

Australia & New Zealand Economics Weekly

For the week commencing 25 February 2008

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Australian debt market stress

Harder rather than easier in 2008

The only consideration at all likely to discourage the Reserve Bank of Australia from continuing to tighten in coming months is the credit market, which is under far greater stress today than at any time since the initiation of the financial market crisis six months ago. This is particularly true of the financial sector, which has seen a sharp increase in funding costs in recent weeks. This disappoints an expectation that after the crisis in the second half of last year funding costs would fall into 2008. The big question is how the RBA is likely to assess the current degree of alarm, the probability of it continuing, and the effects if it does.

Though they have risen sharply in recent weeks, it's not the level short term wholesale market interest rates which will bother the RBA. The current episode of tightening in the face of rising inflation is very similar to the episode from 1994 to 1996. There are of course important differences, but that episode was also characterised by rising inflation and preceded by a period of quite strong output growth. In that episode the cash rate peaked at 7.5%, which is 0.5% higher than it is today but where we think it will also peak in this episode. In the last three weeks the three month bank bill swap rate has soared. It was 7.3% three weeks ago and just short of 7.8% on Friday. Even so, at 7.8% the three month bank bill swap is still well below the peak of 8.8% in 1995. So too one year Libor, as one would expect. Government bond rates rose rapidly in 1995. In this episode they remain well below the peak in 1995, and not all that much higher than they were a year ago. On Friday the ten year government bond rate was 6.45%, compared to a peak of 10.84% in 1994. Neither the government bond rate or the three month bank bill swap rate are higher than the RBA would wish them to be at this point in a tightening episode designed to sharply slow Australian output growth.

If this was all, the RBA would be quite unconcerned. But it is not all, because the interest rates on which corporate debt trades have increased much more. Late last week, for example, the credit default swap (CDS) rate for five year National Australia Bank senior paper nudged through 100 basis points. In mid December it was trading around 40 basis points. The credit default swap rate on Macquarie senior paper was 190 basis points, compared to a mid December level of 60 basis points. These CDS spreads don't exactly mirror actual funding costs but they do provide a good benchmark for issuance and comparison. Over the same period the yield on five year government paper has increased 40 basis points, and the cash rate 25 basis points. Credit spreads have widened more in the financial sector than in most other business sectors, but they have increased substantially for all highly rated Australian corporations. The typical highly rated Australian bank, with no serious increase in bad or doubtful debt, has seen the funding cost for term debt they will typically pay on the bank bill swap rate increase from 15 basis points in July of last year to 100 basis points. The significance of higher rates for bank funding is of course that banks are only borrowing with a view to lend. If it remains the case, and the tightening of credit conditions through the first eight weeks of this year has been insistent, it means business and households will have to pay spreads of 150 basis points or more on borrowing from banks to make lending worthwhile.

Credit availability is changing quite quickly. In November, December and January Australian banks were able to access five year euro fixed rate funding offshore, a pocket of investor demand they promptly



filled. Over the last month, however, the offshore market has become difficult and very expensive for Australian borrowers. Financial institutions are now borrowing in the one year part of the curve, and onshore. The overall trend for shorter and shorter issuance which emerged in the second half of last year has deepened. Funds are available, but at much higher spreads and for shorter terms.

The numbers are telling us that the whole Australian debt market has moved to shorter terms. It is evident in the sharp increases in the rate of growth of narrow and broad monetary aggregates, reflecting a strong preference for cash and the willingness of the RBA to provide liquidity. It is shown in such economy wide numbers as we have for overall debt issuance. In the last quarter of last year, facilitated by the RBA, short term domestic issuance by financial corporations rose to new highs. Short term issuance by non financial corporations fell, which is one of the reasons (but not the only one) that business borrowing from banks increased just a little less than 25% last year. Overall long term domestic securities issuance slowed so dramatically in the in the second half of last year that the level of long term securities on issue at the end of the year not much higher than it had been in the middle of the year. Offshore issuance of Australian securities fell over the same period. After a brief period at the end of last year and the beginning of this in which Australian financial institutions were accessing the offshore market for fixed term paper, the window has again closed and the funding pressures in the domestic market have markedly increased.

