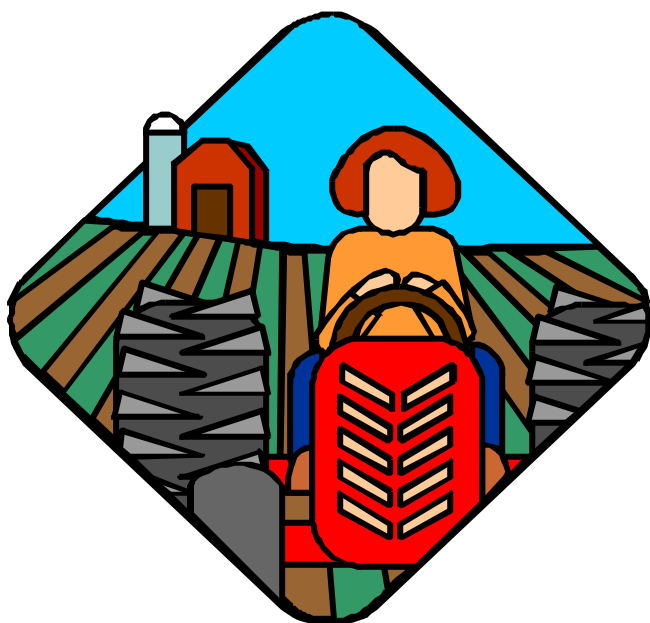


Economic Issues Confronting Northern Victoria



**Presentation to ANZ Bank
Customers and Invited Guests**

**Ian James
Senior Economist
ANZ Bank**

**Echuca
October 6, 2003**

Should we bank a world economic recovery?

World equity markets have banked a resurgent international economy led by the US

- **US economic indicators are showing recovery and repair of corporate balance sheets after the collapse of the dot-com. revolution is well under way.**
- **In the US all policy arms are stimulatory with the Fed funds rate at 1% and another round of tax cuts taking effect in July.**
- **Japan is now recording positive economic growth.**
- **Most of the rest of Asia has lifted its growth forecasts and the Chinese economy continues to grow strongly.**
- **Conditions are more subdued in Europe but some of the forward indicators are looking better and there has been a strong equity market recovery.**
- **After some equivocating bond and equity markets are now dancing to the same tune.**

Some still fret that the recovery may yet be aborted

- **Europe remains weak, with the German, Dutch and Italian economies in recession and France reporting negative growth in the last quarter.**
- **Japan's structural problems in the financial sector remain.**
- **Some countries currencies are clearly undervalued placing strains on the nascent recovery in the US.**
- **The US requires funding for huge current account and budget deficits.**
- **There is a danger that rising bond yields may stifle the recovery especially in the US due to the impact on mortgage financing.**
- **This could lead to a stalling in consumer spending as US households adjust their debt imbalances before US business investment sets in to take up the running in the economy.**

How is the Australian economy performing?

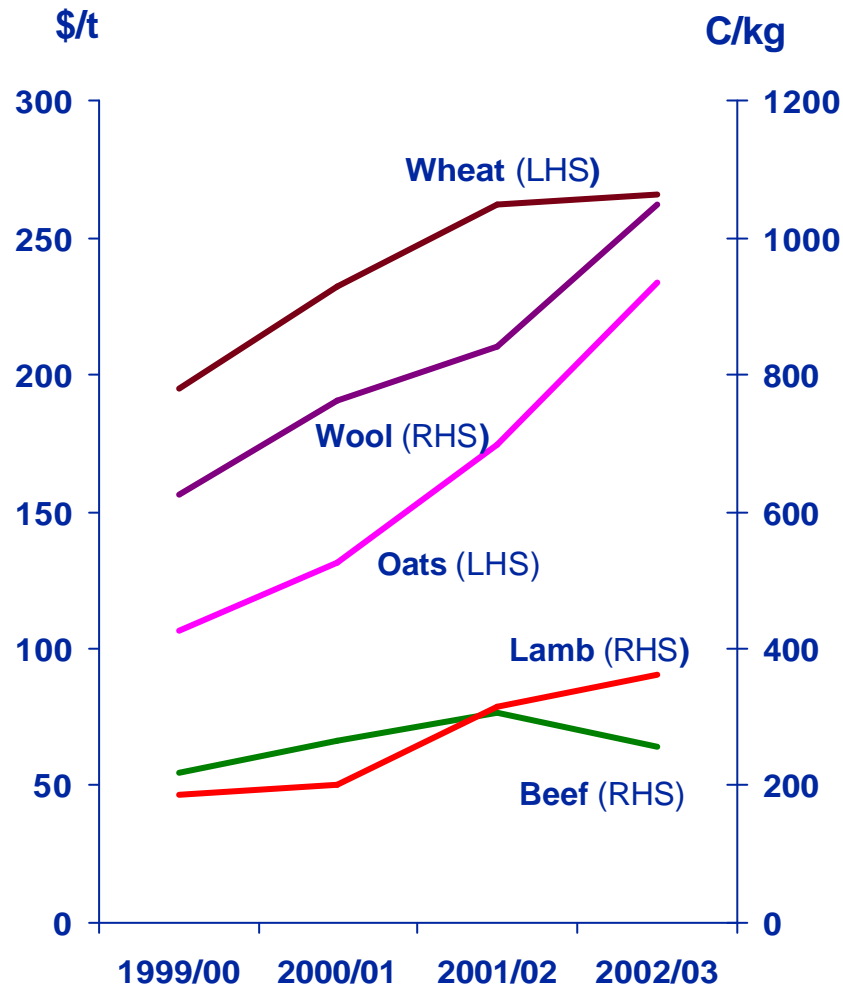
Despite an official growth figure at around zero for the June quarter, the domestic economy has been performing strongly

- **Subtracting the farm sector from growth, the Australian economy is still growing around 3% while domestic demand continues to grow strongly at around 4.7%.**
- **Business and consumer confidence have bounced back strongly post Iraq.**
- **Construction activity while flattening remains strong.**
- **Growth in retail trade continues at a rapid clip.**
- **Household credit growth is extremely strong at 20% per annum.**
- **Motor vehicle sales continue to surge past the record levels of last year with new car sales up 10.5% until the end of September compared to the same months of last year.**

However rural Australia has been doing it tough

- The drought reduced the volume of farm production by 23% over 2002/03.
- Broadacre and dairy farms were hardest hit.
- Milk production had its largest fall since 1951/52.
- Northern Victorian dairy farms took the bulk of the hit
 - production fell 16%
 - milk receipts fell an estimated 30%
 - expenditure on fodder rose over 50%
 - water allocations were the lowest on record
- Service industries in country towns have been adversely affected.

