

# Outlook for the Economy and the Pharmacy Industry

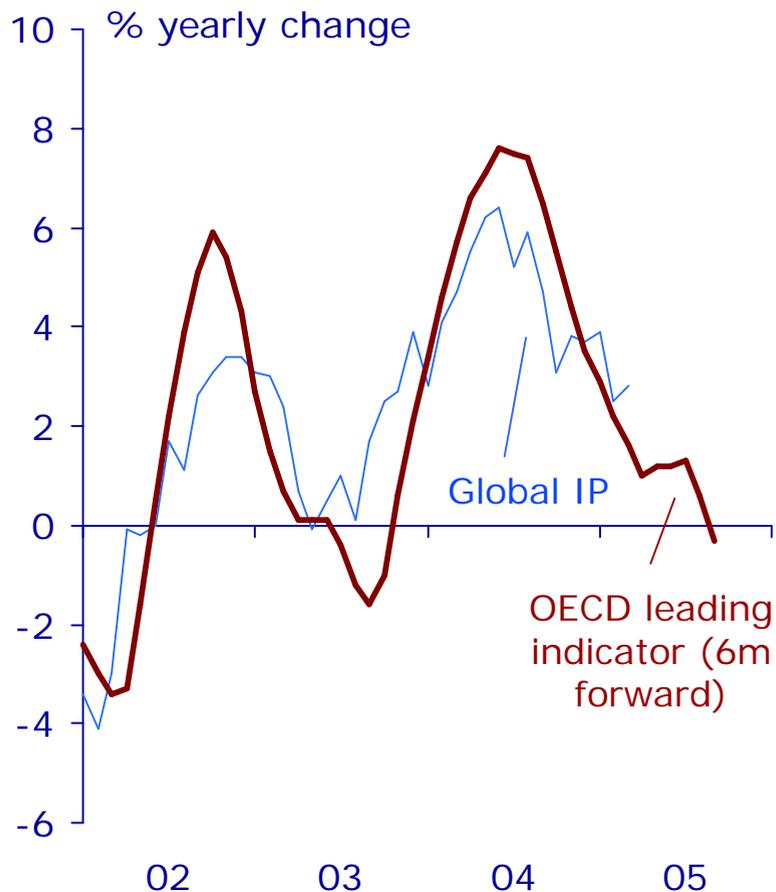
Chris Munn  
Economist  
ANZ Bank

June 2005

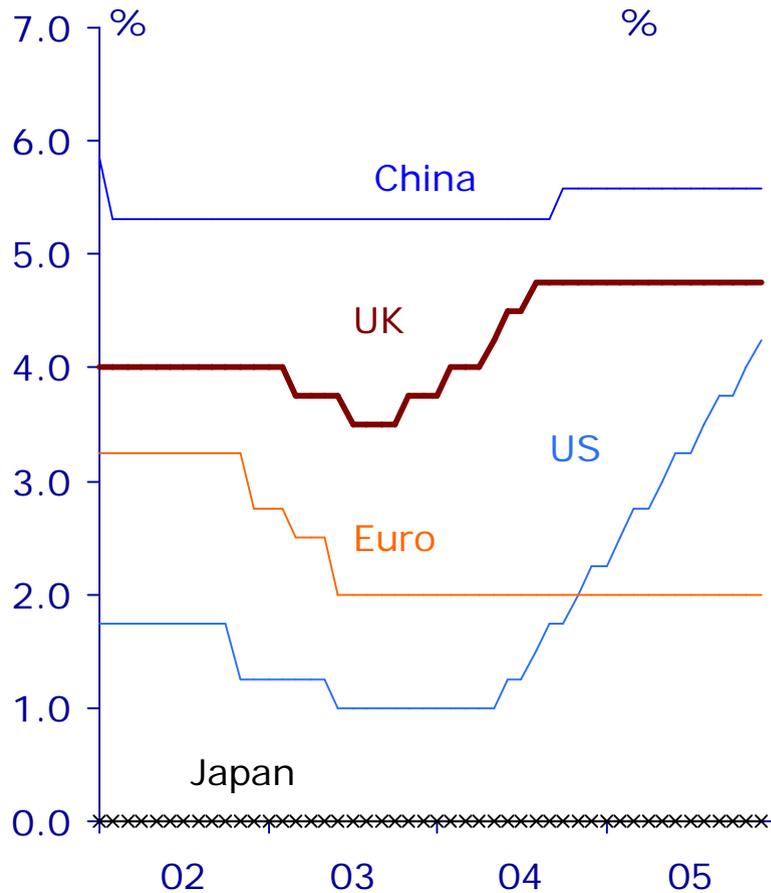
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# After the strongest performance in 30 years, global growth is slowing

## OECD industrial production



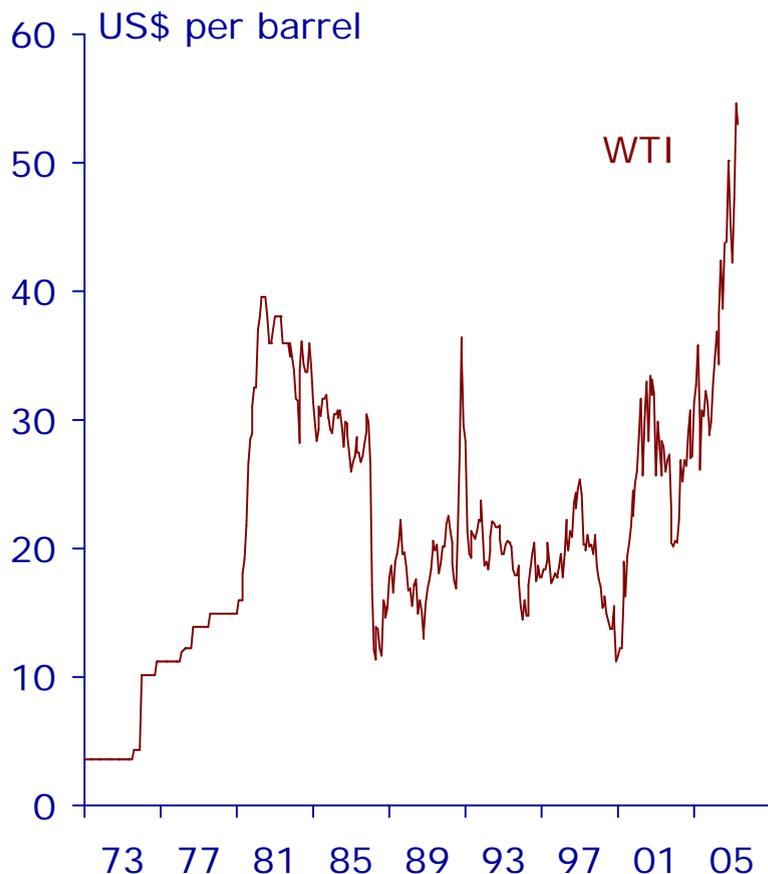
## Official interest rates



Sources: National agencies, IMF, OECD. Bloomberg and Economics@ANZ.

# Higher oil prices have caused a 'soft spot', but shouldn't cause the global economy to collapse

## Oil prices



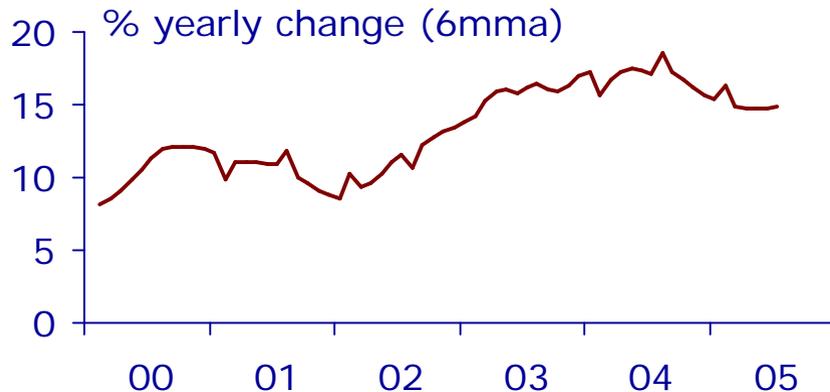
- **Strong global demand, geopolitical risk and speculation has pushed oil prices to record highs**
- **Higher oil prices is hitting household discretionary income and corporate profit margins**
- **The global and Australian economies are now better placed to cope with oil price 'shocks'**
  - **Greater energy-efficiency and increased use of alternative energy sources**
  - **More efficient product and labour markets reduce inflation risk**

# The US and China will keep global growth above trend again this year

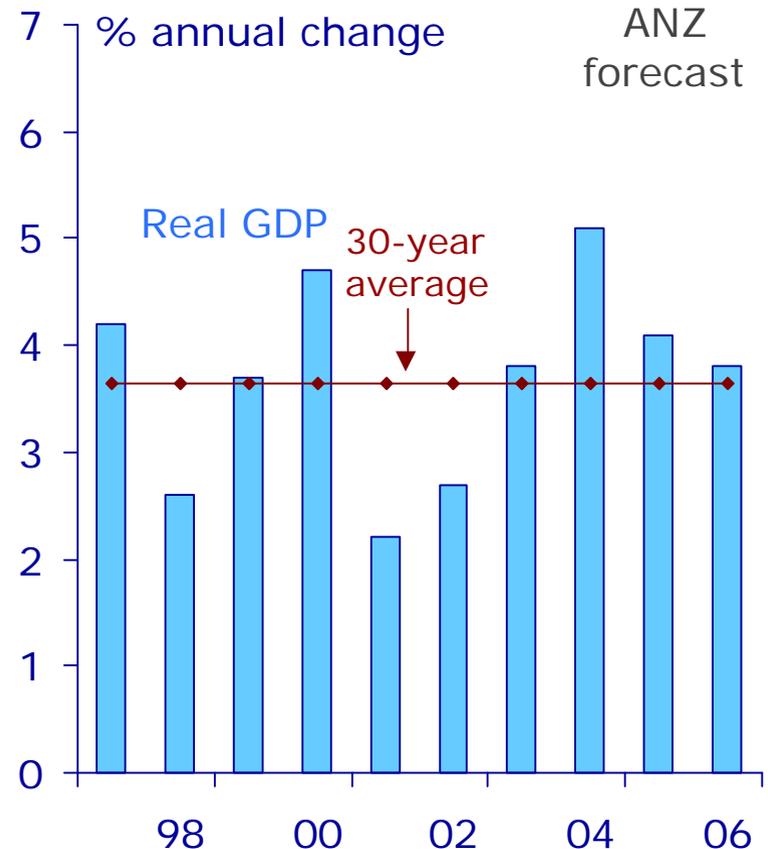
## Real fed funds rate



## Chinese industrial production



## Global growth

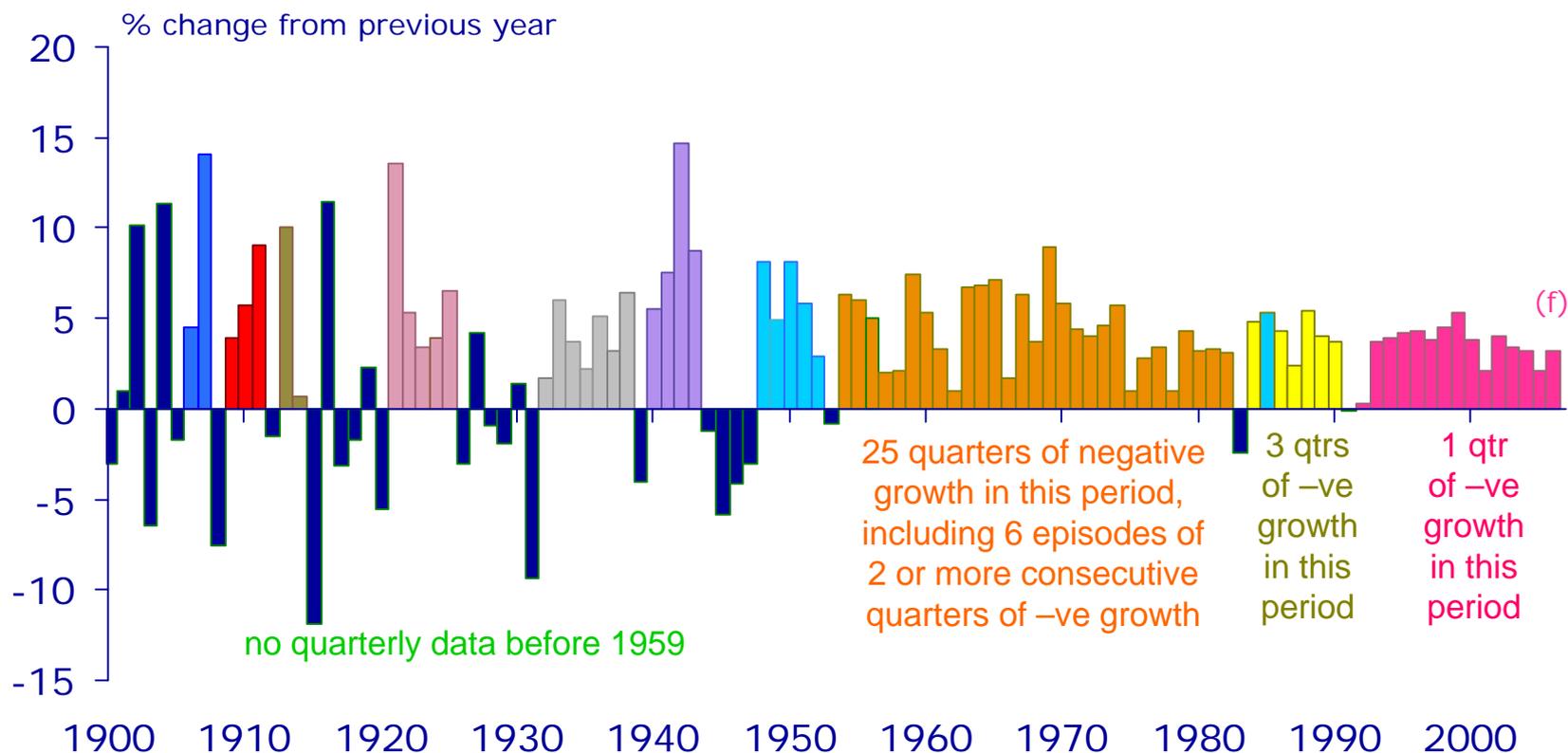


Note: GDP based on 50 countries aggregated using 'purchasing power parity' weights.

Sources: National agencies, IMF, OECD, US Federal Reserve, and Economics@ANZ.

# Australia is enjoying its longest run of uninterrupted economic growth since Federation

## Australian real GDP growth, 1901 - 2006

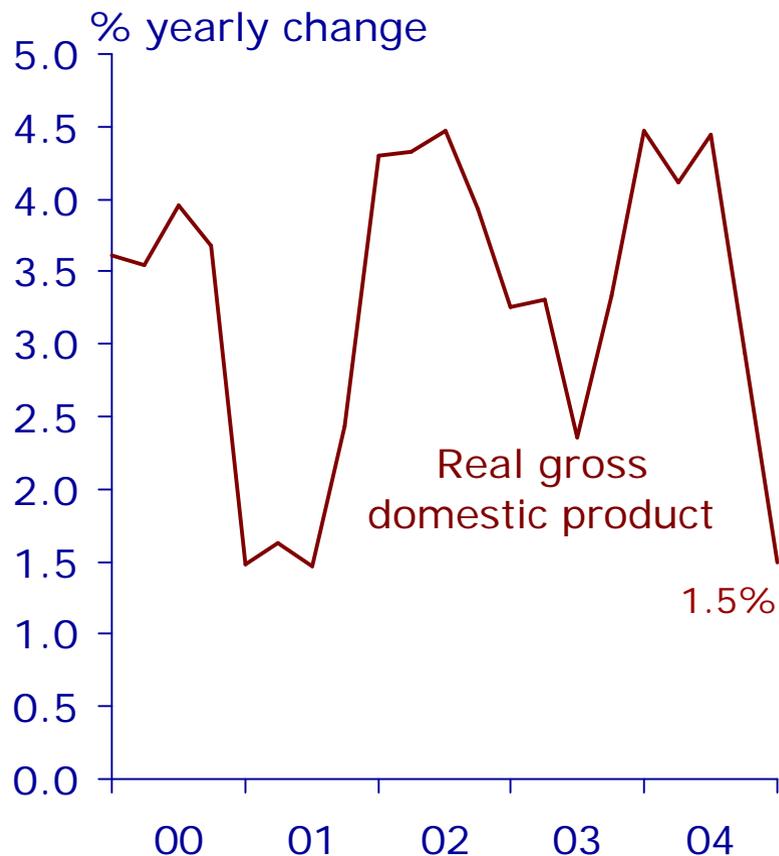


Note: data are for financial years ended 30 June.

