ANZ Economics & Markets Research

ANZ industry update: Aust. industries and the global crisis

How will industries in Australia's 'real' economy weather the global financial storm?

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Inside:

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Key points

The Australian economy is cooling rapidly. Households and businesses now face a very different outlook to the long boom of the very recent past. Indeed, several industries are already showing signs of stress. The natural frontline facing the global financial markets crisis is the financial sector, but all businesses needing to raise finance are feeling the pinch.

For bulk exporters, the main danger is now significantly weaker global demand, even from stalwart customers such as Japan and China. More positively for commodity exporters, a large, sustained fall in the A$ will help offset lower US$ commodity prices. This FX boost will be very welcome at a time of weaker global prices and demand.

For the construction sector, a residential construction recovery is now long overdue. Falling interest rates and supportive government policy will help, but risks remain for investor confidence and financing new developments.

For businesses servicing mainly other businesses, risk aversion and cost–cutting will be felt firstly in peripherals such as corporate hospitality, but will soon flow through to more essential business suppliers and services if actual business activity follows business investment growth downwards.

For retailers and other businesses servicing mainly households, the belt-tightening has already started, with household expenditure contracting in June 2008 and only weak growth expected ahead. Despite the real income benefits of tax cuts, rate cuts, pension bonuses and an easing in inflation pressures, increasing pessimism, uncertainty and the threat of rising unemployment are weighing household spending down, particularly in NSW. For households, the new mood means a shift away from more conspicuous consumption toward reducing debt and rebuilding savings.

The big picture: meltdown then slowdown

As the systemic meltdown in global financial markets lurches from bad to worse, growth in the ‘real’ economy of goods, services, production and trade, has decelerated rapidly. The US and Europe are already in, or soon headed towards, lengthy recession. Asian growth rates are also slowing significantly, albeit from very much higher levels. Even oil, metals and bulk commodity prices have turned back to earth. We expect 2009 to be the low point for global growth, with activity picking up weakly in 2010.[1]

Global economic growth

GDP % p.a.	2007	2008f	2009f	2010f
US	2.0	1.5	0.7	1.7
UK	3.1	0.9	0.2	1.7
Euro zone	2.6	1.1	0.6	1.7
Japan	2.0	0.6	0.7	1.6
China	11.6	9.7	8.0	8.9
Asia ex Japan & China	5.9	5.1	4.8	5.6
World (PPP)	**4.8**	**3.6**	**2.9**	**3.8**

Source: ANZ Economics and Markets Research.

[1] For global details, see *ANZ Global Wrap*, Oct 2008 and *ANZ Economic Outlook*, Dec Qtr 2008.

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Australian outlook: the lean year(s) ahead

Australia is coming from a better starting point than most other developed economies …

… but we will still be hit hard

Australia is better placed to contend with the current global environment than most other developed economies, but economic conditions are, nevertheless deteriorating rapidly. This is a dangerous phase for Australia, with both the global credit and global commodity cycles now tipping south simultaneously.

Unlike other developed countries, Australia is not, at this stage, expected to decline into recession. Instead, Australia is looking at several years' of below-trend growth — just 1.8% in 2009 and 1.9% in 2010, or less than half the 4.2% growth of 2007. This will be manifested in decelerating spending by both households and businesses, with household consumption growth easing to just 1.7% in 2009 and business investment expected to flatline or even contract.

As business investment and activity slows, employment growth will also slow and the unemployment rate will, unfortunately, begin to rise again, to over 5% in 2009. Ahead of this, business and household confidence indicators are already hitting record lows. This change in mood signals real changes in investment, saving and spending decisions that are yet to play out across the economy.

This slowdown is, in many respects, somewhat overdue, given the capacity constraints so evident until recently in the Australian economy — particularly the widespread labour shortages, low residential and commercial vacancies and bulk freight transport backlogs — and the resulting problems with inflation. Indeed, this is why the RBA was still *raising* interest rates in the first quarter of 2008.

On the positive side, Australia is going into this new economic environment with low unemployment, high pent-up demand (with record levels of engineering construction and business investment intentions), good corporate profitability, strong public sector investment, retreating inflation and a relatively solid outlook for our key Asian trade partners. Australia's public policy response has been prompt and generous. The RBA has already cut official interest rates by 125bps and the Government is guaranteeing financial institution deposits and injecting over $10bn into the economy immediately, through increased pensions, first home buyer grants and other spending. National and state government infrastructure spending is also being brought forward. Retreating inflation pressures will allow the RBA plenty of room to make more cuts to official interest rates. Through all of this however, some key national policy issues remain outstanding, most notably those relating to water, climate change, carbon emissions trading, transport infrastructure and aged care.

