

The economy, interest rates and housing markets in 2005-06

Presentation to a luncheon for
UDIA Queensland

Saul Eslake
Chief Economist
ANZ Bank

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& Exhibition Centre**
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www.anz.com/go/economics

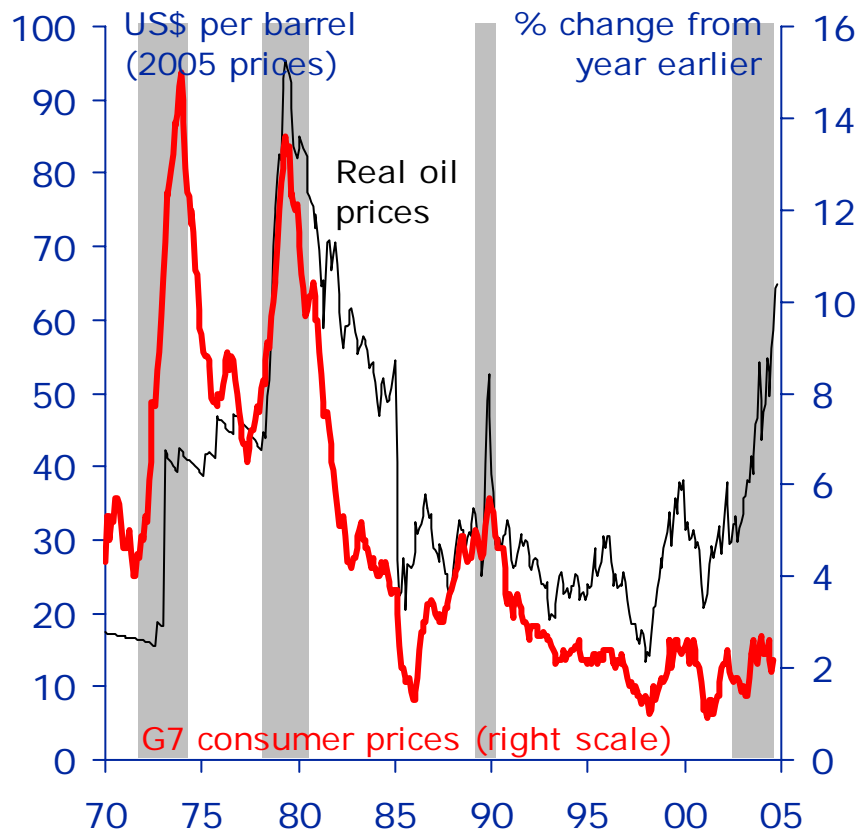
economics@

Key assumptions about the world economy

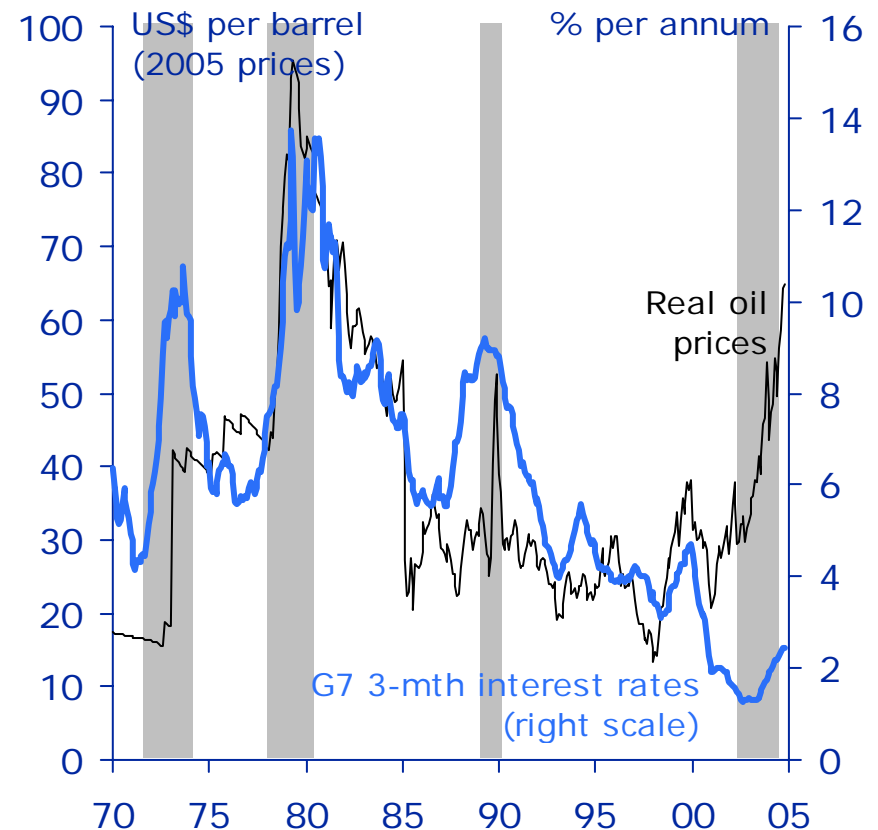
- **Expensive oil is here to stay**
 - crude oil prices will probably stay close to US\$70/barrel near term, and will still be in the \$55-65 range through 2006-07
- **World economic growth is slowing from 5% in 2004 to around 4¼% pa in 2005 and 3¾-4% in 2006 and 2007**
 - higher oil prices and higher US interest rates to have some dampening impact – but much less than in previous 'oil shocks'
 - although most economies will slow a bit, note that Japan is actually picking up after more than a decade of stagnation
- **The Fed will continue to raise US short-term interest rates 'at a measured pace', reaching 4½ % by mid-2006**
- **The US\$ has bottomed (for the time being) against the euro and other 'freely floating' currencies (including the A\$)**
 - US now has the highest, not the 2nd lowest, interest rates among major economies
 - confidence in the euro undermined by political developments
- **Asian central banks will continue to resist significant revaluations of their currencies**
 - China's abandonment of its US\$ peg does not mean that the yuan will rise significantly against the dollar

