How low can you go?

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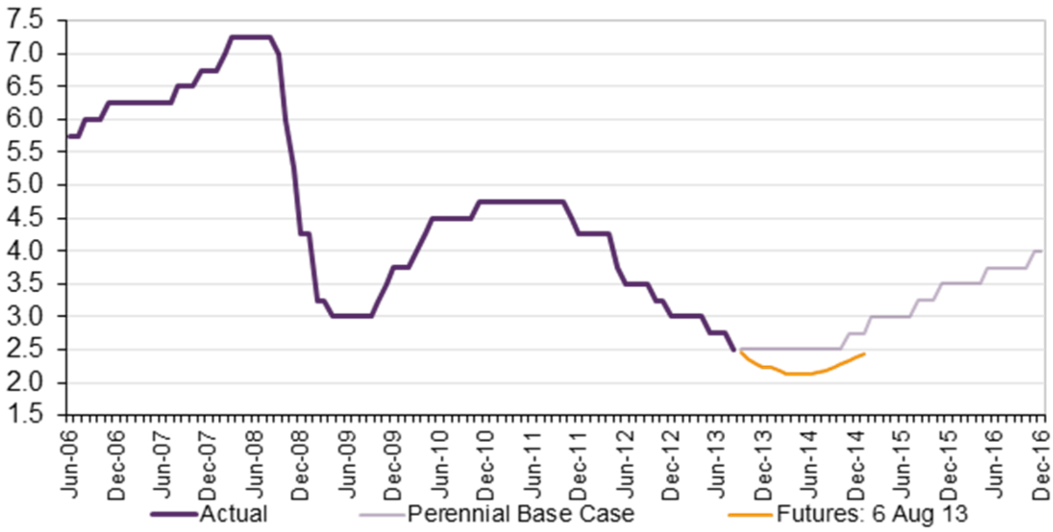
- How low can interest rates go?
- How low can our economy and standard of living fall post the mining boom?

No I'm not going to discuss the current standard of the election debate but rather the two important "lows" that are of interest to investors – how low can interest rates go? And how low can our economy and standard of living fall post the mining boom?

How low for rates?

For once markets and just about every economist post Glenn Stevens' comments at a speech a couple of weeks earlier, were unanimous with their cash rate cut prediction and the Reserve Bank delivered that rate on 6 August. While the cut to 2.5% brings the official cash rate down to the lowest since the Reserve Bank's inception in 1960, the record low is not surprising given our sluggish economy and a global environment with record low rates in the developed world and quantitative easing programs pushing rates down even further. Pleasingly, the unemployment figures released on 8 August showed unemployment stable at 5.7% with most economists expecting a pick up to 5.8%. Perennial's base case forecast for interest rates as shown in the light purple line below sees rates remaining low until the latter half of 2014. Futures markets are currently more negative about our economy pricing in at least one and possibly two more cuts over the next 10 months. Interestingly, despite talk of a tougher Government fiscal stance in the May Budget, the August Economic Statement (released 2 August) update has already seen the projected budget balance for 2013/14 slip from -1.3% to -1.9% of GDP, effectively a 0.6% fiscal easing. The bottom line - expect low rates for the next 12 months.

CHART 1: Australian Cash Rate & 30 Day Interbank Cash Rate Futures



Source: Bloomberg, Perennial.

How low for our economic growth post the mining boom?

This (now heavily politicized) question is crucial for Australia. The Grattan Institute* produced an excellent paper in July, entitled "The Mining Boom – Impacts and Prospects". The three major concerns Australians have about the mining boom (generally 2000-2012) and their responses are summarised below:

1. The boom has been great for miners but has left many behind. Whilst the boom was indeed great for the mining industry, it did substantially increase the size of the Australia's Gross National income benefitting a wide range of Australians and although non-mining states and non-mining industries did not grow as fast, there was some real growth in all sectors (although manufacturing growth was quite

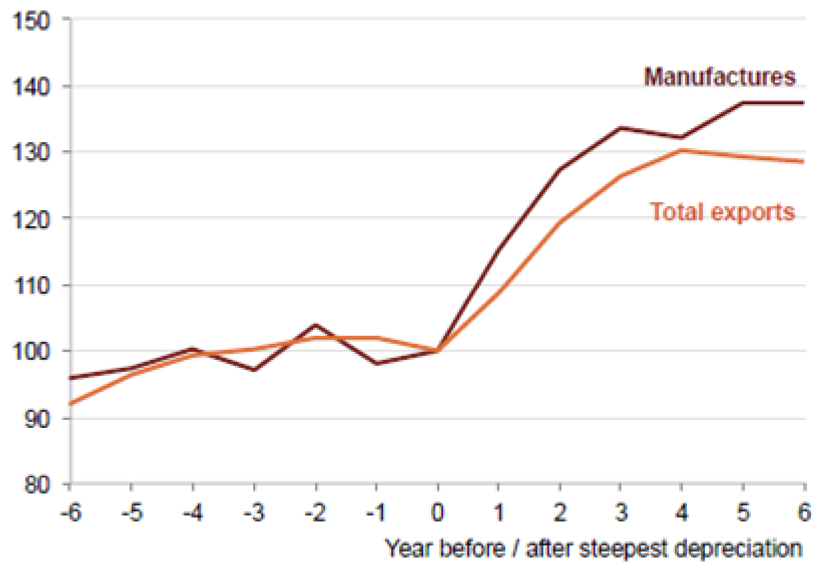
anaemic compared to other sectors). Some manufacturing and tourism jobs were lost in certain regional areas but it was only a minority of these that total employment declined as a percentage of population. Surprisingly, income inequality rose with higher paid workers experiencing the largest growth in earnings over that period.

2. Australia became a “quarry economy” with the high dollar permanently damaging other industries. The report states “We find the main trade-exposed sectors, notably manufacturing, tourism, education of overseas students, and agriculture, have survived in reasonable shape.” It argues that the longer term structural decline in manufacturing has more to do with the typical decline in manufacturing as a percentage of the economy for most higher-income economies. Over that period the trade exposed, non-resource sectors did decline as a percentage, however, total volumes still increased. The other important point is that typically for developed economies manufacturing does bounce back after the exchange rate re-adjusts after the boom (see chart 2 below).

3. We are very vulnerable once the boom ends, particularly if the Government hasn’t saved some of the windfall. Certainly countries with very large resources sectors have more fluctuations in their economy and Australia now has a resource sector much larger than the average OECD economy has (around 11% of GDP compared to under 2%). Despite this, the balance of the Australian economy and overall economic growth has been remarkably stable over time so perhaps this can also be managed well in the future. We must also remember that the volumes of exports will begin to increase dramatically, particularly in LNG where volumes will triple from 2010 levels by 2018. Clearly the Government did not save enough of this windfall and the risk of a downturn cannot be ruled out.

I must admit I was a bit more positive about our post-mining economy post the boom, although we need clear leadership to help ensure we have the right mix of skills and competitive industries to ensure we can absorb the mining shock and continue to steadily grow our wealth per capita into the future.

CHART 2: Comparing 13 countries through similar exchange rate shocks
Year 1 is the year after the steepest depreciation in the currency.



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Source: Grattan analysis of data from BIS (2013) and the World Bank (1960 - 2011). Estimated constant-price values, median country, per cent of GDP.

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