Sources: Angus Maddison, *Monitoring the World Economy 1820-1992*; Reserve Bank; ABS; Economics@ANZ.

# The headline data suggests growth slowed sharply in the second half of last year

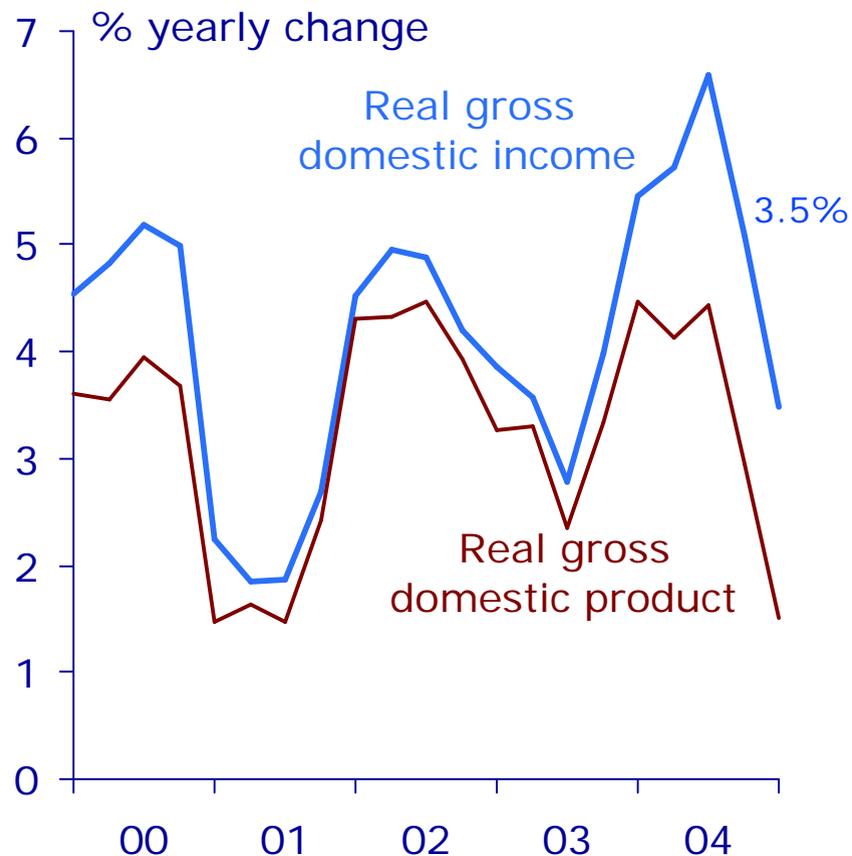
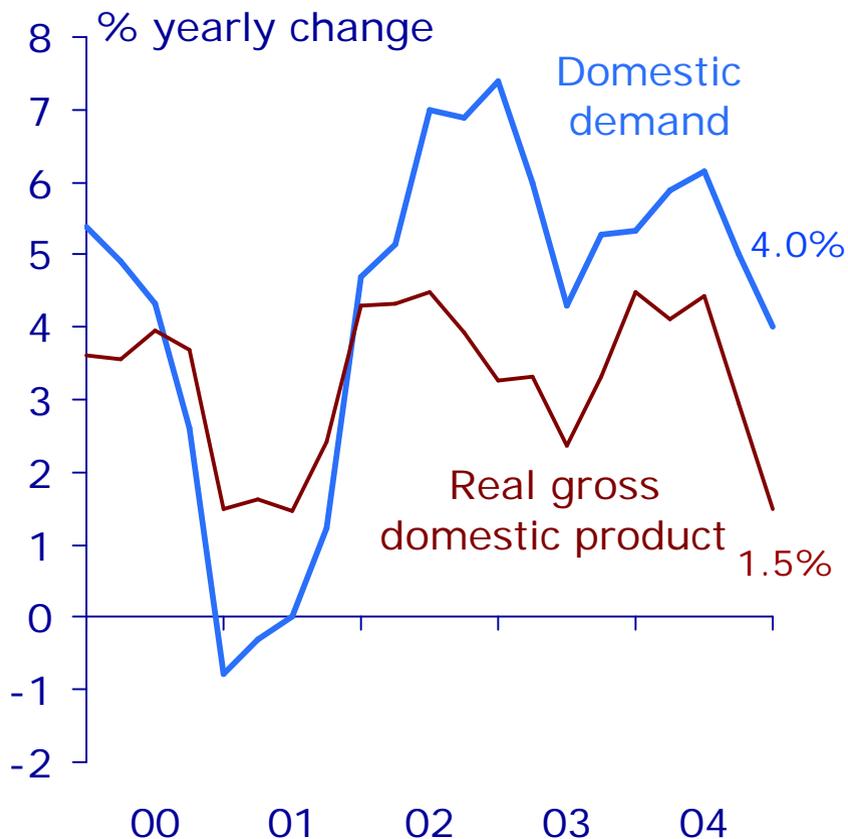
## Economic growth



- The official ABS data suggests that economic growth slowed from..
  - ... 4%yy at the start of 2004 to...
  - ... just a 1.4%yy by end-2004
- This is well below 'average' growth of around 3¼-3½%pa

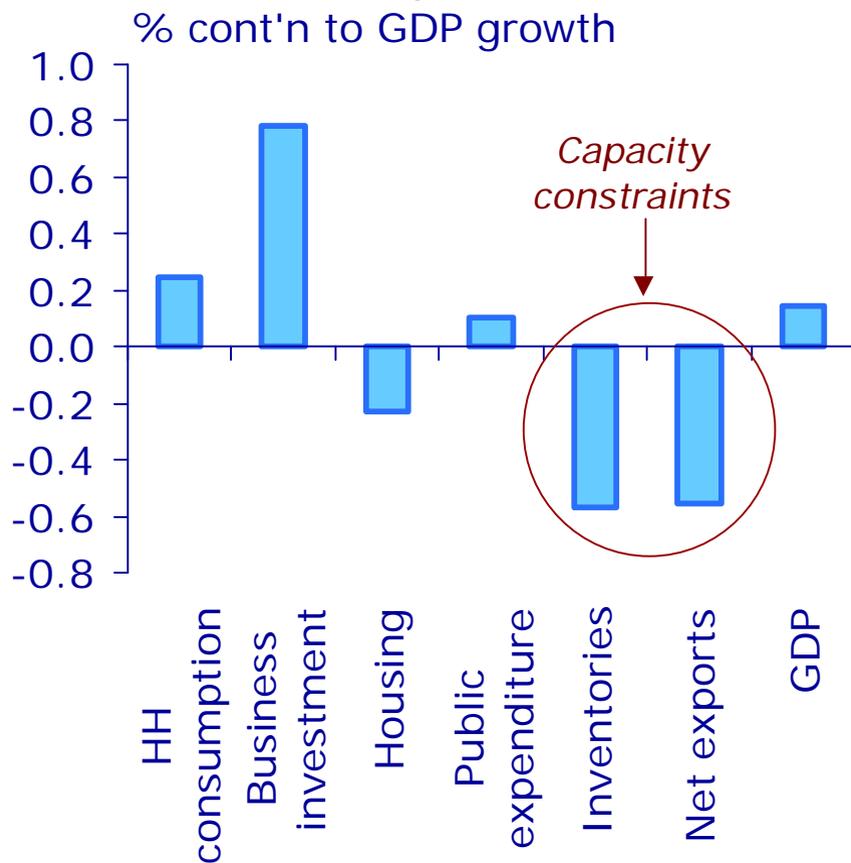
# But the GDP data doesn't tell the whole story

## Australian economic growth

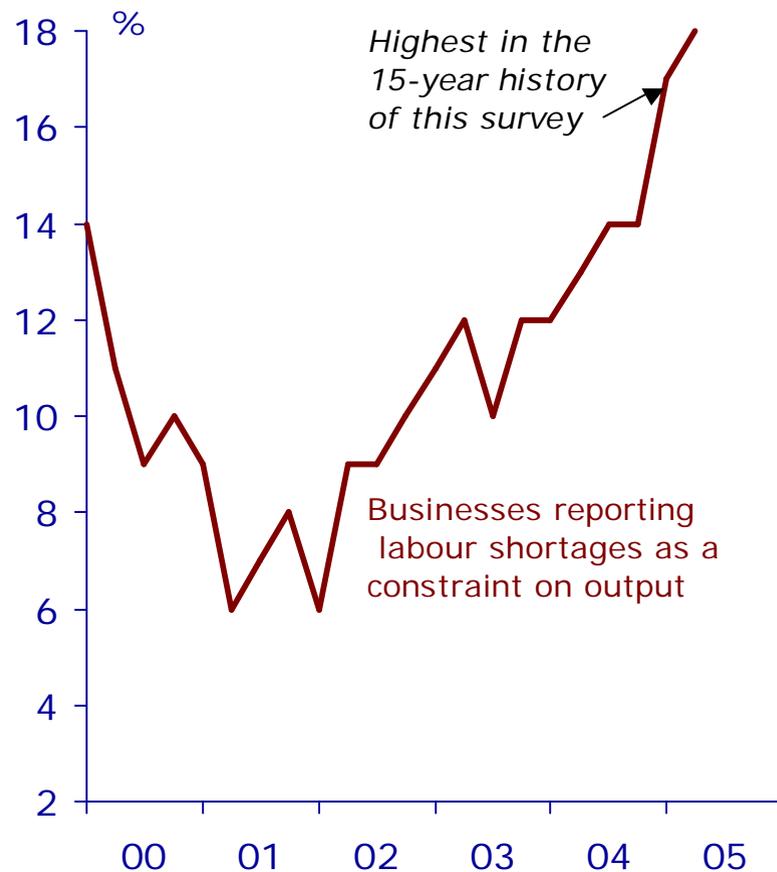


# Part of the slowdown in GDP growth reflects capacity constraints

## Contributions to GDP growth, December quarter 2005

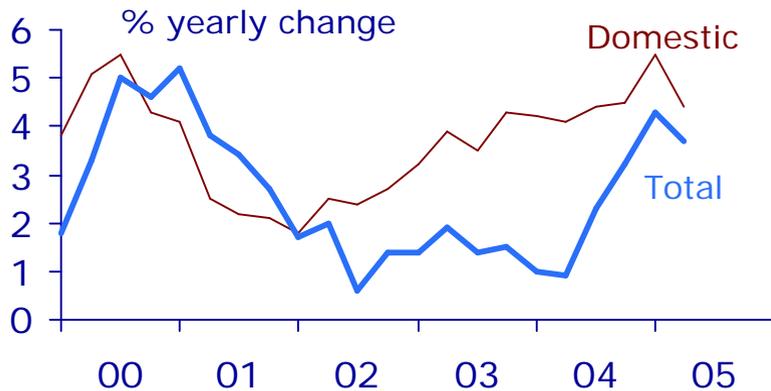


## Labour shortages

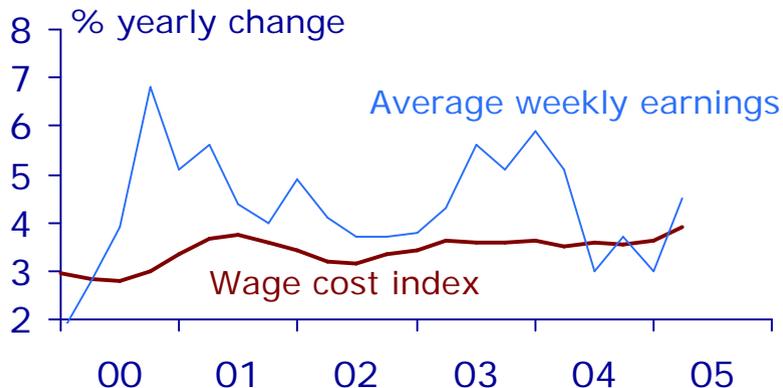


This has been putting upward pressure on some prices – which is why the RBA raised rates

### Final producer prices



### Wages

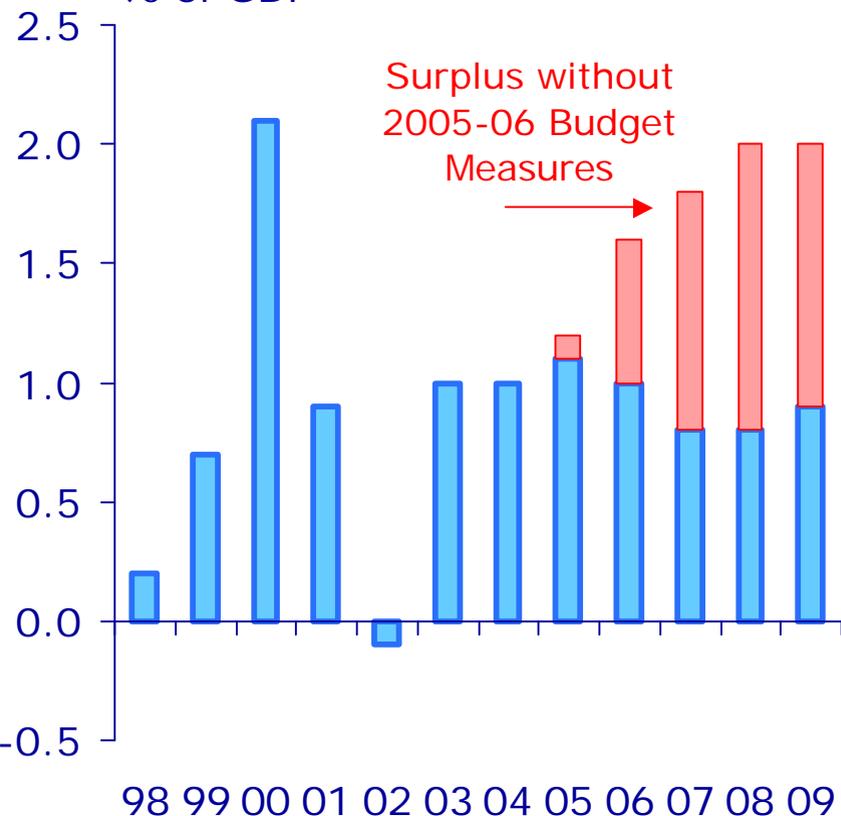


- **Rising domestic material costs and labour shortages (in some industries) has put upward pressure on producer prices**
- **Labour costs are also showing an upward trend**
  - **Although wage pressures thus far remain contained to a few 'pockets' where demand is strongest eg. mining, engineering, construction**
- **The RBA were concerned that continued strong domestic demand would further stoke emerging price pressures**
- **Hence the 25bp rise in interest rates in March**

