ANZ Economic Outlook

June Quarter 2008

02 May 2008

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Inside

World economic forecasts

GDP growth %	2007	2008(f)	2009(f)	2010(f)
Australia	**3.9**	**2.5**	**2.4**	**2.8**
New Zealand	**3.1**	**1.1**	**1.2**	**2.1**
United States	2.2	0.7	0.8	2.2
Euro zone	2.7	1.7	1.3	2.2
Japan	2.1	0.6	0.9	1.7
China	11.6	9.7	9.0	9.9
Other East Asia (exc. Japan & China)	5.9	4.8	4.8	5.2
World (PPP)	**4.7**	**3.5**	**3.5**	**4.4**

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International Overview

Saul Eslake

The global outlook has become murkier

The financial market clouds hanging over the global economic horizon have darkened substantially in the early weeks of 2008. Major global banks have already incurred losses exceeding US$290bn as a direct result of the meltdown in the US sub-prime mortgage market, and there are almost certainly more losses to come from that quarter, lifting the total to somewhere between US$300 and perhaps $500bn. Further substantial losses could result from a possible downgrading in the credit ratings of the so-called 'monoline' bond insurers (which would in turn undermine the credit ratings and hence the value of the US$2.5trn of municipal and other bonds which are enhanced by their guarantees), and from credit default swaps (derivatives which provide insurance against defaults on corporate borrowings) in the event of a rise in corporate bankruptcies.

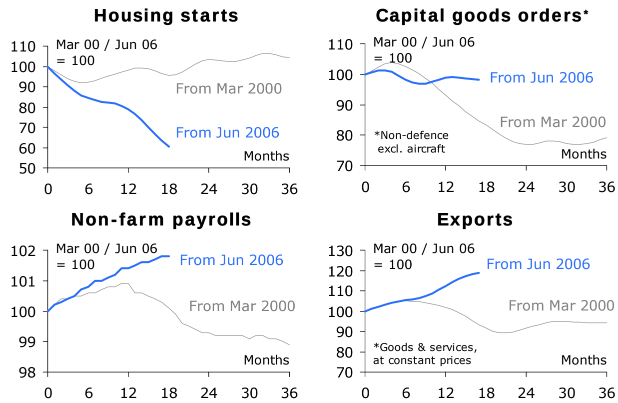
Fear that these actual or potential losses, and the underlying forces which have led to them (such as declining US house prices and rising mortgage defaults) could precipitate a US recession or even a global 'credit crunch' (by eroding the capital position of banks to the point where they were forced to ration credit, or dramatically inhibiting the refinancing of maturing debt securities) have seen share markets fall by around 18% from their late 2007 peaks, erasing nearly US$9 trillion (equivalent to around 17% of global GDP) in paper wealth.

By historical standards, therefore, this is a serious financial crisis. And serious financial crises often occur amidst, or lead to, serious recessions. One recent estimate based on an analysis of 18 bank-centred financial crises in 16 rich countries since the 1970s, most of which were preceded by a period of financial liberalization, is that such crises lead to a drop in real per capita GDP growth of 2%, and that it typically takes two years for growth to return to trend.[1]

US recession possible, but not inevitable

And yet it does not seem obvious from the data that the US economy is in recession yet (as some are suggesting) or behaving in ways which parallel the onset of previous recessions. There's no doubt that the US economy is slowing. But most US economic indicators, other than those pertaining directly to the housing sector itself, have held up much better since the housing market peaked (in June 2006) than they did over the comparable period after the equity market peaked in March 2000, immediately before the recession of 2001 (which was the mildest of the ten recessions the US has experienced since the end of World War II, and which after data revisions last year no longer featured sequential quarterly contractions in real GDP).

Most US economic indicators have (so far) held up better than before the 2001 recession



Note: Data are indexed to their values at the peak of the equity market in March 2000 and in house prices in June 2000, respectively. *Sources:* US BEA, BLS, Commerce Department.

In particular, and notwithstanding the rise in unemployment in December (which many have taken as presaging a recession), the labour market has not deteriorated in the way it has ahead of previous US recessions.

This partly reflects the fact that the (non-financial) corporate sector is in much better shape – and thus under much less pressure to slash payrolls and capital expenditures – than it was ahead of the 2001 recession. The roughly 10% decline in the trade-weighted value of the US dollar (in contrast to the rise in the dollar which occurred after the 2000 peak in the equity market) has also helped, facilitating a rise in exports which has added more to real GDP growth over the past 18 months than the slump in housing activity has subtracted from it.

Whereas it was the response of the corporate sector to the slump in share prices that defined the contours of the recession in 2001, it will be the response of the household sector to the slump in house prices that largely determines whether the US economy falls into recession in 2008, and, if it does, how long and how deep that recession will be. History suggests that housing price 'busts' have larger wealth effects on consumption than share price 'busts', even though the latter typically entail larger price declines than the former, and that downturns following housing 'busts' last longer than those which follow sharemarket 'busts.'[2]

However the same history also suggests that the downturns in output associated with housing 'busts' typically begin to occur at the same time as the bust itself, whereas there is typically a lag of around three quarters between a sharemarket 'bust' and the ensuing downturn in economic activity. Clearly, that piece of history has not been repeated in this particular cycle, since the housing market peaked in June 2006, yet six quarters later we are still yet to see a contraction in real GDP.

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[1] Carmen M. Reinhart and Kenneth S. Rogoff, 'Is the 2007 Sub-prime Financial Crisis so Different? An International Historical Comparison', NBER January 2008.

[2] Thomas Helbling and Marco Terrones, 'When Bubbles Burst', in International Monetary Fund, *World Economic Outlook*, April 2003, pp. 61-94; and Karl Case, John Quigley and Robert Shiller, 'Comparing Wealth Effects: The Stock Market Versus the Housing Market', NBER Working Paper No. 8606, 2001.

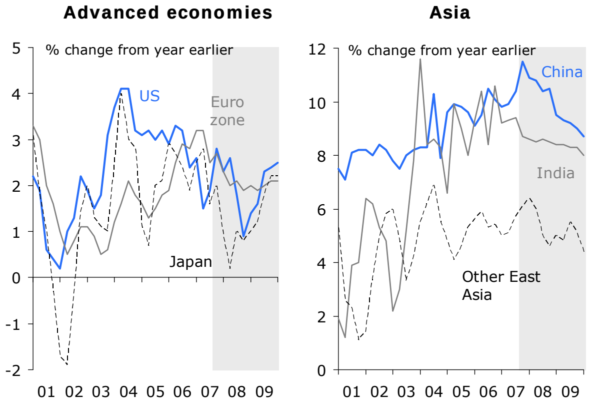
The majority of American home-owners (whose mortgages are at fixed rates) have not experienced a sharp rise in interest rates over the past two years (in contrast to the experience prior to previous recessions), and although they may well become more cautious about borrowing against the (declining) value of their homes in order to finance additional spending, it is not inevitable that they will curtail spending sufficiently abruptly to prompt an outright recession. Ironically, the minority of home-owners who have defaulted on their mortgages may find their cash-flow position has since improved, and may not have to cut back their other spending at all.

Although the possibility of a recession can't be ruled out, we think an extended period of below-trend growth is more likely. The more aggressive easing posture of the Federal Reserve, signified by its large rate cuts in late January, though helpful in curbing panic in the financial markets, will take some time to affect the broader economy; while the bulk of the fiscal stimulus proposed by the Administration (tax rebates for households) won't be felt until June. The first half of 2008 will therefore be especially soft and may even lead into consecutive quarters of negative growth.

Slower growth in other rich economies too

Other advanced economies are also likely to experience weaker economic growth this year. That reflects a combination of weaker export demand from the US (especially important for Canada), and currency appreciation (the obverse of the weakness in the US dollar) in the context of relatively soft domestic demand. This is especially significant in the case of Japan, where there has also been an abrupt contraction in housing activity following the introduction of new building regulations in the middle of last year. In Europe, uncomfortably high inflation rates will make central banks hesitant about easing monetary policy despite slowing economic growth. A contraction in financial services sector activity, and a decline in house prices, represent additional downside risks for the UK.

Growth will slow in most countries in 2008



Sources: national statistical agencies; IMF; Economics@ANZ.

In sum, economic growth across the developed world is expected to average about 1¾% this year, down from 2.2% in 2007, and the slowest since 2003.

Some easing in developing country growth

Developing countries have to date been relatively little affected by the turmoil in the US and European financial markets, although January's sharp falls in equity markets have been paralleled in Asian and other emerging share markets. With most developing economies now running large current account surpluses and having accumulated substantial levels of foreign exchange reserves, they are for the most part much less vulnerable to abrupt changes in capital flows than they were in the 1980s or 1990s. On the contrary, developing country sovereign wealth funds have emerged as an important source of capital for Western banks needing to replenish capital eroded by write-offs.

Moreover, the rapid growth of most of the bigger developing economies has been driven largely by domestic demand, rather than net exports. For example, of China's 11½% growth in 2007, around 9 percentage points came from domestic spending, and only about 2½ percentage points from net exports. Domestic demand accounted for an even higher proportion of India's estimated 8¾% growth in 2007. That doesn't mean these economies have 'de-coupled' from the US economy – their cycles were never especially closely aligned with the US anyway (as was apparent in 2001). But both countries' exports to the US slowed substantially during 2007, and will slow further this year. And, as argued in more detail below, Chinese domestic demand may also slow some in 2008. Together with slowing or falling exports to the US, this will also detract from growth in many of the smaller Asian economies for whom net exports account for a much larger share of GDP and for whom China has become a significant export destination.

Broader consequences of market turmoil

Notwithstanding the initial success which the Fed's actions in January have had in stabilizing global financial markets, investor sentiment remains fragile and asymmetrically vulnerable to further bad news. It would be highly premature to conclude that markets are near to bottoming.

In addition to the downside risks for economic growth, the turmoil of recent months is likely to trigger a range of broader and longer-lasting consequences. The lack of transparency and perverse incentives laid bare by the US sub-prime mortgage crisis, the weaknesses in prudential regulation of banking systems exposed by the Northern Rock debacle and the fraud at Société Générale, and the heightened awareness of the systemic risks associated with complex derivatives are almost certain to lead to increased national regulation of banking and financial systems. The clout of sovereign wealth funds will be enhanced by the role they have played in 'bailing out' Western banks. And the resilience of developing economies in the face of the global financial turmoil will further highlight their growing importance in the global economy, and underscore the on-going relative decline of the United States.

US Outlook

Mark Rodrigues

Prospects for the US economy have deteriorated markedly over the past three months. Problems in the financial system have proved to be more systemic than previously understood, which in turn portends a deeper and more protracted downturn in the real economy.

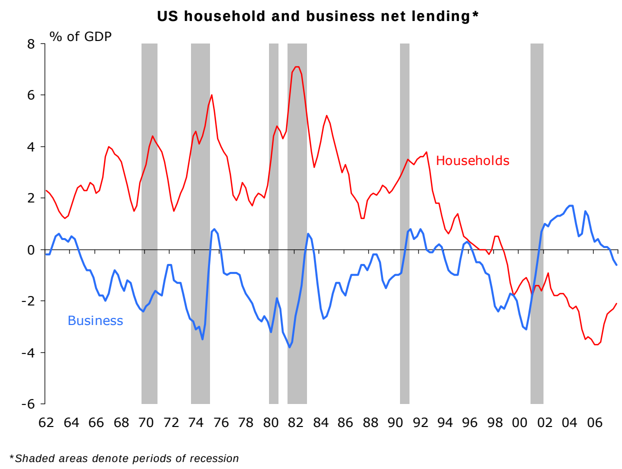
It is now widely expected that the US economy will slip into recession this year, if indeed it hasn't already. The real question at this point is how long it will take for the recovery to arrive. Will it be a relatively short and sharp downturn followed by an equally forceful rebound, *a la* the 2001 tech wreck? Or will it be a more protracted adjustment, characterised by at least a couple of years of sub par economic growth? Our analysis increasingly favours the latter outlook.

A consumer-led downturn

The primary reason why this downturn may last longer than previous troughs is that this time — and in contrast to previous recessions — the primary imbalance in the economy resides with consumers, as opposed to the corporate sector.

Previous recessions have been preceded by a significant deterioration in the net lending position — the difference between savings and investment — by business, which was then subsequently 'corrected' relatively quickly as labour was shed and capital expenditure cut. In contrast, historically, households have generally saved more than they've invested, resulting in a positive net lending position. This time, the roles have been reversed, with the household sector in massive financial deficit, to the tune of around 2% of GDP, while business, by and large, have maintained a broadly neutral net lending position.

In contrast to previous recessions, the major imbalance this time is in the household sector



Source: US Bureau of Economic Analysis

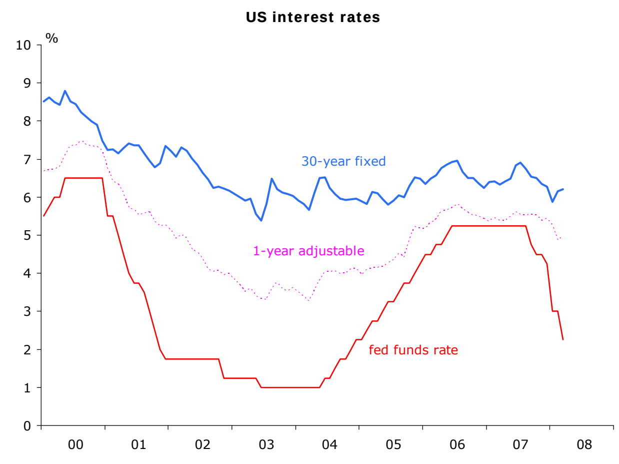
The point here is that businesses by their very nature adjust to changing economic circumstances much quicker than households. They have much greater control over their costs, and the one's that don't simply go out of business! Households on the other hand, don't have the luxury of 'going out of business' and the extent to which they can cut costs is limited by the need to put a roof over their head and food on the table.

Monetary policy has helped financial markets, but not households

Another reason why this downturn may prove to be more protracted than previous cycles is that the transmission channel from monetary policy to market interest rates has effectively been shut as a result of the dysfunction in financial markets.

So while the Federal Reserve has cut interest rates aggressively, by 300 basis points since September last year, the interest rates that consumers pay have not moved by nearly as much. For example, the benchmark 30-year fixed mortgage interest rate has fallen by only around 30 basis points since September, to 6.2%, while the 1-year adjustable rate has fallen by 60 basis points to 5%.