Some farmers did better than expected

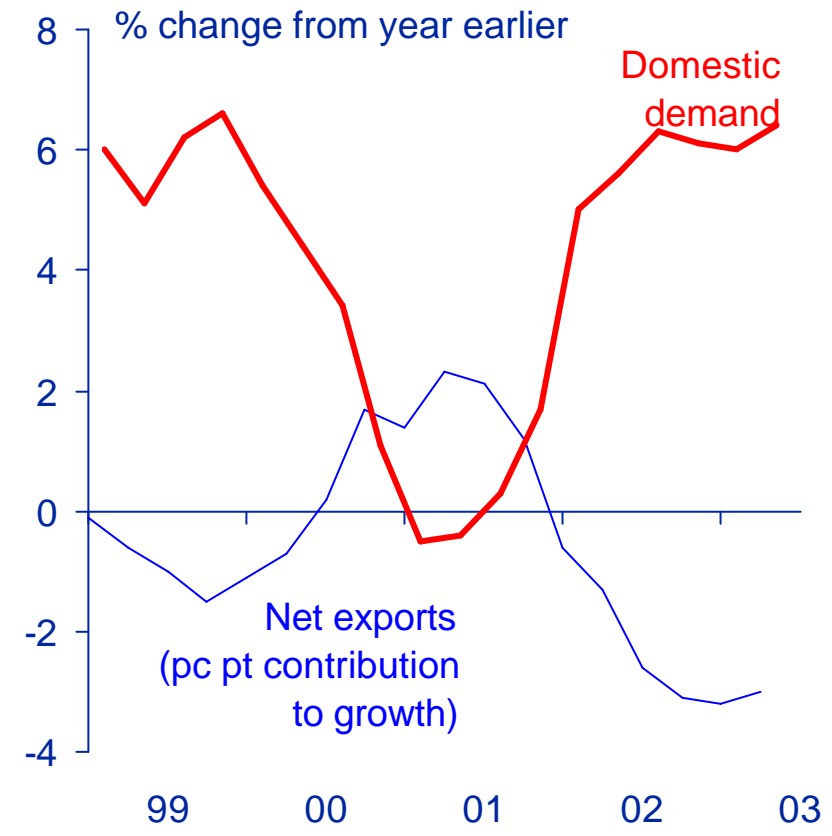
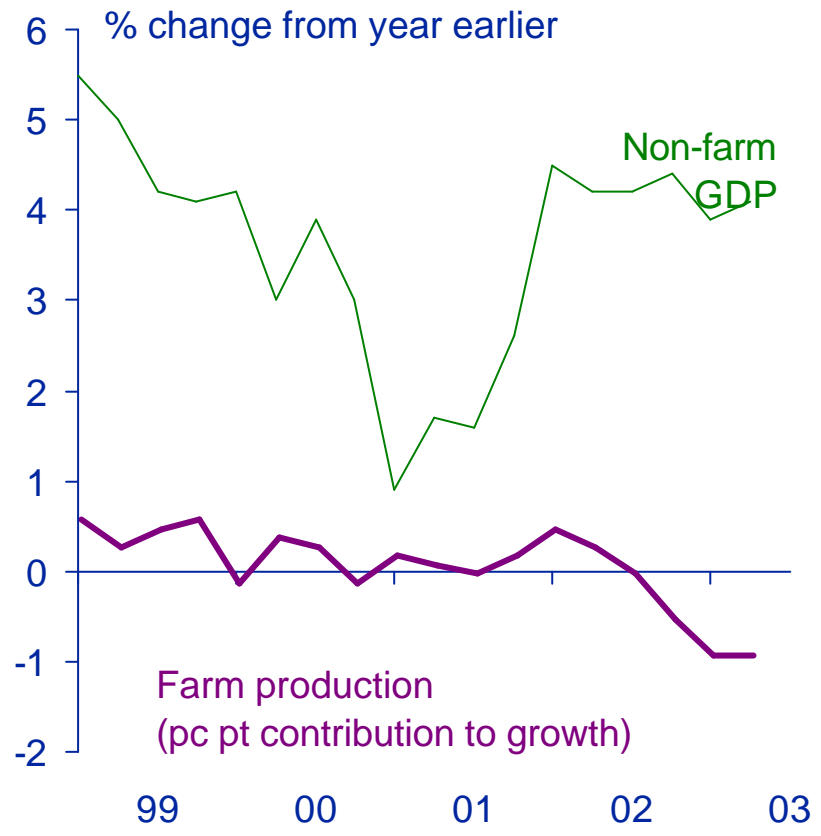


Source: ABS and ABARE

- Farmers have become more astute in managing droughts.
- For farmers with grain to sell, prices were better.
- Livestock prices held up well with lamb prices particularly buoyant.
- Fibre prices were stronger.
- Financials held up better assisted by the fact that the previous two years had been particularly buoyant.
- And, despite the drought rural land prices rose strongly with anecdotal evidence pointing to price increases of around 15 % the norm.

The graphs below tell the story – negatives from a weak world economy and drought offset by booming domestic conditions

Australian economic growth



Sources: ABS; Economics@ANZ

What's the outlook for 2004?

Australian domestic economic growth will slow but there is strong economic momentum going forward

- **The dwelling construction cycle is peaking and will undergo a mild downturn during 2004.**
- **Manufacturing and retail trade growth are also likely to slow.**
- **Growth in consumer spending should remain solid, but below the recent buoyant growth.**
- **Work in the pipeline in engineering and non-residential construction suggest that these areas of construction will remain strong well into 2004.**
- **And despite the appreciation of the dollar exports are expected to pick up as the year proceeds and farm production recovers from the drought.**
- **Tourism is also likely to do much better.**
- **In short, a recovery in farm production and exports will partly offset some slowing in domestic demand through 2004.**

Rural Australia will bounce back strongly

- Close to home, dairy opening season prices are stronger, water allocations are up on last year and feed costs will be lower.
- Non irrigated pasture growth is strong across the country suggesting bountiful feed, hay and silage this season.
- Horticulture including grapes and stone fruits will do much better than last year.
- The winter crop harvest is likely to be a boomer. WA has the best conditions since 1963 and most other cropping areas except southern Queensland are looking good. This will be tempered by lower crop prices although world prices have bounced strongly in the last month.
- Beef prices are likely to hold well as is lamb.
- Wool prices have fallen from their unsustainable peak and may have further to go as prices are still above the long term price relationship between wool and other fibres. Nonetheless they remain relatively strong.
- Wealth creation factors will have an influence on spending patterns in country towns.