Higher oil prices aren't (thus far) leading to higher inflation and interest rates

Oil prices and inflation



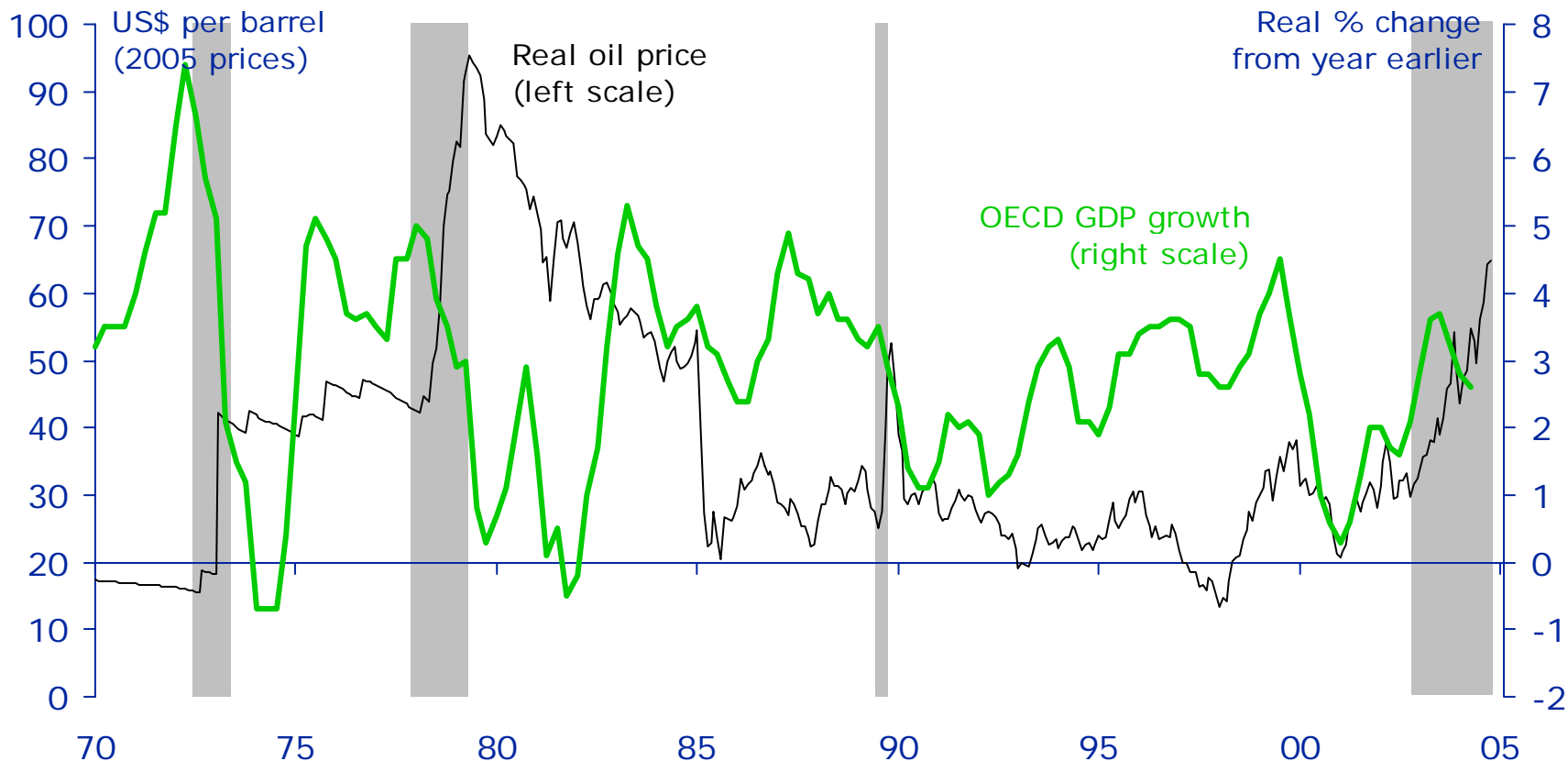
Oil prices and interest rates



Note: Shaded areas denote "oil price shocks"
Sources: Datastream; OECD; Economics@ANZ.

Economic growth has been much less affected by higher oil prices than in previous 'oil shocks'

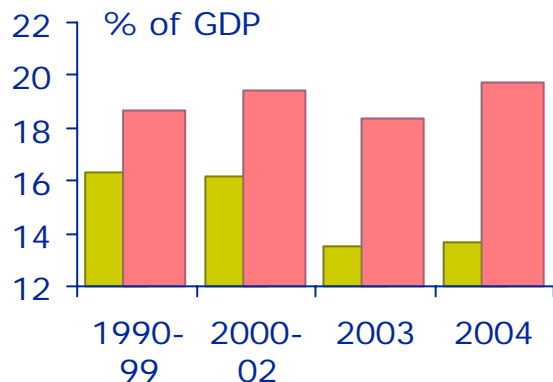
Oil prices and economic growth



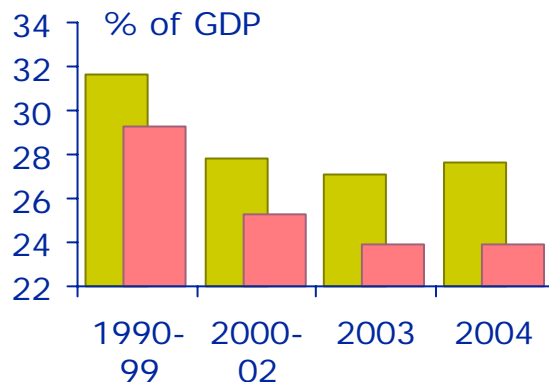
Note: Shaded areas denote oil price 'shocks'.
Source: Thomson Financial Datastream; OECD.