# What has the Government done to address these problems?

## Commonwealth Government underlying budget balance

% of GDP



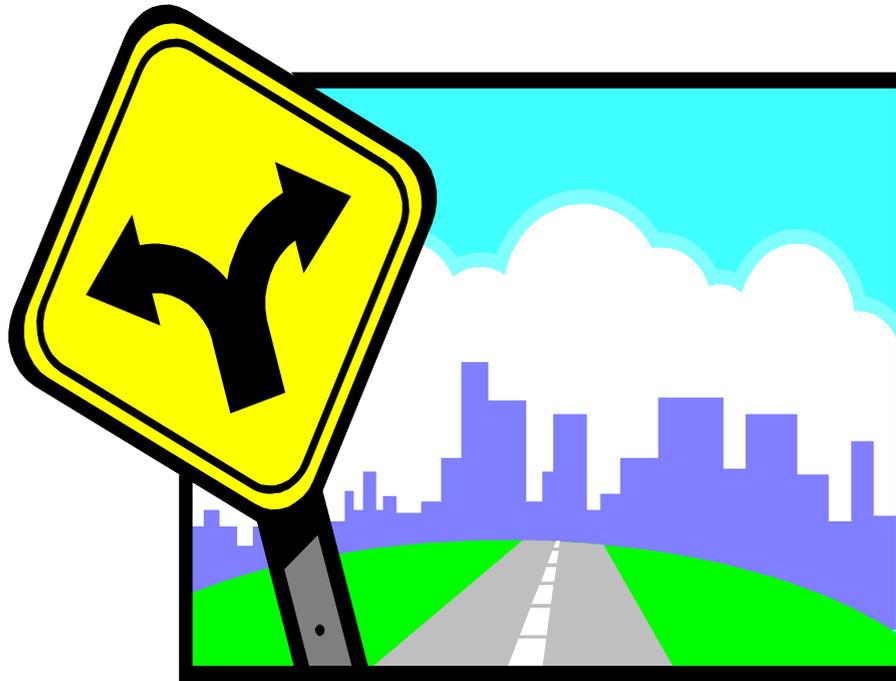
Sources: Commonwealth Budget Papers

- Strong employment growth and company profits has given Government coffers a significant boost
- However, the Government has given most of this extra revenue back, via tax cuts and increased expenditure
- Overall, the Commonwealth Government is imparting a soft fiscal stimulus to economic growth next year
- But it's what the Government does with the extra cash that matters most

# The Budget was a good start, but there is further to go

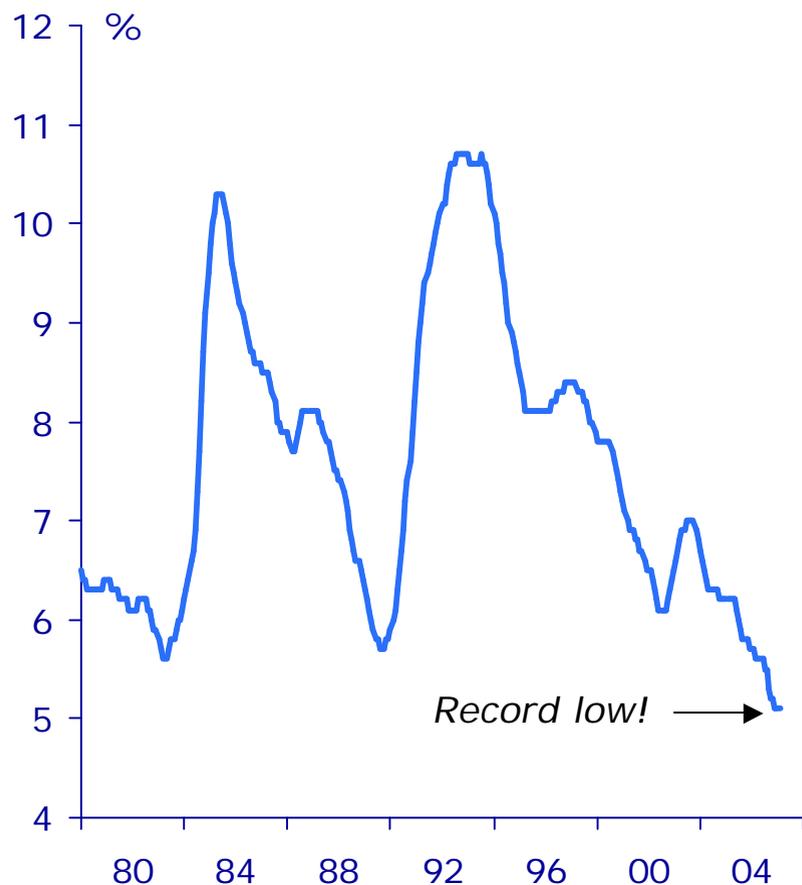
- **Income tax cuts for all with a big lift in top two tax thresholds**
  - A good start, but we still need more comprehensive reform of the income tax system (lowering rates by broadening the base and eliminating the myriad of concessions, exemptions and deductions)
- **Concerted effort to increase labour force participation by moving people from welfare to work**
  - Reducing the lowest marginal tax rate, changing eligibility for Newstart Allowance amongst single parents and receivers of Disability Support, expanded services for work assistance, including wage subsidies for long-term unemployed
- **Not much for businesses except for a few worthwhile tax cuts**
  - Removal of the 3% concessional tariff on business inputs and ability to deduct 'blackhole' expenditures
- **A little bit of extra money for education, but very little to address infrastructure bottlenecks**
  - Disappointing, although this largely falls into the domain of the States
- **An attempt to address longer term fiscal sustainability**
  - Sale of remaining Telstra share in three tranches from late 2006, raising \$34bn. Proceeds plus underlying surpluses to be invested in Future Fund as an offset to unfunded superannuation liabilities