Are there any risks out there?

Essentially four:

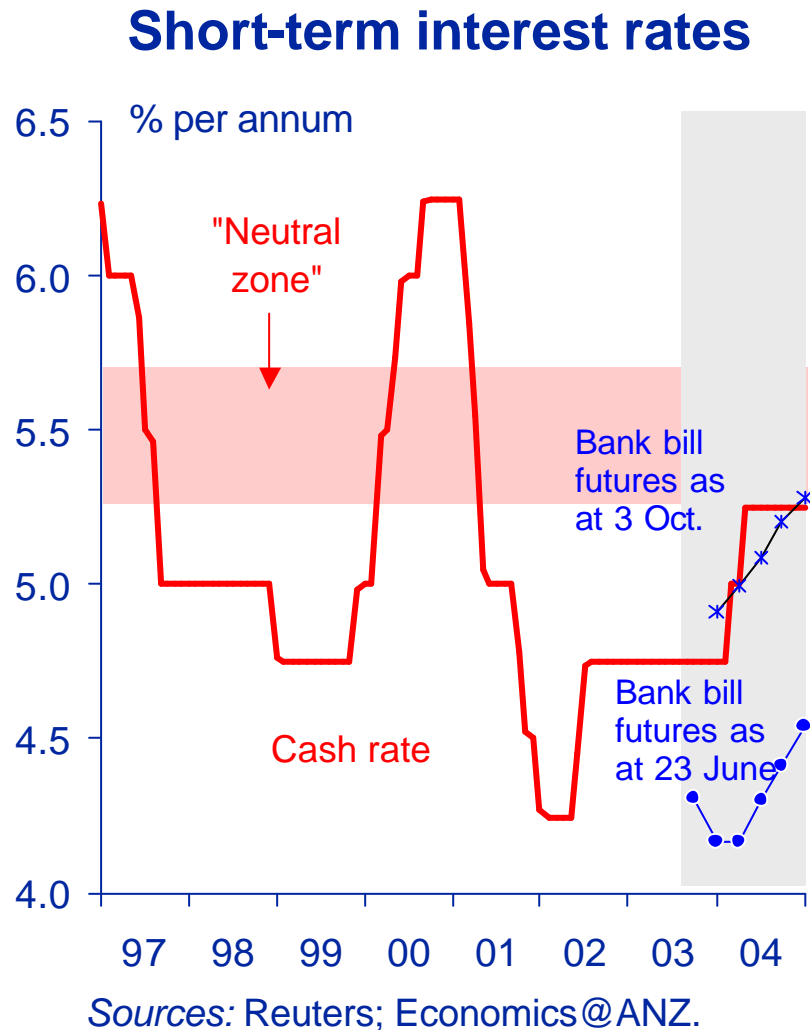
Interest rates

The exchange rate

Household debt and expenditure

Potential collapse in property markets

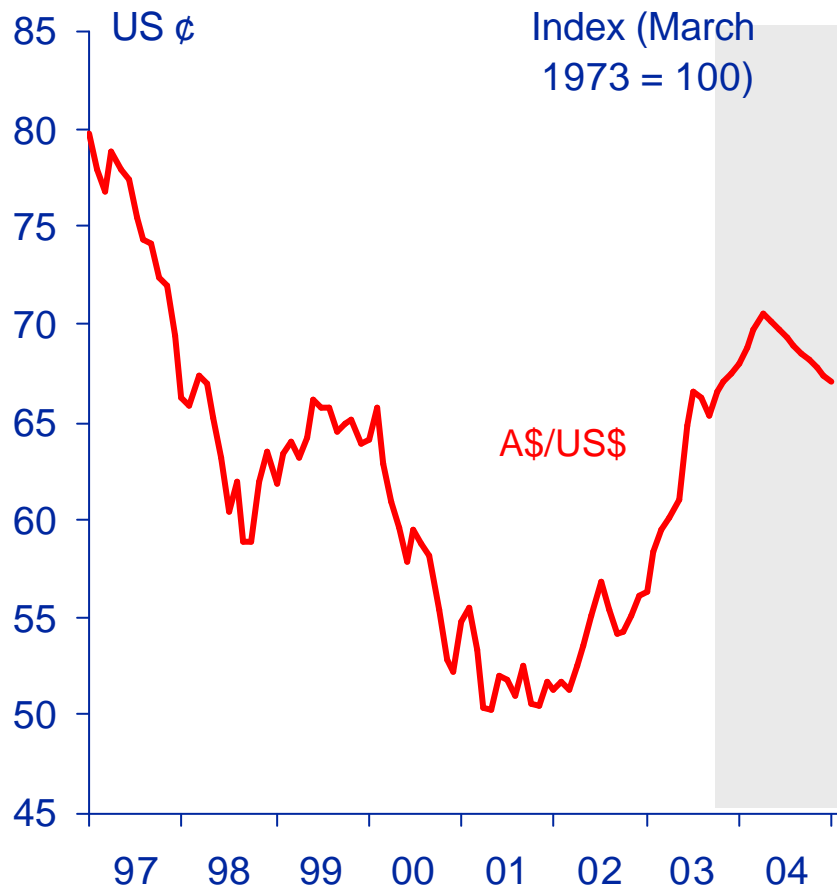
The bias in interest rates is an upward direction



- Financial markets have given up on cuts in interest rates and are now factoring in a rise.
- Nonetheless with domestic demand slowing – albeit to a healthy rate – and with inflation under control there is little justification for a rate rise.
- The RBA remains worried about overheated housing markets and the cash rate is still below the range designated by the RBA as ‘neutral’.
- With the global economy picking up and the drought largely over, the RBA will start giving greater weight to continuing rapid growth in credit.
- Our view is that interest rates will remain on hold this year and that unless the US recovery stalls that the RBA will increase rates by 0.5% in the first half of 2004.