Australian economic indicators

% change p.a.		2007	2008f	2009f	2010f
Gross Domestic Product (GDP)		**4.2**	**2.3**	**1.8**	**1.9**
	Farm GDP	-11.7	6.1	11.1	7.1
	Non-farm GDP	4.6	2.2	1.6	1.8
Household consumption		4.5	2.5	1.6	2.1
Investment:	Dwelling investment	3.1	-0.1	-0.3	12.7
	Total business investment	13.0	8.0	-0.2	3.2
Public demand		2.9	5.7	2.9	2.1
Trade:	Net Exports (contribution to GDP)	-1.8	-1.3	1.0	-0.9
Labour:	Employment	2.8	2.3	0.2	0.7
	Unemployment rate (%)	4.4	4.3	5.4	6.3
Prices:	Inflation (headline CPI)	2.3	4.5	3.5	2.5
	Wages (wage price index)	4.1	4.3	3.7	3.5
Credit (total outstanding)		15.4	10.8	7.1	7.8
	RBA official rate (end of year)	6.75	5.25	4.50	4.50

Source: ABS, ANZ Economics and Markets Research (forecasts as of 20 October 2008)

Business profitability and liability

Financial corporations have, in aggregate, already suffered damage from the global financial crisis and the slowing economy…

… with more to come.

Australian businesses are in a relatively solid position to confront the global financial crisis and economic slowdown, but some have already taken direct hits. The local frontline is very much the financial services sector, which has already suffered a fall in gross operating surplus (GOS, a national accounts profitability measure) in each of the last three quarters (Dec 2007 to June 2008). In June 2008, quarterly GOS for financial corporations fell by 0.5%, to $8.1bn, the first such quarterly falls since 1998. Even after the latest RBA rate cuts (and with more cuts expected), no growth is expected in financial corporations' GOS until late in 2009, due to lower demand for credit and financial services on the one hand, and higher wholesale credit costs on the other — a classic profit squeeze.

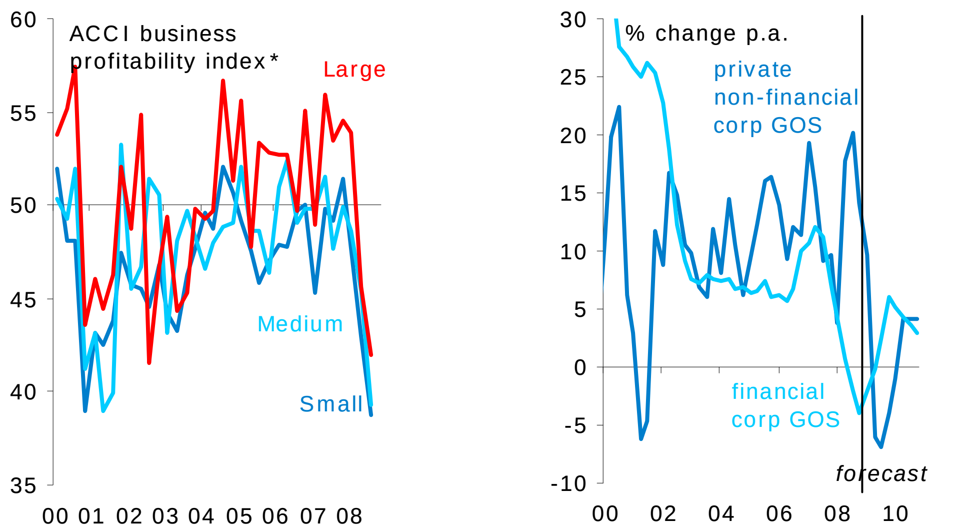
Non-finance sector corporate profits have just been through a huge growth spurt, even outside mining.

Outside of the financial corporations, private sector corporate profit growth was strong until June but is now decelerating rapidly. As could be logically expected in a mining boom, corporate gross operating profits (GOP) grew fastest among mining companies (up 52% p.a. in June 2008). But even among the non-miners, corporate GOP was still up 11.6% p.a. in June 2008, which was the sixth consecutive quarter of double digit growth. Company profits' share of national income is sitting at 28% in 2008, up from 23% a decade ago. Within this, small business is getting smaller, with unincorporated businesses' share of total business profits falling from 16.7% to 12.2% from June 2003 to June 2008.

Non-financial corporate profits will decline a little in 2009, before recovering ground in 2010.

Since June, business surveys have indicated business profitability falling across the board. The ACCI business survey for example, shows that in August far more businesses experienced a fall in profitability than an increase. The sharpest decline was among the smallest businesses, which were already showing slower profit growth than the corporates. In aggregate, non-financial corporate GOS is expected to show strong growth for 2008, largely on the back of good results in the first half of the year (+13.9%), before dropping by at least 2% in 2009 and then recovering ground in 2010 (+4%).

Financial sector profits already shrinking, other sectors deteriorating rapidly



* Index values under 50 means profitability fell for the majority of businesses surveyed.
Source: ABS *National Accounts* (data to June Qtr 2008), ACCI Business Expectations Survey (data to Aug 2008) and ANZ Economics and Markets Research.

Total bank lending to business grew 23% in the year to June 2008.

Outstanding credit from all financial institutions (banks and non-banks) grew 16%.