# Which way for the Australian economy now?

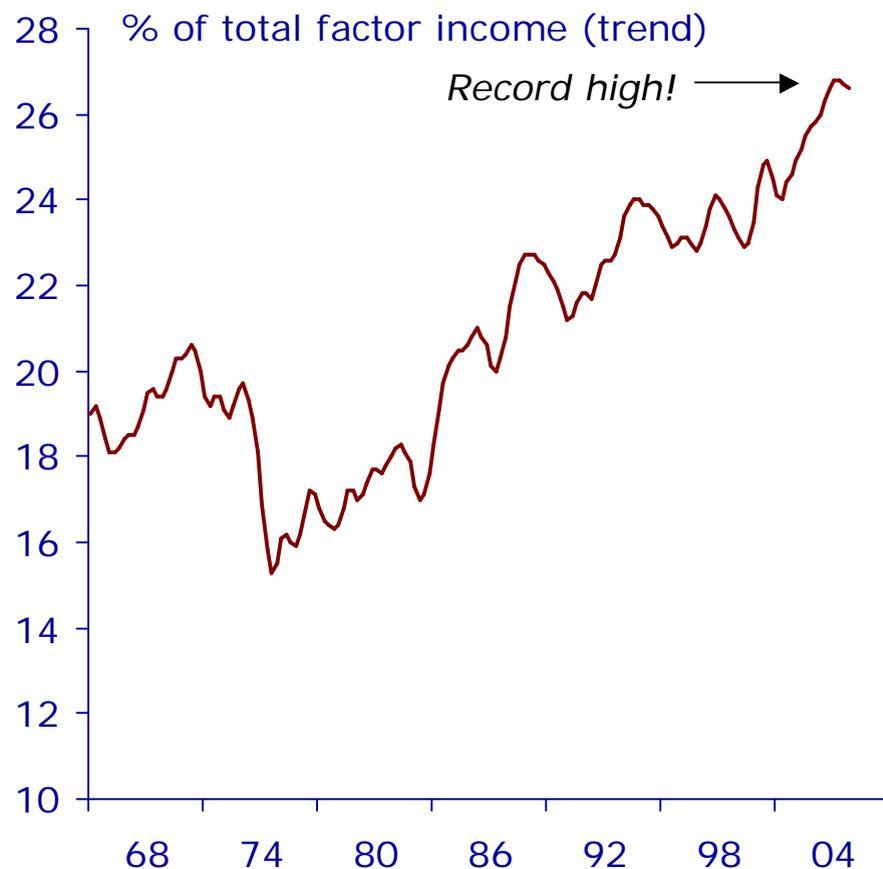


# The macroeconomic environment is still extremely favourable

## Unemployment rate

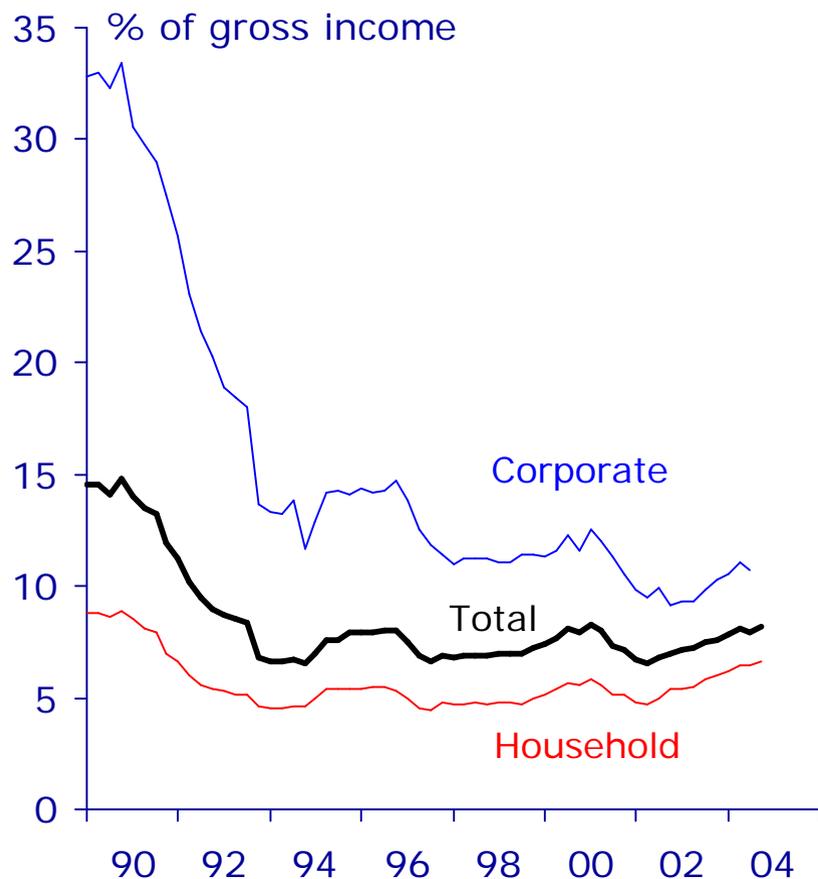


## Profits

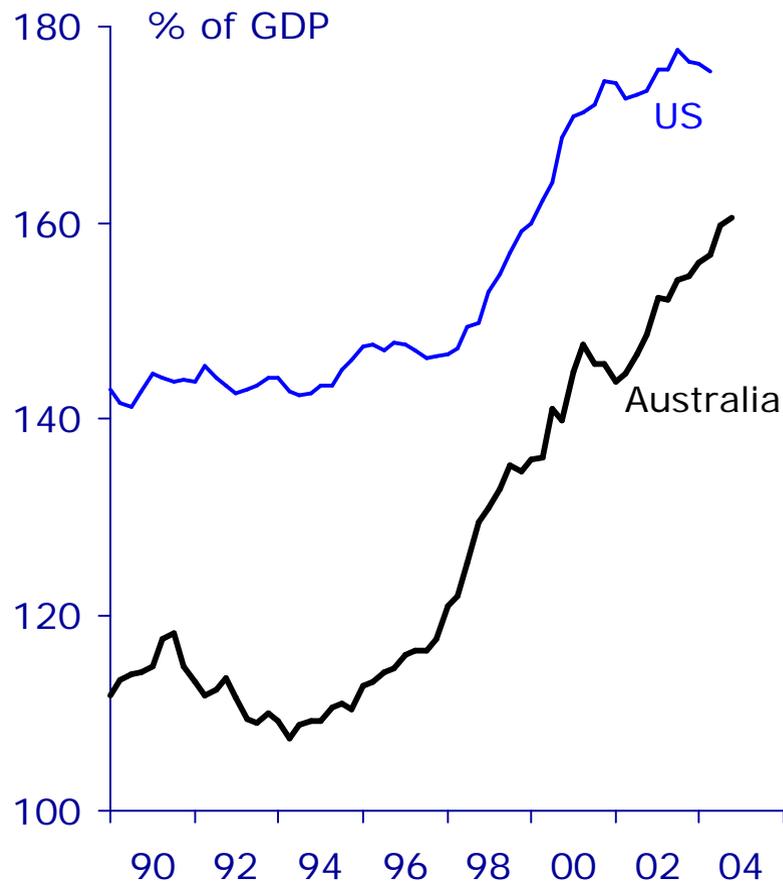


# A slight rise in interest rates won't cause the economy to collapse

## Debt service ratio

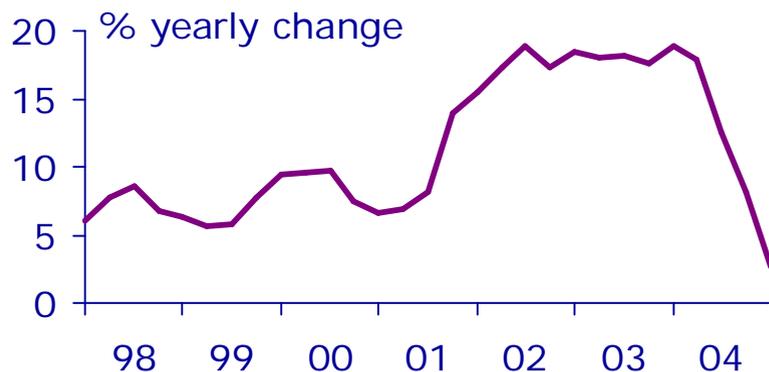


## Total debt to GDP

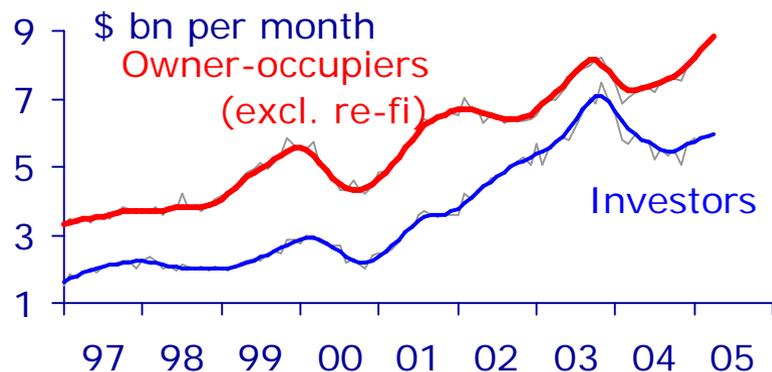


# Housing is achieving a soft landing, but will now stay softer for longer

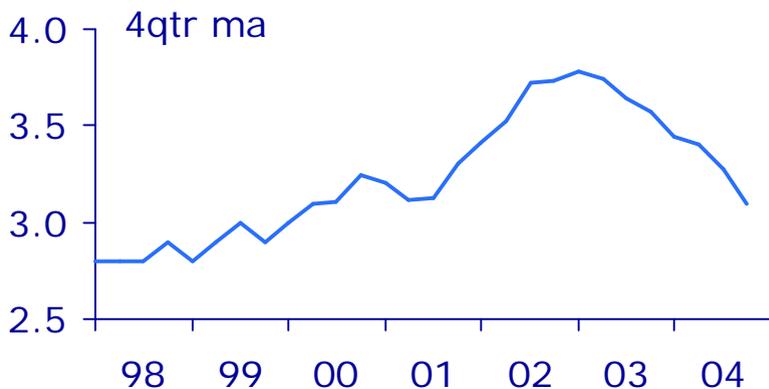
## House prices



## Housing finance commitments



## Rental vacancy rates

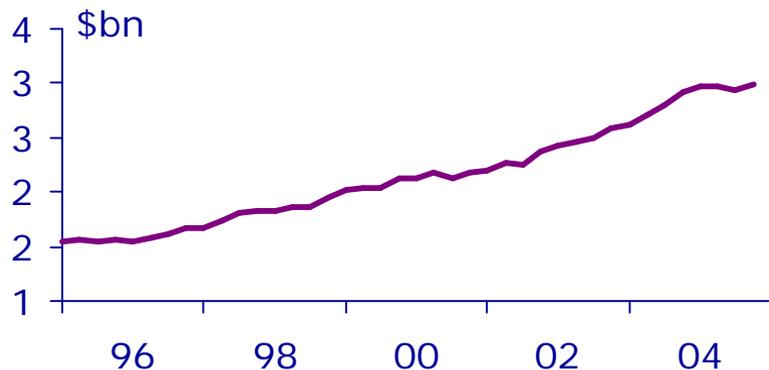


## Pipeline

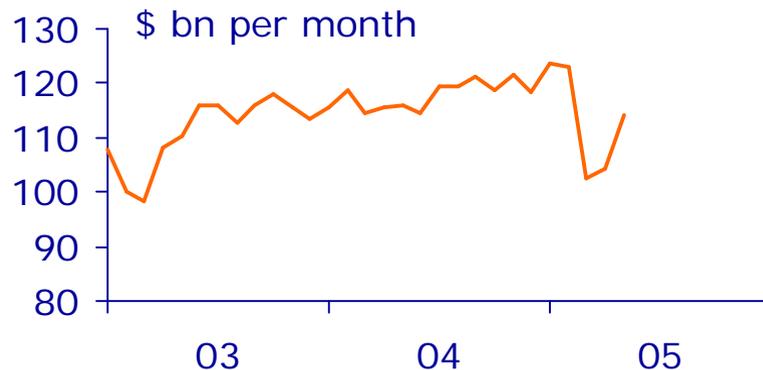


# Conditions have become a little less supportive for consumer spending...for now(!)

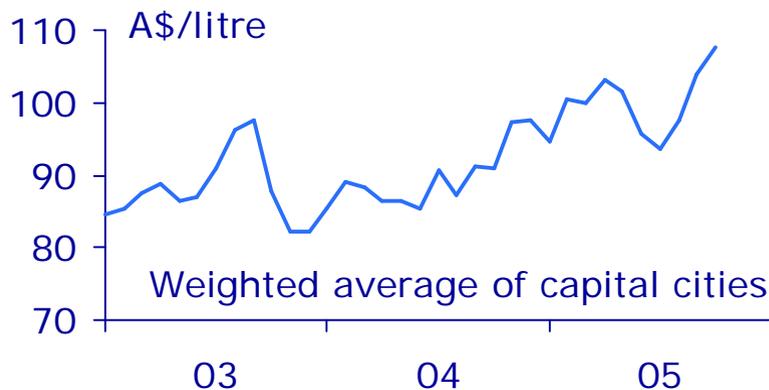
## Household net wealth



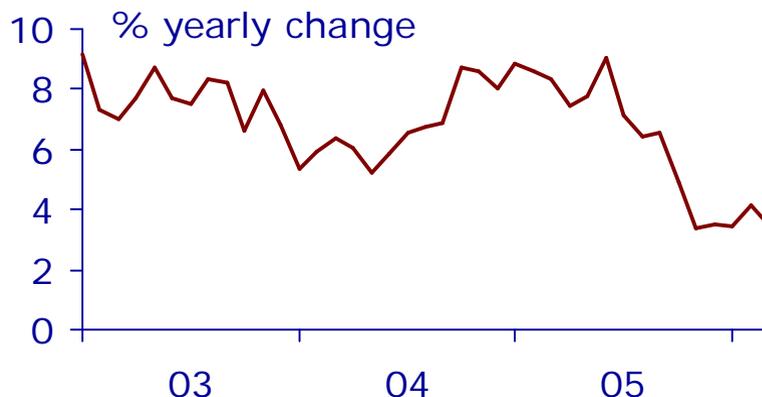
## Consumer sentiment



## Petrol prices

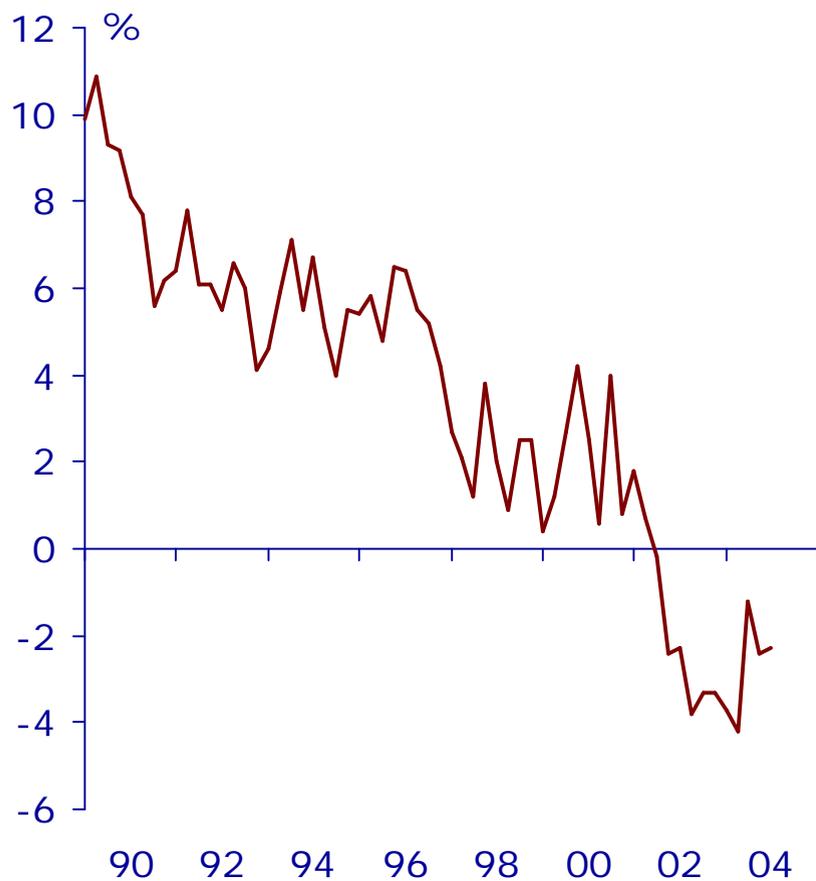


## Retail sales



# Will households save or spend their income tax cuts?

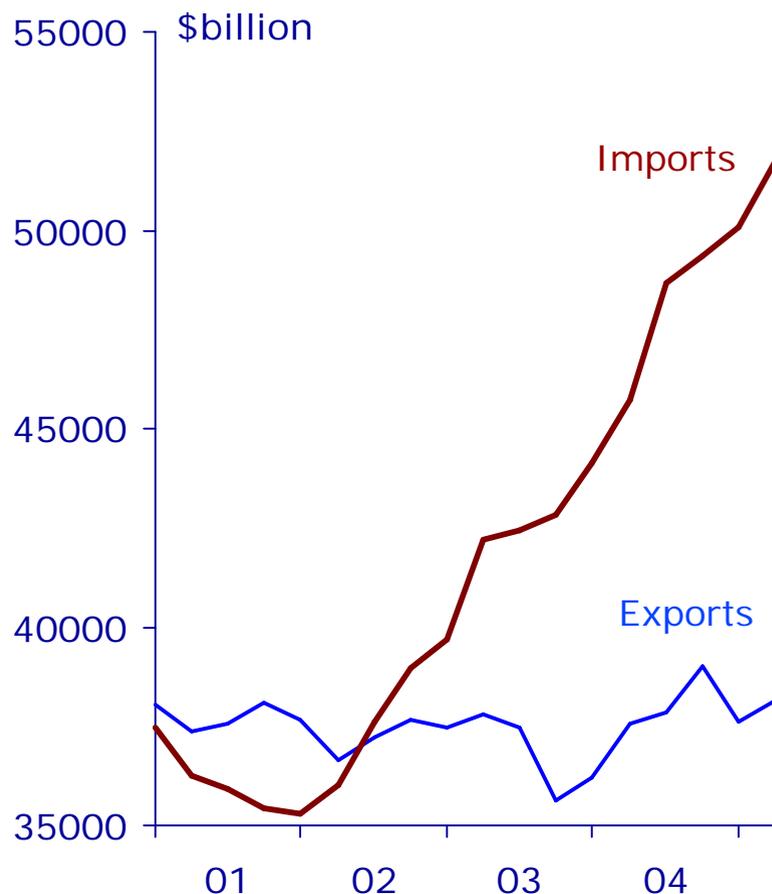
Household savings ratio



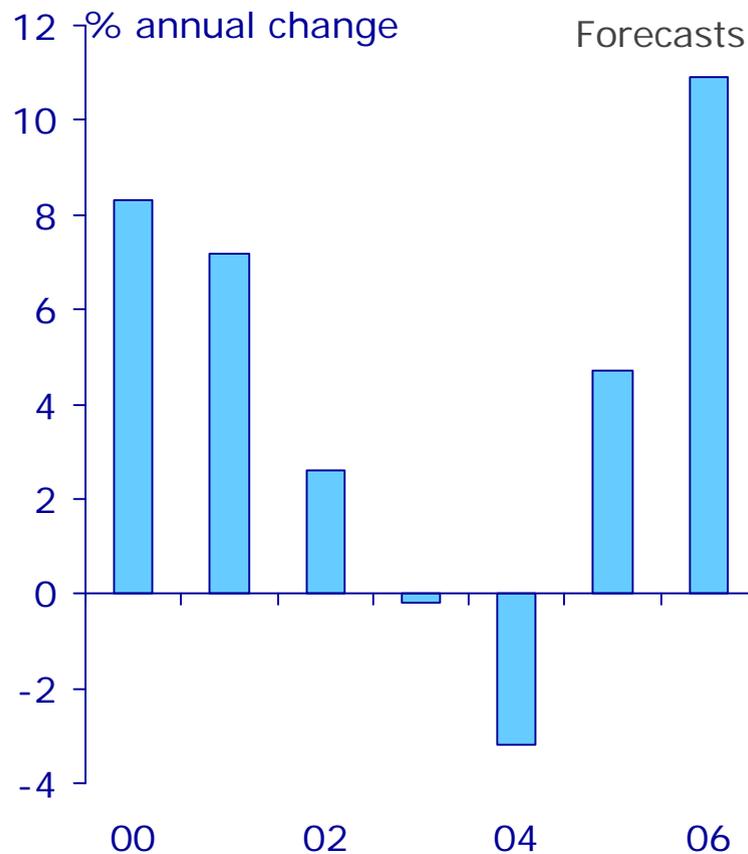
- Income tax cuts will boost household incomes by around \$3bn in 2005-06
  - That's a boost of around 1% to national disposable income
- If households spend all of their income tax cuts, we could see a boost to consumer spending of around  $\frac{3}{4}$ ppt
  - Adding around  $\frac{1}{4}$ ppt to GDP growth
- More likely however, some of these income tax cuts will be saved