The A\$ will rise, with a risk of it pushing through US70¢

A\$ vs US\$



Sources: Datastream; Economics@ANZ

- Most of the rise in the A\$ since early 2002 is due to the decline in the US\$.
- The US\$ still has further downside given that the current account deficit will continue to widen well into 2004.
- The A\$ usually does well during periods when the global economy is strengthening and is gaining some support from the wide spread between Australian and overseas interest rates.
- With the US\$ likely to fall further the A\$ could peak at over US70¢ some time early next year.
- Australia's still large current account deficit and net equity outflows should act as a brake on 'run-away' A\$ appreciation.
- While timing remains uncertain, a shift in Asian currency policies may take some of the pressure off the A\$ and other 'free floaters.'

What is the average Aussie doing?

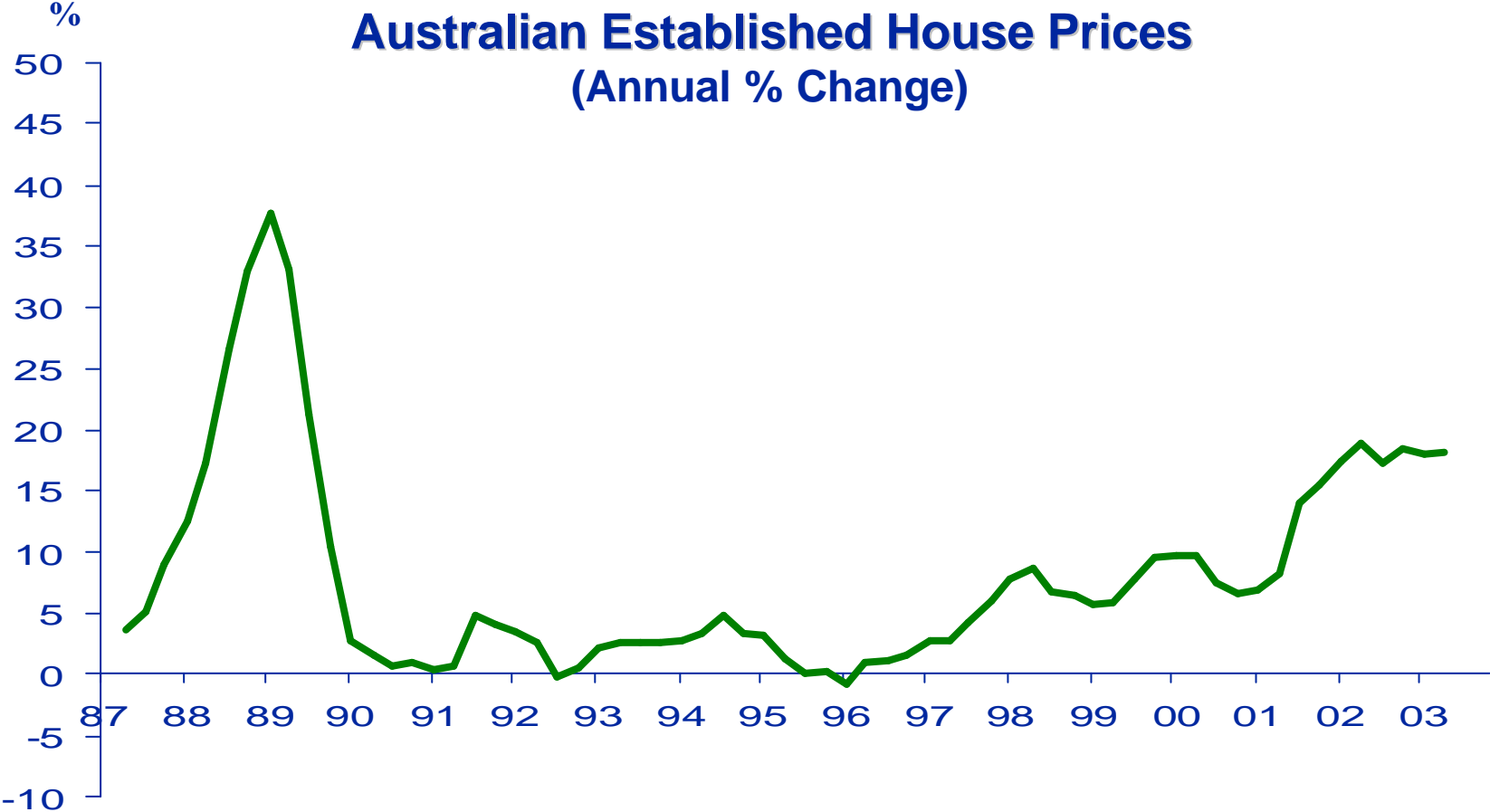
The average Aussie continues to

Party



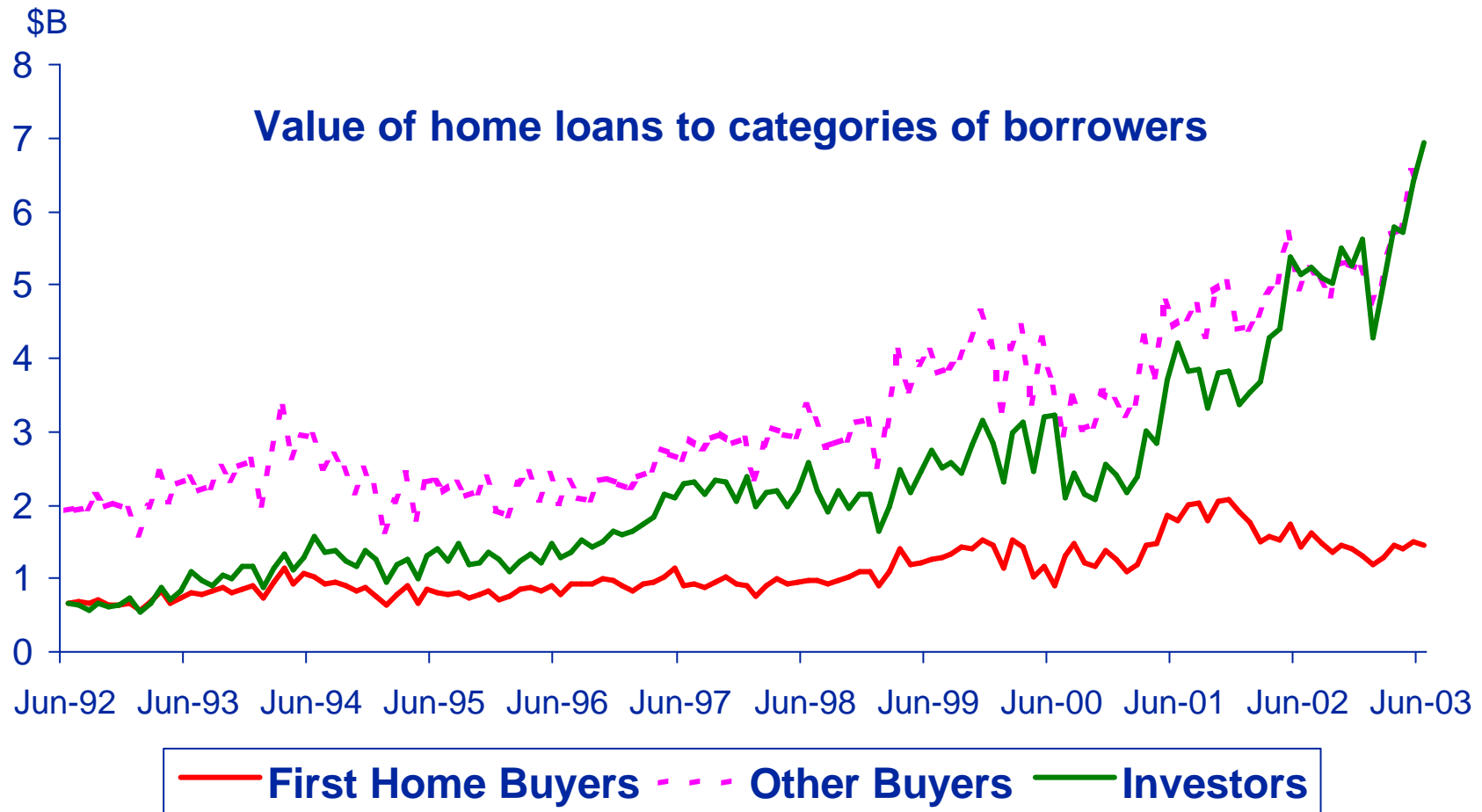
- Household debt continues to mount and the debt to income ratio has risen from 65% to 129% since 1996.