Market interest rates haven't fallen nearly as much as official rates



Source: Thomson Financial Datastream

Of course, Fed action has largely been aimed at restoring confidence in the ailing financial system, to which it has had some degree of success. Notwithstanding this, however, fact remains that the key channel through which easier monetary policy stimulates an economy – by lowering the cost of funds and encouraging spending and investment – remains closed, impeding the usual path to economic recovery.

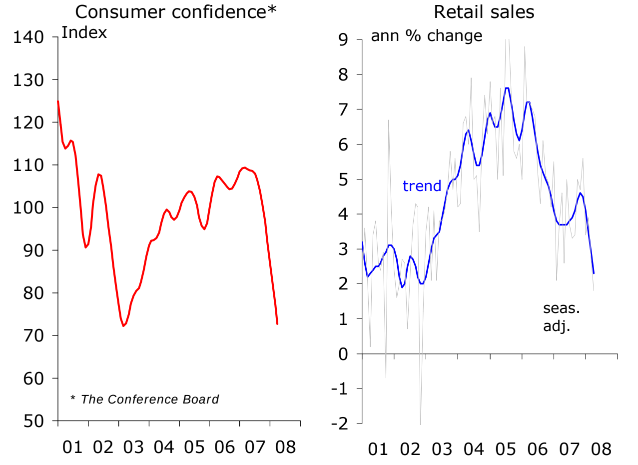
No where is the effect of this more evident than in the US housing market. House prices, as measured by the Case-Shiller Index fell by 11.4% over the year to January 2008. And with an estimated 9½ months supply of unsold housing stock hanging over the market, it seems likely that further declines in prices will be recorded in the year ahead.

Not surprisingly, against such a dire backdrop, new residential construction continues to track new lows. Housing starts fell by almost 12% in January to its lowest level since March 1991. Meanwhile building permits point to further weakness in the near term, down 5.8% in January and over 40% in the year. The outlook is bleak, with a trough in residential construction activity unlikely to be reached until the inventory overhang is cleared and prices begin to stabilise.

Of course, falling house prices are just one of the headwinds US consumers are tackling. Equity prices have also plunged, income growth is slowing and the cost of significant household budget items such as petrol and food are rising sharply. The state of household economic conditions is perhaps best captured by the remarkable plunge in measures of consumer confidence. The Conference Board measure, for example, fell by over 40% over the year to March 2008, with the expectations component of the index at its lowest since December 1973.

There are now clear signs that the weight of these influences are beginning to take their toll on consumers. In trend terms, retail sales declined in February and March, and in underlying terms (excluding gas and autos), has been declining for the past five months.

Consumer confidence is in free-fall, and spending is following



Source: Thomson Financial Datastream

Businesses remain healthy

The one good piece of news in this downturn, relative to previous cycles, is that the corporate sector remains in relatively healthy condition, at least outside the financial sector.

By the end of 2007, the gross operating surplus of domestic non-financial business amounted to 25.2% of GDP, down slightly over the year, but in line with the long run average. Meanwhile, net interest cover – a measure of the serviceability of debt – remains solid at 8.4 times earnings, well above the rate of 4.5 heading into the 2001 recession.

This is not to say that the corporate sector will be immune from the fallout in the consumer sector. Clearly it will not. Slower demand from households will hit bottom line sales, forcing business to tighten its belt and rein in investment plans. But the fact that, in aggregate, businesses have not over-extended themselves suggest that the adjustment required by the corporate sector will be less than it otherwise would be.

Importantly, this means that the labour market should hold up better than in previous economic downturns, moderating the feedback effect into household incomes.

To be sure, the labour market has clearly eased in recent months: non-farm payroll employment has fallen in each of the past three months (to March 2008) and the unemployment rate has crept up to 5.1%, from the cyclical low of 4.4% a year earlier. And we also expect the unemployment rate to continue to trend up over the next twelve to eighteen months as the broader economy continues to slow, peaking at around 6¼% in the second half of 2009. But, as has already been noted in the *International Overview* section of this publication, the labour market has not deteriorated in the way it has ahead of previous US recessions, and our outlook suggests the overall, the rise in the unemployment rate will be more modest than is typical during a recession.

Recession, followed by two years of sub-trend economic growth

Overall, we have downgraded our forecast for economic growth to just 0.7% in 2008 and 0.8% in 2009. Within this, we see the trough in the cycle occurring over the next six months, with stagnant growth in the March quarter and negative growth in the June and September quarters – a technical recession – followed by a very gradual recovery by late 2008 and over the course of 2009, as the effects of the monetary and fiscal stimulus begin to kick in. Of course, this is predicated on the current strains in financial markets easing, and official interest rate cuts eventually flowing through to market rates.

Against this backdrop we expect the Federal Reserve still has some work left to do. Rates are likely to be cut another 75bp, giving a trough in the fed funds rate of 1.5% by late 2008. Interest rates are likely to be left at these levels until the recovery becomes entrenched, probably not till early 2010.

Of course, there are clear dangers with leaving interest rates so low for so long, as Fed Chairman Bernanke is acutely aware. Although PCE inflation – currently running at an annual rate of 2.1% in core terms – is not particularly troubling, and should ease further as demand abates, the risks to this benign outlook remain clearly skewed to the upside. Global inflationary forces are on the rise, with a tight supply in energy, commodity and food markets putting upward pressure on a host of consumer items. Meanwhile, the deflationary impulse from China looks to have passed its peak. If such an environment were to eventuate, the Fed my well be forced to delayed the return to trend economic growth beyond the two years currently envisaged.

Euro zone and UK Outlook

Riki Polygenis

Slower growth to create room for monetary policy easing later this year

The European Central Bank (ECB) and Bank of England (BoE) are facing conflicting headwinds. On the one hand, tighter financial conditions are having negative repercussions for economic growth. But on the other hand, inflation is running well above the banks' respective target rates. This is forcing them to make a choice between propping up economic growth or following their mandated inflation targets.

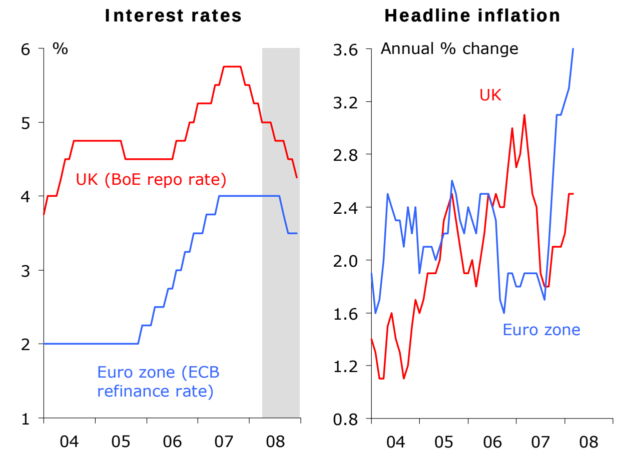
While a slower US economy has resulted in some slowdown in demand for exports, it is the financial market rather than trade linkages that have proved most problematic for the Euro zone and the UK. Banks in the region were highly exposed to the securitised debt market that collapsed as a result of US sub-prime mortgage defaults. The IMF expects bank losses in the UK to be $40bn, equal to 28% of those in the US. In Europe, bank losses are estimated at $83bn (or 58% of losses in the US), of which $45bn has come from banks within the Euro zone itself. Not only has this created severe dislocation in short-term money markets, it has also put a strain on bank capital and prompted a marked tightening in lending standards for households and businesses.

Against this backdrop, economic growth in the **Euro zone** has held up better than expected. Industrial production and survey data imply positive, though below trend, growth in the first quarter of 2008. These aggregates however, are masking significant disparities between countries. Economic activity has remained relatively robust in the two largest economies, Germany and France. But in Spain and Italy, leading indicators such as the manufacturing and services Purchasing Managers' Indexes (PMI) have turned down sharply. Tighter lending standards are also heavily impacting on the housing market in Spain and Ireland, which experienced a significant run-up in house prices in recent years.

Given the current environment, growth is also expected to slow in Germany and France. While exports and forward orders have been holding up due to strong demand from Eastern Europe and Asia, the appreciation of the € to near record highs against the US$ and the £ will start to take its toll. In addition, reduced availability of credit will impact on investment decisions, with European businesses highly dependent on the banking system for funding. And household consumption is expected to ease as higher fuel and food prices eat into discretionary spending. Overall, ANZ is forecasting economic growth to slow to just above 1½% in 2008 compared with 2.6% in 2007.

With headline inflation at 3.3% - well above its 2% target, the ECB will continue to talk tough on inflation in the near term. However, slower growth will progressively take pressure off inflation and provide scope for cuts to the official refinancing rate later this year.

Interest rates to fall as inflation eases



Sources: Bloomberg, Economics@ANZ

In the **UK**, concerns over growth have outweighed inflationary concerns. The Bank of England (BoE) has cut its official bank rate three times since November. Amidst dislocation in short-term money markets, the BoE has also been more proactive in implementing measures to restore liquidity. These include more recently allowing banks to swap mortgage-backed securities for government bonds. Unfortunately, these measures have been insufficient to prevent financial conditions from tightening. Higher funding costs for banks have created a situation in which decreases in the official bank rate have not necessarily flowed through to households and businesses, with mortgage rates in some instances actually rising. In addition, the erosion of bank capital has limited the ability of banks to extend new lending, and lending standards have been tightened significantly.

Like in the Euro zone, economic growth has surprised on the upside. While slowing, real GDP managed a 0.4% rise in the March quarter (2.5% p.a.). However, this is unlikely to persist. Higher prices for household staples such as fuel and food will eat into discretionary spending and sharp falls in housing prices, tighter lending standards and falling consumer confidence will also weigh on household spending (with which makes up over 60% of GDP). The slowdown should be reasonably orderly, with resilient labour market conditions providing support. Tighter lending standards and weaker external demand will also likely to weigh on business sector activity, although the weaker sterling should help to provide some offset for exporters.

Overall, real GDP growth is forecast to slow to 1¾% in 2008, a considerable slowdown from 3.1% in 2007. Such a slowdown will help to create a margin of spare capacity in the economy and eventually put downward pressure on inflation, which to date has remained stubbornly high at 2.5%. This will provide the BoE with further headroom to implement further monetary policy easing later in the year. ANZ is forecasting three further 25bp cuts by the end of the year which will take the official bank rate to 4.5%.

Japan Outlook

Amy Auster and Jasmine Robinson

BOJ confirms worsening outlook

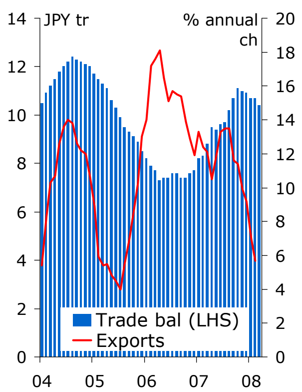
The Bank of Japan (BOJ) has downgraded its forecasts for growth for the coming year, suggesting real GDP growth will not exceed 1.5% for the Japanese fiscal year ending in March 2009. In its biannual "Outlook for Economic Activity and Prices," the BOJ pointed toward tightening global financial conditions, higher materials prices and a build-up in Japan's capital stock over the past few years as reasons for decelerating growth.

Notably, the BOJ's report indicated that a majority of Policy Board members view the risks to growth and inflation as skewed to the downside in the coming year. The prevailing view with the Board suggests that the BOJ is not looking to raise its policy interest rate any time soon.

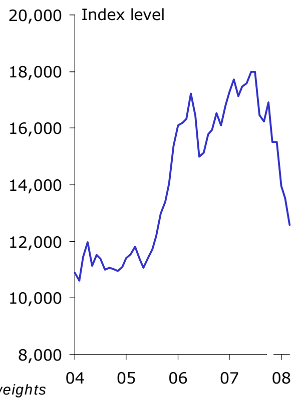
Our forecasts suggest that the BOJ may still be overestimating the likely growth rate this year; we expect real GDP growth to be below 1% in the calendar year. Key to our forecast are the two channels through which the credit crisis and global slowdown are filtering through to Japan: the contribution of net exports to growth, and the wealth effect of the bear equity market.

Exports and equity markets losing steam

Japan exports and trade balance



Equity market performance



**Aggregated used purchasing power parity weights*

Sources: Datastream, ANZ

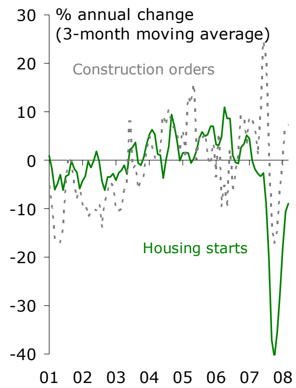
Export growth in yen terms has slowed from 9% per annum in the fourth quarter of last year to just under 5% in the first quarter. The stronger yen is playing a role here, but so is slowing external demand. At the same time, import growth was around 9% in both quarters. The impact on net exports can be seen in the chart above, with the 12-month trailing trade surplus having declined from a peak of 12.6 trillion yen in November to 12.1 trillion yen in March. We expect the trade balance to show a similar trend to the 2005-2006 period, and thus anticipate a falling contribution to real GDP growth from net exports. Last year, net exports contributed 1.1 percentage points to Japan's total 2.0% growth, so a falling contribution in this area is material to the growth outlook.

The other major effect is the decline in the equity market, which has fallen by more than 30% since its peak in July 2007. The OECD estimates that a 20% correction of the equity market in Japan will reduce real GDP growth by 0.5 of a percentage point in the year of the correction, and another 0.4 of a percentage point in the following year, due to the wealth effect. Certainly consumption has been weak, rising by only 0.1-0.2% on a quarterly basis for three of the four quarters in 2007. More recent high frequency data is not all that encouraging, as household expenditure softened to 2% p.a. growth in March 2008, while retail sales volume growth fell to under 1% p.a. in the first quarter of 2008.

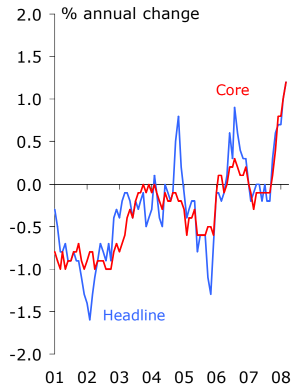
There are a few factors that could generate a higher growth outcome for this year than we are now forecasting. The first would be a more rapid and sharp recovery in the housing sector, which has been laid flat by the re-imposition of earthquake-related building codes. Housing starts looked to be improving in January and February, but unfortunately plunged in March.

Slide in domestic demand could hamper reflation

Housing starts and construction orders



Price trends



Sources: Datastream, ANZ

A second factor that could contribute to stronger than expected growth is a fall in commodity prices. While Japan is a very energy efficient economy, prices are putting pressure on producers. Relief on this front would bring about a massive improvement in Japan's terms of trade that would be a real benefit for the economy.