In the developing world, gross saving has risen much more than gross investment

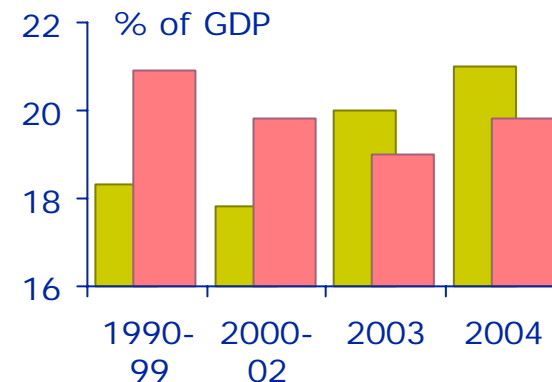
United States



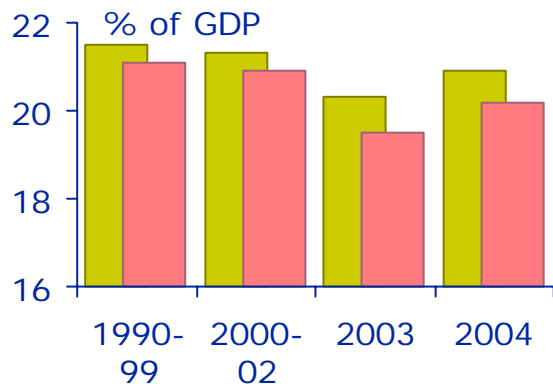
Japan



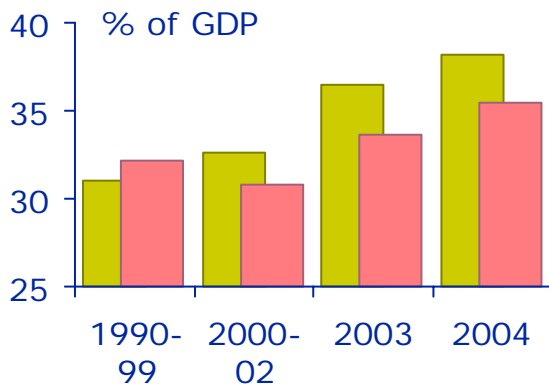
Latin America



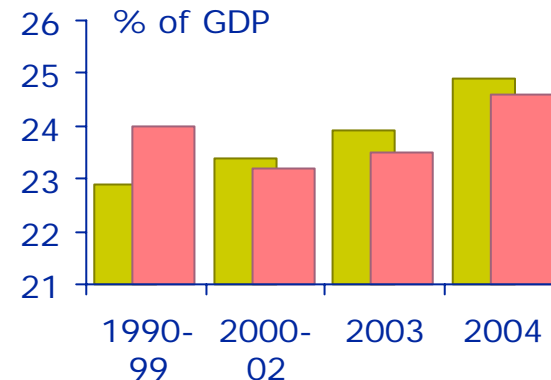
Euro area



Developing Asia



World



Saving

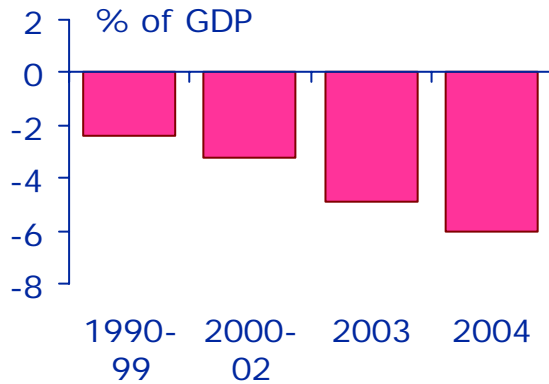


Investment

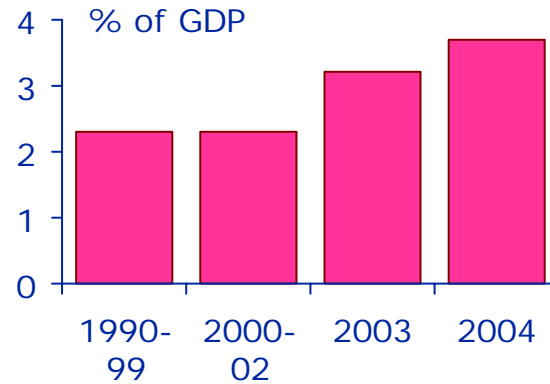
Higher saving by developing economies is allowing (forcing?) the US to run big deficits