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Weekly calendar

Events & economic releases

Week commencing Monday, 25 February 2008

Country/ region	Event or economic release	Period	HSBC	Market consensus	Actual previous	
Monday, 25 February						
US	Existing home sales (15:00 GMT)	Month (millions)	Jan	4.80	4.80	4.89
Tuesday, 26 February						
NZ	RBNZ 2yr Inflation Expectation (13:00)		Q1	-	-	2.7%
GER	IFO business climate (09:00 GMT)	Index	Feb	101.8	103.0	103.4
		Current conditions	Feb	105.8	107.3	107.9
		Business expectations	Feb	98.0	98.8	99.0
US	S&P/Case-Shiller Home (14:00 GMT)	Composite-20 (Yr)	Dec/Q4	-8.7%	-9.5%	-7.7%
		National (Q4/Q4)	Dec/Q4	-6.7%	-	-4.5%
US	Consumer confidence (15:00 GMT)	Index	Feb	83.0	83.0	87.9
US	OFHEO House Price Index (15:00 GMT)	Quarter	Q4	-1.5%	-1.0%	-0.4%
Wednesday, 27 February						
NZ	Building Permits (08:45)	Month	Jan	-1.0%	-	-5.2%
AU	Construction Work Done (11:30)		Q4	2.0%	-	2.8%
NZ	NBNZ Business Confidence (13:00)		Feb	-	-	-24.9
GER	GfK consumer confidence (15:00 GMT)	Consumer climate (index)	Mar	4.4	4.4	4.5
UK	GDP (09:30 GMT)	Quarter	Q4, prelim	0.6%	0.6%	0.6%
		Year	Q4, prelim	2.9%	2.9%	2.9%
US	Durable goods orders (13:30 GMT)	Month	Jan	-3.5%	-4.0%	-5.0%
		Ex-transportation	Jan	-0.65%	-1.4%	2.3%
US	New home sales (15:00 GMT)	Month	Month	620k	600k	604k
US	Bernanke testimony (15:00 GMT)					
JP	Industrial production (23:50 GMT)	Month	Jan, prelim	-0.8%	-0.7%	1.4%
		Year	Jan, prelim	3.6%	3.8%	0.8%
JP	Retail sales (23:50 GMT)	Large stores, year	Jan	-2.0%	-1.8%	-1.5%
		Retail trade, year	Jan	2.6%	-0.2%	0.2%
Thursday, 28 February						
NZ	Visitor Arrivals (08:45)		Jan	-	-	-1.2%
AU	Conference Board Leading Index (10:00)		Dec	-	-	0.8%
AU	Private Capital Expenditure (11:30)		Q4	3.0%	-	-6.5%
US	Initial jobless claims (13:30 GMT)	Initial claims (23/02)	Wk 23 Feb	345k	350k	348k
		Continuing claims (16/02)	Wk 23 Feb	2810k	-	2784k
JP	Household spending (23:30 GMT)	Nominal, year	Jan	0.4%	-	3.1%
		Real, year	Jan	-0.5%	-0.6%	2.2%
Friday, 29 February						
NZ	Trade Balance (08:45)		Jan	-200M	-	33.0M
AU	Private Sector Credit (11:30)	Month	Jan	1.0%	-	1.1%
		Year	Jan	13.0%	-	16.5%
GER	CPI	CPI - month	Feb, prelim	0.5%	0.5%	-0.3%
		CPI - year	Feb, prelim	2.9%	2.7%	2.7%
		HICP - month	Feb, prelim	0.5%	0.5%	-0.3%
		HICP - year	Feb, prelim	3.0%	3.0%	3.0%
US	Personal income and spending (13:30 GMT)	Personal income	Jan	0.2%	0.2%	0.5%
		Personal spending	Jan	0.3%	0.2%	0.2%
		Core PCE deflator				
		Month	Jan	0.27%	0.2%	0.2%
		Year	Jan	2.2%	2.2%	2.2%
US	Chicago PMI (14:45 GMT)	Index	Feb	47.0	50.0	51.5
US	University of Michigan confidence (15:00 GMT)	Index	Feb, final	71.0	70.0	69.6

Notes:- p= preliminary, r = revised, nf = not forecast, nsa = not seasonally adjusted, ann = annualised, bn = billion, m = million
Source: Dow Jones, Reuters, Bloomberg



Monthly calendar

Events & economic releases

Month commencing Monday, 03 March 2008

Monday 03 March	Tuesday 04 March	Wednesday 05 March	Thursday 06 March	Friday 07 March
AU TD Securities Inflation (FEB) AU TD Securities Inflation (FEB) AU Company Operating Profit (4Q) AU Inventories (4Q) AU RBA Commodity Index SDR (FEB)	AU Retail Sales (JAN) AU Current Account Balance (4Q) AU RBA Cash Target (MAR)	AU Gross Domestic Product (4Q)	AU Trade Balance (JAN) AU Building Approvals (JAN) AU Exports (JAN) AU Building Approvals (JAN) AU Exports (JAN) NZ Reserve Bank of New Zealand Reviews Official Interest Rate	AU Foreign Reserves (FEB) 7-13 MARCH NZ REINZ House Sales (FEB)
Monday 10 March	Tuesday 11 March	Wednesday 12 March	Thursday 13 March	Friday 14 March
AU HIA New Home Sales (JAN) AU ANZ Job Advertisements (FEB)	AU Home Loans (JAN) AU Investment Lending (JAN) NZ Terms of Trade Index (4Q)	AU Westpac Consumer Confidence (MAR) NZ Food Prices (FEB)	AU Consumer Inflation Expectation (MAR) AU Employment Change (FEB) AU Unemployment Rate (FEB) AU Participation Rate (FEB) NZ Retail Sales (JAN) NZ Retail Sales Ex-Auto (JAN) NZ Business NZ PMI (FEB)	NZ Manufacturing Activity (4Q) NZ Non Resident Bond Holdings (FEB)
Monday 17 March	Tuesday 18 March	Wednesday 19 March	Thursday 20 March	Friday 21 March
NZ New Zealand's February Performance of Services Index		AU Westpac Leading Index (JAN) AU DEWR Skilled Vacancies (MAR) AU Dwelling Starts (4Q) AU Preliminary BoP Imports (FEB) NZ Credit Card Spending (FEB)	AU New Motor Vehicle Sales (FEB) AU New Motor Vehicle Sales (FEB) NZ Visitor Arrivals (FEB)	
Monday 24 March	Tuesday 25 March	Wednesday 26 March	Thursday 27 March	Friday 28 March
		AU Conference Board Leading Index (JAN)	AU Job vacancies (FEB) NZ Trade Balance (FEB) NZ Current Account Balance (4Q)	NZ GDP (4Q)



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