A third area with potential upside is wages. The BOJ's biannual report notes some evidence of wage inflation, which in the context of low-demand Japan is a good sign. Japan's demographics have long been a bugbear of productivity, but as labour becomes more scarce with baby boomers retiring, higher wages could help to lift domestic consumption and rebalance growth away from investment and exports.

A final positive for Japan is the continued low inflation rate, particularly relative to the rest of Asia. Inflation has accelerated to a welcome 1.2% p.a. as of March, but is not a threat to the economic outlook. Japan is nearly alone in Asia in this regard, as no monetary tightening is required and the economy can continue to benefit from abundant local liquidity to support investment.

Asia Outlook

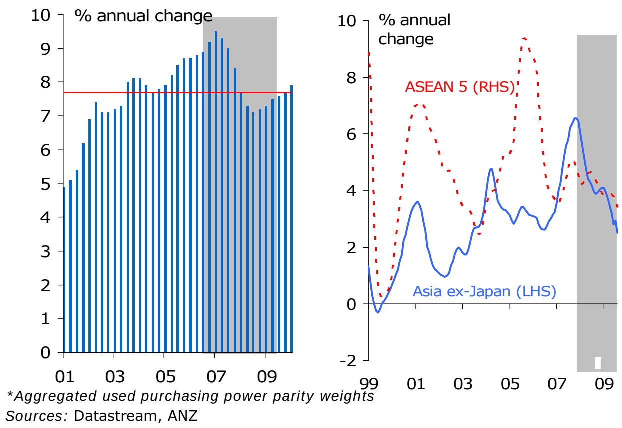
Amy Auster and Jasmine Robinson

Inflation crisis set to subside as growth slows

The nascent inflation problem with that we identified in the last edition of the AEO has turned into a full blown crisis. Rapidly rising food prices are grabbing headlines in Asia and around the world, giving voice to concerns that yet another round of higher inflation will reach the shores of the US and Europe if Asian wages (and therefore exports) rise in order to address the higher cost of living. With food representing a higher share of the CPI in Asia than in the G7 — ranging from 23.4% for Singapore to 50% in the Philippines — the recent acceleration in soft commodity prices has had a disproportionately large impact on headline inflation in East Asia.

While there is no question that the rise in food prices is a real issue, we believe that it will prove temporary. Inflation is a lagging variable, and at present the high rates of inflation around the region reflect the fact that global demand – and particularly Asian demand – was well above its historic trend rate of expansion from early 2004 until last year. However, the bursting of the credit bubble in the US is an extreme event of deflation. As this shock winds its way through the real economy – resulting in a US recession that will take G7 growth to well below trend – growth around the world and in Asia will slow. Inflation expectations will adjust downward and Asia will experience *dis*inflation, or a decline in the rate of inflation.

Slowing demand should cause inflation to ease



*Aggregated used purchasing power parity weights

Sources: Datastream, ANZ

This process may take several months to unfold, leaving an uncomfortable interim period in which growth is softening while prices remain high. It also seems most probable that the downturn in growth during this business cycle will not bring inflation in East Asia back to the very low levels recorded from 1999 through 2002, when Asian demand collapsed in response to the Asian financial crisis and then the US tech wreck. From early 1999 through to the end of 2002, headline CPI in Asia ex-Japan averaged 1.9% p.a.; since the beginning of 2004, this has accelerated to 3.7% p.a. At the last aggregate reading, our GDP-weighted index for headline CPI in Asia had jumped to 7.2% p.a., which is nearly double the average rate over the past three years.

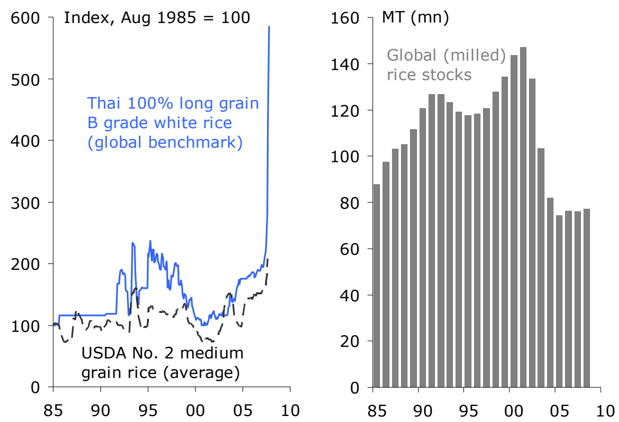
Going forward, we are forecasting that Asia ex-Japan inflation will decline to below 5% by mid-year, and settle at around 4% in 2009. This will feel like a higher inflation environment compared to recent history, and may in the end lead to slightly higher import prices in the developed world. From a macroeconomic point of view, however, 4% headline inflation in Asia is probably quite reasonable given the level of development in the region and the uncertainty associated with the continual development of monetary policy by Asian central banks as they move away from their history of using the US dollar to anchor inflation expectations. For regional inflation to anchor within a 1-3% per annum target suggested by OECD central bank, East Asian central banks and governments – particularly in the fast-growing economies of China and Vietnam – will likely need to accept higher interest rates and lower growth rates than what has been the trend in the past five years.

What about rice?

Of all the noise about global inflation, the spike in rice prices has lately generated the most newsprint. Rice is Asia's staple food, and high rice prices directly impact all socioeconomic groups. The focus on rice prices is particularly acute in Southeast Asia, which happens to be the home of the largest rice exporter, Thailand, and runner up Vietnam.

Since the start of the year, the benchmark export price of Thai rice has trebled, breaching US$1,000 per tonne – the highest level since the early 1970s. Supply issues are illustrated by stocks, which are at their lowest level since the mid-1970s.

Southeast Asia rice price hikes well above market



Sources: Datastream, Bloomberg, US Department of Agriculture.

At the same time, rice prices outside of Southeast Asia have not risen at the pace of Thai rice prices. As can be seen in the chart above, the recorded price of US medium grain rice has doubled since 2005, but come nowhere close to the sudden trebling of the price of Thai long grain B grade rice recorded since the end of last year. This suggests that particular supply side issues are at play when it comes to rice prices in Asia. These issues need to be separated from the general story of excess demand in the region that has generally pushed inflation expectations higher.

The table below details some of the particular circumstances that have caused the benchmark Thai rice price spike. Initially, there was a poor crop season in Bangladesh and the Philippines, and a bit of rice disease in Vietnam; short supplies in the region were then exacerbated by a ban on some rice exports from Vietnam that was itself imposed in an effort to help ease Vietnamese inflation. Indonesia and India have also imposed export restraints.

In many regards, then, government responses to the initial problem of gradually rising inflation are now responsible for its acceleration. Fortunately, Thailand has thus far refrained from capping supply. But importing countries, such as the Philippines, are active in building up stocks, and the government has begun to distribute "rice passes" which are expected to cost around 5 bn Philippine pesos a year to low-income households to help combat inflation. Measures such as these will continue to generate an excess of demand over supply of rice for the short term, and keep prices high. Malaysia is planning to subsidise locally-grown rice, which may help ease the situation somewhat.

Poor harvests and export restraints inflate rice price

	Action taken in Asia
Bangladesh	Imports 180,000 tonnes of white rice from Myanmar (Jan 08). Crop losses due to flooding. Further import of 400,000 tonnes from India (Mar 08)
China	Export tax at 5% (Dec 07)
India	Export of non-basmati rice banned (Mar 08)
Indonesia	Under Indonesia's new rice export rules, state procurement agency Bulog is allowed to sell medium-grade rice overseas only when national stocks are above 3 mn tonnes and domestic prices are below a government's target price (Apr 08)
Philippines	To import up to 2.2 mn tonnes of rice this year due to shortfall in local harvest (Mar 08)
Singapore	Allows rice importers to bring in more stocks to meet increased demand amid consumer fears over supply (Apr 08)
Vietnam	Ban on rice sales until June 2008 (Apr 08)

Months in brackets reflect date of announcement.
Source: Thomson Reuters 2008

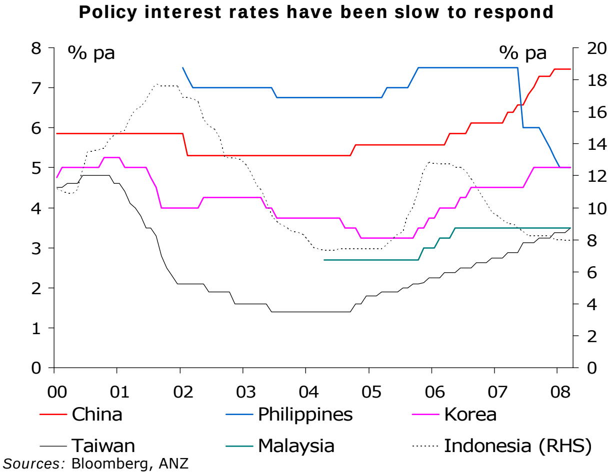
While these underlying supply pressures are not expected to fade in the short term, some reprieve is expected as output improves. According to the UN FAO's April release, world rice production is expected to rise by 12 mn tonnes or 1.8% in 2008 assuming normal weather conditions, with significant output expected out of Asia (Bangladesh, China, India, Indonesia, Myanmar, the Philippines and Thailand). In addition, an anticipated easing in fuel costs as global demand softens will also help to alleviate input costs.

Central bank response to higher inflation

Although we believe that the recent spike in rice prices in East Asia can mainly be blamed on short-term supply issues, there has been a generalised rise in price levels that needs to be addressed. Rice prices – and prices of soft commodities in general – have also been pushed up by the shifting use of arable land for biofuel production, and by hoarding. The sustained rise in oil prices has made it more expensive to package and ship basic foodstuffs, as well as all other goods.

In our view, most Asian central banks have been well behind the inflation curve over the past year. Having become used to a low inflation environment, central banks that use interest rates to manage inflation expectations seemed reluctant to raise interest rates as growth recovered in 2005 and 2006. The relative inexperience of the region with the benchmark interest rate approach during a period of accelerating inflation – for example, in Korea, Indonesia, Thailand and the Philippines – certainly played a role here and lessons have clearly been learned. Indeed, the inflation outlook is positive for these countries, as interest rates stand ready to rise again should inflation continue to accelerate.

Policy rates still below 2000 levels for most countries despite higher inflation



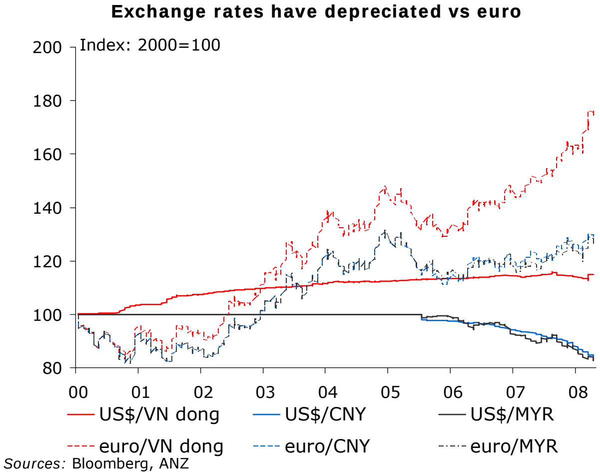
Sources: Bloomberg, ANZ

For central banks that continued to use their exchange rate to manage inflation expectations – including in China, Malaysia, Vietnam and Singapore – the very slow pace of exchange rate regime reform is now proving problematic. When exchange rates are pegged or managed against the US dollar, inflation expectations in that particular country fall in line with inflation trends in the US. As a result, it is generally found that domestic interest rates in these countries are lower than might otherwise be the case. The IMF calls this an interest rate "wedge".

The interest rate wedge provided by managed exchange rate regimes is an attractive proposition to governments in developing countries, since it allows for a higher level of investment than might otherwise occur. The conditions of low domestic interest rates and high levels of investment have certainly prevailed in China and Vietnam over the past several years, to the point where investment has been a key driver of growth.

The downside of maintaining a cheap exchange rate and low domestic interest rates is that the result tends to be excess domestic liquidity, which eventually leads to higher domestic inflation. Higher domestic inflation leads to an appreciation of the real (inflation-adjusted) exchange rate, and a loss of competitiveness. This is exactly what is now happening in these economies, particularly in China and in Vietnam.

Currency movements insufficient to tighten monetary conditions



Source: Datastream

The loss of competitiveness and trend toward higher inflation has been particularly exacerbated by the historically unprecedented weakness of the US dollar over the past nine months. Although much has been made about the appreciation of the Chinese yuan, Malaysian ringgit and Vietnamese dong against the US dollar over the past nine months, in fact these currencies have depreciated against the euro over this period. Since 2000, the depreciation against the euro has been well in excess of 20%. On a trade weighted basis – in particular in China, as Europe is now its biggest export market – the depreciation of these currencies against the euro has had a policy impact. In other words, the failure to manage exchange rates on a trade-weighted basis has created easier monetary conditions during a period in which tighter conditions were required by rapidly-expanding economies.

In Vietnam, the State Bank of Vietnam (SBV) has allowed the dong to appreciate at an accelerating rate, principally by widening the daily US dollar-dong trading band around a rate set each morning. As seen in the previous chart, however, the recent appreciation has been insufficient to reverse the longstanding policy of slight annual depreciation in terms of the US$/dong exchange rate. In late March, a further surge in inflation to 19.4% per annum sparked concerns over the outlook for the economy and sent the dong sharply lower, where it has remained. Other policies have been enacted in Vietnam in an attempt to restrict prices growth. In February, the SBV increased reserve requirements for credit institutions and raised policy rates to slow credit growth. A one-year government bond issue in March, compulsory for all commercial banks, saw 20.3 trillion dong (US$1.3 bn) drained from the economy. Nonetheless, inflation will prove tough to get under control in the current policy environment. The surge in inflation and required policy response, plus capital outflows that will force the current account deficit to shrink, have led us to revise down our real GDP growth forecast for 2008 from 8.0% to 6.0% p.a..

The behaviour of the Malaysian ringgit has played an interesting role in the evolution of monetary policy in Singapore. The Monetary Authority of Singapore (MAS) uses its exchange rate as its key tool in maintaining price stability, using its estimation of the S$ nominal effective exchange rate (NEER), which is a trade-weighted measure. As Malaysia is Singapore's largest export partner, it has the largest weight in the S$NEER. While the ringgit was pegged to the US$ – prior to July 2005 – the effect of the ringgit on the S$NEER was to increase the weighting of the US dollar in the basket. Since July 2005, and particularly over the past six months, our estimation of weights in the S$NEER indicate that the 17.3% weighting of the ringgit in the S$NEER may have had the effect of accelerating the rate of appreciation of the S$NEER against the US$. This month, in its six-monthly review, the MAS acted to re-centre the exchange rate policy band at a higher level, with no change to the slope or width of the band. This effectively allows for a stronger appreciation of the S$ to help curb imported inflation, but also raises the question as to whether the US$/ringgit and therefore the S$NEER should have been appreciating even more rapidly over the past year or so.