- The household saving ratio for the first time in history is now negative.
- More recent data shows that retail sales remain extremely strong rising again in August for the eighth consecutive month to be up 6.7% over the year
- And the spending spree has seen new motor vehicle sales continuing to break records.
- Total household credit is growing at 20% and unsecured consumer borrowing 12.7%.
- And after years of building equity in their homes Australians are indulging in a new game – equity withdrawal to finance consumption expenditure – borrowing \$26 billion or equivalent to 5% of household income in 2002/03 against their houses.

Confidence has been buoyed by the wealth impact of a rapid rise in property prices



Source: House Price Index ABS Cat. No. 6416.0

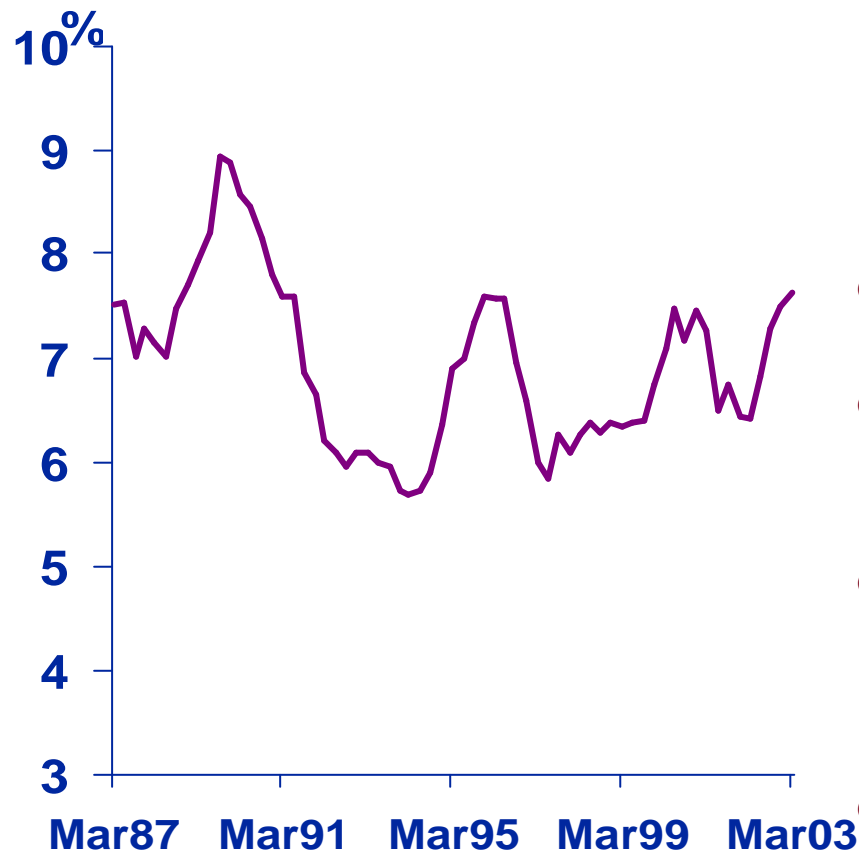
Which has in turn generated a strong interest in investing in residential property.



Source: Reserve Bank of Australia

Is there any danger in all this?

Household debt service ratio (interest payments as a % of household income)

