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Flash Notes

Australia: Thoughts on the Queensland flooding

Besieged by the flood of the century, more than 75% of Queensland, an area bigger than Texas and California combined has been declared a disaster zone. While the Brisbane River peak was lower than first feared, and well below the record levels of the 1974 floods, more than 15,500 homes are flooded and another 12,000 affected to some degree by inundation in Brisbane, Australia's third-largest city.

Economic impact relatively small and temporary

The flooding will continue to devastate communities and businesses. Work has already stopped on at least A$5 billon worth of commercial projects. With the situation yet to stabilize, any assessment of the overall economic impact is highly speculative. Queensland Treasurer Andrew Fraser says he expects the flood damage bill to cost billions of dollars, while Reserve Bank board member Warwick McKibbin says a hit to the economy of 1% is "not out of the question".

At this juncture, there seems likely to be a downside risk to the near term forecasts for GDP growth. However, this should be temporary, as rebuilding and replacement of household durable goods along with reconstruction and cleaning, will generate growth. That could kick in as early as next month and is likely to boost Q2 GDP.

But the biggest economic impact will probably be the disruption caused to coal exports. Queensland is the world's largest producer of metallurgical coal and Australia's largest coal-exporter, accounting for about 20% of the nation's A$1.3 trillion economy. It is estimated that with three out of the four Queensland mines being shut, coal producers in the state have suffered an estimated $2 billion in lost production. It could probably take weeks to months of repairs and inspections before resuming normal operations. That said, the disruption to coal output and export volumes will be partly offset by higher prices, which should boost incomes in the medium term.

Upward pressure on prices; Still expecting RBA to raise rates in Q2

Queensland accounts for about 30% of the nation's fruits and vegetable production; and with many fruit and vegetable plantations destroyed, food supply shortages should lead to an increase in prices in the short term. That said, food only accounts for a small portion of the consumer basket, and we are hopeful that the rise in food prices is unlikely to affect inflationary expectations. The floods will clearly affect the labour market too. Reconstruction efforts will generate more labour, exacerbating the current tight job market, and the likely result is further upside risk to inflation.

The disruption to growth confirms our previously held view that the RBA will keep the cash rate unchanged in Q1. However, we think that it will not be deterred from continuing on its rate hike cycle. We are maintaining our view that the next increase in interest rates will be in Q2 this year, with rates increasing to 5.50% by year-end.

Fiscal position intact

So far, the State's debt position has not been affected but its ratings will probably be reviewed once it announces its mid-year budget review 2010/11, which is expected to incorporate the effects of the flood. Assessing the overall costs at this point of time is also fraught with difficulty.

The Federal Government is expected to cover between 50-75% of the flood costs, which many have predicted could hamper Labor's projections to have the budget returned to surplus by 2012-13. The Prime Minister has indicated that assistance from the Federal Government is likely to reach "hundreds of millions of dollars".

Nonetheless, with the market conscious that the bulk of the cost not covered by insurance will be met by the Federal Government rather than the State, we do not expect these expenses to have a material impact on the health of Queensland's finances.

Upside for AUD/USD limited for now

The floods forced the Australian currency down to a one-month low against the US dollar. Lows of 0.9804 in the AUD/USD pair were attained yesterday, before a broad-based softness in the USD contributed to a modest firming in the AUD. It looks like the AUD/USD may struggle for a while yet to regain the 1.00-mark as the weather continues to dominate price action and with ongoing talks of further monetary restraint in China. In the interim, 0.9800 next downside target once 0.9890 barriers go.