Why inflation will fall

We believe that the rate of inflation in Asia will decline going forward, not because of central bank action, but because of a material slowdown in the G7. The debate about whether Asia has "decoupled" from the US is alive and well, but it is helpful to delve into the concept of decoupling, and what it means. In particular, the trend of higher inflation in Asia at present means that a powerful element of the decoupling story is something that cannot be deployed in the near term to support growth. This may remain the case for all of 2008.

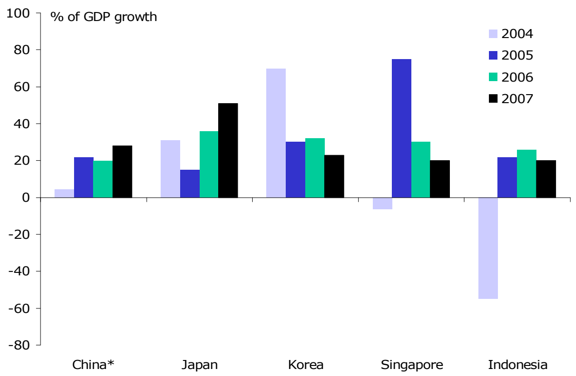
First, though, there are two important elements of the Asian region that are not decoupled from the US. The first is exports. While the US is a far less important trade partner than was the case perhaps 10 years ago, Asia is still reliant upon demand in the

G7 overall. We are forecasting a decline in real GDP growth for the G7, to a trough of 0.4% per annum growth in the second quarter of next year. The lead up to this slowdown will see Asian export growth slow, and net exports contribute far less to growth than has been the case recently.

As can be seen in the chart below, net exports have contributed at least 20% of GDP growth to the large Asian economies over the past 2 to 3 years. Trade is expected to decline along with the contribution that exports will make to growth.

Growth will be hit by falling export growth

Contribution of net exports to GDP growth

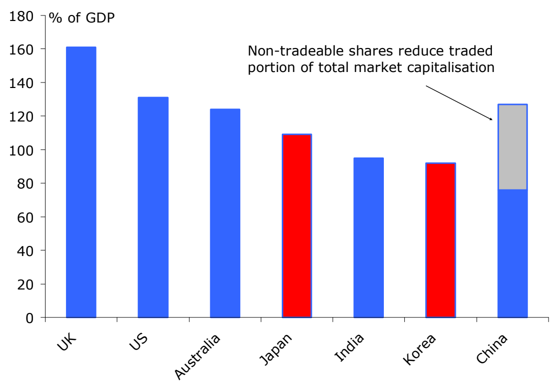


**Calculated using nominal GDP data; all others are real GDP.*
Sources: Datastream, ANZ

A second area where Asia has not decoupled from the US is in equity markets. The Hang Seng declined more than 33% from its peak on 30 October 2007 to its low on 17 March 2008 and virtually all Asian equity markets fell into bear market territory. The larger the stock market capitalisation, the bigger is likely to be the impact; the chart below highlights the importance of the equity market in Japan and Korea in particular. The OECD estimates that a 20% decline in the Japanese stock market (which fell by 35% from July 2007 through March 2008) would wipe 0.5 of a percentage point off of real GDP growth in the year of the correction.

Equity market declines have not helped

Market capitalisation as a percentage of GDP



Sources: Bloomberg, Datastream, ANZ

A decline in the contribution of net exports and the negative wealth and possibly investment effects of the decline in equity markets is expected to have a material impact on growth in the East Asian region in the coming 12-18 months. We forecast a slowdown in East Asia ex-Japan from real GDP growth of 9.3% last year to 7.8% this year and 7.4% next year, which is below historic trend. The slowdown is expected to be led by China; the downturn in East Asia excluding Japan and China is less severe, from 5.9% last year to 4.8% in this year and next. The region overall falls to below-trend growth, which should be sufficient to reduce demand such that inflation declines.

Asian growth forecasts

	2007e	2008f	2009f
China	11.4	9.8	9.0
Hong Kong	6.3	5.7	4.1
Korea	5.1	4.1	2.8
Taiwan	5.7	4.7	4.6
Indonesia	6.3	5.9	6.3
Malaysia	6.4	5.3	5.0
Philippines	7.2	5.2	5.4
Singapore	7.8	4.0	5.0
Thailand	4.8	5.6	6.0
Vietnam	8.5	6.0	7.0
India	8.7	8.0	8.0
East Asia ex Jap. & China	**5.9**	**4.8**	**4.8**
East Asia ex Japan	**9.3**	**7.8**	**7.5**

Source: Economics@ANZ

What is the ace in the back pocket that really would allow Asia to decouple from the United States? Monetary policy, of course. With East Asia no longer strictly tied to the dollar bloc, Asian central banks should be able to act at their leisure to ease monetary conditions by cutting interest rates in order to stimulate domestic demand.

Unfortunately, the failure to sufficiently tighten monetary policy over the past year has led to a persistent inflation problem in East Asia that may be harder to fix than many would have thought. In the event that Asian central banks don't stay on top of inflation expectations in the next few months – which are not nearly as well anchored in East Asia as they are in the G7 – monetary policy will have to remain tighter for longer via either higher interest rates or ongoing currency appreciation.

The clear risk is that policy intervention aimed at allowing an unsustainable level of demand – by controlling prices of commodities through measures such as subsidies, export controls, hoarding and the like – will end up perpetuating the inflation problem rather than solving it. In the end, this would lead to a deeper economic downturn in 2009, such that Asian growth would fall to well below trend and, by virtue of its size, prevent the global economy from returning to the above-trend growth rate in 2010 that is now anticipated in our forecasts.

Australian Outlook

Tony Pearson

The Australian economy is at a turning point

Australia's economic growth rate will slow substantially over the next year. It would be easy to attribute this to the ongoing global financial crisis and slowing global growth, but in fact these will be at best side issues. The primary reason Australia's growth will slow is because Australia's policy makers want it to. And they will do whatever it takes to achieve that outcome.

The problem for policy makers is that growth has been too strong rather than too weak. Economic growth in the second half of 2007 was running at an annual pace of around 4%, well above the non-inflationary trend rate of around 3 to 3¼%. Growth in domestic demand was even stronger, at around 5½% p.a. And this has led to an inflation problem. Over the year to the March quarter, core inflation increased by 4.25%, well above the target band of 2% to 3%, and the highest rate since inflation targeting began in the early 1990s.

The response of the Reserve Bank to these pressures has been to aggressively lift domestic interest rates, with the cash rate being increased four times by a total of 1% since August last year.

There are tentative signs that this is now acting to cool demand for credit from both households and the corporate sector. It is also cooling household spending and further constraining dwelling construction. It needs to be emphasised that these developments would be viewed by policy makers as a desirable outcome. The Australian economy will need to slow to below its trend rate of growth — that is, to something less than 3% — over the next twelve months to ensure that sufficient "slack" develops in the economy to allow price pressures to ease back from current highs.

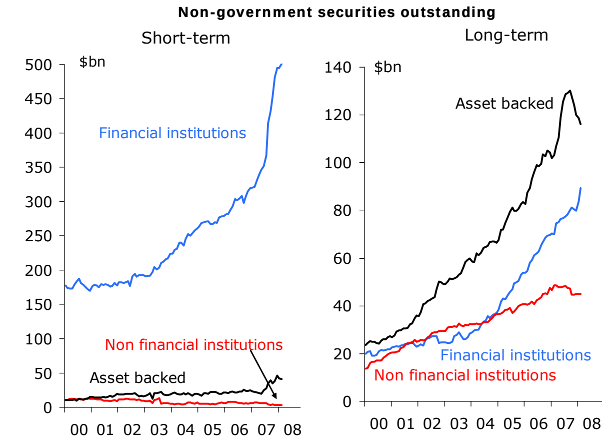
It is unlikely that Australia will enter recession in the next year, in part because commodity prices will remain very supportive of economic growth, and in part because both monetary and fiscal policy can quickly be eased should private sector activity decline more steeply than necessary. But it is clear that a turning point has been reached, and there will unavoidably be some business sectors and some regions which will feel considerable pain.

International environment not all negative for Australia

There is no doubt that the crisis which has beset the international banking and financial system in the past 12 months has already had an impact on our economy. Although these problems have nothing directly to do with the Australian economy, and although Australian banks have negligible exposure to US sub-prime mortgage losses, Australia relies heavily on foreign capital. This is reflected in the massive current account deficit, which currently stands at a record 7% of GDP and is the world's fourth largest in absolute terms. Domestic financial markets have also been caught up in the increased global market volatility.

The most obvious impact on financial markets has been the fall in equity prices. But an arguably more enduring effect has been higher market interest rates, as lenders globally demand a higher risk premium on loans. For some non-bank borrowers there has also been a tightening of access to offshore credit markets and some winding back of domestic securities issues.

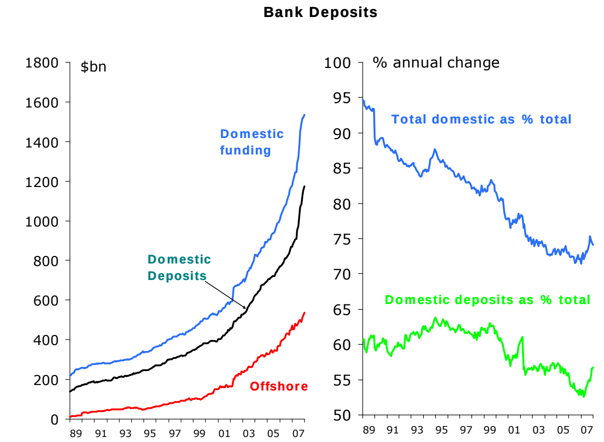
Domestic security issues by non financial institutions are falling



Sources: Reserve Bank and APRA

The good news is that Australian banks have continued to enjoy access to both offshore and domestic sources of funding. In fact the recourse to domestic deposits by Australian banks has actually increased, in part due to the offer of more attractive deposit interest rates, and also because of a "flight to quality" as investors have sought the safety of cash in preference to riskier investment opportunities.

Australian banks continue to enjoy strong funding growth

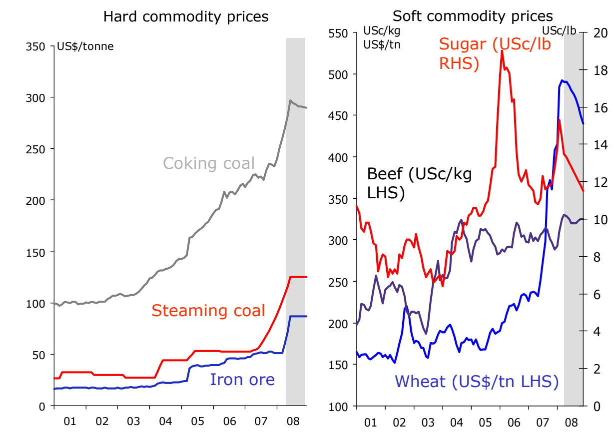


Sources: Reserve Bank and APRA

The international environment is not all negative for Australia. In fact the reverse is true, because in 2008 Australia will enjoy a very large increase in export receipts from another lift in key commodity prices. Looking at Australia's most important hard commodity exports, it is likely iron ore contract prices will increase by around 70%, while steaming coal prices will more than double, and coking coal prices will more than triple! This will be the largest aggregate increase in commodity prices in the whole stellar commodity price cycle of the past six years. This amounts to an increase in export values for the contract year of $54.8bn, equivalent to a massive 4.5% of nominal GDP. And this in turn will deliver yet another significant tax revenue boost the Federal budget bottom line in 2008-09, further complicating its desire to tighten fiscal policy to remove some steam from the economy.

This favourable hard commodity price outcome is partly due to continued supply shortfalls as production struggles to keep up with demand. It also reflects an expectation that developing economies of key importance to Australia, such as China and India, will continue to enjoy solid growth rates even as growth in developed countries like the US, UK and EU zone, slows sharply.

Favourable commodity prices will continue



Sources: Reserve Bank and ANZ

The story is also positive for rural commodity prices. Rural prices have enjoyed strong gains in recent years, doubling during this decade, and with sharp increases over the past year or so. Prices for grains and most recently, rice, have shown particularly sharp rises. This has reflected a combination of global supply and demand factors. On the supply side, drought in Australia and in the northern hemisphere has led to lower food production. This factor can be expected to partially unwind when (or if) production conditions return to normal.

On the demand side, there has been increased demand for grains and protein for human consumption from Asia (in the form of bread, red meat and especially poultry), increased demand for grains as animal feed, and the growth of the synthetic fuels (biofuels) industry in the US and EU for which grains and sugars are inputs.

These demand factors are expected to persist. So while we expect some easing back in rural prices over the next year, much of the structural demand-induced gains will be preserved, and prices are not expected to return to the lows of the early 2000s.

Too much growth = too much inflation

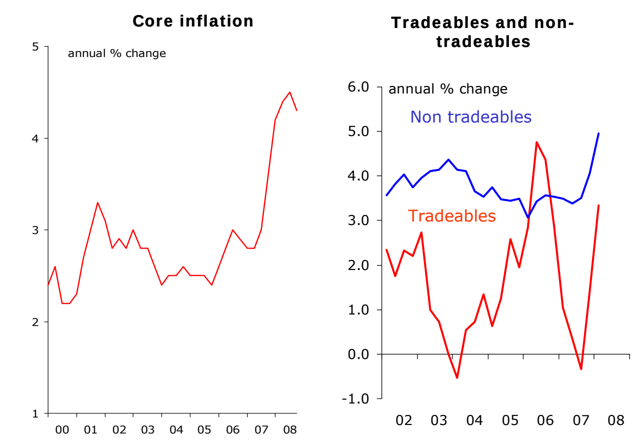
The Australian economy ended 2007 on a high note, with growth in GDP in the second half year of 4%, well above the long term non inflationary trend of 3% to 3.25%. Domestic demand – comprising household consumption, business investment, dwelling construction, and government spending and investment - was even stronger, growing at an annual rate of around 5.5%.

The problem is that after 16 years of continuous growth the economy is now running out of spare capacity. The unemployment rate is down to the lowest level in over three decades and employers across all states and almost all industry sectors report that finding and retaining suitable labour is a significant challenge. Indeed, finding enough labour is currently reported to be one of the main impediments to business growth in several of the industry and business sentiment surveys.