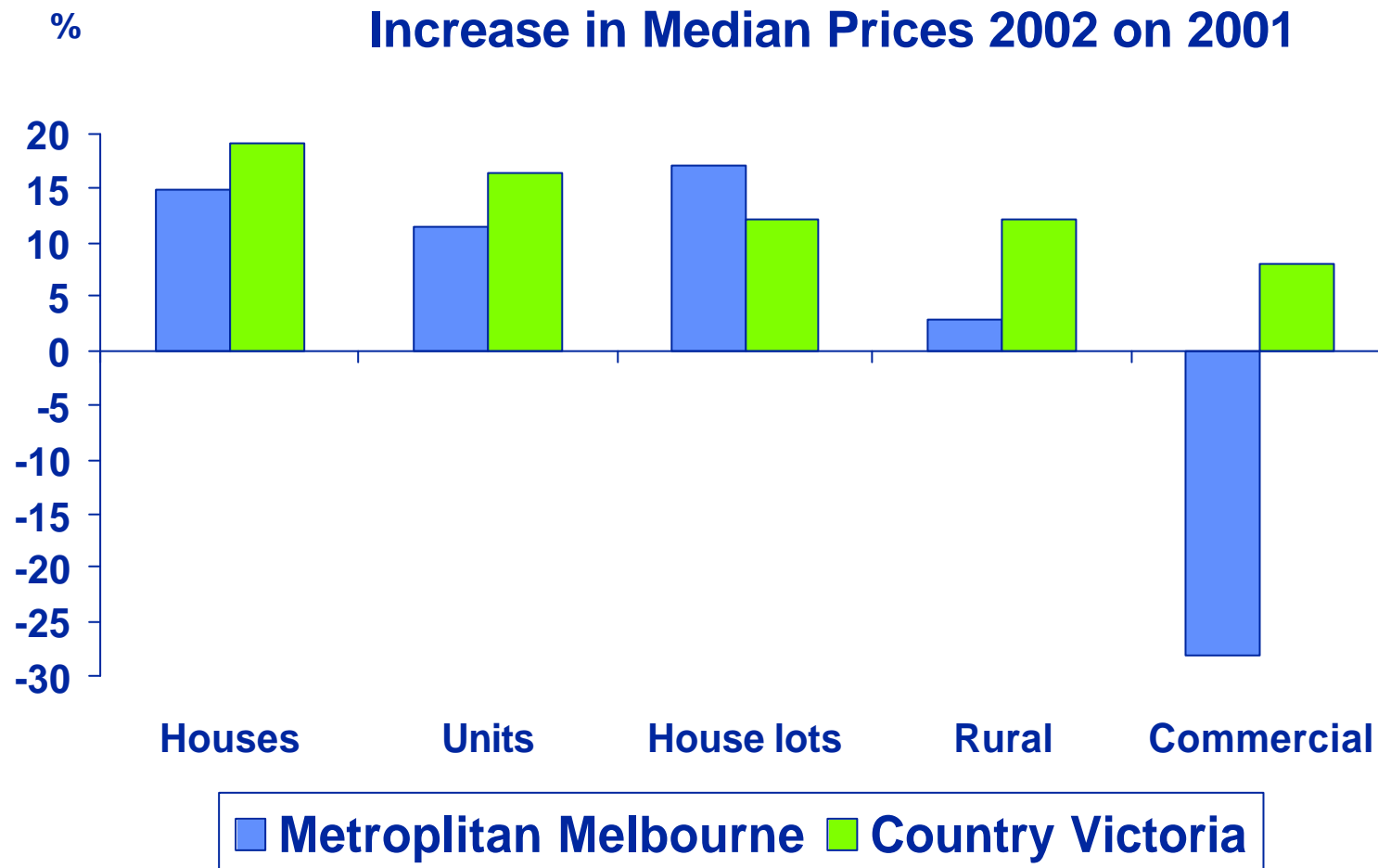


Source: Reserve Bank of Australia

- Over the past 12 years the borrowing capacity of an average-income household has risen by nearly 175% assisted by:
 - decline in interest rates
 - financial innovation and competition in the financial sector.
- At present while individuals may be vulnerable it seems manageable
- The household debt service ratio while rising is lower than what it was at the peak of the last boom in 1990.
- However present household behaviour remains dependent on maintenance of existing house price increases.
- Moreover Australian households have placed themselves in the position where they are more vulnerable to economic shocks.

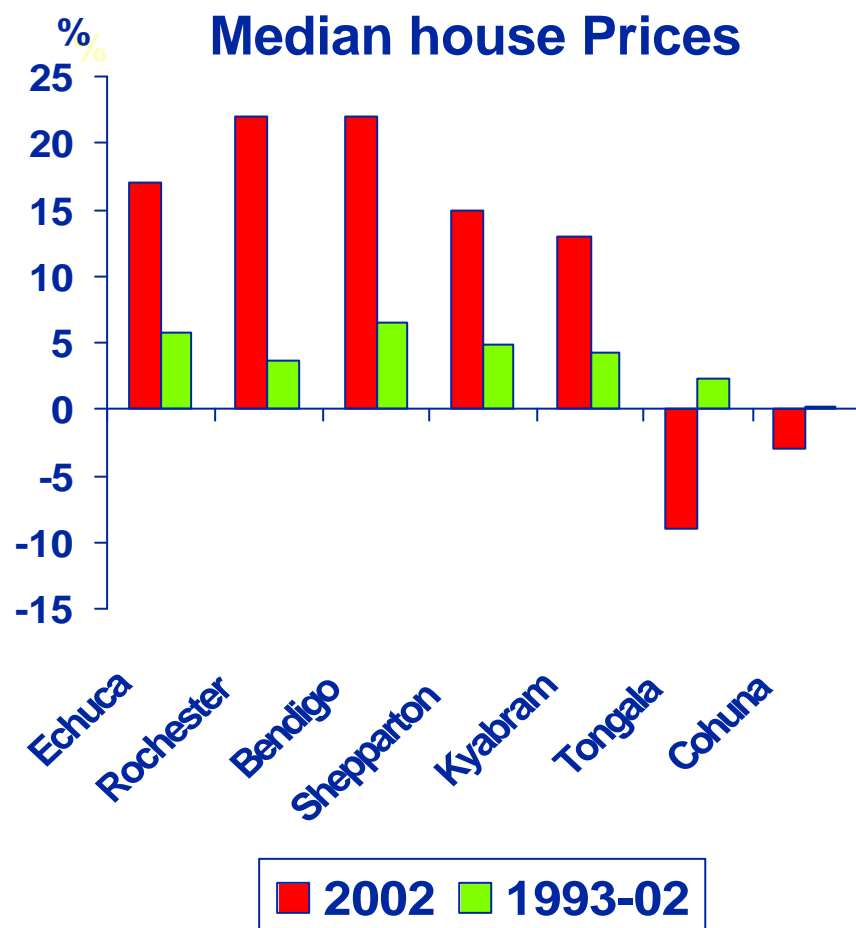
Is property investment a good idea?