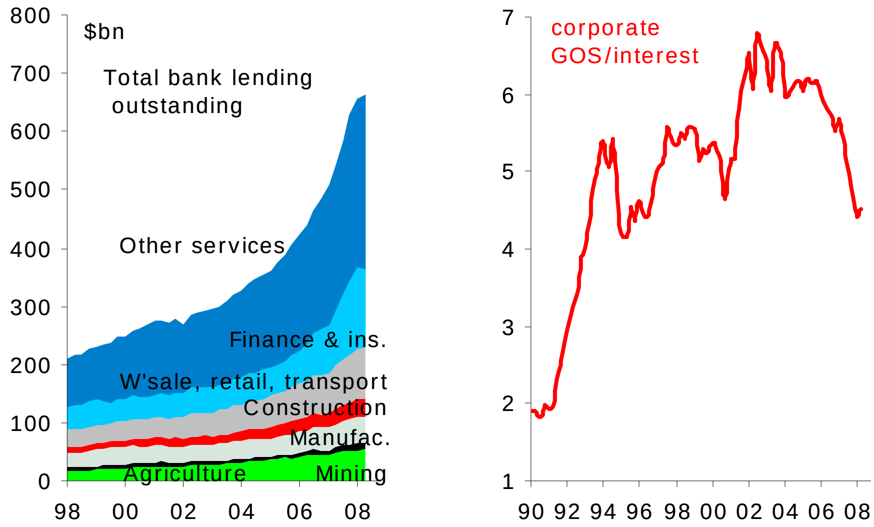
Australian businesses are still adding to their borrowings, but the growth in total business debt is decelerating.

So just how vulnerable are Australian businesses to tighter credit conditions? There are many ways for companies to raise finance, on and off the market. Simple borrowing from banks and other sources remains the most popular. As of June 2008, financial institutions' outstanding credit to Australian businesses totalled $747.7 bn, up 20% from just a year earlier. Some of this increase was due to financial 're-intermediation', whereby businesses finding it difficult to get funding directly from financial markets, investors or other sources go back to their banks for funding. This business is essentially refinancing rather than new financing. Even so, it has added to a dramatic rise in total business borrowings.

Corporate interest 'cover' and the corporate debt gearing ratio are at reasonable levels

Combined with rising interest rates, this increase in debt has caused a decline in 'corporate interest cover' (that is, the ratio of profits earned to interest payable), but even so, the debt level appears eminently manageable. As of June 2008, national aggregate corporate interest cover was running at a comfortable 4.5 (that is, corporate GOS equalled 4.5 times corporate interest payments), their lowest level since 1995-96 but still double the lows of 1990-91. The national corporate gearing ratio (debt to assets) also remains comfortable, at 80% in June 2008 (compared with a decidedly uncomfortable 160% in 1990!). Looking forward, net interest will fall as rates and debts come down again, but so too will business profits and the value of some assets.

High total lending + high interest rates = lower interest 'cover' (profit/interest)



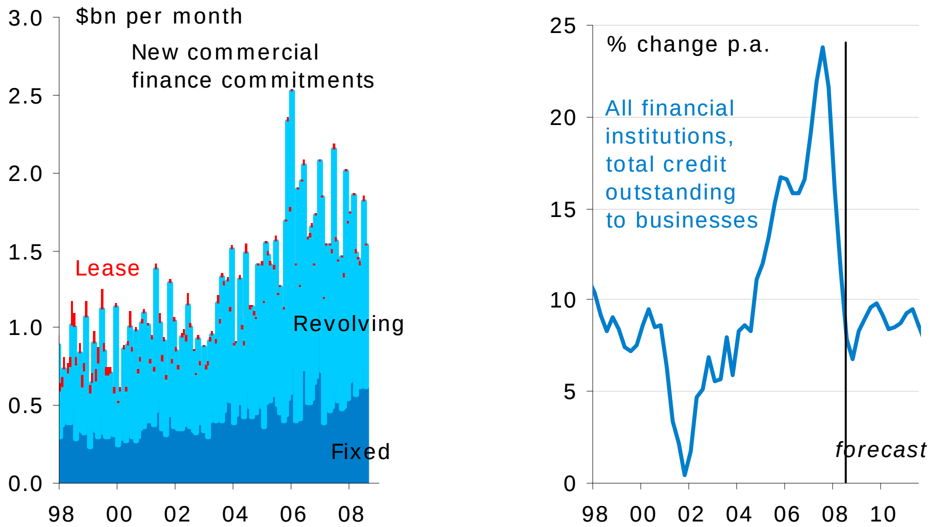
Source: RBA (quarterly data to June Qtr 2008) and ANZ Economics and Markets Research.

Monthly new business finance commitments are shrinking rapidly,

but growth in total business credit remains firmly positive

Since March 2008 new commercial finance commitments have shrunk in every month (in annual growth terms), such that total business credit is decelerating, after several years of double-digit growth. New business finance commitments averaged $36.7 bn per month in H1 2008, compared to $40.6bn a year earlier. This trend is evident across all private-sector industries for which data are available. We expect business credit growth to slow further (but to remain firmly positive) going into 2009, as business investment intentions are wound back.,

Business credit growth rates are falling sharply — back to single digits in 2008



Source: ABS *Lending Finance* (monthly data to July 2008); RBA (quarterly data to June Qtr 2008) and ANZ Economics and Markets Research.