# Solid global growth and a resources boom should see exports turn the corner

## Trade volumes

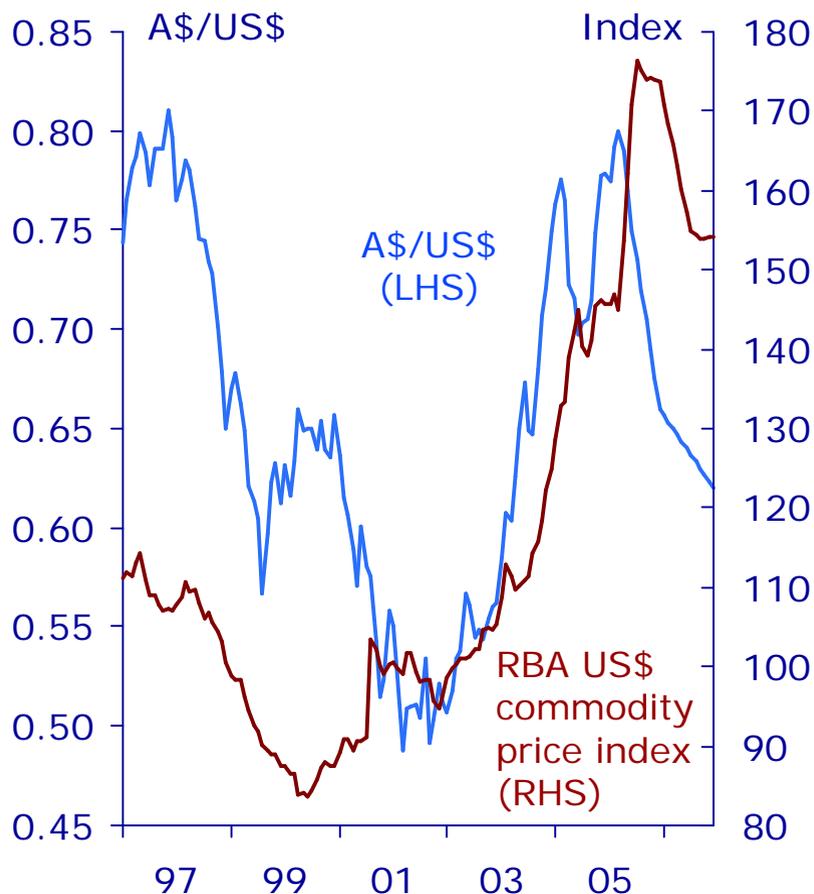


## Resource exports

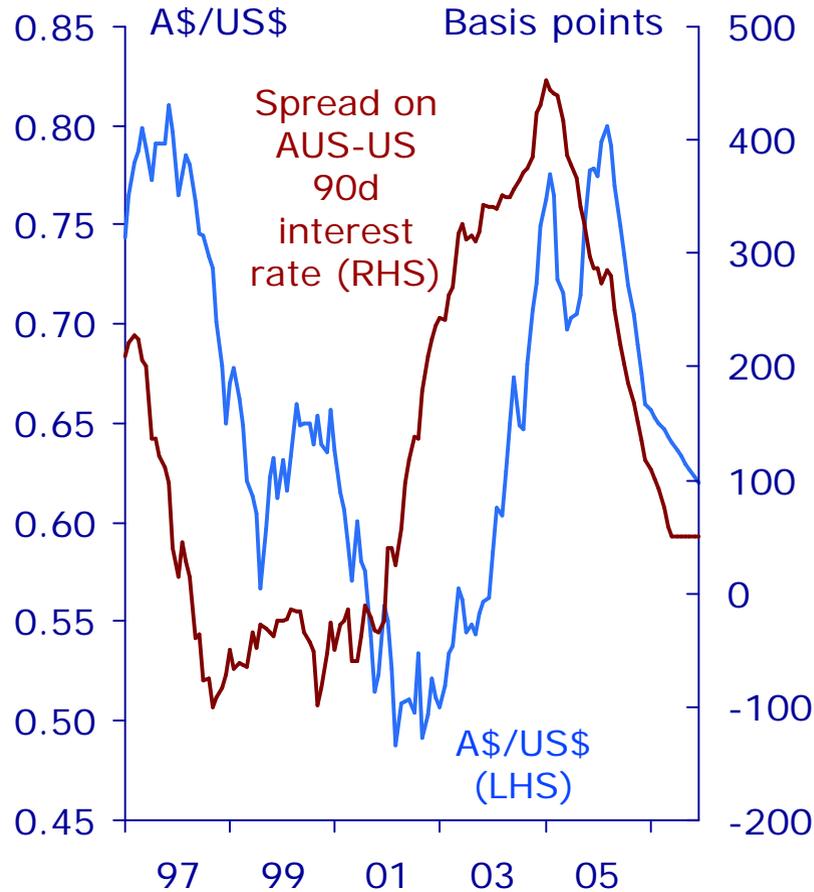


# A depreciating A\$ should also give exporters a boost

## A\$/US\$ and commodity prices

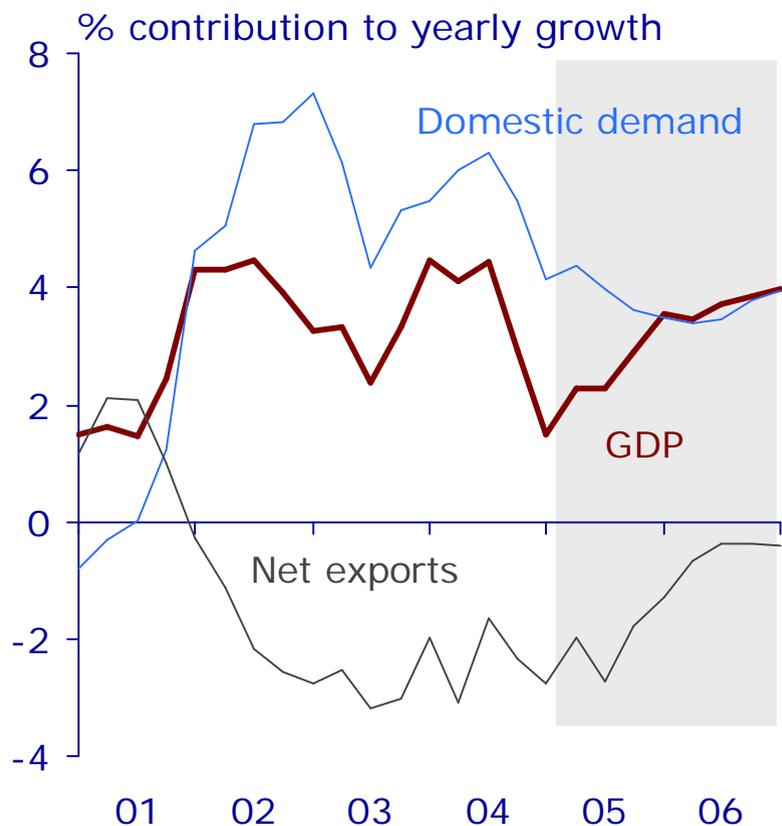


## AUS-US interest rate spreads

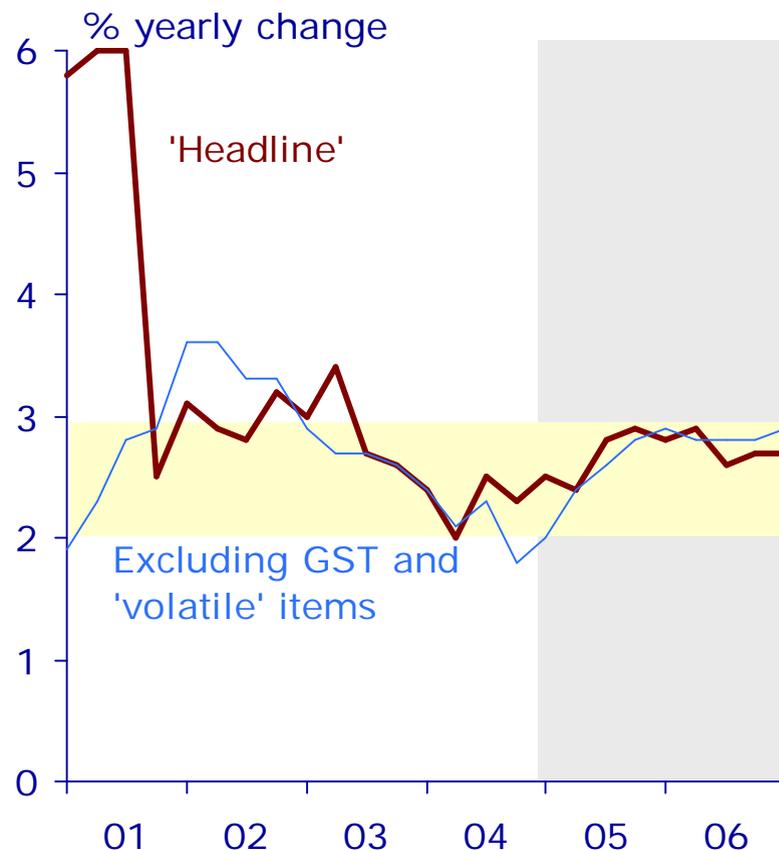


# Economic growth should moderately improve and inflation is expected to gradually rise

## Economic growth

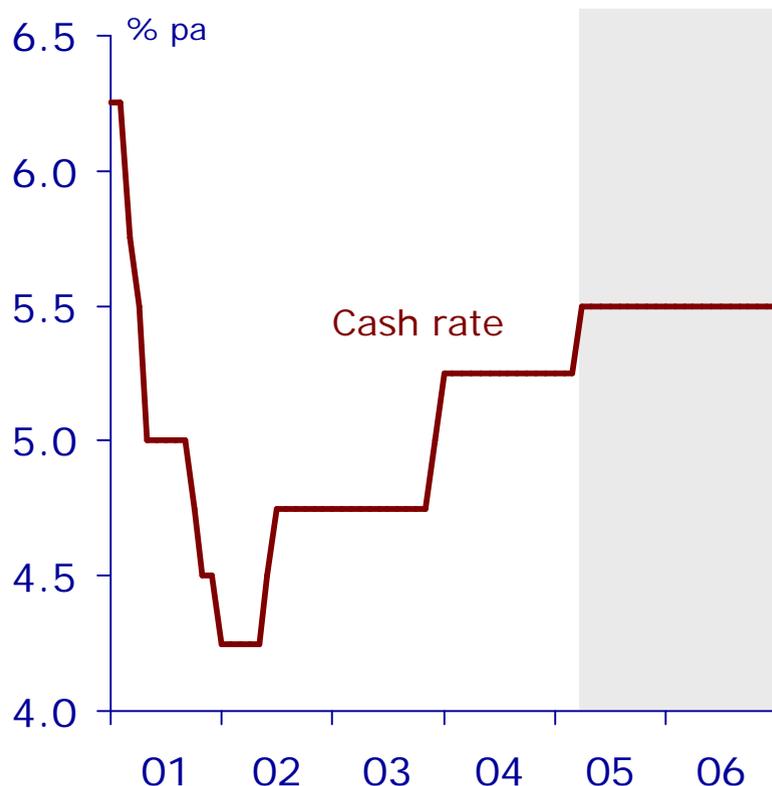


## Inflation



# Softer growth should keep the RBA on hold, but a tightening bias will remain

## Interest rates



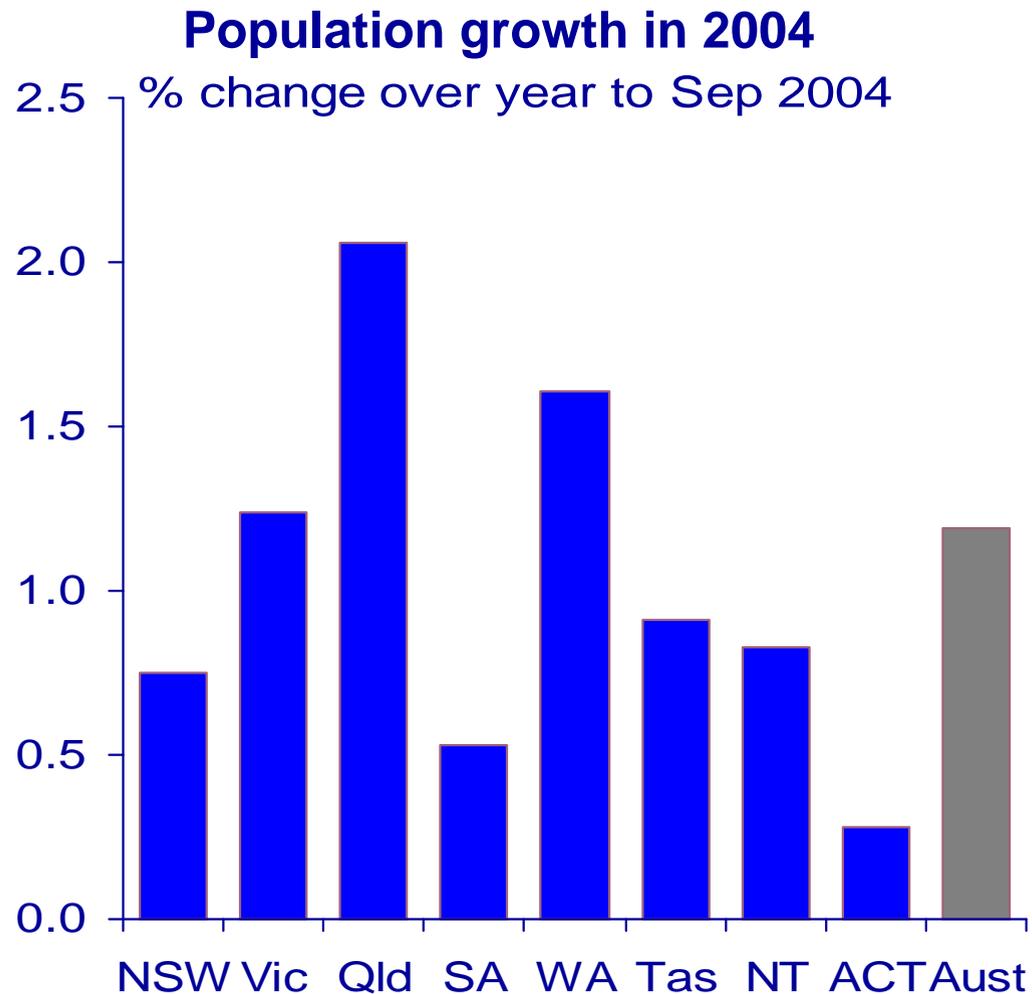
Source: RBA, Reuters, Economics@anz

- **Signs that the (domestic) economy is cooling has seen the RBA become less concerned about the upside risk to inflation**
  - This is because the downturn looks to be cyclical as well as structural
  - The sharp reaction to the March rate rise, as demonstrated by the big fall in consumer sentiment, may have also seen the RBA become a little wary
- **Our view is that these factors will likely keep rates on hold for now**
- **Nevertheless, the RBA sees the outlook as far from soft**
  - Income tax cuts, strong terms of trade, low unemployment, rising wages
- **So the policy bias remains for higher, not lower, interest rates**

# The pharmacy industry



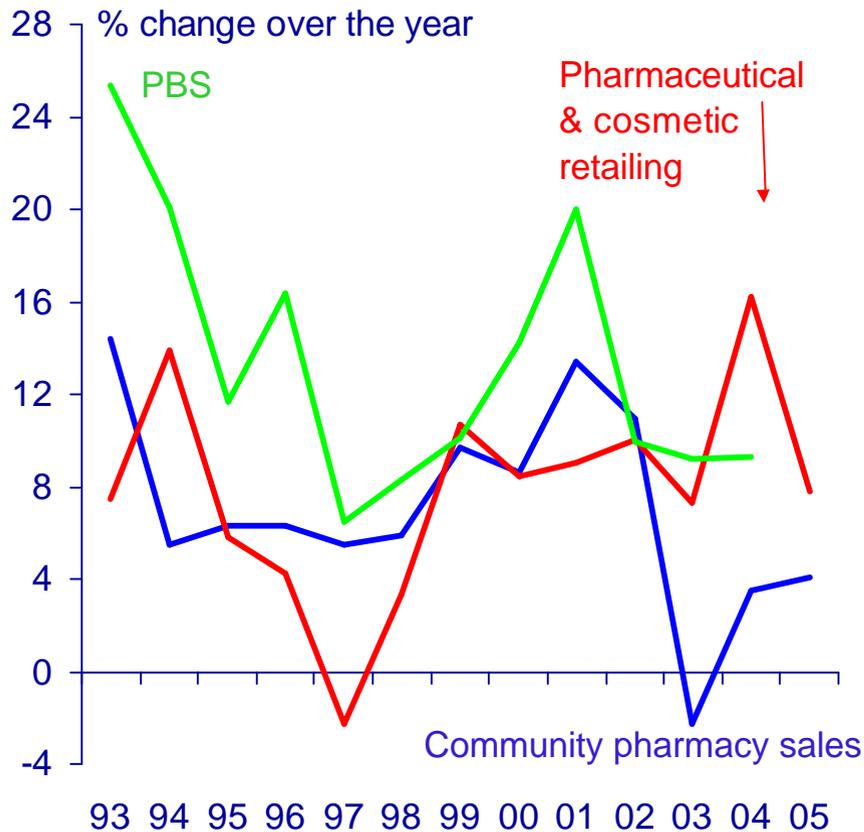
# Interstate and overseas migration will have an impact