Net lending as a % of GDP

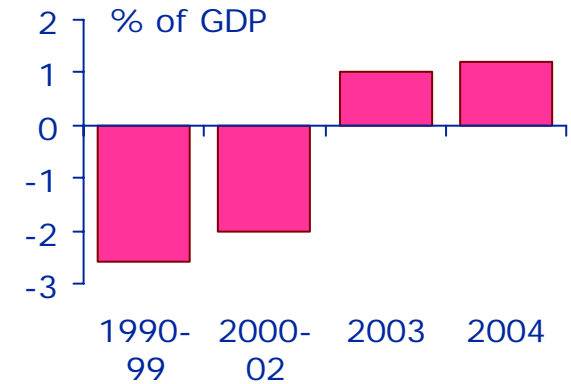
United States



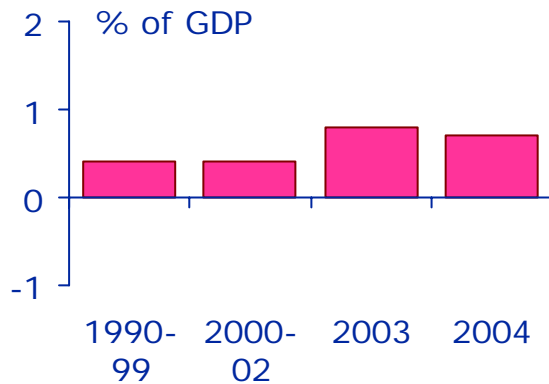
Japan



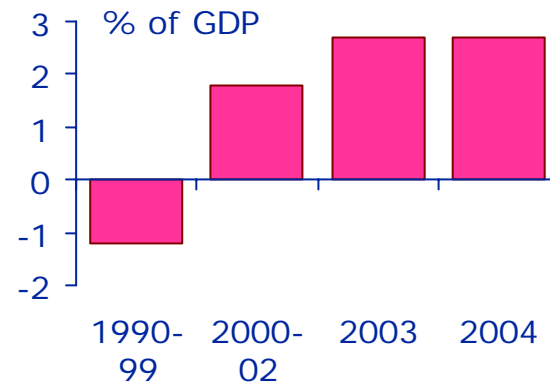
Latin America



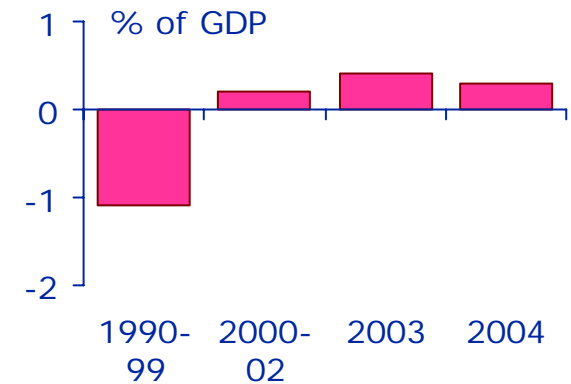
Euro area



Developing Asia



World

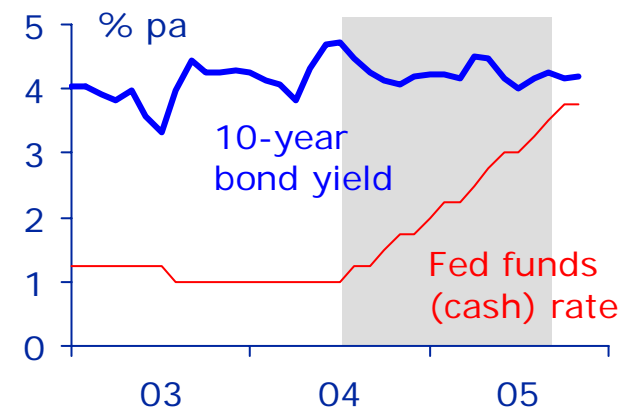
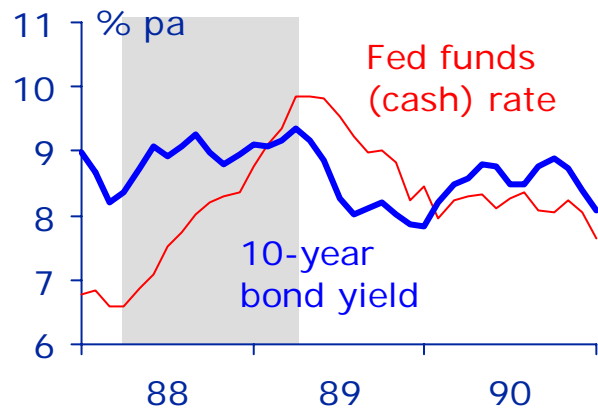
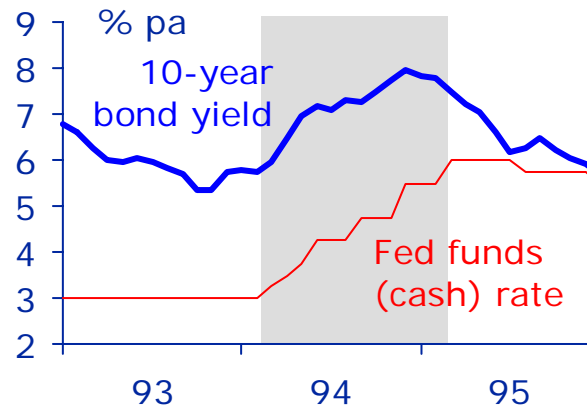
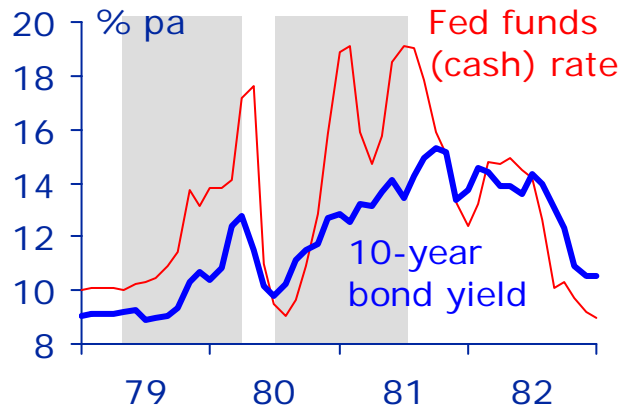


