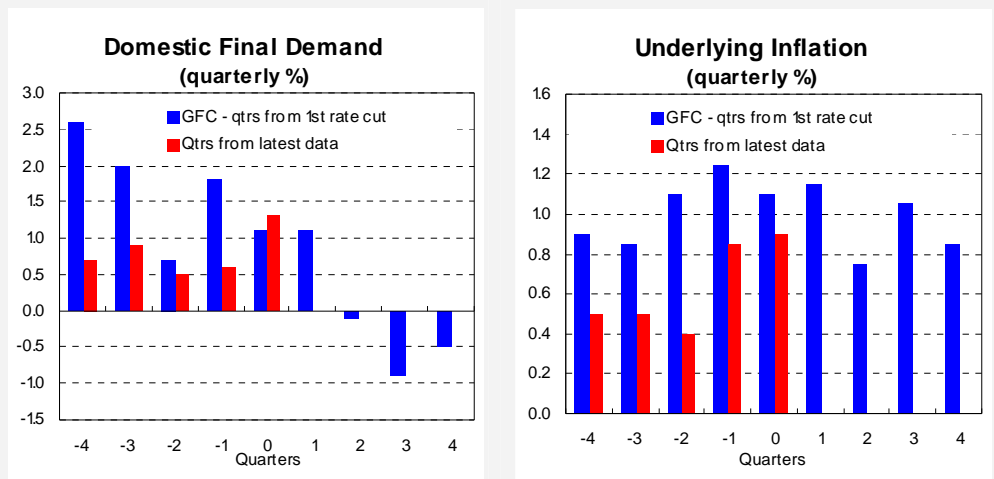
Cash Rate

At the height of the GFC, the cash rate was restrictive on the economy with the cash rate at a peak of 7.25%. The first cut was 25bp in size on 2 September 2008 and the total cuts during the GFC were 425bp (the last cut occurring on 7 April 2009). Similarly, the current cash rate is also restrictive, but much lower at 4.75%.

Bank Bill Rates

The spread between bank bill swap rates (BBSW) and the overnight indexed swaps (OIS) give an indication of the level of stress in the money market. As shown in the chart above, spreads rose to above 50 bps during the GFC for an extended period of time as trust within the banking system deteriorated. These tensions peaked after the bankruptcy of Lehman Brothers when these spreads surged and credit markets came to a standstill.

Spreads have risen over the past week or so amid concerns about contagion of the Euro zone debt crisis to the banking sector. While these spreads have eased over the past few days they remain quite elevated and thus money markets are possibly showing some early signs of stress. Although money market conditions are not currently as difficult as they were during the GFC, the RBA will be watching developments in this market closely, particularly if these tensions escalate or persist for a lengthy period of time.



GDP Growth

The current GDP picture is muddled by the impact of the floods, so we compared domestic final demand in the two periods, which excludes the temporary large detraction of net exports in Q1 11 (largely driven by the floods). Australia's domestic final demand leading up to first rate cut from the RBA during the GFC was quite strong in comparison to recent growth data, albeit the most recent data for domestic final demand in March quarter 2011 was also quite solid (Period 0 in red in above chart).

Inflation

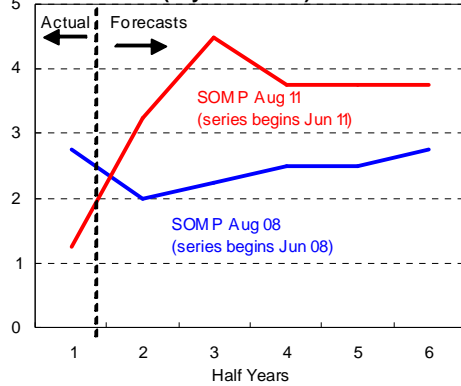
Inflation was a key theme prior to the height of the GFC, and underlying inflation was running well above the RBA's 2-3% per annum target band. Quarterly underlying inflation ranged from 0.85% to 1.25% in the four quarters before September 08. The RBA's first rate cut occurred when the last reading of annual underlying inflation was at 4.35% (for June quarter 08). Thus, the RBA began cutting rates, despite underlying inflation running well above their target band.

This year, the last two inflation readings for quarterly inflation (Q1 and Q2) were 0.85% and 0.9%. Both are on the high side, however, underlying inflation is currently at 2.7% and still within the RBA's 2 to 3% target band.