Impacts on Australian industries

The impact on Australian industries will vary, but all will be affected in some way. In addition to the financial market fallout, some industries face long-term challenges that are not related to the global financial crisis. These include:

- agriculture and water utilities (drought and climate change)
- electricity generators and heavy industries (climate change and the planned Carbon Pollution Reduction Scheme, scheduled to commence in 2010)
- manufacturing (high costs and strong international competition)
- construction (pent-up demand, high costs and labour shortages)
- hospitality and tourism (flat inbound tourism and flat local demand)
- health, community services and aged care (rapidly growing demand due to demographic changes and national income growth).

The financiers

Financial corporations have suffered significant losses to date, with more to come.

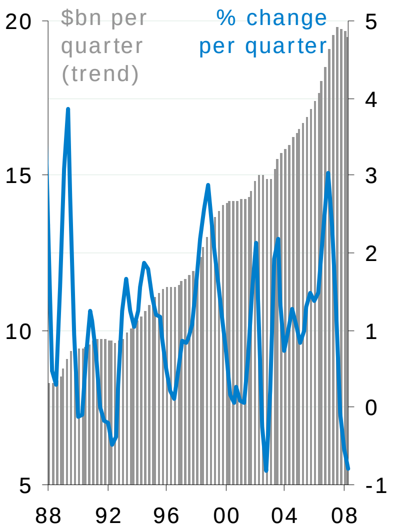
As noted above, the Australian financial sector is the front line against the global financial crisis for Australian businesses. The financial sector has already taken some major hits in terms of aggregate profitability (GOS) and business activity, with both GOS and gross value added declining for the last three quarters (September 2007 to June 2008, trend). Further profit and activity deteriorations are expected as global events continue to unfold.

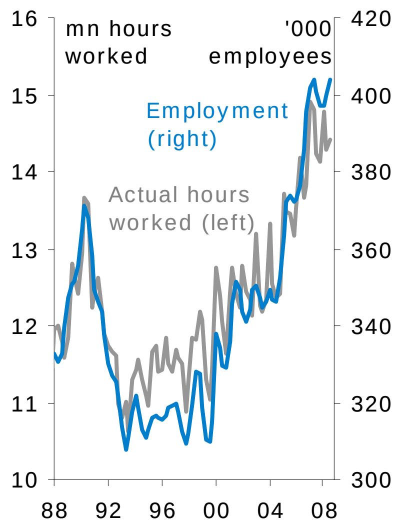
Australian finance sector employment has not yet contracted, but finance sector jobs are at immediate risk.

The effects of this calamity are not yet showing up in Australian labour market data, which shows a record level of 403,800 finance sector jobs nationally (trend). Actual hours worked are also close to peak levels. Nationally, 82% of finance and insurance industry jobs are full-time, higher than the national full-time rate of 72% for all employment. Finance and insurance jobs are disproportionately concentrated in Sydney (NSW has 42% of jobs in this sector, compared with 31% of total national employment), which is already suffering the weakest state economic performance and weakest economic outlook.

Employment typically follows, rather than leads, other economic activity indicators, so this picture of record finance sector employment will change rapidly as financial institution activity continues to contract — as happened in Australia in 1990-92 (see employment graph below) and is happening now internationally, with around 135,000 finance jobs cut already. Australian finance sector employment actually *increased* in August 2008, but jobs in the smaller, supporting 'services to finance' and 'insurance' sectors had already begun to turn down, indicating early job losses in back office and supporting areas.

Finance's gross value added is falling. Employment is high but may soon follow





Source: ABS *National Accounts* (data to June 2008) and *Labour Force Australia* (quarterly detailed, data to Aug 2008).

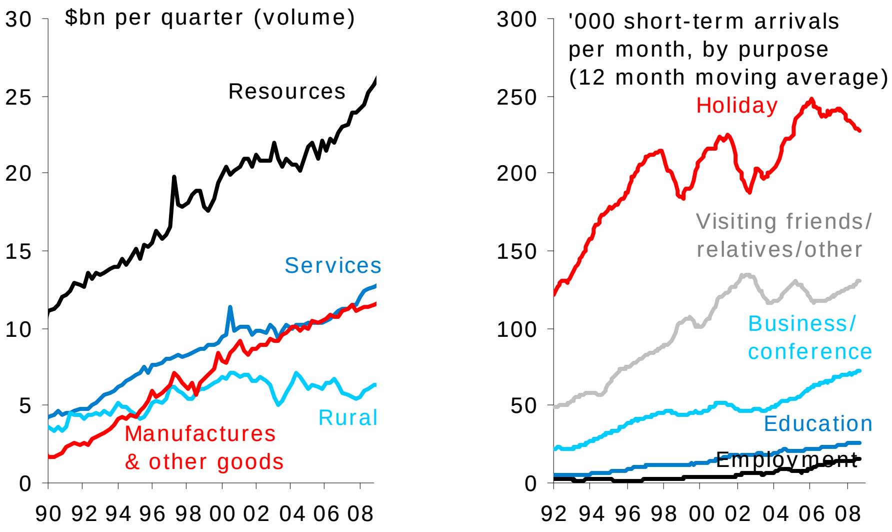
The exporters

Australia's resources exporters have been riding a wave of rising commodity prices for several years, with the bulks (iron ore and coal) at the crest and other metals close behind. Rural commodities made a late but welcome return to form in mid-2008, with high prices and recovering production levels. Commodity markets can move rapidly however, and prices for almost all rural and resource commodities are now falling as global demand (and supply constraints) ease.