'Net lending' is gross saving minus gross investment. It is conceptually equal to the current account balance.

6 Source: BIS; Economics@ANZ.

Strikingly, US long-term rates have fallen even though US short rates have more than trebled

Four episodes of rising US interest rates

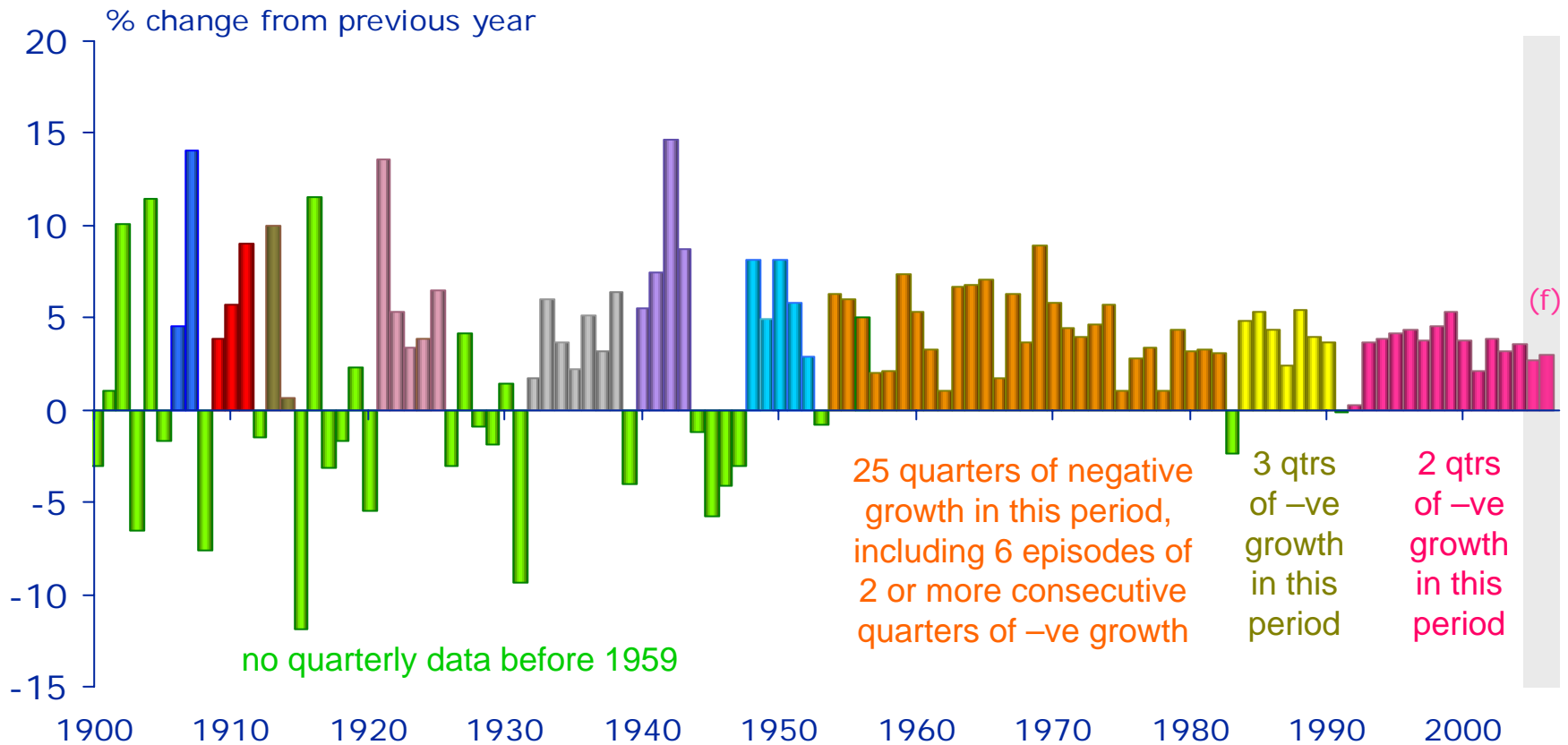


- Unlike Australia, in the US most personal and business borrowing is done at fixed rates
- Thus, what happens to long-term rates is much more important
- Usually, long-term rates rise while the Fed is tightening monetary policy
- But in this latest episode, long-term rates have fallen