The capacity utilisation rate of businesses is also at a cyclic high. Combined with growth running well above trend and a considerable boost to income from the ongoing commodity price boom, the stage has been set for an upswelling of inflationary pressure.

And that inflationary pressure has now been revealed in full force. Headline inflation rose by 1.3% in the March quarter, to be up 4.2% over the year to March 2008. But the real horror story was in the core numbers, up 1.25% in the quarter and 4.25% over the year. The annual core rate is now at the highest rate since the introduction of inflation targeting in the early 1990s, a fact that might suggest the Reserve Bank has been somewhat behind the curve in its efforts to control the inflation dragon.

Price pressures accelerate



Source: Australian Bureau of Statistics

A further concern is that it is domestically-induced price pressures that are leading the charge. Non-tradeables inflation is now running at 5%, the highest pace this decade excluding the introduction of the GST. And much of the pressure is coming from items that will not be quickly impacted by slowing domestic demand, including utilities, rent and pharmaceuticals. Tradeables inflation is now also uncomfortably high at an annual rate of 3.3%, despite the strong A$, although much of this is due to petrol, fruit and vegetable prices. And the increases are broad based: in the March quarter 66 of the 90 individual components (73%) of the headline CPI recorded increases and another 5 components were flat.

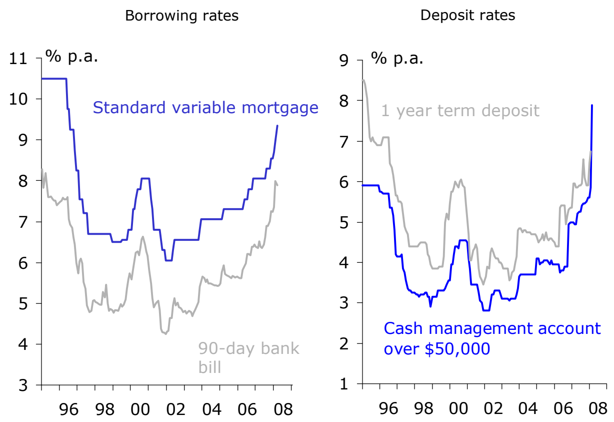
Economic growth will need to slow to below trend for at least a year to generate sufficient spare capacity to allow price pressures to ease. We forecast growth will decelerate to around 2½% by early 2009 and remain at that more subdued pace into 2010. 2009 is likely to be the slowest year of growth since 2001, which coincidentally was also the end result of the Reserve Bank tightening into a global downturn.

Higher interest rates begin to bite

The Reserve Bank has been aggressive in tightening monetary conditions over the past year, lifting the cash rate on four occasions by a cumulative 1%, taking the cash rate to 7.25%. In combination with market-induced increases in interest rates, variable borrowing costs for home buyers and businesses are at their highest levels in 12 years.

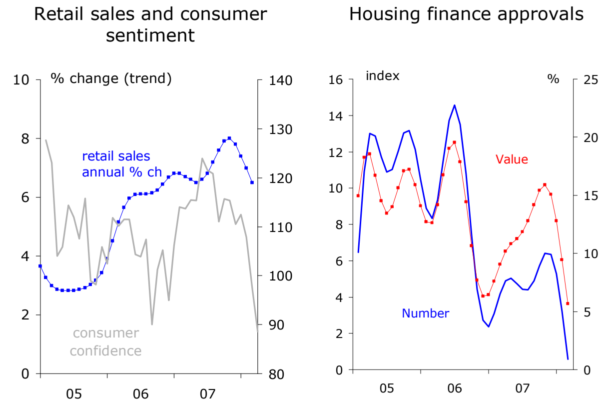
There are tentative signs that the tighter monetary conditions are working, with retail spending, consumer confidence, housing finance approvals, and business conditions and confidence, all easing in the first months of 2008.

Interest rates at 12 year highs



Source: Reserve Bank

Economic momentum begins to slow



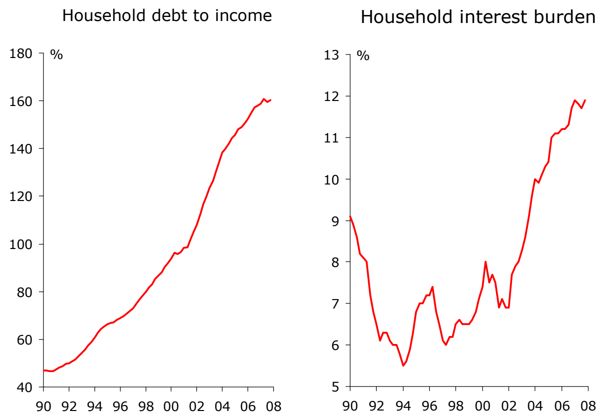
Sources: ANZ, ABS, Melb Institute, RBA

Households feel the squeeze

As always, the squeeze of tighter financial conditions affects different sectors to varying degrees. It will be the household sector in aggregate which initially feels the most intense pain from higher rates. In the December quarter 2007, the ratio of household debt to household disposable income was 160%, twice the level of a decade earlier. The interest payment burden — that is, the ratio of interest paid to household disposable income — was 11.9%, well above the ratio of 9% at the peak of the 1989-90 episode of high interest rates.

The situation of the household sector is in marked contrast to that of the corporate sector. The corporate gearing ratio that is, the ratio of debt to corporate equity — was exceedingly high in the second half of 1990 at over 160%. It has subsequently declined fairly steadily, to less than 70% by the end of 2007. As a result, corporate interest cover has been improving, to be around three times higher than in 1990.

Households have a heavy interest servicing burden



Source: Reserve Bank

Bad news for the non-mining states

The confluence of the global and domestic factors will also have differential impacts on the states and territories. Those regions exposed to external demand and the ongoing commodity price boom will be insulated in part from tighter domestic policy settings. This suggests Western Australia, the Northern Territory, Queensland and increasingly, South Australia, will fare relatively well, with only a modest slowing in economic activity.

In contrast, regions less exposed to the commodity boom and with a heavier reliance on domestic demand, will suffer more acutely from tight domestic policy. For New South Wales, Victoria and Tasmania, the moderating effects of higher interest rates are expected to hit hard. New South Wales is the most exposed on this front, with the highest interest servicing burden in the country – in 200607 (the most recent data available) interest payments consumed 11.9% of the state's household after-tax income, compared to an average in the rest of Australia of 9.5%.

The shakeout in financial markets also poses issues for New South Wales. With 44% of Australia's finance and insurance sector located in the state (by value added), and with the sector comprising over 10% of New South Wales' gross state product, the global financial crisis is likely to have a negative impact in the form of reduced activity and employment in the state's finance industry.

A feature of the second half of 2007 was a narrowing in the growth differential between the resource "haves" and "have nots" as domestic household spending lifted in response to generous personal income tax cuts, strong employment growth and solid wage gains. Over the next year this narrowing will be reversed.

Business winner and losers

The outlook of further increases in commodity prices, but high interest rates and A$, and slowing domestic demand, will have different impacts on different industry sectors. Industry sectors which should do well in this environment include:

- exporters enjoying high commodity prices, including metals, energy and some agriculture;
- services to mining, including transport, infrastructure, manufacturing machinery for mining, exploration and science and technology.

Industry sectors which face stronger headwinds include:

- exporters not enjoying high prices to offset the cyclically high A$. This would include many manufacturers and export-oriented service businesses such as education and tourism;
- import competing industries;
- industries focussed on servicing household demand including retail, hospitality, recreation and personal services;
- industries focussed on dwelling construction.

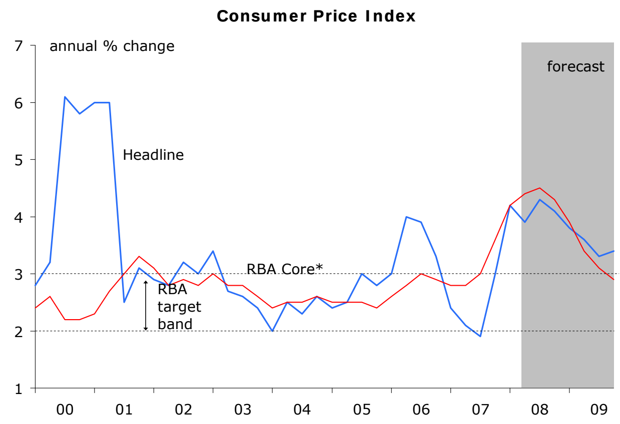
The unequal burden of adjustment will cause consternation among significant segments of the business community. Inevitably, there will be winners and losers. Their outlooks are discussed in more detail in our feature article below (p. 21).

Where does that leave the Reserve Bank?

The Reserve Bank expected inflation to be higher in the March quarter, but even so would have been concerned at the sharpness of the acceleration in price pressures. In the short term it is unlikely to increase interest rates further as it waits to assess the impacts of the aggressive interest rate increases since July last year, and the further moderating effects of market-induced increases in the cost of credit and tighter credit approval criteria. Inflation responds with a lag to a slowing in economic activity and there has been insufficient time to get a good handle on the fallout from the recent tightening in credit conditions.

But the Reserve Bank can't afford to wait too long. It would want to see clear evidence of a continued and significant slowing in economic momentum to give it confidence that demand-induced price pressures will gradually ease. But even with the current signs of slowing growth, we expect headline inflation to remain above 4% in 2008, easing back to 3.5% only by the end of 2009 — still well above the Bank's target range of 2 to 3%.

Inflation to stay above the target range



* Average of trimmed mean and weighted median measures

Source: Australian Bureau of Statistics and ANZ Economics and Research

In that case, policy would remain on hold for a considerable time, well into 2009. But any sign that momentum was being maintained, or indeed re accelerating, would elicit a sharp response in the form of a further tightening of policy. The danger period for the Reserve Bank will be the second half of the year, when households receive another $10bn in personal income tax cuts from 1 July, and when the higher income flows from further massive gains in commodity prices begin to flow into Australia. The short term risks to interest rates are clearly skewed to the upside.

New Zealand Outlook

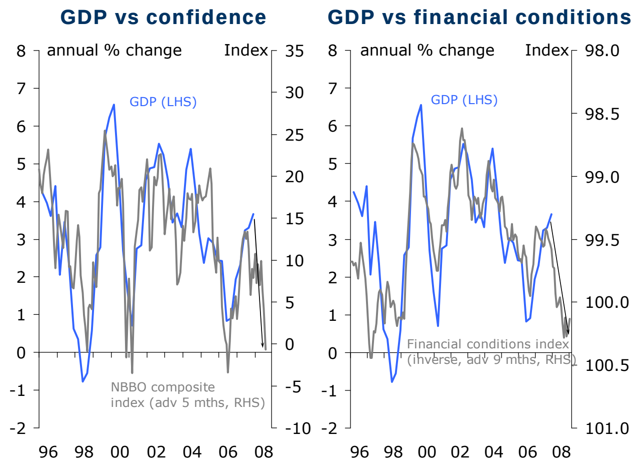
Khoon Goh

The NZ economy likely stalled in early 2008

Economic activity ended 2007 on a strong note, with year-on-year growth of 3.7% in the December quarter. However, indicators since point to a sharp turn in activity, with momentum over the first half of this year looking to have stalled – at best. Both business and consumer confidence have slumped, and financial conditions remain very tight. The falloff in business confidence, in particular, suggests GDP contracted in either the March or June quarter.

The partial data to date show domestic demand weakening. The turn in the housing market is intensifying with house sales down over 50% from levels seen a year ago, and house prices falling. The housing market correction is starting to spillover into consumer spending. In addition, price increases for core staples such as food and petrol are eroding households' discretionary income. This has seen retail spending on non-food and fuel items flat to down for almost a year now.

Business confidence and conditions heading south



Sources: ANZ National, Statistics NZ, Reuters

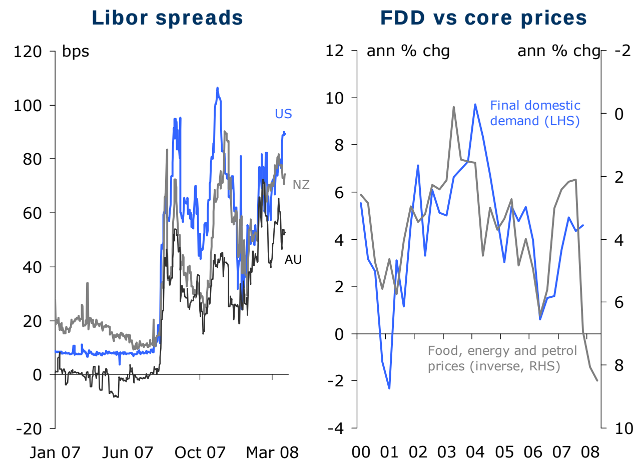
There are still some areas of support for the economy. The labour market remains strong with the unemployment rate at a record low of 3.4%. Commodity prices remain high, with the dairy payout for the current season revised from NZ$6.90 per kg of milksolids to NZ$7.30. In addition, fiscal policy is set to become more stimulatory with this year's Budget set to contain a three year programme of tax cuts.

Growth headwinds dominate the outlook

However, headwinds continue to intensify, and are set to dominate the growth outlook this year. Drought conditions over much of the country (although improving recently) will weigh on agriculture production and rural spending over the first half of this year. Net migration inflows have softened from an annual rate of over 14,000 (0.3% of the population) early last year to 4,700 currently (0.1% of the population), with the risks pointed to the downside. The currency and interest rates remain at restrictive levels. Ever higher food and petrol prices, together with higher mortgage interest costs, look set to further squeeze household budgets and see domestic demand remain under considerable pressure.

A growth adjustment was inevitable given the imbalances built up in the economy after years of strong growth, and the fact that the RBNZ had been trying to engineer one for some time. But the adjustment is occurring at a time when the global credit cycle has turned and global growth looks to have peaked. The re-pricing of risk and altered credit environment could yet have a more material impact on economic activity, as rising spreads see households and businesses face higher interest costs. Lending standards are also being tightened and the liquidity pressures facing the finance company sector mean lending is being curtailed to certain pockets of the economy. While this is not necessarily a negative development, and indeed it can be viewed as a prudent one in the current environment, it nonetheless reinforces the impact that the turn in the credit cycle is having.

Credit costs and inflation rising, demand falling



Sources: ANZ National, Statistics NZ, Bloomberg

The long awaited household de-leveraging is at hand…

In many regards, the credit channel of monetary, after having lent considerable support to the economy over recent years by providing ample liquidity at low prices (interest rates), is now firmly working in reverse. Given the extent of leverage built up in the economy (current account deficit of 7.9% of GDP and net international liability of 87% of GDP), the altered credit environment looks set to have the greatest impact in the household sector, given the high levels of indebtedness (debt equivalent to 164% of disposable income) and interest servicing costs (equivalent to 14.5% of disposable income).