Property prices in country Victoria outpaced Melbourne last year



Source: A Guide to Property Values 2002 – Land Victoria

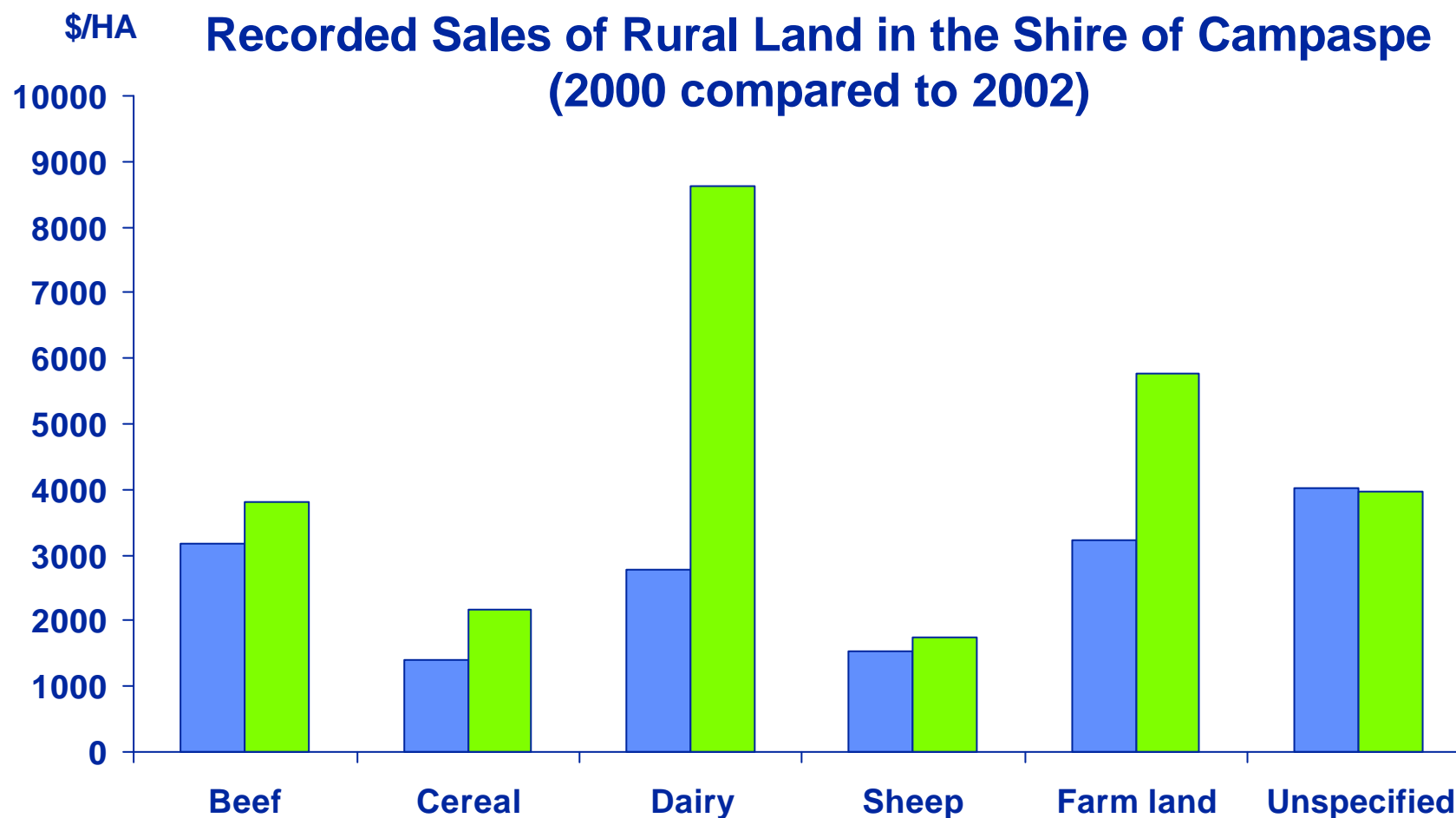
And house prices in the larger local towns continue to climb at faster rates than in Melbourne



Source: A Guide to Property Values 2002 – Land Victoria

- Underpinned by (until the drought) improved employment prospects in agriculture due to farm consolidation and growth in more intensive areas of agriculture.
- Movement of lower income groups out of metropolitan areas due to affordability.
- Growth of tourism.
- Lifestyle considerations.
- Investors seeking the better yields available in country towns than capital cities.
- Improved communications and upgrading of transport links to capital cities.

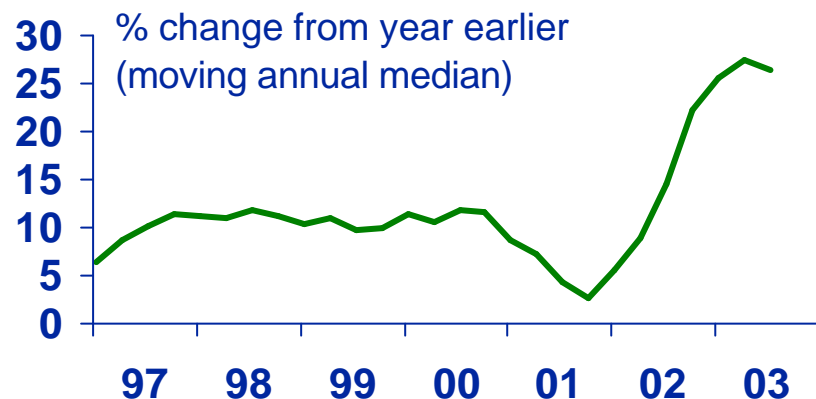
Rural land prices have also climbed despite the drought



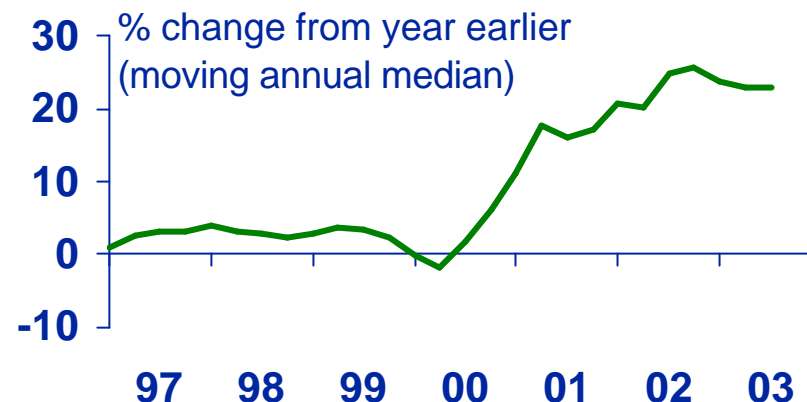
Source: A Guide to Property Values 2000 and 2002 – Land Victoria

However, in Melbourne, where the current boom started, prices appear to be levelling off