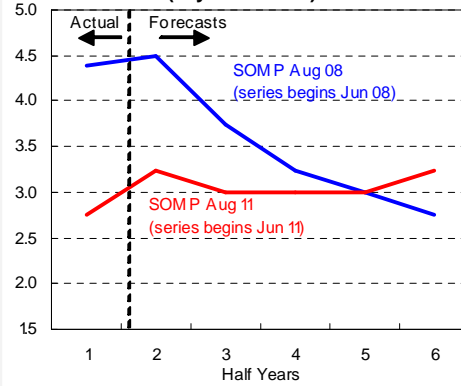
RBA Forecasts

However, key to the direction of monetary policy will depend on the outlook for growth and inflation. We also examine the RBA forecasts in the Statement of Monetary Policy in August 2008, just before the RBA cut rates, and the most recent Statement in August 2011 (see charts below). The RBA expected underlying inflation to decline to within the target band at the end of the forecast period in August 08; however, in the current climate the RBA is expecting underlying inflation to pick up. Further, the RBA's most recent forecasts expect economic activity to accelerate. In the RBA's most recent commentary, the central bank is still expressing concern about the medium-term outlook for inflation.

RBA Growth forecasts
(% year ended)



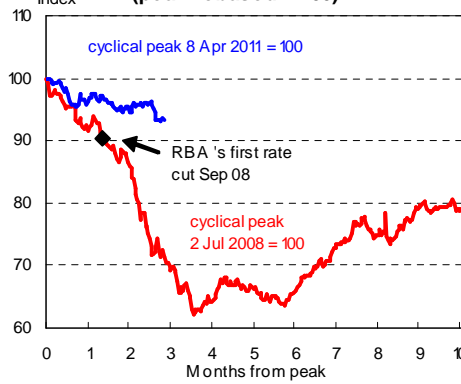
RBA Inflation forecasts
(% year ended)



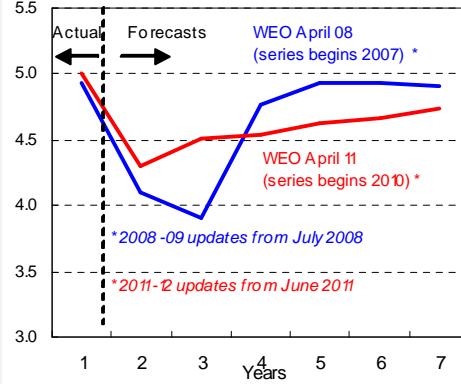
Commodity Prices

A similarity of the current episode to the GFC is that there was a surge in commodity prices prior to the market turmoil. Reflecting rising commodity prices, business investment was also strong in both periods, particularly in mining. The run up in commodity prices in both periods was followed by a significant decline amid weaker global growth prospects. In 2008, the RBA began cutting rates in September, just over a month from when commodity prices began to fall and had dropped 9.8% from their cyclical peak. In the chart below, we have rebased the commodity price index peaks in 2007 and 2011 to 100. It shows that commodity prices have dropped 6.7% since they peaked on 8 April 2011, not as much as they did during the GFC. Commodity prices fell a total of 38% in the GFC.

CRB Commodity Prices
(peak rebased = 100)



IMF World Growth Forecasts
(% annual change)



World Growth

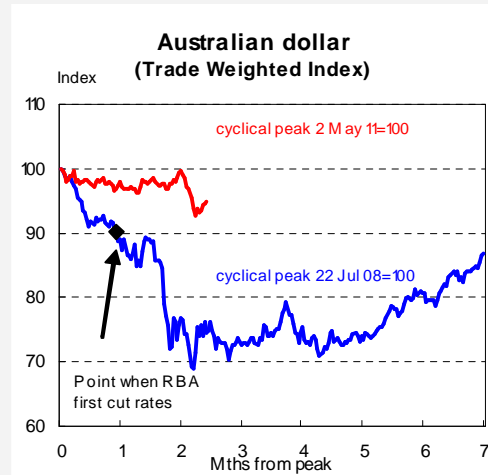
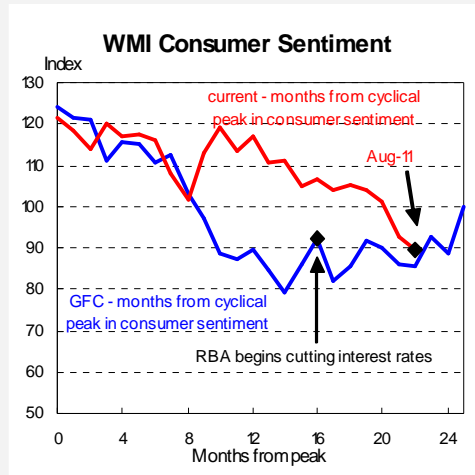
Consistent with the decline in commodity prices in both episodes is an expected slowdown in global growth according to the IMF (see chart IMF World Growth Forecasts above). Currently, global growth expected to weaken from 5.0% growth in 2010, but still expected to be above trend this year and next at 4.3% and 4.5% respectively. In contrast, expectations in July 2008 just before the GFC were for global growth to slow from 4.9% in 2007 to 4.1% in 2008 and 3.9% in 2009.

However, there are growing downside risks in both situations. In 2008, prospects deteriorated quite drastically after credit markets seized up. Global growth subsequently weakened much more than the above forecast in 2008 and 2009, with actual growth at 2.9% and -0.5% respectively. Much like the GFC, there is much uncertainty in regards to the sovereign debt problems in Europe and the US and the potential impact this could have on global growth. In addition, although both periods are seeing weakening growth prospects for advanced

economies, prospects for developing economies such as China are quite positive.