Note: Shaded areas show periods when the Federal Reserve has been tightening monetary policy by raising the 'Federal funds' (cash) rate. Sources: Datastream; Federal Reserve

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

Australian real GDP growth, 1901 - 2006

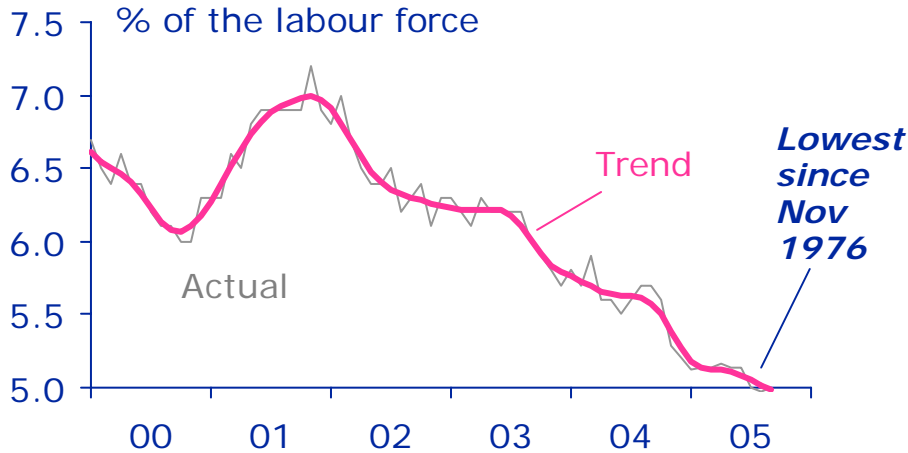


Note: data are for financial years ended 30 June.

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

After 15 years of continuous growth Australia's economy is starting to run into capacity limits