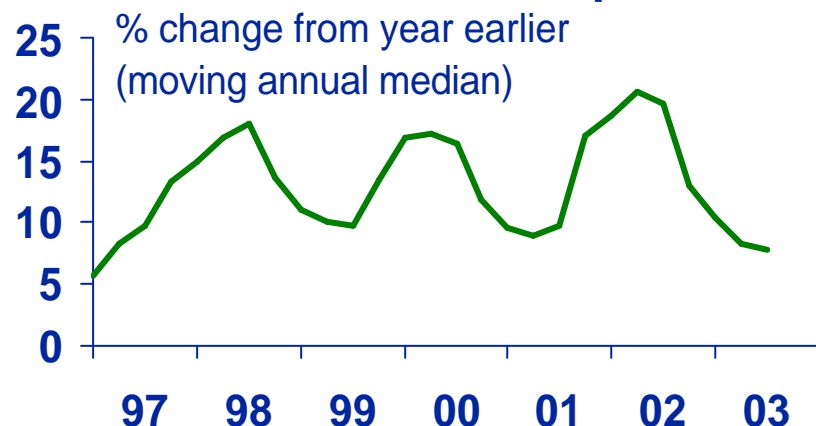
Sydney house prices



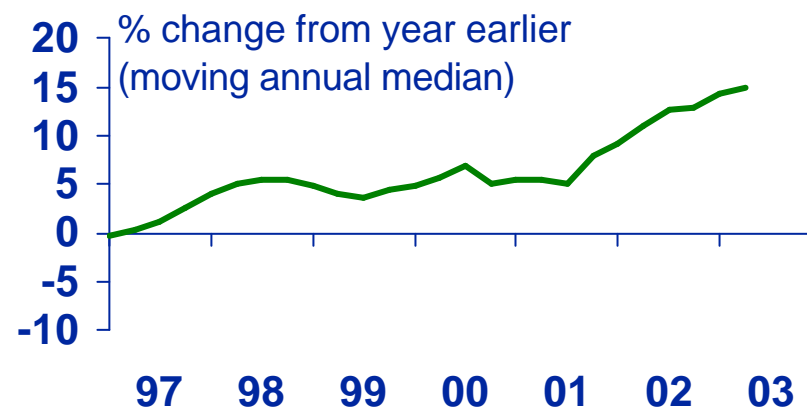
Brisbane house prices



Melbourne house prices



Other capitals house prices

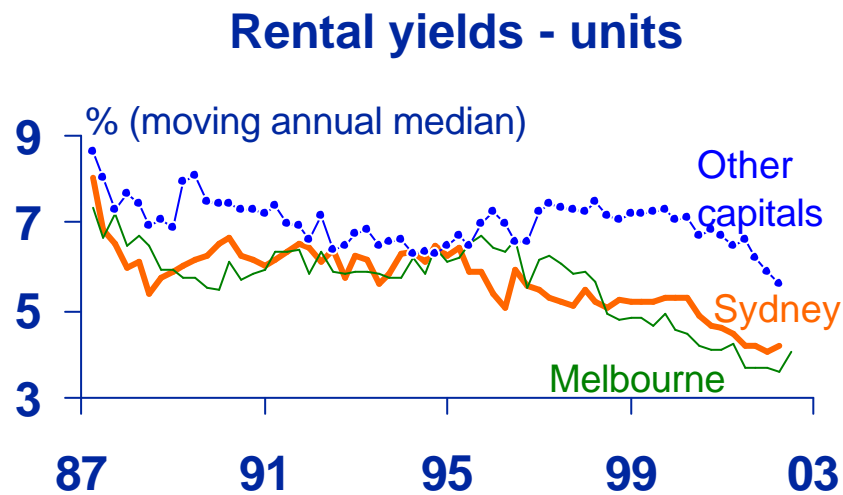
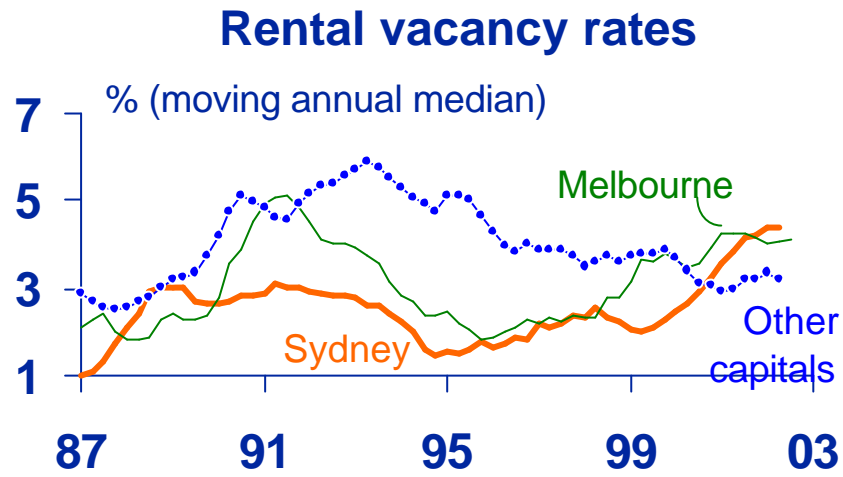


Sources: REIA; Economics@ANZ.

The wealth and debt increases by the household sector may be drawing to a close

- The rapid increases in household debt, house prices and household wealth are, for the most part, a by-product of the secular declines in inflation and interest rates since the early 1990s
 - although deregulation, financial innovation and competition among lenders have also played a role.
- For the most part, these increases in debt, house prices and wealth are sustainable
 - however household spending will probably be more sensitive to perceived changes in economic conditions.
- However debt servicing levels are now much closer to the likely upper limit of what can be sustained
 - implying that growth in borrowing is likely to slow over time unless interest rates continue to fall
- But the secular decline in interest rates since the early 1990s is just about over – implying that, at some stage
 - growth in debt and wealth will slow significantly
 - house prices will not (in general) rise faster than CPI inflation
 - household spending will grow more in line with household incomes

The growing interest in investment in property markets may be a new source of volatility



Sources: REIA; Economics@ANZ.

- By definition, owner-occupiers face zero vacancy rates and rarely sell when faced with the prospect of declining house prices
- Owner-occupiers are thus an inherently stabilizing force in property markets – except during periods of rising interest rates and unemployment
- But investors may become net sellers in response to rising vacancy rates and ‘earnings disappointments’ – in the same way as investors in equities
- The enlarged presence of investors may thus have introduced a new source of volatility into property markets

Would you like a “soft copy” of this presentation?

Do you have any other questions?

Send an e-mail to:

jamesi2@anz.com