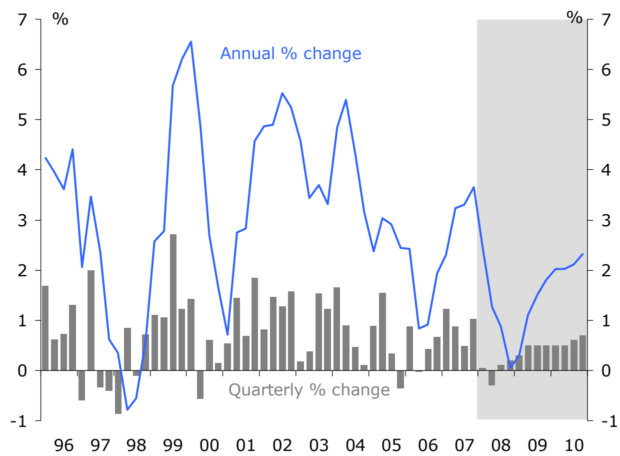
Therefore, unlike previous economic cycles, which tended to be driven by the corporate sector, it is the household sector that is set to lead the slowdown. They are set to go through a period of de-leveraging in response to the many headwinds they face (higher cost of living including interest costs, falling asset prices, more restrictive access to credit and growing uncertainty about the future).

… leading to a prolonged period of subdued growth

Unlike the corporate sector, the de-leveraging process for households tends to be a long drawn out affair. Corporate de-leveraging involves a deeper slowdown as businesses adjust quickly by cutting investment, inventories, employment and costs, as well as sell off non-core assets in order to improve cashflow and restore balance sheets. However, the subsequent rebound tends to be quick. The 199798 recession was a typical corporate led slowdown, and even though the unemployment rate rose, private consumption growth still troughed at a respectable 1.8%.

Household de-leveraging on the other hand, leads to a more prolonged period of subdued growth as they have only one level to pull – spending. And there is a limit to which households can realistically cut spending, which means restoring household balance sheet health will take time. Since household spending and residential investment accounts for two-thirds of GDP, the drag on overall economic activity will lead to a prolonged period of subdued growth over the next two to three years.

Economic growth to hit a low point in 2008



Sources: ANZ National, Statistics NZ

We are forecasting growth of 1.1% for calendar year 2008 and 1.2% for 2009, recovering modestly to 2.1% in 2010. While the slowdown is mainly driven by households, corporates will not be immune. Although corporate balance sheets on the whole remain sound, profitability is already under pressure, and the weaker growth environment will lead to less investment and hiring by businesses. This will see the labour market ease and the unemployment rate rise towards 5% by the end of 2010. Government-related spending will provide ongoing support, but will be insufficient to offset the broader weakness. Exports can expect to be supported by an eventual turn in the currency. However, this will be offset somewhat by weaker global growth prospects. Inflation will remain above the RBNZ's 1-3% target band for all of this year, moving to within the band by mid-2009. A slowing economy will see non-tradable inflation ease from current elevated levels, and limit the extent of exchange rate pass-through from a lower currency.

Risks remain to the downside

Given the current credit environment and New Zealand's vulnerable external position, risks to growth remain to the downside. Current account deficits did not matter when growth was strong and credit was cheap and abundant. However, the shift in global sentiment means the risk of a disorderly adjustment has risen. By disorderly we mean credit dislocation extends and global forces break the link between the NZ$ and interest rates, as risk is reassessed and peripheral investments are scorned. A lower currency in turn leads to a rise in inflation at a time when the RBNZ has no inflation headroom, possibly forcing interest rates higher.

Key financial market views

While the RBNZ is in "wait and see" mode and views the OCR remaining at current levels of a time yet, the tone in their April *Review* was softer compared to March. This is an indication that the Bank is giving itself flexibility to respond should the outlook deteriorate markedly, which seems a non-trivial risk at present.

The RBNZ acknowledges significant downside growth risks, but near-term inflation risks from higher food and energy prices remain a concern. However, higher food and energy prices also act as an indirect deflationary force by reducing household disposable incomes and curbing domestic demand. In many ways, the effect of higher food and petrol prices is similar to higher interest rates. The only difference being that interest charges are not included in the CPI calculation. So while the near-term inflation impact is strong, the deflationary effects from dampened domestic demand will start to filter through. But this hinges on those price effects not being fully compensated for by wage increases.

We expect the RBNZ easing cycle to begin in September this year. Prospects for lower interest rates remain contingent on labour market developments, which we expect to turn rapidly given the weaker growth outlook. The easing cycle will be aggressive once it starts, and we forecast the OCR to be at 6% by September 2009.

The NZ$ continues to hold up at present on the back of yield support, US$ weakness and A$ strength. But with further signs of economic weakness, and the RBNZ likely to shift to an easing bias and cut rates later this year, the NZ$ is expected to move lower over the second half of this year as yield support gives way. An underperforming economy relative to the US and Australia over the second half of this year will see the NZ$ head below 70 cents against the US$ by the end of this year, and below 80 cents against the A$.

Financial Market Update

Sally Auld, Mark Pervan and Katie Dean

Paying the price…

The first part of 2008 has been a period of extreme distress, volatility and divergence in financial markets. In Australia, a (hitherto) robust local economy and financial system has not been enough to keep investors calm amidst what the IMF has described as "the largest financial shock since the Great Depression". As in overseas markets, equities have tumbled and the cost of funds in capital markets has soared. And yet, as global growth prospects have been marked down, Australian commodity export prices have hit new record highs, the RBA has aggressively lifted interest rates and the A$ has found momentum.

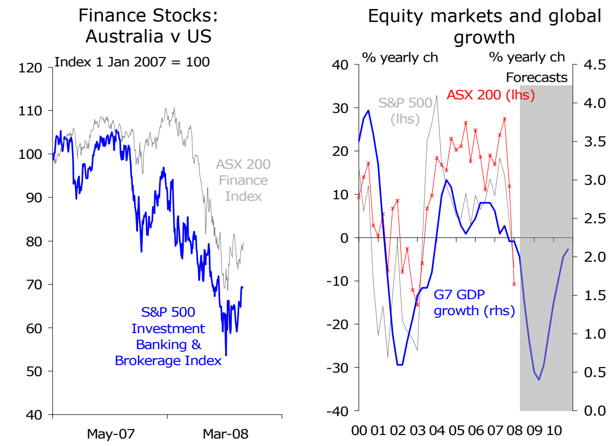
The Australian sharemarket has been one of the hardest hit by the global credit shock. By the end of April, the ASX 200 was a shocking 18% below its 2007 peak, outperforming the Nikkei (-24%) but significantly underperforming the US S&P 500 (-11%) and even the German DAX (-15%) and UK FTSE (-10%).

There are both cyclical and structural causes for the Australian sharemarket's poor performance. Cyclically, the drop in equity prices can be explained by a mark down in Australia's economic prospects. GDP growth is expected to slow from an above-trend 4% in 2007 to a below-trend 2.5% in 2008. No wonder then that investors consider local stocks less attractive.

However, there is also a structural component to the equity market correction. Australia has been hit hard because it is still seen as a relatively undiversified, high-risk economy. Reflecting this, investors have punished local banks harder than their foreign counterparts. US banks, which have collectively written down around US$150bn in losses (with more to come) are still trading at a price-to-earnings (p/e) ratio of 14-15. In contrast, Australian banks, which are still reporting *profits*, have been sold so heavily they are now trading at a price-to-earnings ratio of around 10-11. The Australian finance sector has been by far the worst performing industry sector on the local equity market (see chart below). This matters because the ASX 200 itself is undiversified in that it is significantly overweight financials. The finance industry has the biggest weighting in the ASX 200, accounting for 37% of market capitalisation. In contrast, banks and investment banks combined make up around 9% of the US S&P 500.

In recent weeks investor confidence has been gradually resuscitated, capital markets have re-opened and equities have staged a modest recovery. Will this allow for a more 'balanced' assessment of Australian stocks, in particular in the finance sector? In short, the answer is no. With global investors tetchy, and with local growth slowing, the Australian equity market will continue to rely on global investors' risk appetite for direction. Until investors are convinced the US economic downturn is nearing a trough - the second half of this year on our forecasts - risk appetite will remain muted and local stocks will struggle.

Australian shares have been punished



Sources: Bloomberg and ANZ

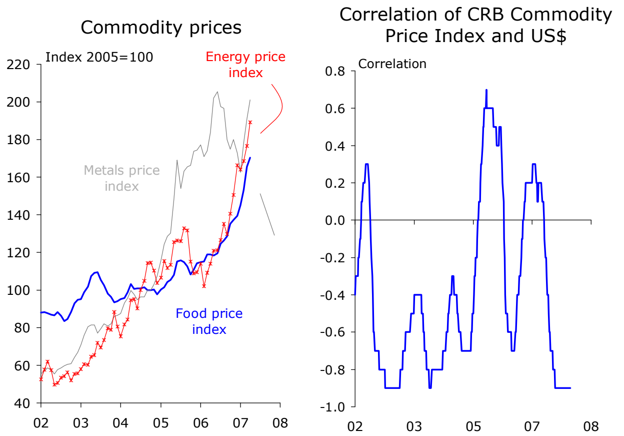
Commodities become *the* new asset class

The experience of 2008 shows that forecasters can no longer use 'fundamentals' such as supply and demand, to forecast commodity prices. Yes, global supply constraints have lifted the price floor in these markets. But in most markets, bar the bulks, this should have been offset by the sharp deterioration in the global demand cycle. Instead, the allure of ongoing strong growth in developing economies continues to attract investment dollars looking for a higher-returning home from more traditional, and recently poor performing, debt and equity markets. The rise of commodities as an alternative asset class has infected almost all traded goods, pushing the price of both resource and agricultural commodities to record highs this year. We can't see this investment trend changing too much in the foreseeable future.

The other dominant, and less fundamental, driver for commodity prices has been movements in currency markets. More precisely, investors have been buying commodities (with their ears pinned back) as a hedge against the falling US$. Since the start of the year, the inverse correlation has been very strong, tracking close to -1.0 (see chart below). Oil and gold have had the strongest relationship at around -0.95, reflecting the preferred commodities favoured by swinging investment funds from debt and equity markets.

However, we think the currency hedge play may be close to running its course. The US$ is showing early signs of bottoming - and momentum-driven investors won't need much convincing to take handsome short term profits off the table. In the absence of more compelling supply or demand fundamentals, commodity prices will skew to the downside.

Commodities are not just rising on 'fundamentals'

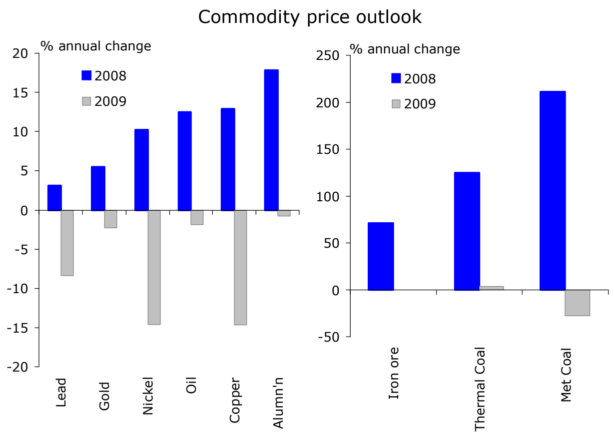


Sources: Bloomberg, IMF, ANZ

Encouragingly, fundamentals for most commodities still remain very robust, which should keep a high floor on prices. Western demand conditions are weakening, but strong demand in China and India remains relatively unaffected. The supply dynamics are arguably even more compelling. Oil prices will continue to be influenced by the spectre of limited new capacity and now look unlikely to drop below US$100/bbl until 2010. Base metal markets, still adjusting to higher demand conditions, could again be impacted by rising industrial action. Copper prices have further short-term upside, while aluminium and nickel look the pick of the bunch for the coming year.

The bulk markets of iron ore and coal probably exhibit the best upside. China will continue to consume huge amounts of imported iron ore, while coal markets remain on their knees from massive supply disruptions in Australia and China earlier in the year. The massive scale of the operations will also continue to cause rail and port infrastructure bottleneck constraints, limiting the supply response to still booming Asian steel and energy markets.

Bulk commodities will continue to outperform

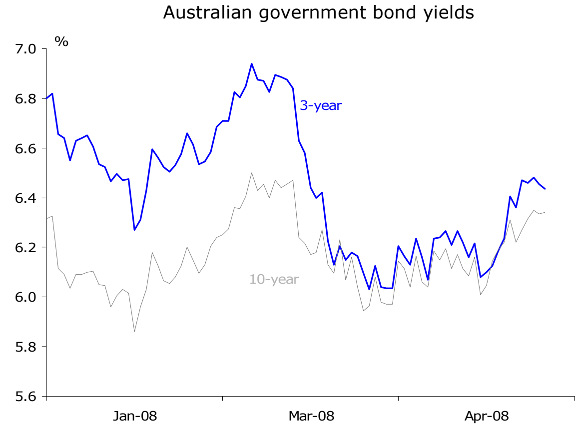


Sources: ANZ

Divergent forces for local interest rates

The developments outlined above have left interest rate markets in Australia at the mercy of a couple of very different forces. In one corner, the commodity export boom, very strong inflation data and ongoing tightness in the labour market continue to highlight that the risks to domestic interest rates remain to the upside over the next 3 to 6 months. But in the other corner, a perception that the RBA might be finished with interest rate rises and the prospect of significantly slower global growth has encouraged some investors to position for the prospect for lower rates. Accordingly, term yields have currently settled in the middle of recent trading ranges.

Australian term rates have become range-bound



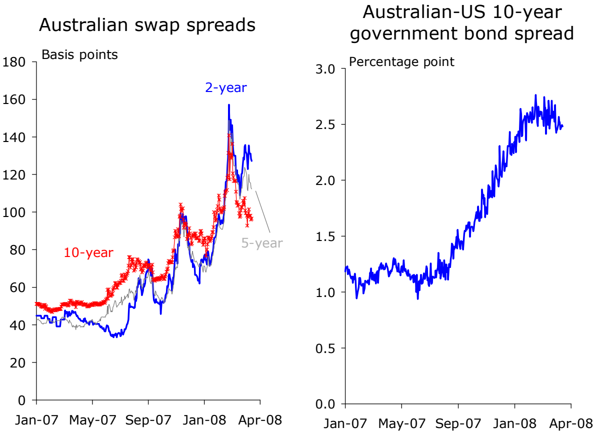
Sources: Bloomberg

While we are not forecasting another rate rise from the RBA, our view remains that the risk to domestic interest rates is still very much skewed to the upside. Elevated inflation and inflation expectations mean that the RBA will continue to run domestic monetary policy with a tightening bias. In this context, we think term yields could return to the top of recent trading ranges in coming months (6.9% for 3-year government bonds and 6.5% for 10-year government bonds). In a strategic context, we think any push towards these levels could well represent the peak in term yields for the cycle. Further evidence in coming quarters that the domestic economy is slowing should provide growing confirmation of this view.

