

# Economics Report

1 February 2011

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## Caton's Corner February 2011

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### A soggy start to the year

All Australians know what the main story has been so far this year; the weeks of heavy rainfall, followed by widespread flooding. This is not only a massive event for all those in the path; it is also a major economic event. More on that below.

Despite a sudden concern about Egypt (there's clearly some pyramid scheming going on) markets weathered January reasonably well. With one trading day to go, the Australian share market, as measured by the ASX200 index has advanced by 0.6% so far this year, while the US share market (as measured by the S&P index) is up by 1.5%, and by more than 88% from its early-March 2009 trough. The so-called "January effect" in the United States says that when the market rises in January there is a more than 75% chance that it will be up for the entire year. The other reason to be optimistic about the US market is that it is the third year of a Presidential term. This is generally a good year for the economy, as the Administration does whatever it can to engender a feeling of prosperity going into the election. The market has never failed to rise in the third year in the entire post-war period, and the average gain since the early-1960s has been more than 20% after inflation! In the words of the great Vietnamese philosopher Anh Do: there are just two times; there is now and there is too late.

Why have markets risen, and why are they likely to rise further? While most of the worries that plagued markets last year, and which I wrote about often, have not gone away, they have certainly not got worse. Indeed one of them, the fear of a "double dip" recession in the United States, has just about vanished. Two months ago, the "consensus forecast" for 2011 GDP growth in the world's largest economy was 2.4%. It is now 3.2%. This is a massive change to occur in just two months. As people become more optimistic about the economic future, they become more optimistic about earnings growth, the lifeblood of share markets.

### The Floods

An economist must tread carefully. Let me make it clear at the start that the **human costs of the floods are far and away the most important**, and only some of these are picked up in traditional economic measures.

The most important economic cost comes about through the **destruction of capital**, which covers infrastructure, household capital and business capital. Estimates here vary widely, between \$10 billion and \$30 billion. The true number is probably closer to the lower end of this range. In any case, the economic impact of the January 2011 floods is almost certainly the largest ever for a national disaster in Australia.

What economists and analysts tend to focus on is what an event such as the flooding means for the **ongoing performance** of the overall economy, as measured by GDP, inflation and the labour market, for

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example. **The long history of disasters, both natural and man-made, is that early estimates of the macroeconomic effects turn out almost always to be overstated.** This was true in the case of hurricane Katrina, September 11, the Kobe earthquake, the San Francisco earthquake in the late-1980s etc. In this regard note that **one cannot find any evidence of the 1974 Brisbane flood in the macro-economic data for that period**; indeed the Statistician did not even see fit to mention the flood in the text accompanying the GDP data for that quarter.

Of course, this time is different to some extent. The population of Brisbane is two and a half times the size that it was then, while coal exports (obviously hard-hit) are a much larger proportion of GDP than they were then.

The economic effects beyond the loss of capital are myriad. In no particular order, they include massive disruption to the agricultural sector, to mining, to tourism and to distribution channels. Fruit and vegetable prices rose strongly, by about 13%, in the December quarter, and they will rise strongly again in the March quarter, thus adding to CPI inflation (although bear in mind that fruit and vegetables are less than 3% of the overall CPI). This is a direct cost to consumers, of course, but the temporary increase in measured inflation will be ignored by the RBA in its interest-rate decisions. The reduction in mining and in other usual business activity stalled by the floods will have a noticeable effect on March quarter GDP growth, as well as on the current account figures. The effect on the latter will be offset to some extent by the fact that world coal prices have already risen sharply, reflecting Queensland's importance as a global provider of many types of coal.

But what happens next? The bad news is that some businesses, which may have been struggling beforehand, may simply take any insurance payout and close down. Residential property prices in flood-affected areas will be held down for a long time. Tourism in Queensland, already affected by the strong currency, will be hit by the unfavourable publicity, which seems not to take account of the sheer size of the State! The "good" news is that reconstruction will add to measured GDP in the June quarter and beyond, and that the overall loss of output (as distinct from capital) may be only small. The other piece of good news is that the increased uncertainty engendered by the floods has almost certainly postponed the next increase in interest rates. As I said above, the RBA will ignore the impact effect of the floods on inflation, just as it didn't raise rates when the price of bananas sky-rocketed in 2006 after hurricane Larry! But the RBA can't afford to ignore any effects on **ongoing** inflation, such as may come from increased construction costs and wage pressures etc, so investors should continue to plan for higher rates eventually.

### **No rebate for my Chevy and the levy is high**

And, of course, there is the new hot political issue of the recently-announced levy to cover the Federal Government's contribution to repairing infrastructure and making emergency assistance payments. On 27 January, the Government proposed a levy of 0.5% on taxable income above \$50,000, rising to 1% on taxable income above \$100,000. The levy will operate for 12 months, and raise \$1.8 billion of the projected \$5.6 billion overall cost to the Federal government. The rest of the cost will be met by spending cuts elsewhere, including the scrapping of the Cleaner Car Rebate Scheme, so look for no diminution in the number of pre-1995 clunkers on the road.

I see this more as a political issue than an economic issue. It's clear that the flood-related spending is a worthy objective. But how should it be paid for? In brief, there are four possibilities: the government could cut spending elsewhere, it could raise the money by

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means of a levy or by some other means, it could simply allow the deficit to increase in the short term, or it could use some combination of the above three.

The last is the best option. There's never a bad time to run the ruler over "other" spending. **The deficit could and should be allowed to run up temporarily.** The problem here is that Australia has been turned into a nation of "debt fetishists" by politicians, who have railed for years about our alleged "public debt problem" when the fact is that Australia's public debt has been minuscule by international standards. Of course, at any one time there should be a plan to work back eventually to Budget balance, but temporary departures from that plan, given Australia's excellent fiscal position, are justifiable in special circumstances, which is clearly what we have right now.

It would have been better for the Government to fund at least some of the spending by allowing the deficit to rise temporarily. The initial public reaction to the levy has not been favourable and this may turn out to be a game not worth the candle!

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**The views expressed in this article are the author's alone. They should not be otherwise attributed.**

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