Unemployment rate



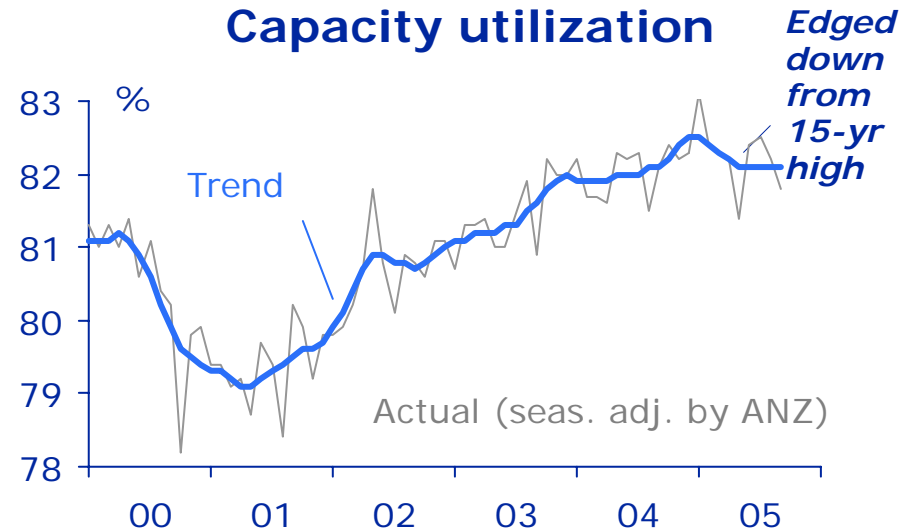
Job vacancies



Labour shortages

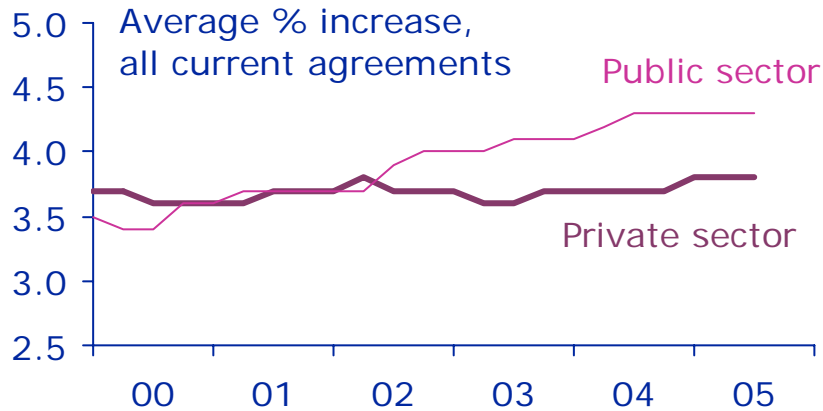


Capacity utilization

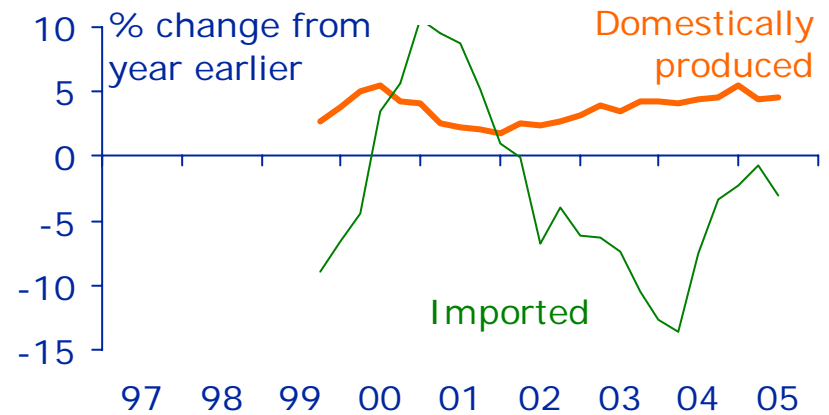


Wage and price pressures are beginning to pick up although A\$ strength is offsetting some of this