Manufacturing exports have been greatly overshadowed by the resources boom, but have been quietly, steadily growing in volume and value for some years. Manufactured and other processed exports overtook rural exports in around 1995 and until recently, were running at similar levels to services exports. About half of manufactured exports (by value) are machinery and transport equipment and half are other goods, from food to furniture to pharmaceuticals.

Services exports grew strongly through 2007 and into 2008, even though tourist arrival numbers were falling. The growth hotspots were business-related rather than tourist-related, including professional, financial and even construction services. Growth in education exports has been relatively steady.

Export volumes (and values) have soared ... but tourist numbers are down



Source: ABS, ANZ Economics and Markets Research.

Australia's trade balance (exports less imports) turned positive in June 2008 for the first time since 2002. Trade is now contributing to GDP growth instead of detracting from it and the current account deficit is shrinking. Looking forward, there are positive and negative developments for exporters:

Slowing global growth will mean weaker demand and lower prices for commodity exporters,

But the lower A$ will boost A$ export returns and improve local and global competitiveness.

Access to international credit and finance will remain problematic for some.

- **a lower and more volatile trading range for the A$** (trading below US$0.70 through 2009 than the near-parity highs of 2007-08) means better A$ returns for exporters (but offsetting lower returns due to falling global commodity prices), and an easier ride for manufacturers and others who compete in the domestic market against imported goods and services.
- **falling commodity prices** will bring lower direct returns for resources and rural exporters, but may help manufacturers by lowering their input costs. On the upside, lower global petroleum prices will ease input and transport costs.
- **slower global growth** in key export markets (such as China, Japan and other Asian economies) will see slower demand for Australian goods and services. In this climate, the already sluggish inbound tourism market is unlikely to pick up anytime soon and education exports may be slower also.
- **access to credit** and finance for trade, transactions, expansion and other purposes will remain expensive and, in some locations, difficult to obtain.
- the potential for **trade barriers** in other countries may increase, in response to rising unemployment and the more difficult global trading environment.

The builders:

Residential construction

Non-residential construction

Engineering and infrastructure construction

Manufacturers and suppliers of building materials

The builders

Australia's construction sector consists of residential, non-residential and engineering construction. These sectors operate on different activity cycles and respond to different variables in the economy. Traditionally, residential and non-residential construction have tended to run counter-cyclically to each other. Total construction activity is currently high, with record levels of gross value added and employment. Labour shortages are reported to be widespread.

Growth in non-dwelling construction (buildings and engineering) is decelerating rapidly as business investment and lending slow.

Nationally, non-residential construction activity has been growing strongly but is now decelerating, albeit after reaching a high level. Non-dwelling investment grew 17.3% in 2007 (10.8% for new buildings and 20.9% for new engineering construction), slowing to an estimated 4.6% in 2008 and an expected 0.5% in 2009. The AiG monthly survey of construction activity indicates forward orders of new engineering business have been contracting since March 2008 while forward orders of commercial buildings have contracted since April. The AiG Indexes of new business being written by these two sectors hit their lowest ever readings in August and September.

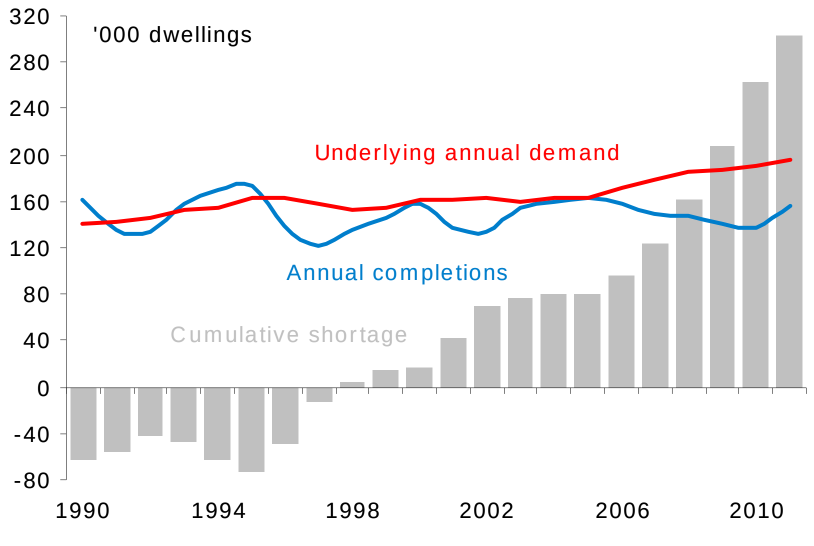
Residential construction activity is already flat and is not expected to pick up pace until 2010.