Consumer Sentiment

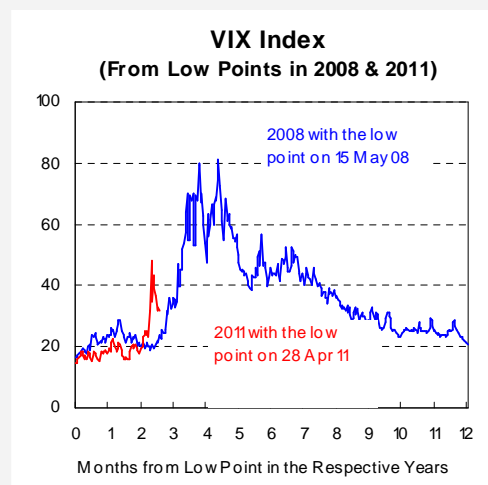
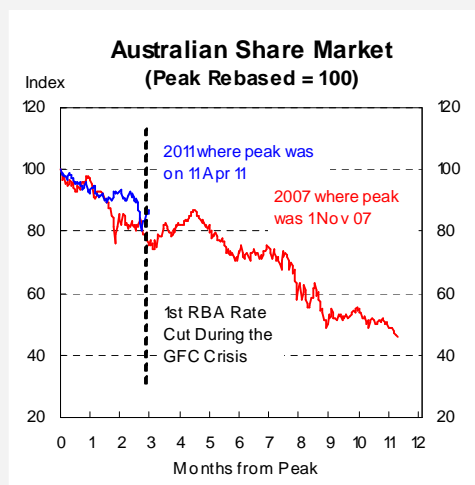
Consumer sentiment has fallen 26.2% from its peak in October 2009. The Westpac-MI consumer sentiment index is at 89.6 and now at below the level at which the RBA began cutting interest rates in September 2008. The deterioration in confidence reflects deepening caution by households, and suggests that consumer spending will remain subdued. During the GFC, household consumption went backwards in the September and December quarters in 2008, contracting 0.6% and 0.1% respectively.



Australian Dollar

We also rebased the cyclical peaks of the Australian dollar in the chart above in both periods. During the GFC, the Australian dollar (in trade-weighted terms) fell 9.9% from its cyclical peak reached on 21 July 2008. From peak to trough, the Aussie fell sharply (down 31%).

Since its most recent peak reached on 2 May 2011, the Aussie has also weakened but by far less, falling only 5.6%. The higher level of the Aussie is weighing on certain sectors of the domestic economy including tourism and manufacturing sectors.



Share Market

In the chart above, we have rebased the peaks to 100 to compare like with like. The downturn in the Australian share market that began after 1 November 2007 lasted nearly one year. The current downturn that began after 11 April has lasted almost three months. Interestingly, the Reserve Bank cut rates for the first time during the global financial crisis (GFC) after three months of the share market peaking. The volatility in the share market is one area of

similarity between the GFC and currently.

Risk Appetites

One popular measure of risk appetites in financial markets is the CBOE SPX Volatility index, commonly known as the VIX index. The higher this index, the greater the risk aversion among investors. Recently, the VIX index spiked to 48.00 (on 8 August 2011), the highest level since September 2009. Generally, a level above 30 indicates heightened risk aversion. During the GFC, the VIX index rose to a high of 80.86 (on 20 November 2008). While the VIX index is a long way from these GFC heights, it certainly has risen a long way in a short space of time. Heightened risk aversion is generally reflected in sharp move towards safe-haven assets.

Conclusion

Summing up, there are many similarities although there are also many differences in economic and financial conditions globally and domestically. The volatility in financial markets is reminiscent of the days of the GFC. Money markets were however, dysfunctional for a long period leading up to and during the GFC. In contrast, money market conditions are currently less difficult and are only showing possible signs of tension. However, the RBA will be watching developments in these markets closely, particularly if these tensions escalate or persist for a lengthy period of time.

Some economic conditions are also similar. Building inflationary pressures, high commodity prices boosting incomes and business investment combined with prospects of weakening global growth were also common themes facing the domestic economy.

Current forecasts from the RBA, however, appear much more optimistic, than just before the height of the GFC. But at present, the uncertainty regarding the sovereign debt issues in Europe poses a potential risk to global growth. In our opinion, there are more downside risks emanating domestically, particularly from the household sector. The pessimism of households is reflected in the slump in consumer sentiment and is at risk of being weighed down further amid volatility in share markets. The high Aussie is also likely weighing more on certain sectors than during the GFC.

On balance these factors suggest to us that the RBA is likely to keep rates on hold for the remainder of the year, however, the uncertainty regarding the impact of sovereign debt issues on global growth indicate that there is rising chance of a RBA rate cut.

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