Credit spreads remain wide, although swap spreads have narrowed from the peak seen in early March. Our central view is that spreads are unlikely to move back towards their peaks in the near term, but will continue to remain wide (at least by historical standards). Real money investors in Australia continue to remain cautious buyers of non-government debt; as such, non-financial debt issuance has continued to be very minimal over the last quarter. In a strategic context, we think that swap spreads will narrow once the interest rate cycle turns – but we think this dynamic is sometime away (probably 2009). When it occurs, we believe that spread narrowing is likely to be greatest in the 2-year and 3-year part of the curve.

Australian interest rate differentials to offshore markets remain wide. The fact that a number of central banks have been easing monetary policy (for example, the Fed, BoC, BoE) at a time when the RBA has been raising rates has exacerbated this dynamic. The AUS-US 10-year interest rate differential remains around 250bps, its widest point since early 1996. However, as the chart below illustrates, the spread seems to be showing some signs of stabilisation. A growing perception that the US interest rate cycle may be close to a trough appears to have provided support to AUS-US interest rate differentials in the near term; however, we do not expect meaningful contraction in Australian interest rate differentials to offshore markets until the domestic market is more certain that the RBA cash rate has reached a peak for the cycle.

Australian swap spreads have narrowed while spreads have stabilised



Sources: Bloomberg

A tug of war for the A$

The tug-of-war dominating local rates markets is even more apparent in currency markets. Pulling in one direction, export commodity prices and record wide interest rate differentials are creating significant corporate demand for the A$. But pulling in the other direction, heightened risk aversion has diminished the role of speculators in A$ trading. After all, who wants to own the currency of a country enjoying a once in a generation commodity boom but still runs the fourth highest current account deficit in the developed world?

Faced with these mixed forces, it is no surprise to see that on a trade weighted basis, the A$ has been largely range-bound over 2008. This does of course mask some different performances on key crosses. While the A$ has been able to climb grittily higher against a record low US$ and a beleaguered pound, our currency has underperformed against most other major crosses, namely the ¥ and the €.

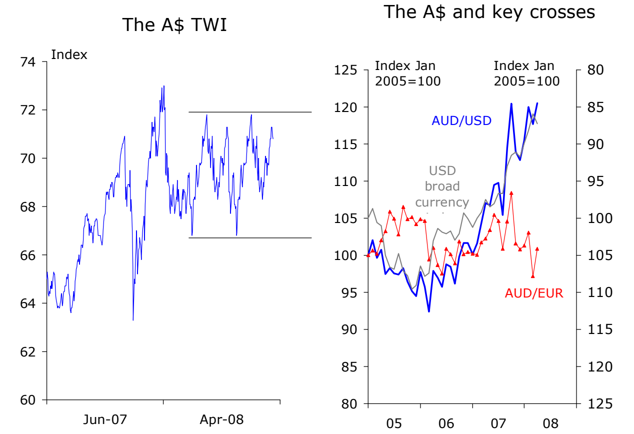
Will the A$/US$ break parity? In our view, the answer to this key question is yes, but not this cycle. If the A$ had enough of its own momentum, it would have already broken parity against the record low US$. Instead, the € has remained the key beneficiary of US$ weakness. To be sure, there is around US$50 billion in income (4% of nominal GDP) due to Australian exporters in 2008-09. This creates significant corporate demand for the A$, and thus significant upside risks to the A$/US$ in the short-term.

However it does not, by itself, guarantee a sustained climb higher in the A$/US$ cross. The A$/US$ cross is the fourth-most traded currency pair in the world, so the role of investors remains crucial. With the RBA not expected to raise rates again this cycle and the Fed nearing the bottom of its easing cycle, the yield advantage offered to investors by the A$ versus the US$ is near a peak. Moreover, as outlined above, we do not anticipate another big upswing in broad commodity prices to give investors in the A$ another leg up.

Also key to our view is that the US$ is nearing its trough. With the Fed approaching the end of its easing cycle, and the BoE and (eventually) the ECB on track for rate cuts, the US$ yield differential against key currencies is not only stabilising, but set to move in the US$'s favour. The technicals also suggest the US$ is near a trough as, despite bearish US$ sentiment, the broad US$ index has consistently failed to break below the key 70 level.

The very nature of currency markets of course mean that we can't rule out a sharp spike higher in the A$/US$ in the short-term. But, in terms of *sustained* levels, we are increasingly convinced that recent highs around US$0.95 will be the peak for the A$/US$ cross.

A$ strength will be expressed on the crosses



Sources: Bloomberg, RBA, ANZ

While the A$/US$ looks to be near a peak, the stage has now been set for the A$ to (finally) outperform on key crosses. Strong corporate demand from the commodity price export boom sets the A$ apart from most of its Northern Hemisphere competitors. Moreover, the outlook for yield differentials outlined above suggest that any rebound in the US$ will be most strongly expressed against the € and, to a lesser extent, the ¥. Having underperformed significantly in recent years, the A$/€ looks the most vulnerable to a big move. Hence, we are targeting the A$/US$ to ease to US$0.90 by year-end and the A$/€ to recover to 0.61 by end-2008. With economic conditions slowing sharply across the Tasman, we also anticipate a sharp upward move in the A$/NZ$ in the coming months. This cross has already moved swiftly from 1.137 to 1.200 recently and is expected to rise above 1.25 by year-end.

Feature article: industry challenges multiply in 2008

Mark Rodrigues, Julie Toth

When powerful forces collide

Australia's economic landscape over the next 12 to 18 months will be shaped by the interaction of two powerful and opposing forces. On the one hand, rising interest rates – from both official and market sources – and tighter access to credit threatens to expose the nation's reliance on foreign borrowing to fund domestic consumption and investment. On the other hand, the combination of still-strong demand from developing economies and tight supply looks set to deliver yet another leg up in the current commodity price cycle. If expectations for contract prices for bulk commodities are realised, Australia's terms of trade will rise by a further 20% in 2008, delivering some $55bn (4.5% of GDP) in additional income.

On balance, we expect economic growth will slow to 2.5% by the end of 2008, from the current above-trend pace of around 4% per annum. But clearly, given the forces at play in the economy at present, this slowing in the pace of economic activity will not be felt uniformly across industries. In the following pages, we consider the outlook for Australian industries, under the banner of five key themes within the emerging economic story:

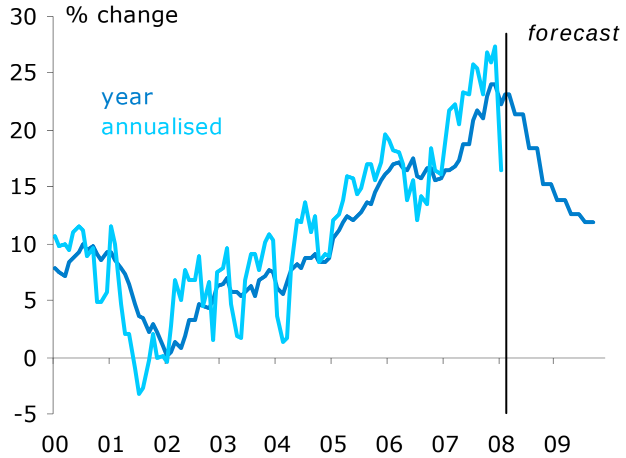
- higher interest rates and the 'credit crunch';
- household finances stretched;
- high A$ and tougher export conditions;
- ongoing labour and skill shortages; and
- a dynamic policy environment.

Higher interest rates and the 'credit crunch'

Australia does not have a sub-prime sector to speak of and its corporate sector, by and large, has not been exposed to losses on securities collateralised by US sub-prime loans, Australia. Because of its reliance on foreign capital however, it is highly exposed to the tightening in global credit markets that has ensued. As a result, Australian businesses have experienced a significant increase in the cost of credit and, for non-bank borrowers, significantly reduced access to wholesale funding markets. These borrowers have been able to obtain finance from the banking system, which has continued to be able to obtain wholesale funding, albeit at a higher cost. This increase in demand for intermediated finance has seen growth in business credit surge, peaking at a two-decade high of 24% in January 2008.

But there are now signs that higher interest rates and tightening lending standards are beginning to bite. Business credit grew at an annualised rate of 11% in the first three months of 2008, well down on the 20% plus rates seen throughout 2007. Overall, we expect business credit growth to continue to moderate, to 14.8% p.a. by the end of this year and 9.9% by December 2009.

Stellar growth in business credit is finally slowing

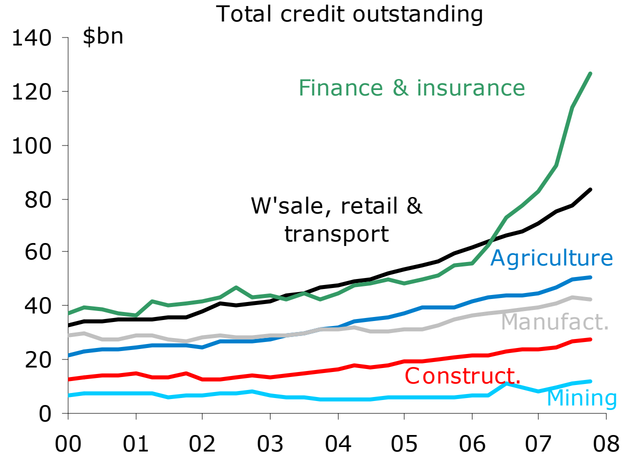


Sources: RBA and ANZ Economics and Markets Research

As credit costs rise and financial conditions tighten, some business and industries will feel the pinch more than others. Obviously, business with large debts and high levels of gearing will be most affected by rising credit costs. Such businesses exist across all industries, but some sectors stand out.

For the industries for which credit data are available, the largest stock of credit outstanding and the strongest growth over the course of 2007 was in the finance and insurance industry. Total bank credit outstanding grew by 63.4% in the year to the December quarter 2007, to some $126.6bn. Strong credit growth in this industry may reflect increased recourse to bank funding from some non-authorised deposit-taking institutions, but has also been driven by the strong performance of the sector, which grew by 11.2% over the year. ABS data also points to strong credit growth in property and business services, with almost all of the credit growth in both the finance and property industries in fixed, as opposed to revolving facilities. Of the goods-producing industries, the mining and wholesale, retail and transport industries recorded strong growth in credit balances outstanding over 2007.

Debt levels have surged in the finance industry



Source: Reserve Bank of Australia

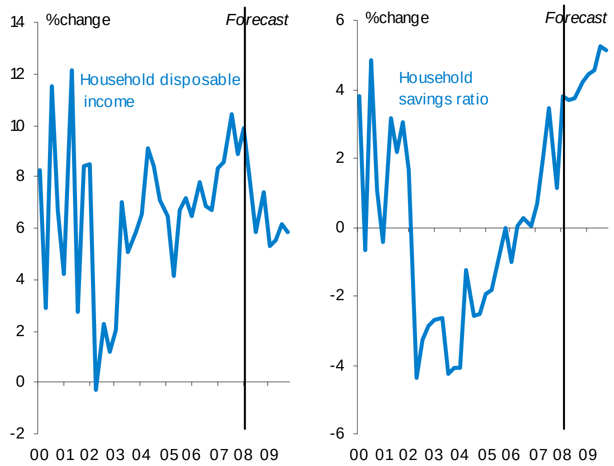
Notwithstanding the escalation in leverage, however, corporate Australia remains well placed to deal with the rising interest burden. For example, the ratio of earnings to interest — a measure of the serviceability of debt — remains around historic highs at 11.9 in the December quarter 2007. The interest cover ratio varies across industries, but in all cases, the ratio has increased in recent years.

Looking forward, businesses that require new credit to assist their running costs (as opposed to funding for investments that can be scaled back or postponed) will be most vulnerable to higher credit costs. With the end of the drought across parts of Australia, many agricultural businesses are likely to be in this situation. Financially, drought recovery is a dangerous phase for farm businesses because input costs must be met before any incomes are received, and at a time when cash reserves are at their lowest. As a result, borrowings tend to rise through this phase. The beginnings of this process are already evident, with new fixed loans to agriculture businesses growing 84% over the year to February 2008 and new revolving loans up 44%.

Household finances stretched

Australian households have done very well as a result of strong growth in employment and wages, and of course, successive rounds of income tax cuts. Household disposable income grew by 9% in 2007 and is expected to grow a further 7% in 2008 and 6% in 2009. But increasingly, the benefits of these favourable fundamentals are being eroded by a number of headwinds: rising interest rates; significant price inflation for household essentials including rent, food, petrol, utilities and health insurance; turmoil in equity markets, and; negative economic news from offshore, to name a few. As these factors undermine disposable incomes and general consumer confidence, households are beginning to adopt a more cautious approach to their finances, and to increase their savings.[3]

Households are becoming more cautious as the economic environment deteriorates



Sources: ABS and Economics@ANZ

[3] See *Australian Outlook* section above and *ANZ Consumer Trends: household incomes and spending*, Nov 2007.

While increased savings may be prudent for households in the current environment, it means less will be spent on discretionary goods and services. Australians have a track record of spending most of their tax cuts, but with a higher savings ratio, more of 2008's cuts will be saved than was the case in 2007.

As a result, we expect real retail turnover to grow by 2.6% in 2008 — almost half the 4.8% growth of 2007 — and by just 2.1% in 2009. Anecdotally, the slowdown has already begun, at least in some parts of the country and for some segments of retail.[4] Outside retail, other businesses that depend mainly on households and individuals for their customer base are also feeling the effects of reduced consumer discretionary spending. These include hospitality (clubs, pubs, cafes and restaurants), culture, recreation, entertainment, domestic tourism and personal and household services. 'Gloomy economic conditions' were blamed, for example, for weak ticket sales at the Melbourne Comedy Festival in March, while Queensland holiday bookings were reported to be half their usual level over Easter, due to 'an uncertain economy' (as well as changed local school holiday dates and unpredictable weather).[5]

The other major industry to suffer from the stress of households as interest rates rise is, of course, residential construction. As rates have risen, new home starts have failed to keep pace with demand, pushing vacancy rates lower and established house prices higher in sought-after locations. Nationally, we expect dwelling investment to grow just 0.4% in 2008. Residential construction is unlikely to gather pace again until after interest rates begin to fall, sometime in the next 12 months.[6] In the meantime, alterations and additions will remain an attractive alternative to trading up and out of the family home.