Source: ABS

# Pharmacy turnover has been fairly flat despite the strength of the economy

## Pharmaceutical retailing

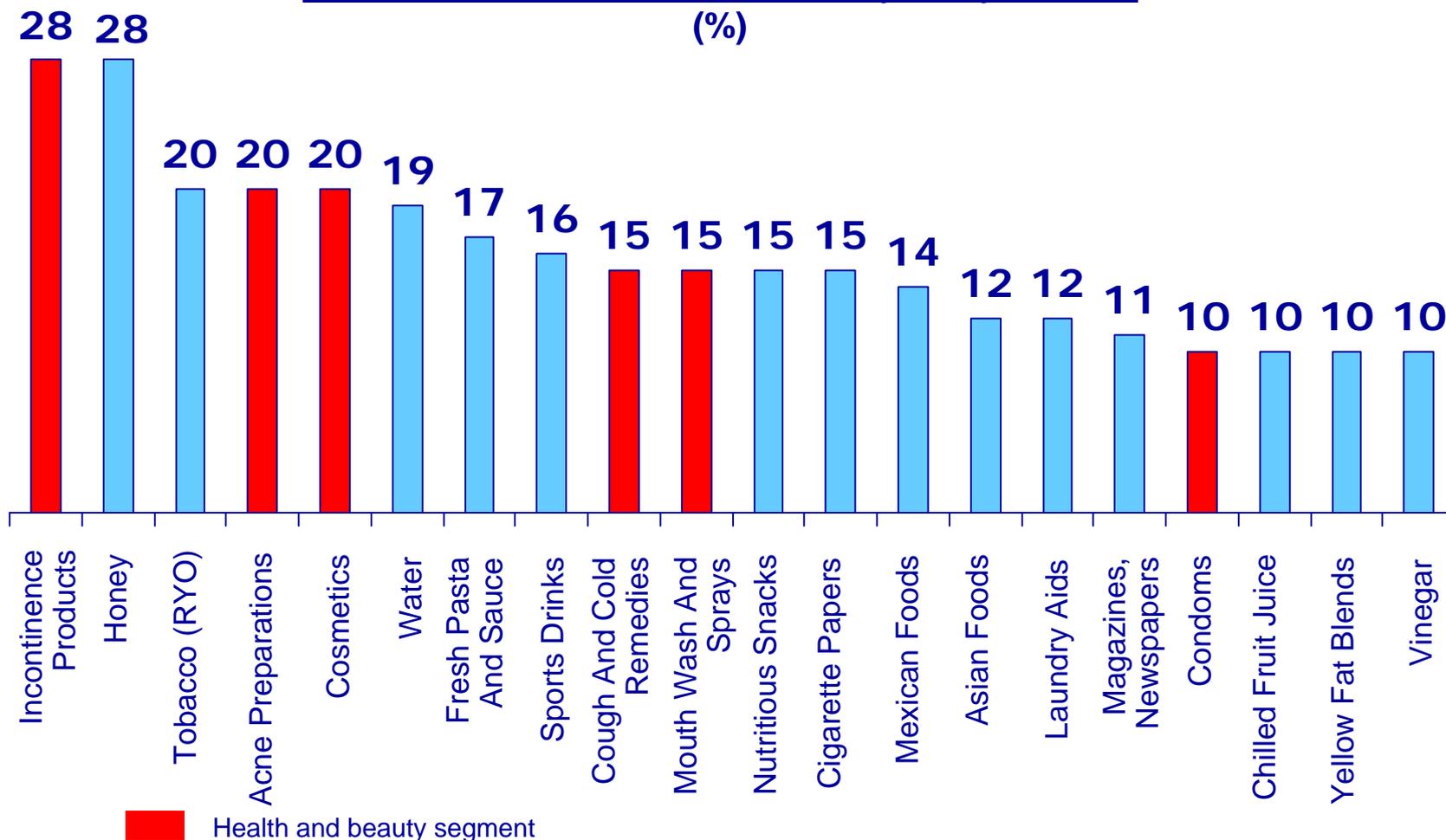


Source: ABS

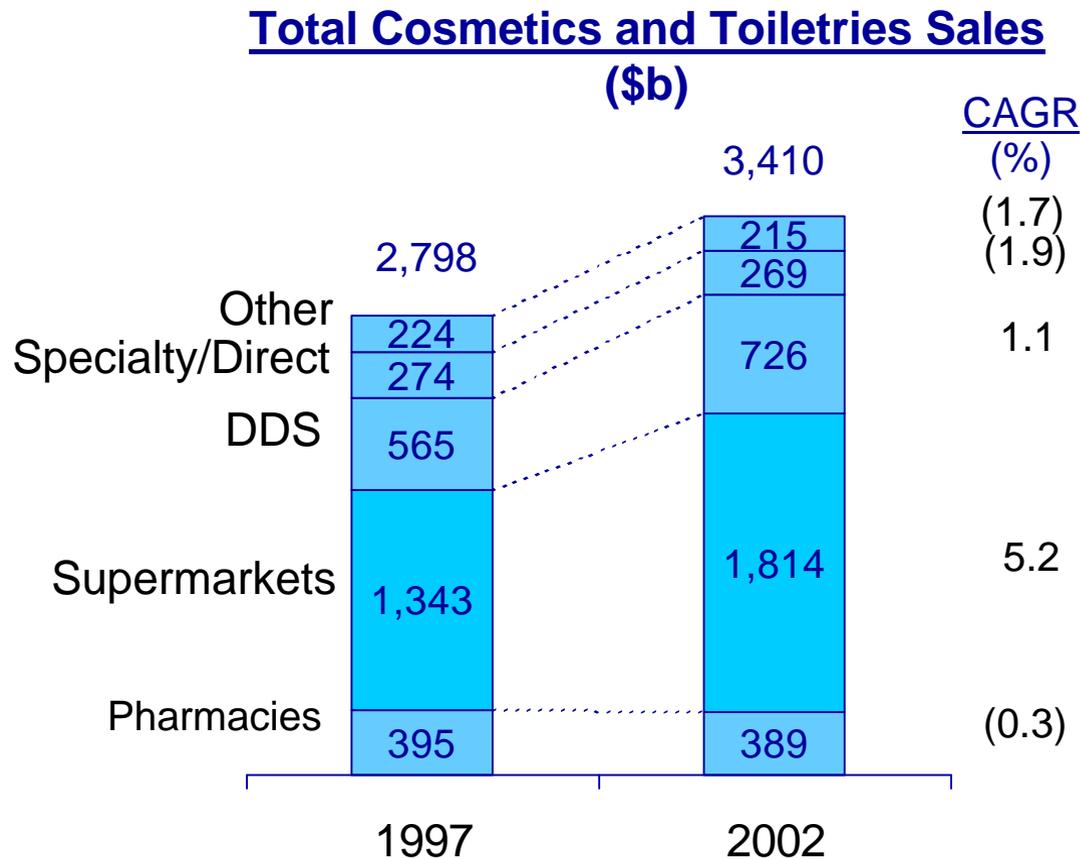
- Growth in pharmacy turnover has picked up following a poor year in 2003
- According to the Guild, turnover grew by 4.1% in Australia in 2003-04, despite a 9.3% increase in the PBS.
- But IBISWorld estimate that turnover was better than that, with growth of 6.9% over the same period
- Industry revenue was estimated at \$9 bn in 2003-04
- And at the same time ABS data suggests pharmaceutical and cosmetic retail sales have been growing more strongly
- Likely to be the result of increased competition from supermarkets and health and beauty chains

# Six of the 20 fastest growing grocery categories fall into the health and beauty or over the counter segments

**Value Growth In Australian Grocery: May 2002-03**  
(%)



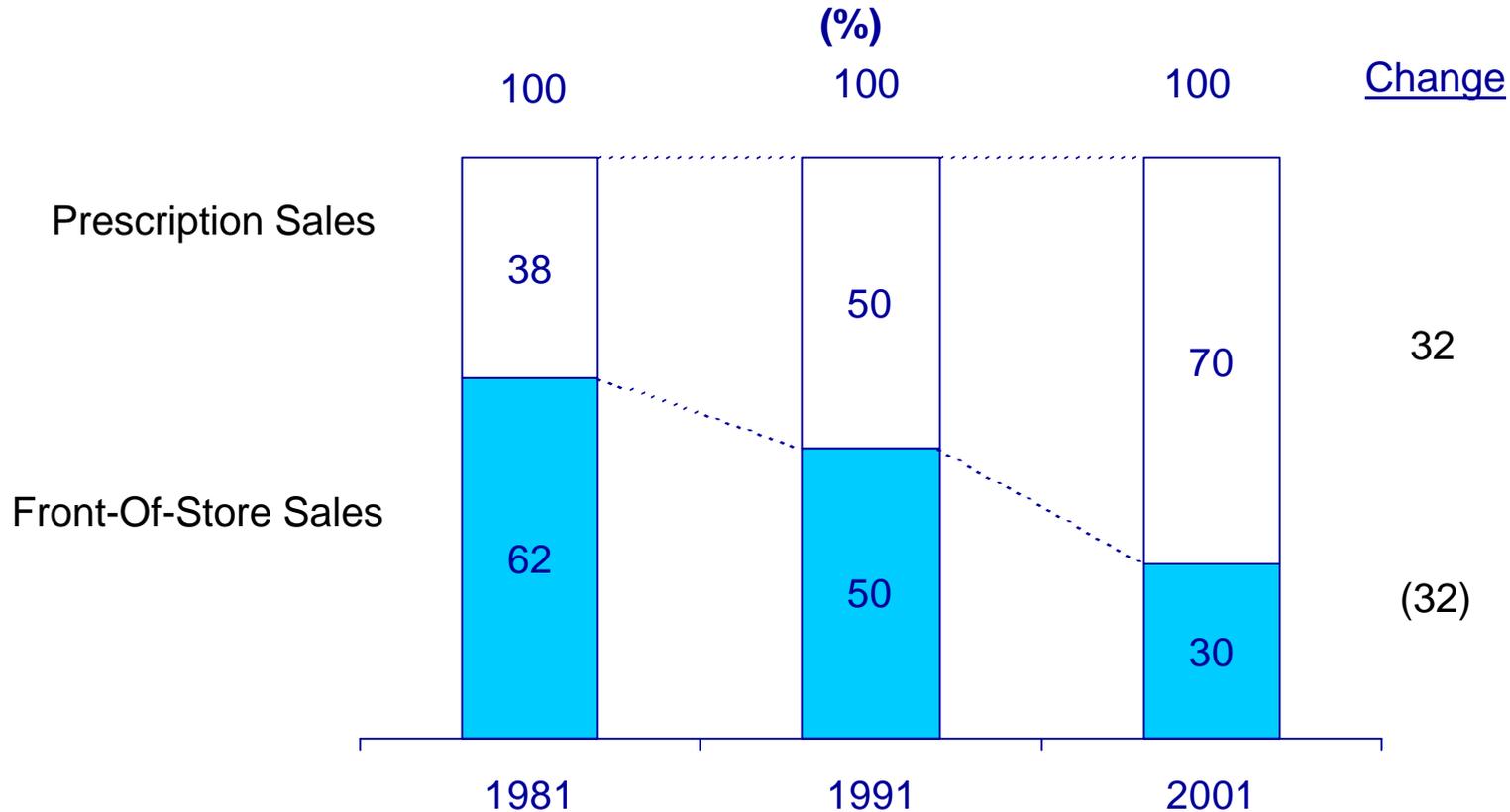
# Supermarkets winning share in cosmetics and toiletries from supermarkets



Note: Priceline included in DDS channel

# Growth in dispensary at expense of front-of-store is a long term trend

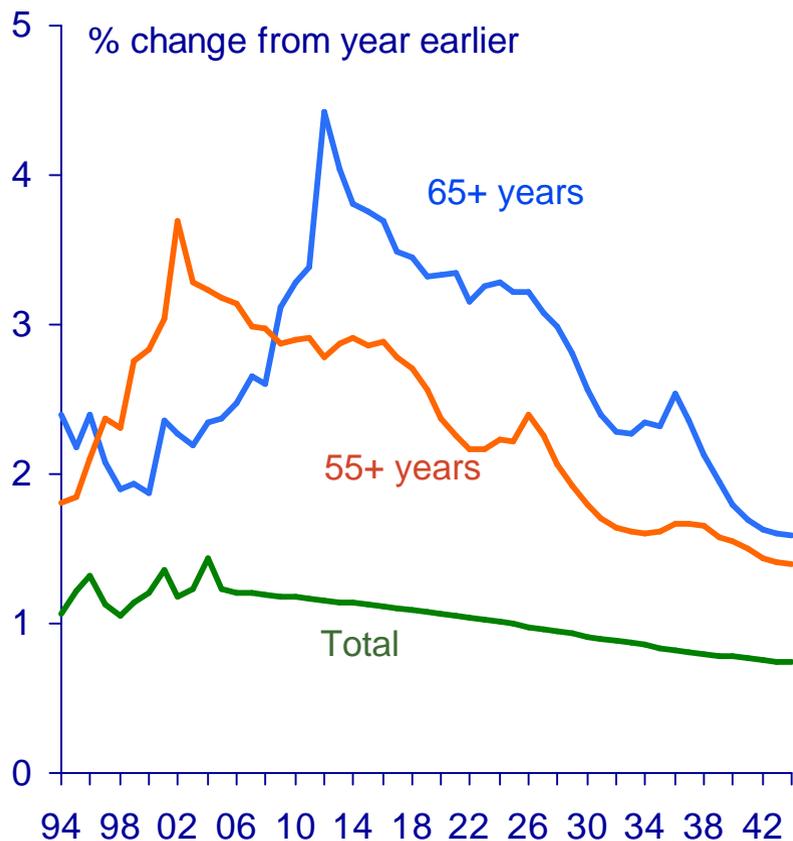
**Average Australian Pharmacy Sales**  
**Dispensary Versus Front-Of-Store: 1981-01**



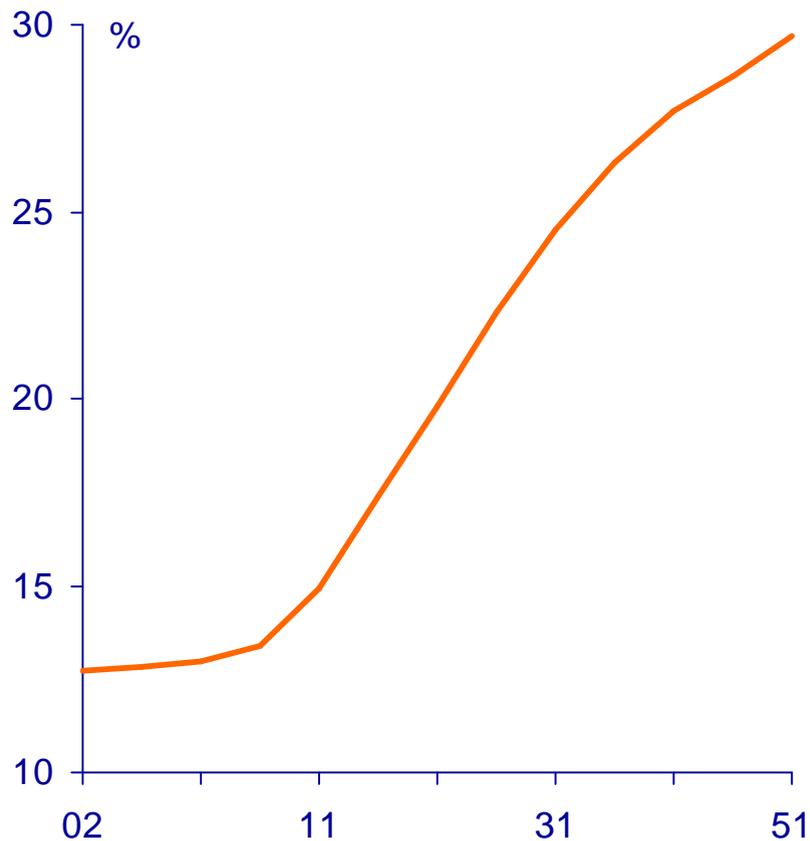
Source: IBIS World reports; BCG analysis