The national housing shortage is set to tighten further as dwelling supply falls further behind.

In contrast, residential investment has been flat for some time. It grew only 3.1% (by value) in 2007, after contracting in 2005 and 2006. Further contraction is expected in 2008 (-0.1%) and 2009 (-0.3%) before the dwelling construction cycle picks up again from 2010, in response to lower interest rates and the pressure of pent-up demand. In terms of actual dwellings being built, numbers are currently declining due to weakness in demand and despite an existing national dwelling shortage. The decline in approvals and completions, on top of the existing shortage, is keeping vacancy rates near all-time lows. But with non-residential construction activity now flattening also, it presages a lengthy quiet period for the construction industry and its suppliers, as demand for credit softens among households and businesses and the general appetite for property investment remains subdued.[2]

In October the Federal Government announced measures to help boost flagging construction activity, with a temporary increase in the first home buyers grant for new homes to $21,000 and the bringing forward of infrastructure projects (from the Building Australia Fund). State governments have also announced plans to bring forward large road, ports and other construction projects. These measures will 'pull forward' residential and engineering construction activity.

Australia's residential dwelling market is set to get even tighter



Source: ABS and ANZ Economics and Markets Research

[2] See 'Australian house prices unlikely to fall', Oct 2008 and *ANZ Australian Property Outlook*, Sept 2008.

Business to business

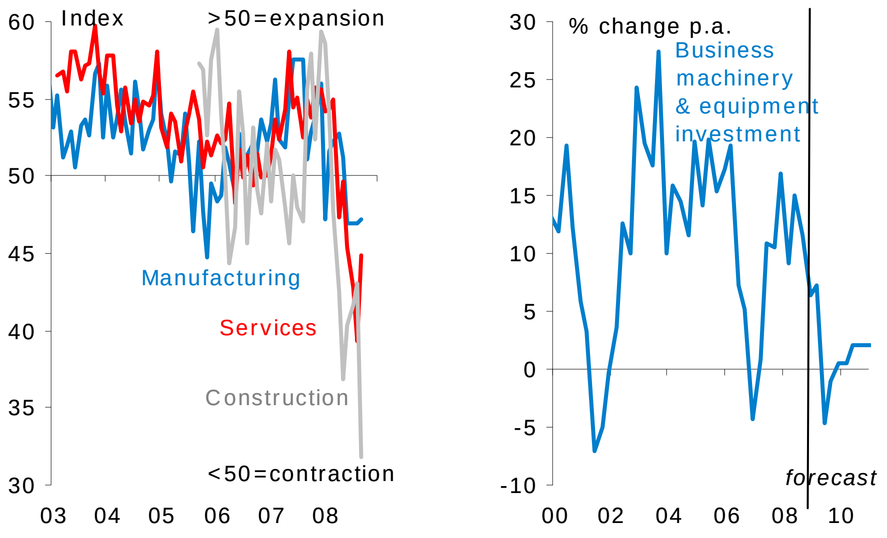
Total business investment in Australia currently accounts for around 17% of GDP. Much of this is in the form of non-dwelling and engineering construction (see above), but around $90bn is also invested in machinery and equipment — equal to around 8% of GDP. Its significance is greater however, in that plant and equipment investment is necessary to future growth and development. Plant and equipment investment includes spending on vehicles, machinery, furniture, fittings and many other physical business assets (other than buildings).

Business investment in plant and equipment has been growing strongly for several years, with another increase of 10.2% estimated in 2008. But business investment spending reacts quickly to changes in conditions and expectations. In August, intended business investment on plant and equipment for 2008-09 (as indicated in the latest ABS Capital Expenditure survey) was expected to grow 22%p.a., with about half in mining and half in manufacturing and other industries. Investment intentions by retail, business services and other services however, were already down. Financial market events since that August survey means that actual realisation of these investment intentions is likely to fall sharply. The weak A$ will further discourage forward orders of new industrial and business equipment, since much of it is imported, with prices set in US$. We now expect business spending on plant and equipment to contract by 4% in the September quarter 2008 and then stabilise (i.e. zero growth) through 2009.

This low period for business investment (in plant and equipment) is likely to hit hardest on suppliers of items that can be postponed and/or replaced with a second-hand rather than a new item, such as new commercial vehicles, some types of standard manufacturing and agricultural machinery, office furniture, IT hardware and communications equipment. Investment in new technology and extras such as solar power generation or water recycling equipment may also stall, except perhaps where the payback periods in utility savings are good.

Additional (non-investment) business to business goods and services are also needed, including materials, stock, energy, transport, communications, legal, financial, accounting, hospitality and many other specialist services. Anecdotal evidence indicates some of these categories are already declining (or at least decelerating) also, starting with corporate hospitality and travel. Business surveys are now indicating a contraction in activity and demand across the board, with the largest contractions being reported in construction and services. Manufacturing businesses have not, as yet, reported the same level of severity, perhaps due to their greater ability to take advantage of falling input prices and the falling dollar to improve their bottom line and/or export performance.