High A$ and tougher export conditions

Concomitant with the boom in commodity prices and rising domestic interest rates has been a marked appreciation in the A$ exchange rate. Over the past year, the A$ has risen by 13% against the US$, and is up 25% in the past two years. The current trading range of between US$0.92 and US$0.95 is around the highest since the early 1980s. The effect of such a major shift in the value of the currency has been profound, though not uniform, across industries.

Industries whose revenue streams are denominated in foreign currency, exporters, and those subject to significant import competition have seen profit margins eroded substantially as the A$ has appreciated. The mining and agricultural industries, for example, whose revenue streams are primarily denominated in US$ have seen their A$ returns ease

[4] See *ANZ Industry Report: Retail Trade*, Mar 2008.

[5] Daniel Ziffer, "Laughs dry up as gloom hits festival", *The Age*, 2 April 2008; Anooska Tucker-Evans and Paul Weston, "Tourism industry cops triple blow as bookings fall", *Courier Mail*, 23 March 2008.

[6] See *ANZ Housing Snapshot*, April 2008.

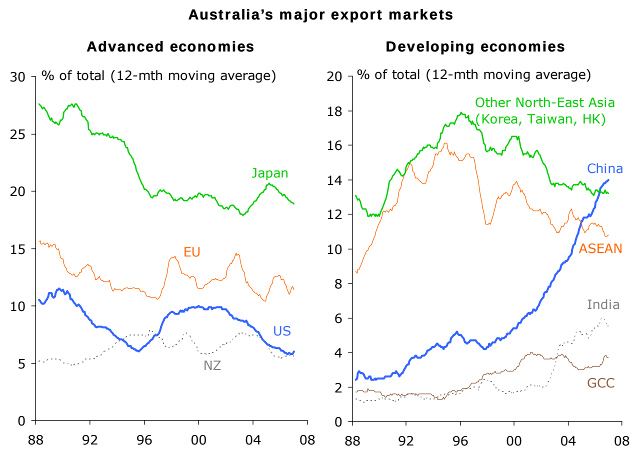
as the US$ has depreciated. Of course, for the mining industry, and more recently, agricultural producers, this has been more than offset by substantially higher US$ prices. Exporters of manufactured goods have been hit harder, with the high A$ reducing price competitiveness in foreign markets and against imports at home. The domestic tourism and education sectors have suffered in a similar manner, with the high A$ making it more expensive for foreigners to holiday and study in Australia. Tourism has been hit doubly hard, as the appreciation of the currency has also made it more attractive for Australian residents to holiday overseas instead of locally.

The higher A$ it isn't all bad, however. Importers, and industries whose costs are primarily denominated in foreign currency have benefited from the A$'s appreciation. Industries that require large capital equipment from overseas — for example, trucks in the mining industry or aircraft in the aviation industry — have benefited from the depreciation of the A$ to the extent that their exposures are unhedged. And, though it is not readily acknowledged, most industries have benefited from lower petrol prices than would otherwise be the case had the dollar not appreciated over the past few years.

For those struggling under the weight of the high A$, there is some light at the end of the tunnel, although we expect it will be some way off. The factors that have underpinned the A$ in recent years — rising commodity prices and widening interest rate differentials with the rest of the world — should unwind in 2009, and we expect the A$ to ease gradually back to US$0.84 by the end of 2009.

In the mean time however, exporters will also have to contend with more challenging global demand conditions than we have seen in recent years. Industries reliant on demand in the US — which is expected to slip into recession this year — and other advanced economies will be most affected.

The center of gravity for Australian exporters has shifted to Asia



Source: ABS

In aggregate, however, Australia's export markets have gradually re-oriented away from traditional advanced markets such as the US, Japan and Europe, towards developing markets in Asia, and in particular, China. To the extent that these emerging markets can continue to grow solidly through the downturn in the industrialised world, this shift in the locus of Australian export markets should help moderate the fallout for Australian companies.

Ongoing labour and skill shortages

With unemployment hovering around 4% nationally, reports of skill and increasingly, general labour, shortages are rife. Over the past 12 months, the ACCI Business Expectations Survey and other business surveys have consistently identified labour shortages as a main constraint on business growth, across a wide range of industries.

The extent of 'shortage' in each industry can be difficult to quantify, but one measure is the number of advertised vacancies relative to the size of the workforce. This shows shortages have intensified most in industries that generally have a high proportion of skilled and professional workers, including mining, communications, finance and insurance, property and business services. Perhaps surprisingly, vacancies relative to the size of the workforce are lower and flatter in education, health and manufacturing. In industries characterised by larger numbers of lower-skilled jobs, vacancies as a proportion of the workforce have not risen to the same extent. This pattern can be seen in retail trade, wholesale trade, hospitality and personal services. This is not to say there are no pockets of shortage in these industries (by specialisation or location), but at a national level, there are relatively fewer vacancies than in the higher-skill sectors.

Vacancies on the rise in key high-skill industries

Vacancies per 100 industry employees	Feb 2006	Feb 2007	Feb 2008
Mining	3.0	3.2	3.6
Manufacturing	1.4	1.6	1.4
Construction	0.8	0.8	1.0
Communications	0.2	0.9	2.1
Finance & insurance	1.8	2.0	2.4
Property & business services	2.8	3.0	3.6
Education	0.5	0.6	0.7
Health	1.4	1.4	1.4
All Industries	**1.5**	**1.5**	**1.7**

Sources: ABS and ANZ Economics and Markets Research

Another indicator of differences in labour demand across industries is, of course, employment itself. While jobs have been growing at a clipping pace for the economy as a whole (up 2.8% in 2007 and an expected 2.4% in 2008), this growth has not been evenly spread. Growth industries have included the giant retail, education, health, and property and business sectors, as well as transport, utilities (mainly electricity), construction (mainly non-residential) and even manufacturing.

Indeed, after declining for most of the past two decades, manufacturing employment grew 5.2% in the year to February 2008, reaching its highest level since February 2003. Recent jobs growth in manufacturing has been concentrated in petroleum and chemicals, mineral products and metal products with smaller rises in other segments. The latest AiG Performance of Manufacturing Index indicated employment growth was strongest in textiles, clothing and footwear (albeit from a small and previously declining base), machinery and equipment (despite high-profile automotive job losses) and construction materials. With an older workforce and a large variety of highly specialised trades, skill shortages have become a perennial problem in manufacturing. Paradoxically, the segments with the lowest growth (such as clothing and textiles) often have greater difficulty filling skilled vacancies, due to problems in attracting new people into formal trades training for what can be perceived to be a declining or outdated industry.

In contrast, some other industries have been shedding labour in recent months. Employment *fell* in February 2008 in agriculture (-6.3%), hospitality (-2.1%), communications (-7.1%), finance and insurance (-3.4%) and cultural and recreational services (-1.3%).

The surprise entry in this group of industries is probably finance and insurance, which appears to have already begun to shed labour in response to the global financial downturn. Finance businesses employed 207,000 people in February 2008, down 7.3% from the all-time peak of 224,000 in February 2007. Insurance employment was also down from its all-time peak of 87,700 in May 2007, falling 8.5% to 80,200 in February 2008. The finance and insurance industry is heavily concentrated in Sydney (42% of the sector's jobs are in NSW) and to a lesser extent, Melbourne. For reasons that are not clear, all of the decline in finance and insurance jobs over this period was in NSW and Queensland. The rise in vacancies at the same time indicates a rise in demand elsewhere or for particular, specialist skills.

Job losses in hospitality, cultural and recreational services were spread more evenly around the country. They reflect flat activity (and a flat outlook) for Australia's domestic tourism sector. Job losses in communications services reflect a technology-based cycle in that industry that sees activity fluctuate as new products and services peak and then mature.

In agriculture, employment has been falling for some time due to drought. It dropped from a recent peak of 450,000 in 2001 to 370,000 in 2002 and has hovered below 360,000 since mid-2004. February 2008 saw a new low of 336,000 people employed in agriculture nationally. With the end of the drought in many areas however, labour demand is likely to rise again. Regional agribusiness employers are likely to find it tough to now attract much-needed workers back from more lucrative mining and construction jobs elsewhere.

A dynamic policy environment

The next few years are likely to see significant change in the policy and regulatory environment, with the Rudd federal government setting out an ambitious reform agenda. In response to persistent inflationary pressures, the Rudd Government has announced its intention to slash public spending in its forthcoming Budget. At the same time however, it has identified education, skills training, health and community services (including the high-cost areas of aged care and childcare) as priority areas, indicating that the axe is likely to fall elsewhere, in the less visible areas of government administration. Already, there are freezes on new recruitment and finance reviews across several government departments.

A swathe of government reviews are underway on a range of industry-related issues also, including:

- the Bracks review of the automotive industry,
- the Garnaut review of climate change policy,
- ACCC reviews of petrol, grocery prices, airport car parking, rules for water markets and more,
- a new body, 'Skills Australia' to review future workforce skills and training needs,
- a review of universities by Prof Denise Bradley,
- a review of the textiles clothing and footwear industry by Professor Roy Green,
- a review of the 'National Innovation System',
- a re-formed pharmaceutical industry working group for policy advice on that industry,
- a review of IT contracting and spending across the federal public service,
- a review of occupational health and safety laws aimed at harmonising them nationally in 3 years,
- three reviews of drought assistance and policy by: the Productivity Commission; the Bureau of Meteorology and CSIRO; and an expert panel,
- the recent "2020 summit" on the economy, environment, polity and society, which produced a series of policy recommendations for government consideration and, if nothing else, reinvigorated the national reform agenda, and
- a comprehensive "root and branch" review of the national taxation system (including company, personal, sales and indirect taxes), which will commence sometime in the next two years.

Without pre-empting the outcomes of these and other policy reviews, the government is unlikely to make significant cuts to its support of key industries or sectors (such as car manufacturing, aged care, childcare or farming) and in some cases, may even increase its support. On the other hand, practical progress on moving toward a national 'seamless' economy seems likely in areas such as education and training, and occupational health and safety.

Australian and New Zealand Economic Forecasts

	Annual (period average) % ch.				Quarter % ch.			
	2007	2008(f)	2009(f)	2010(f)	Mar-08(f)	Jun-08(f)	Sep-08(f)	Dec-08(f)
Australia								
GDP	3.9	2.5	2.4	2.8	0.3	0.5	0.8	0.7
Household consumption	4.5	3.0	2.2	3.4	0.1	0.5	0.7	0.5
Dwelling investment	3.5	0.4	4.5	11.3	0.8	-1.2	-1.2	0.0
Business investment	11.2	4.5	0.7	0.6	1.8	1.1	1.4	0.6
Public demand	3.4	5.6	3.4	3.2	1.1	1.1	1.1	0.9
Domestic final demand	5.2	3.6	2.4	3.4	0.6	0.6	0.8	0.6
Net Exports (cont. to growth)	-1.7	-1.5	0.3	-0.5	-0.5	-0.3	0.1	0.3
Inflation: Headline CPI	2.3	4.1	3.5	3.1	1.3	0.9	1.0	0.7
Core CPI*	3.1	4.4	3.3	2.9	1.2	1.1	1.0	0.9
Wages	4.1	4.3	4.1	3.8	1.1	1.0	1.0	1.1
Employment	2.8	2.4	1.4	1.3	0.8	0.5	0.4	0.4
Unemployment rate (%)	4.4	4.2	4.6	4.6	4.1	4.1	4.2	4.4
Current account balance (A$ bn)	-67.0	-60.9	-50.1	-66.3	-18.7	-15.9	-14.1	-12.2
(% of GDP)	-6.2	-5.2	-4.0	-5.1	-6.6	-5.5	-4.7	-4.0
New Zealand								
GDP	3.1	1.1	1.2	2.1	0.1	-0.3	0.1	0.2
Inflation: Headline CPI	3.2	3.4	2.6	2.3	0.7	1.0	0.9	0.8
Wages	4.2	4.6	4.1	4.1	1.5	0.9	1.0	1.1
Employment	1.8	0.5	0.3	1.2	-0.2	-0.2	0.0	0.0
Unemployment rate (%)	3.4	4.1	4.5	5.0	3.5	3.8	3.9	4.1
Current account balance (NZ$ bn)	-13.8	-11.9	-12.3	-13.0	-3.0	-3.0	-3.0	-3.0
(% of GDP)	-7.9	-6.5	-6.5	-6.7	-6.5	-6.5	-6.5	-6.4

*Average of RBA weighted median and trimmed mean statistical measures.

Financial Market Forecasts

	Annual (period end)				Quarter (period end)			
	2007	2008(e)	2009(f)	2010(f)	Mar-08	Jun-08(f)	Sep-08(f)	Dec-08(f)
Interest rates (% p.a.)								
Australia								
90 day bank bills	7.24	7.50	5.82	5.72	7.86	7.70	7.60	7.50
10 year bond rate	6.33	5.50	5.00	6.40	6.05	6.30	5.95	5.50
United States								
3 month LIBOR	4.70	1.75	3.00	5.00	2.69	2.50	2.00	1.75
10 year bond rate	4.02	3.50	3.75	5.65	3.41	3.90	3.75	3.50
Euro area								
3 month LIBOR	4.68	3.25	3.50	4.25	4.73	4.50	3.60	3.25
New Zealand								
90 day bank bills	8.88	7.73	6.20	6.20	8.88	8.80	8.38	7.73
Exchange rates								
A$/US$	0.88	0.90	0.78	0.72	0.91	0.94	0.92	0.90
NZ$/US$	0.77	0.69	0.62	0.58	0.79	0.78	0.74	0.69
A$/¥	97.77	91.80	88.14	86.40	91.03	93.71	93.84	91.80
A$/€	0.60	0.61	0.61	0.63	0.58	0.60	0.60	0.61
A$/£	0.44	0.47	0.43	0.41	0.46	0.47	0.47	0.47
A$/NZ$	1.14	1.30	1.26	1.24	1.16	1.21	1.24	1.30
US$/¥	111.7	102.0	113.0	120.0	99.7	99.7	102.0	102.00
€/US$	1.46	1.47	1.27	1.15	1.58	1.58	1.54	1.47
A$TWI	68.70	68.79	63.11	60.42	68.90	68.90	70.63	68.79

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