# Population growth will slow but the proportion of older people will rise

## Projected population growth



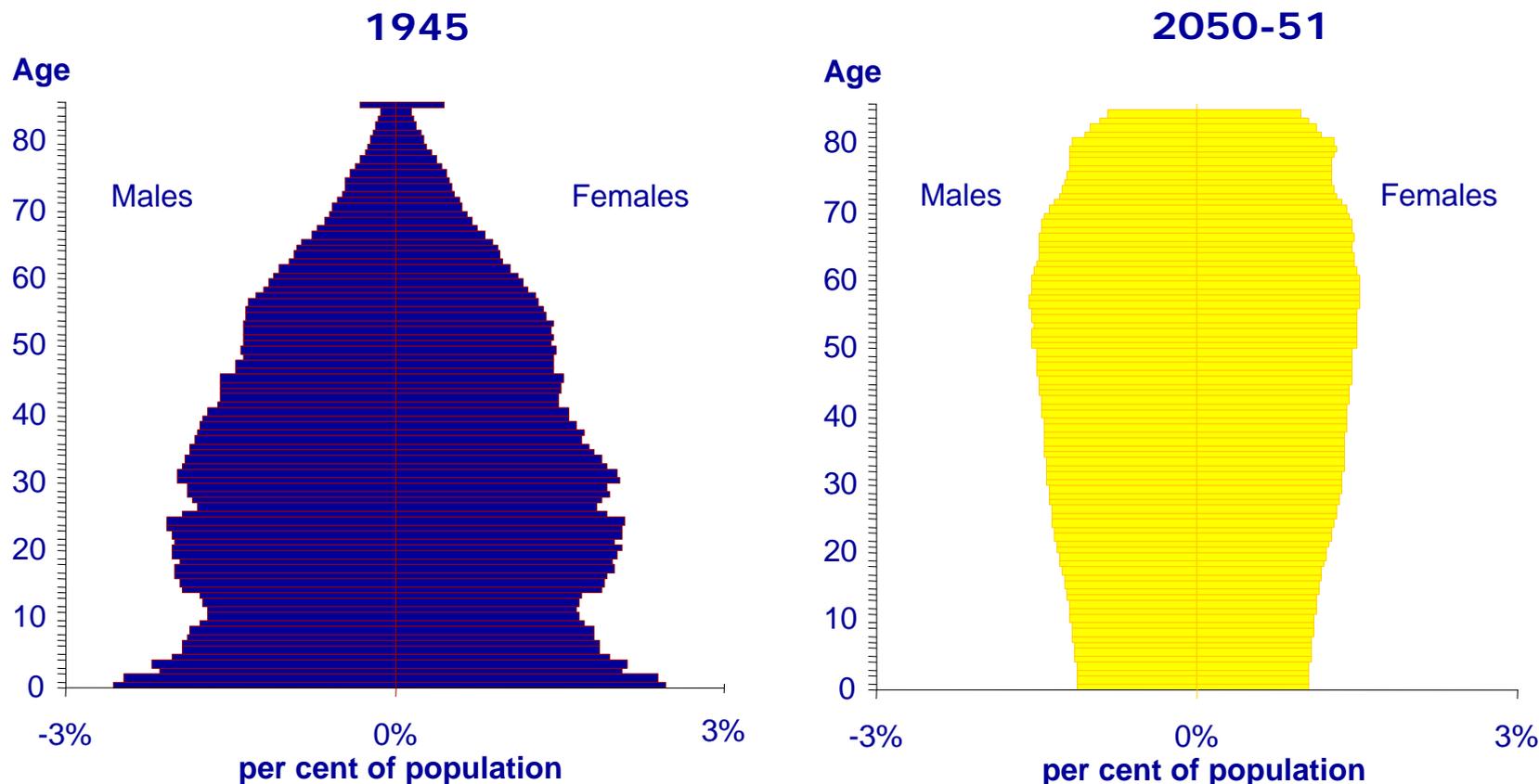
## Proportion of the population 65+



Source: ABS Population Projections

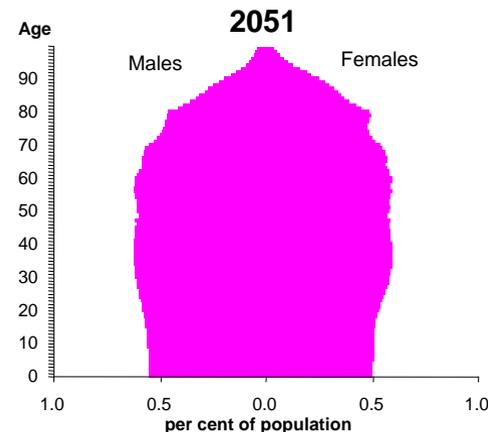
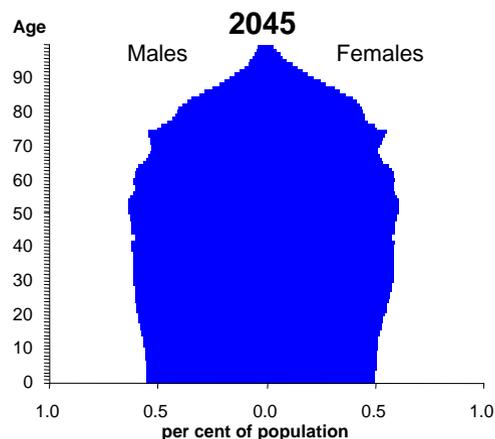
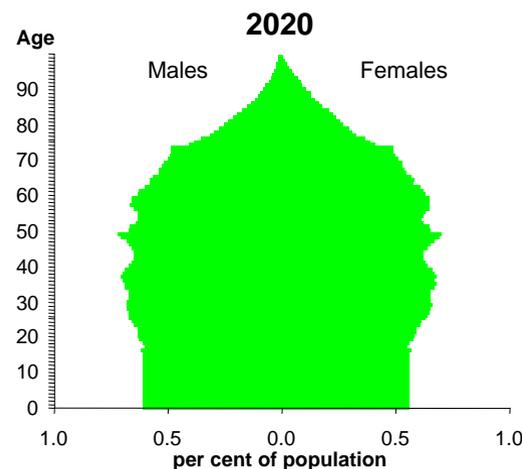
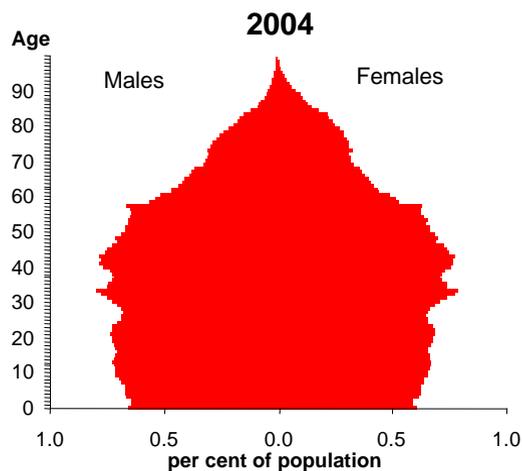
# Australia's demographic profile will change profoundly over the next forty years

## Age distribution of the Australian population

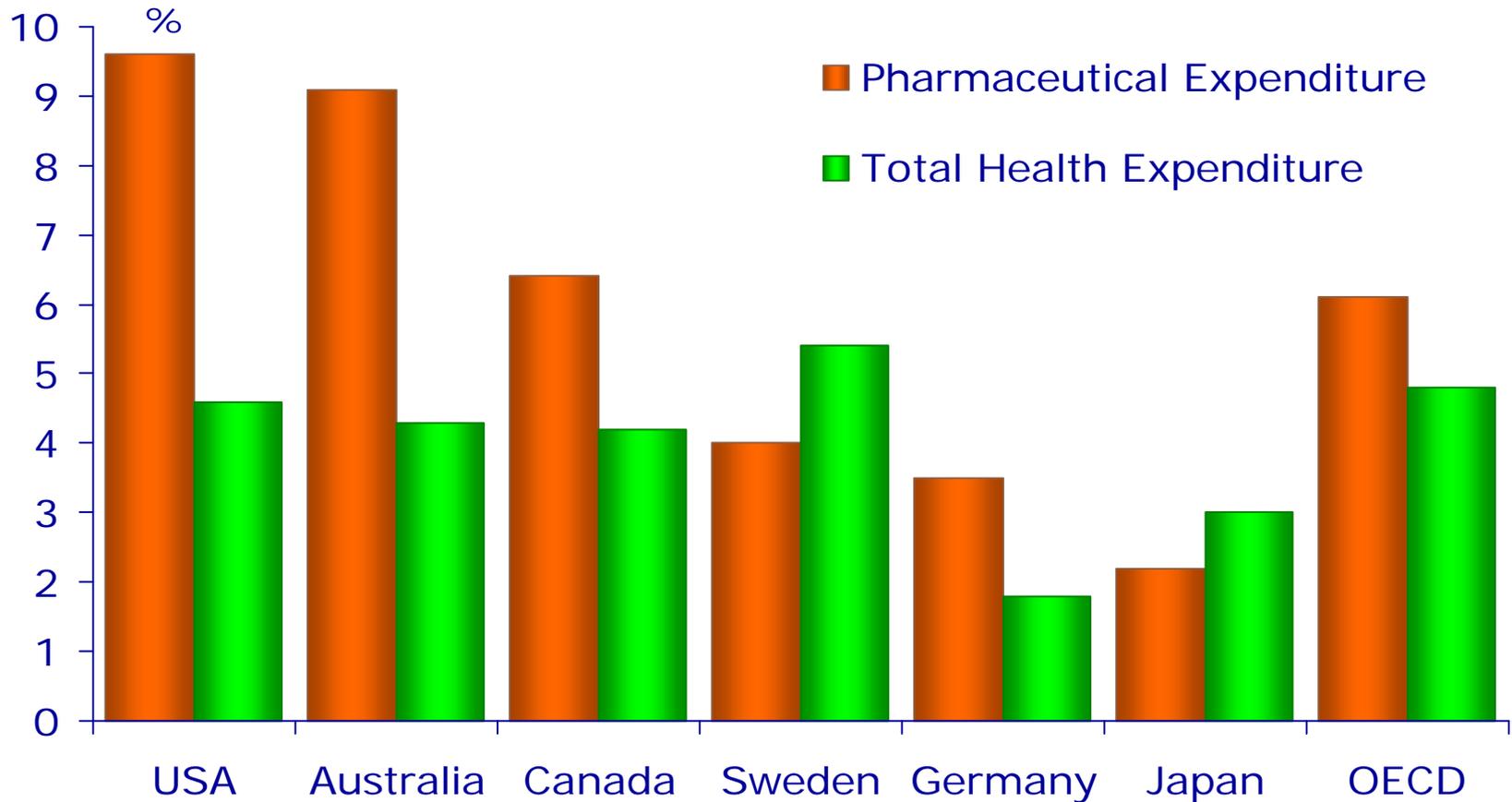


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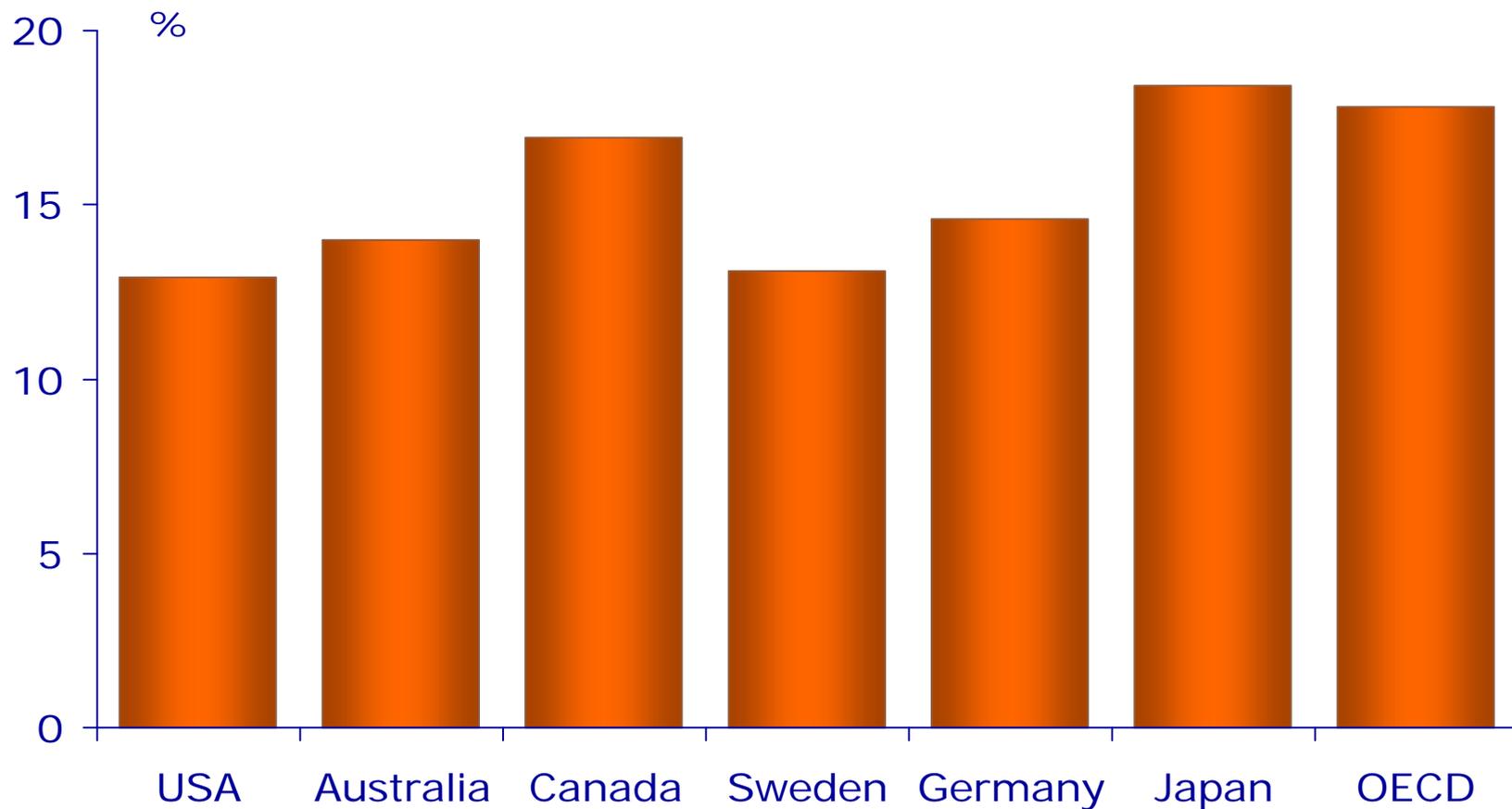


# Annual growth in pharmaceutical expenditure and total health expenditure, 1998-2003



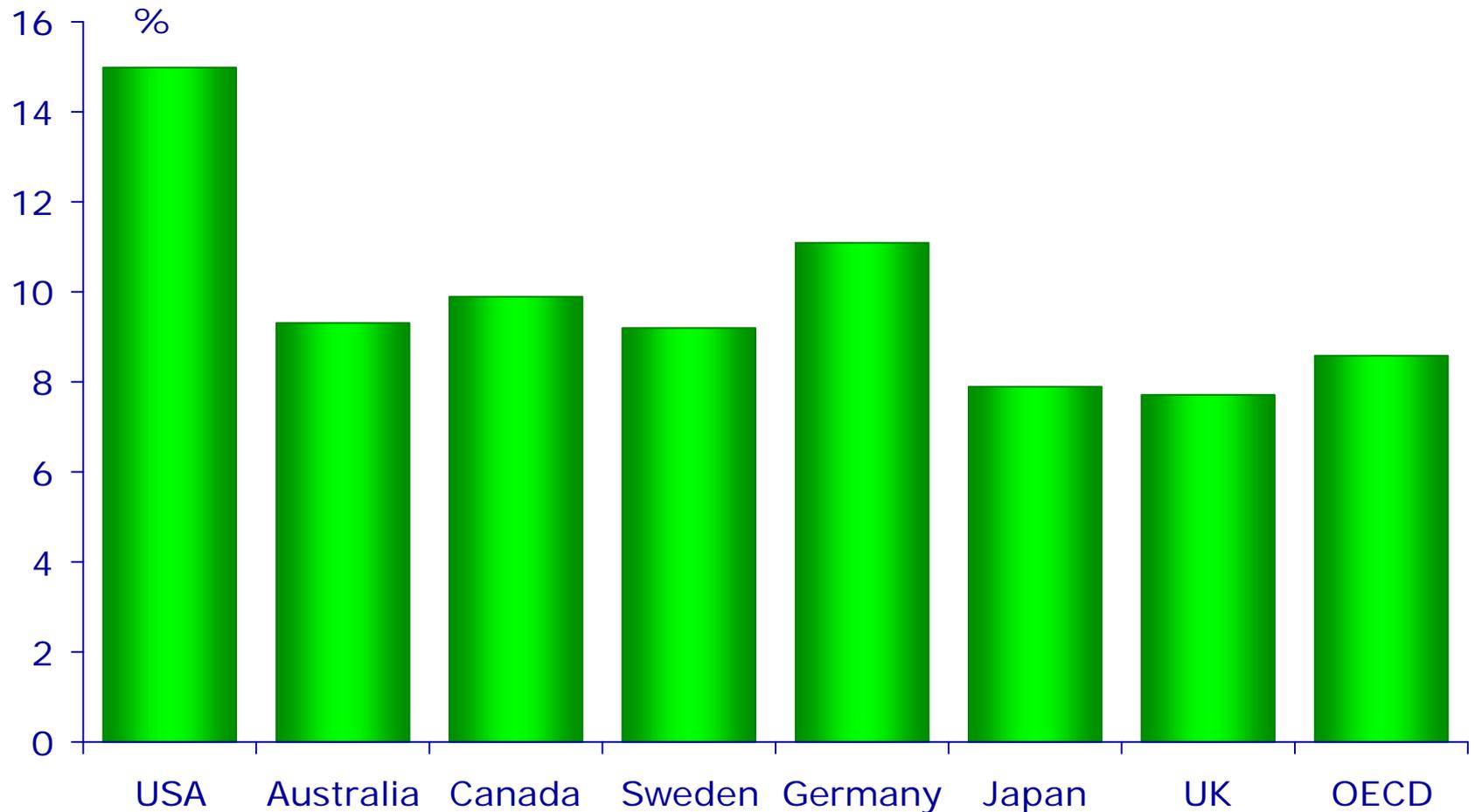
Source: OECD Health Data 2005

# Pharmaceutical expenditure as a percentage of total health spending



Source: OECD Health Data 2005

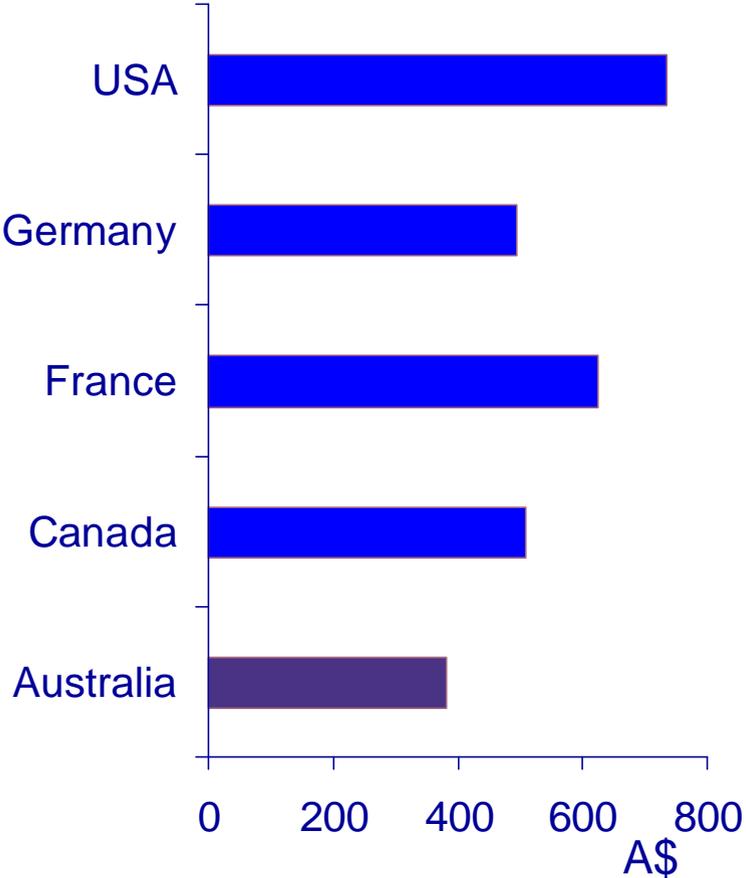
# Health expenditure as a percentage of GDP