Business conditions are deteriorating, business equipment spending will follow



Sources: AiG industry performance indexes (data to Sept 2008), ABS, *National Accounts* (data to June 2008) and ANZ Economics and Markets Research.

Business to households:

Retail

Hospitality

Passenger transport

Culture and recreation services

Health

Education

Personal finance and insurance

Property services

Personal services

Communications

Gas, electricity & water retailers

Business to households

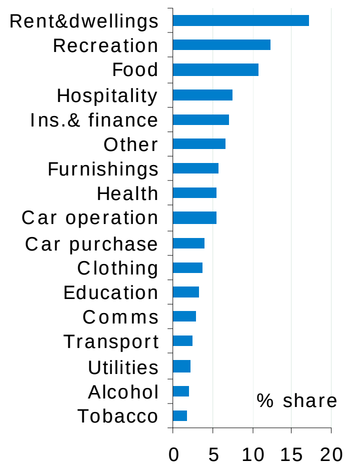
Household financial health is crucial to business financial health, since household consumption comprises around 60% of the national economy (GDP). The largest single component of household consumption expenditure is rent and housing costs (around 17%) followed, somewhat surprisingly, by recreational goods and services (12%) and then food (11%). It is debatable exactly which components of household expenditure should be regarded as ‘essential’ and which are ‘discretionary’ (almost all categories include elements of both), but ‘essentials’ such as rent, food, health, education, utilities and insurance and finance, take just under half of total expenditure. This means about half is discretionary in the sense that households can cut back on them fairly easily and quickly as needed.

Growth in total real household consumption has decelerated rapidly over the past year. It actually *contracted* (by 0.1%) in the June quarter 2008, for the first time since 1993, although it was still 2.9% higher than a year earlier. The June contraction was strongest in some of the more discretionary categories, such as tobacco (-1.1%), operation of vehicles (-2.0%), purchase of vehicles (-0.8%) furnishings (-0.6%) and clothing (-0.4%). Transport services (airlines, buses, taxis and the like), hospitality (hotels, restautrants and cafes) and ‘other’ goods and services showed their second quarter of decline, reflecting the poor domestic market for tourism in recent years. These more discretionary categories are concentrated in the auto, retail and hospitality sectors, which are extremely vulnerable to changes in both real and perceived financial conditions.

On the other hand, real expenditure on food and groceries declined too (-0.8%), confirming anecdotal reports of substitution to cheaper items within this large but essential category in response to rising costs for less avoidable household expenses in the June quarter, such as mortgages, rent, petrol and utilities. Some of these costs have since come down again (notably mortgages and petrol), but other concerns have replaced them to weigh on consumers’ wallets. For pensioners, the Government’s $1,000 grant will boost spending at christmas.

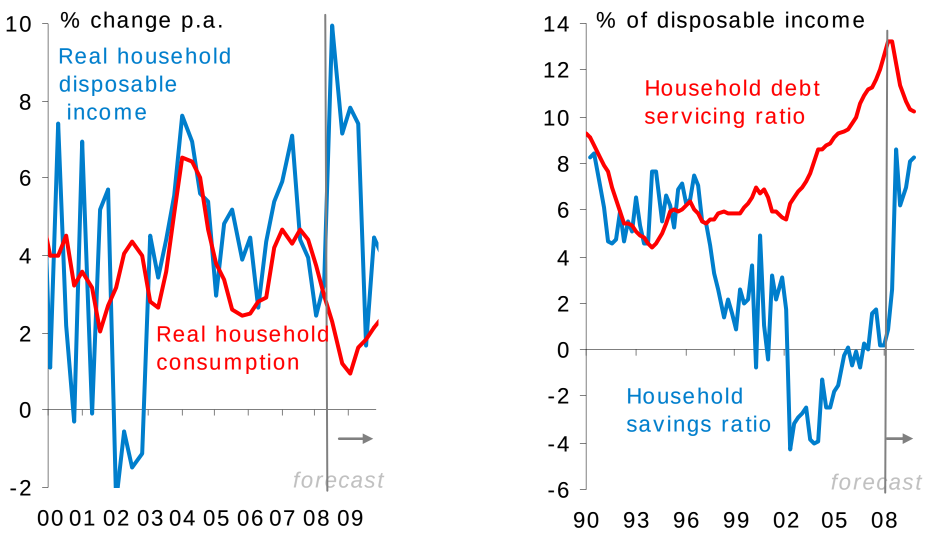
The outlook for Australian households and the businesses selling to them is subdued at best. Employment growth is slowing across the board and is likely to actually decline in banking, hospitality and retail (and possibly some other sectors). Unemployment will unfortunately rise back over 5% in 2009 and may climb over 6% in 2010. This will have a major impact on the households directly affected, but it will also cause all households to tighten their belts ‘just in case’ and in response to the general change in mood and sentiment — conspicuous consumption is likely to fall from favour very quickly as circumstances change. Instead, savings and debt consolidation will become the order of the day.

Total household expenditure categories, Jun 2008



Source: ABS *National Accounts.*

Unemployment, debt consolidation and more savings will detract from spending



Sources: ABS, *National Accounts* (data to June 2008) and ANZ Economics and Markets Research.

