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Economic Update

29 February 2008

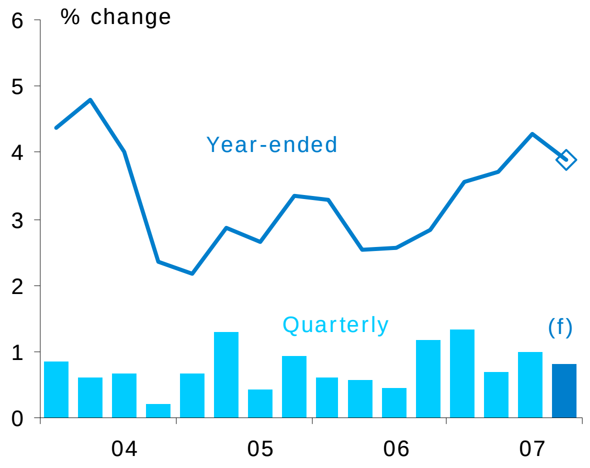
Australian Q4 2007 GDP preview

(Slightly) slower growth unlikely to impress RBA

We expect next Wednesday's *National Accounts* to show that GDP grew by 0.8% in the December quarter 2007, and by 3.9% over the year.

While this would represent a modest slowing from the previous quarter's annual growth of 4.3%, this is unlikely to provide much comfort for the RBA, which has argued that, *"a significant slowing in demand from its recent pace is likely to be necessary to reduce inflation over time."* A slowing in economic growth from a rate that is well above trend – which we estimate to be around 3-3¼% - to something that is still above trend, will not be sufficient to aid the RBA in its efforts to reduce inflation.

December quarter 2007 GDP growth



Sources: Australian Bureau of Statistics, Economics@ANZ

The composition of growth is unlikely to be all that comforting either. The most significant brake on growth in the quarter is likely to have been the external sector, which reflects a combination of weather-related supply disruptions to exports and strong demand for imports. Abstracting from this, growth in the domestic economy is expected to have been 1.2% in the quarter and 5.7% over the year. In other words, demand in the Australian economy continues to run well ahead of its productive capacity, with the excess being met by production from overseas.

It is this 'excess demand' that has been the fundamental driver of inflationary pressures over the past couple of years, and it is this that the Bank hopes will be reined in with tighter monetary policy and slowing global demand. The problem is that these headwinds are being largely offset by the ongoing boost to both corporate and household incomes from the surging terms of trade. This was no more apparent than in the December quarter CAPEX survey, which showed that even in the midst of the financial turmoil when the survey was conducted in January and February, businesses still expected to increase their capital expenditure by over 20% in 2008-09, on top of double-digit growth this year.

For the RBA, all of this merely confirms what they already knew: that the downside risks to growth from tightening policy pale in comparison to the upside risks to inflation of sitting tight. Expect more rate hikes, both before and after next Wednesday's GDP report.

December quarter 2007 GDP forecasts

	Qtr % ch		Cont to % ch
	Dec	Sep	Dec
Household consumption	1.2	1.2	0.7
Dwelling investment	1.0	1.4	0.1
Business investment	0.6	0.2	0.1
Public demand	1.3	0.4	0.3
Domestic demand	*1.1*	*0.8*	*1.2*
Changes in inventories	--	--	0.1
Gross national expenditure	*1.2*	*1.1*	*1.2*
Net exports	--	--	-0.7
Statistical discrepancy (E)	--	--	*0.3*
Gross Domestic Product	**0.8**	**1.0**	**0.8**
(year ended)	(3.9)	(4.3)	(3.9)
Non-farm	*0.7*	*0.6*	*0.7*
Farm	*8.0*	*24.0*	*0.2*

Source: Australian Bureau of Statistics; Economics@ANZ

Details

Partial indicators of **household consumption** point to further strength in the December quarter. The volume of retail sales increased by 1.6% in the quarter while sales of motor vehicles surged 2.7%. The remaining 55% of household consumption is made up of services, for which have little reliable partial data. But assuming similarly solid growth in spending on services to previous quarters yields overall household consumption growth of 1.2% in the quarter. This is a remarkably strong figure in a

Mark Rodrigues – Senior Economist, Australia Ph: +61 3 9273 6286 Email: mark.rodrigues@anz.com

quarter where households were slugged with higher interest costs and petrol prices, and points to a degree of resilience in consumer spending enabled by strong income growth.

Dwelling investment is expected to post a modest increase in the quarter, continuing the broadly sideways trend evident over the past couple of years. The latest Construction Work Done survey suggests that new home building fell slightly in the quarter but this is likely to be offset by ongoing strength in alterations and additions which now account for almost half of total dwelling investment.

Business investment is forecast to have increased modestly in the December quarter (+0.6%), which is no mean feat given the mature phase of the overall investment cycle. Non-residential construction is expected to have fallen, reflecting declines in both building and engineering construction activity. However, this is likely to be partly offset by a solid increase in machinery and equipment investment in the quarter. Looking forward, CAPEX data suggest that the peak in the long-running investment cycle is still some way away, with the first read on expenditure intentions for 2008-09 pointing to growth in excess of 20%.

Growth in **public demand** is expected to increase solidly in the December quarter, reflecting a combination of ongoing solid growth in government consumption (largely wages) and a further increase in public investment, as work associated with federal and state infrastructure programs ramps up.

Net exports are expected to have subtracted 0.7ppts from GDP growth in the December quarter. Weather-related supply disruptions saw exports virtually stall in the quarter, while ongoing strong domestic demand, particularly from import-intensive capital investment projects, likely pushed imports up by over 3%.

The farm sector is expected to have continued its rebound from the drought, with **farm GDP** forecast to have grown by around 8% in the December quarter, contributing 0.2ppts to overall GDP growth. Including last quarter's 24% increase, such an outcome would lift farm GDP to almost 90% of pre-drought levels.

Further partial information will be available early next week ahead of the National Accounts, with the release of Business Indicators on Monday and the Balance of Payments and Government Finance Statistics data on Tuesday. We will finalise our GDP estimate following these releases.

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AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

10th Floor 100 Queen Street, Melbourne 3000, Australia

Telephone +61 3 9273 6224   Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121   Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Telephone +1 212 801 9160   Fax +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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