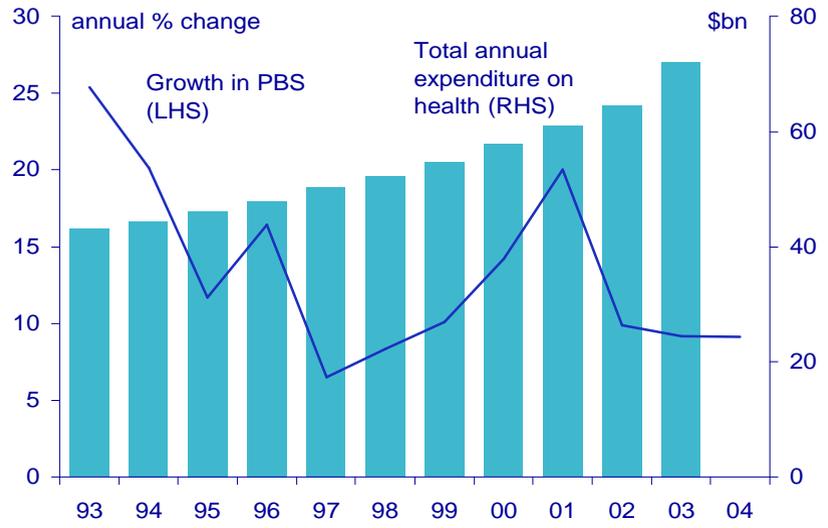
Source: OECD Health Data 2005

# Government expenditure on health is increasing

**Annual per person expenditure on pharmaceuticals**

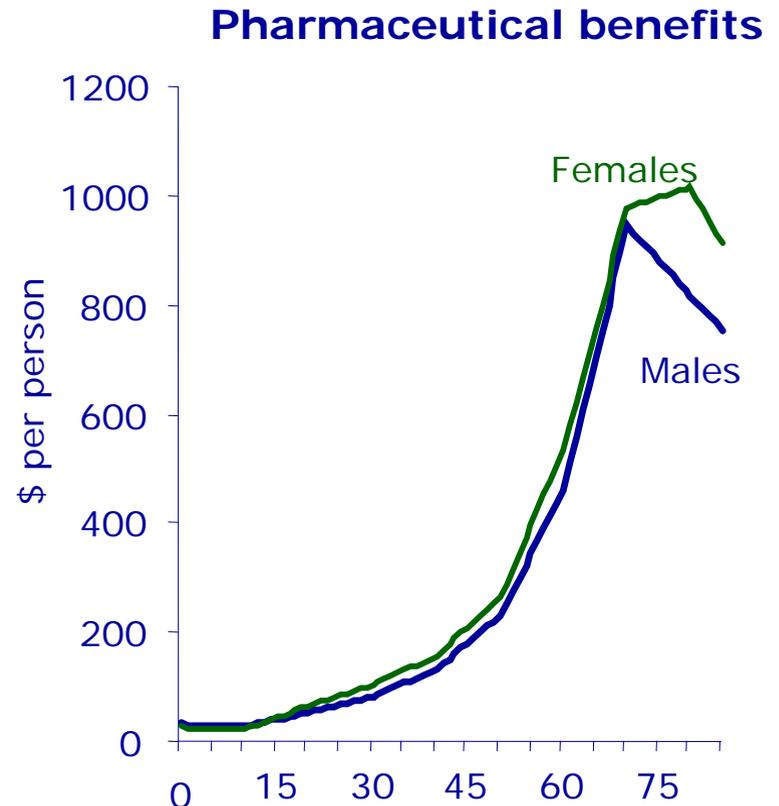
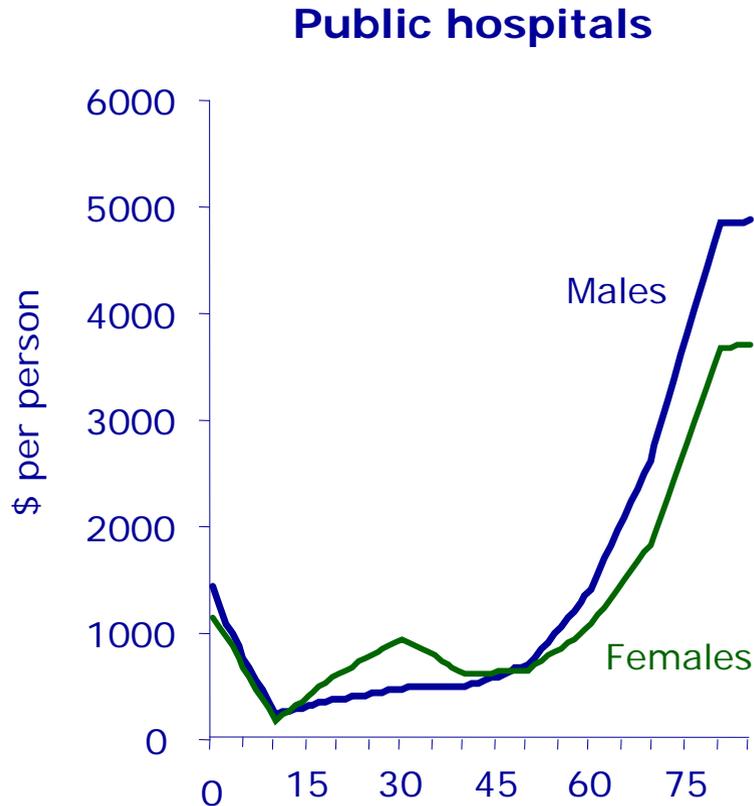


**Total health expenditure & growth in PBS in Australia**



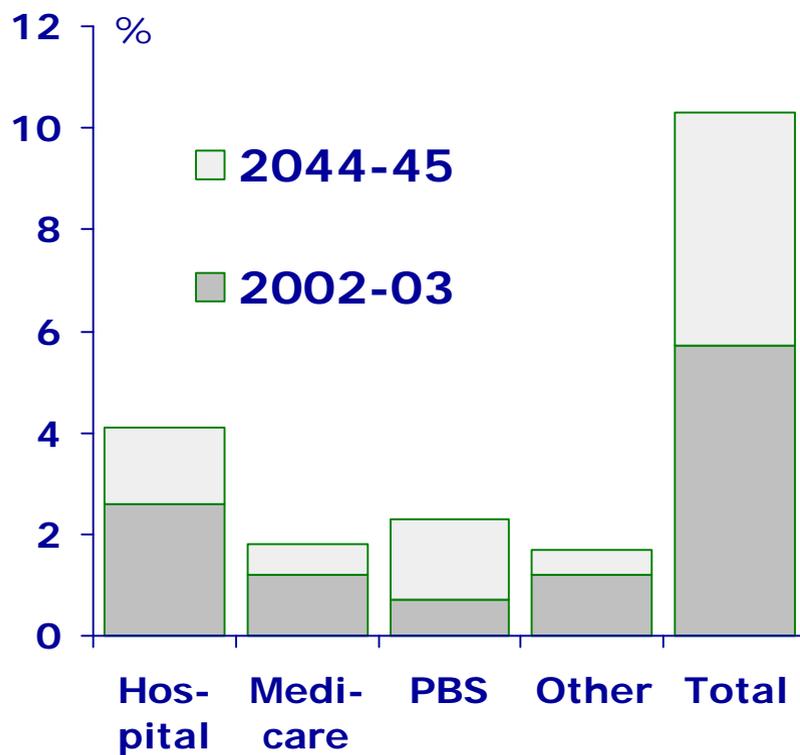
# Costs of hospital treatment and pharmaceutical benefits will rise rapidly as the population ages

## Cost of hospitals and pharmaceutical benefits by age



# Health care costs will thus rise substantially as a percentage of GDP

Government health spending as a % of GDP

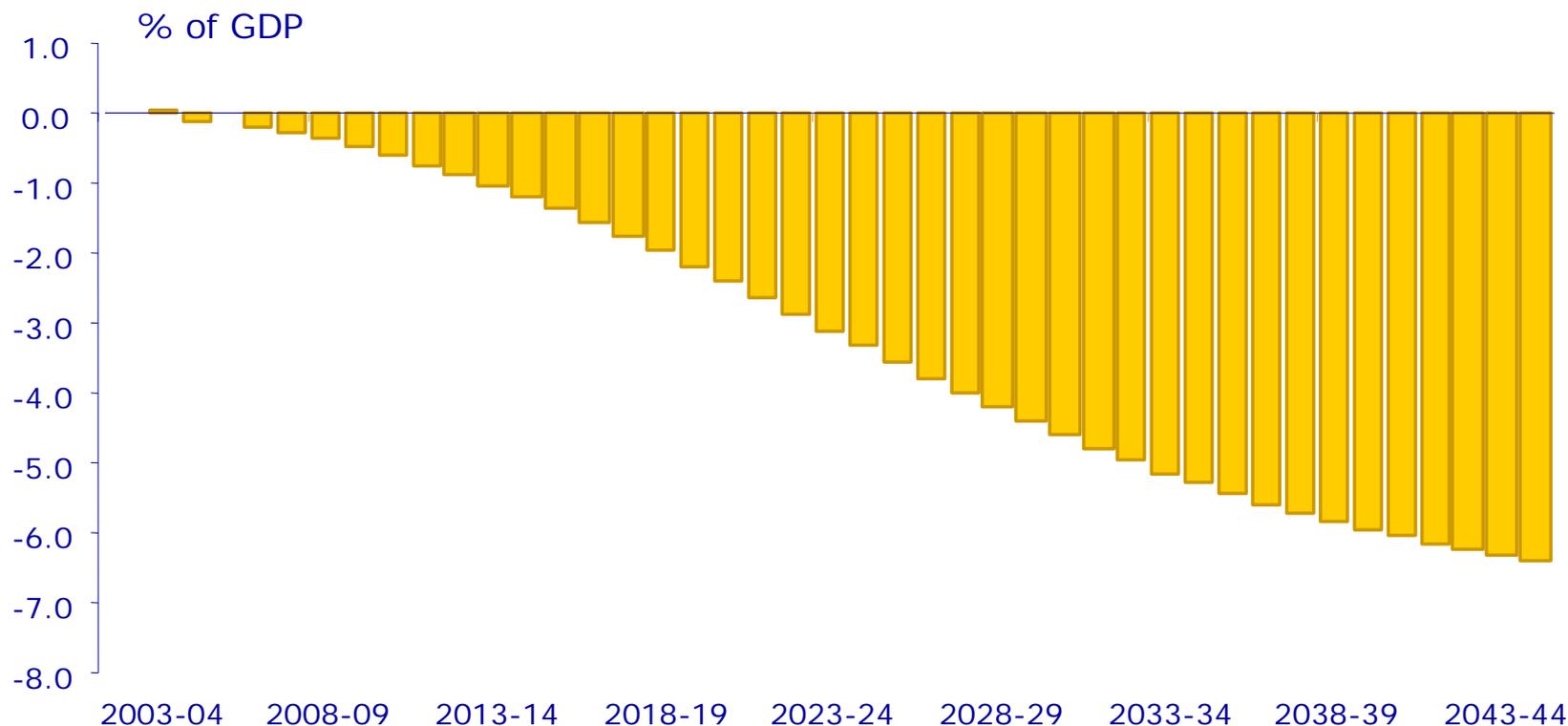


- Hospital expenditure will rise from 2.6% to 4.1% of GDP by 2044-45
- Medicare expenditures will rise rather less steeply, from 1.2% to 1.8% of GDP
- Spending on the pharmaceutical benefits scheme will rise more than threefold, from 0.7% to 2.6% of GDP
  - increases in drug prices ahead of general inflation an important additional factor
- Total health spending by governments will rise from 5.7% to 10.3% of GDP
- Total age-related government spending will increase from 18.7% to 25.2% of GDP

Source: Productivity Commission, *Economic Implications of an Ageing Australia*, March 2005.

# Other things being equal, rising age-related costs will have a major impact on government finances

## Change in net fiscal position of Commonwealth, State and Territory governments due to ageing, 2003-04 to 2043-44



Source: Productivity Commission, *Economic Implications of an Ageing Australia*, March 2005.

# Creating a sustainable health system!

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- **Australia faces considerable long-term pressures on health expenditure**
- **With the aim of ensuring the long-term viability of the health system, the Government announced a number of policy decisions in the 2005-06 Federal Budget, including:**
  - **The Medicare Safety Net threshold is being raised to \$500 for concession card holders and Family Tax Benefit Part A recipients and to \$1,000 for all other individuals.**
  - **This measure builds on the 12.5% cut in the price of generic medicines. Together these measures are expected to save an estimated \$1bn over 4 years.**
  - **However the savings will be reduced by the increase in the income threshold for the maximum rate of Family Tax Benefit, meaning that 40,000 families will qualify for the Health Care card.**
  - **The Budget also encourages more prescribing of generic medicines as a method of reducing the costs of the PBS. In the Budget, the Government also announced increased spending on cancer screening, and for an expanded smoking cessation program. Funding will also continue for asthma and diabetes management, and additional funding for research into juvenile diabetes.**

# Sales of generic pharmaceuticals are relatively small in Australia.....

## Sales & Patent expiry dates for selected 'blockbuster' drugs

Drug	Global sales (\$US pa)	Patent Expiry Date
Zocor	5,280	Jul 05
Norvasc	3,362	Feb 08
Zoton	3,100	Sep 09
Claratyne	3,011	Jun 06
Zoloft	2,140	Oct 05
Pravachol	1,817	Jun 06
Flixotide	1,270	Feb 06
Zyrtec	1,158	Feb 07
Accupril	553	Sep 06

Source: DITR, 2002

- **Patents on over 100 drugs are due to expire in the next 5 years**

## Generics use around the world

Country	% of prescriptions
Denmark	60
Canada	40
UK	47
Germany	40
USA	45
Australia	19

Source: Australian Pharmaceutical Summit, 2004

- **Currently only 19% of prescriptions are filled by generic medicines compared to 40-50% in the US and Europe**

# But sales are growing and have significant potential for further growth

## Market share of generic manufacturers in Australia

Company	%
Alphapharm	71
Arrow Pharmaceuticals	12
Hexal	7
Douglas Laboratories	6
Mayne	4

Source: BRW, Sep 1994

- **Growth outlook is positive for generics due to:**
  - **patents on over 100 pharmaceuticals are due to expire between June 2005 and 2010**
  - **demographic trends favour greater consumption of generic pharmaceuticals**
  - **an increase in life expectancy**
  - **generics can ease the burden on the PBS**

# The outlook for the pharmacy industry is still bright

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- **Solid growth is expected due to:**
  - an ageing population
  - rising incomes
  - increased health consciousness – currently over 50% of the Australian population use some form of complementary medicine
  - new products and technology
- **But deregulation will be a critical factor**

# Summary of forecasts

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	2003-04	2004-05	2005-06
Global growth	5.1	4.1	3.1
Australian growth	4.1	2.2	3.4
Unemployment rate (Jun)	5.8	5.3	5.4
Inflation	2.4	2.5	2.8
Cash interest rate (Jun)	5.25	5.50	5.50
A\$/US\$ (Jun)	0.70	0.75	0.66
Victorian growth	3.7	3.3	3.6

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