Appendix: industry size and growth, 2008

Australia's top 5 industries by real output (gross value added) in June 2008 were:

1. property and business services (12% of GDP)

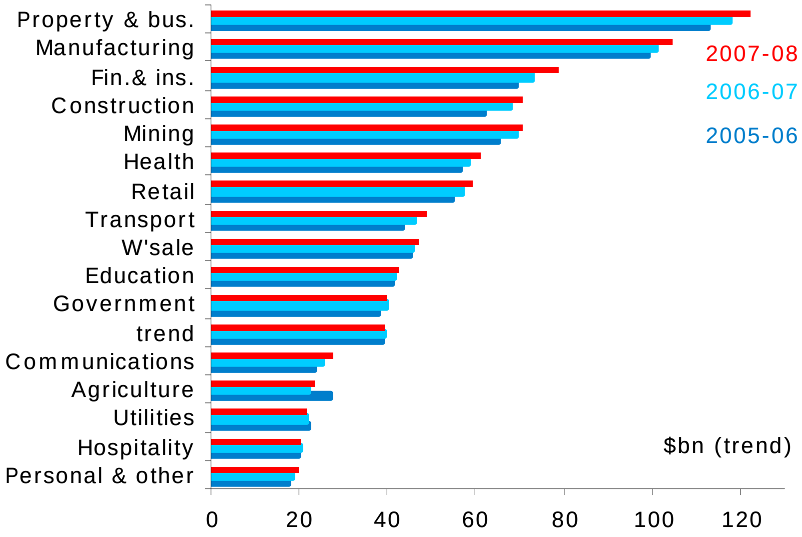
2. manufacturing (10.2%)

3. finance and insurance (7.5%)

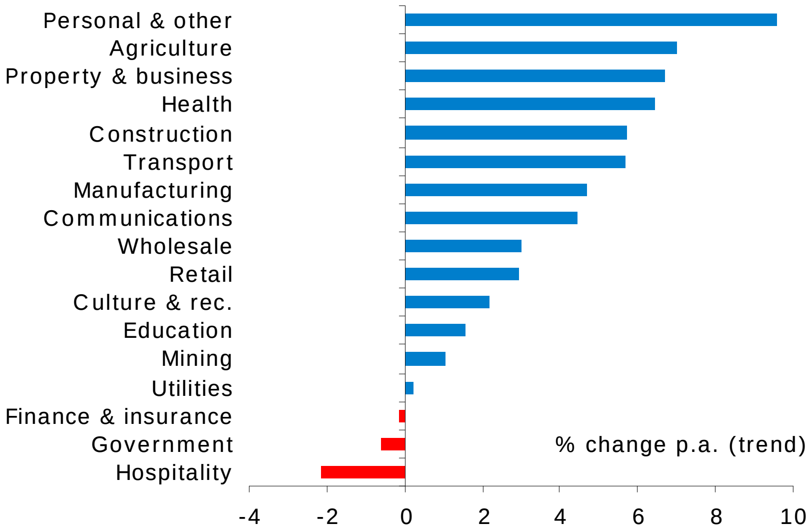
4. construction (6.9%)

5. mining and services to mining (6.8%)

Industry gross value added (annual, trend)



Growth in industry gross value added, June 2008 (trend)



Australia's top 5 industries by employment in August 2008 were:

1. retail trade (14.5%)

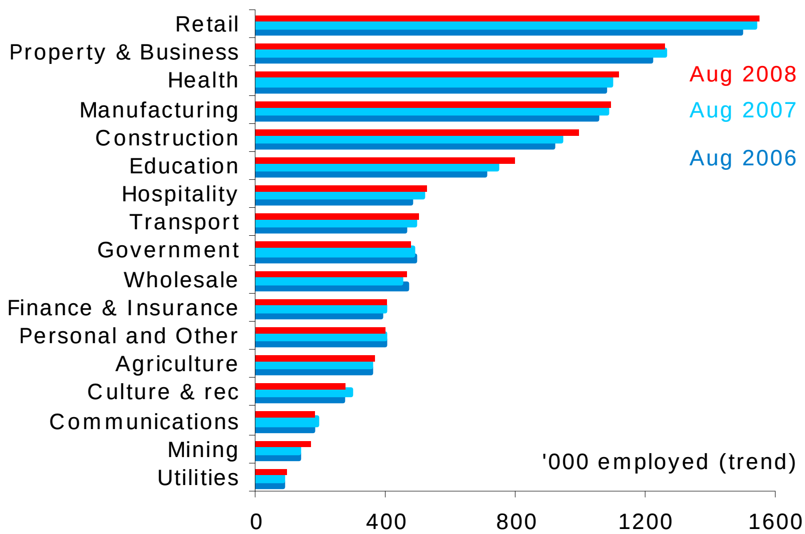
2. property & business services (11.8%)

3. health and community services (10.5%)

4. manufacturing (10.2%)

5. construction (9.3%)

Industry employment (trend)



Sources: ABS *National Accounts* and *Labour Force Australia* (quarterly detailed).

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