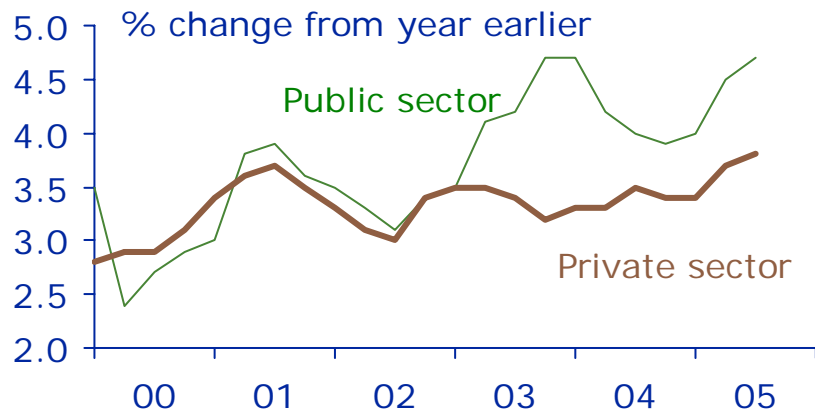
Enterprise bargaining settlements



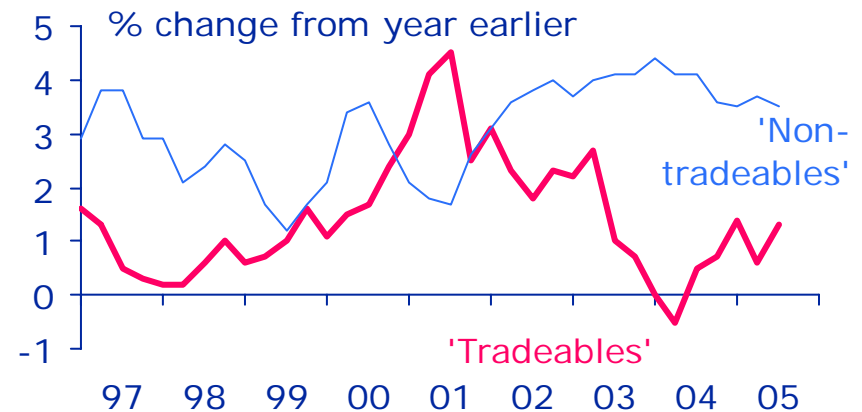
Producer prices



Wage price index



Consumer prices*



10 Sources: Dept of Employment & Workplace Relations; ABS.

The economy is near the point in the cycle where the seeds of previous recessions have been sown

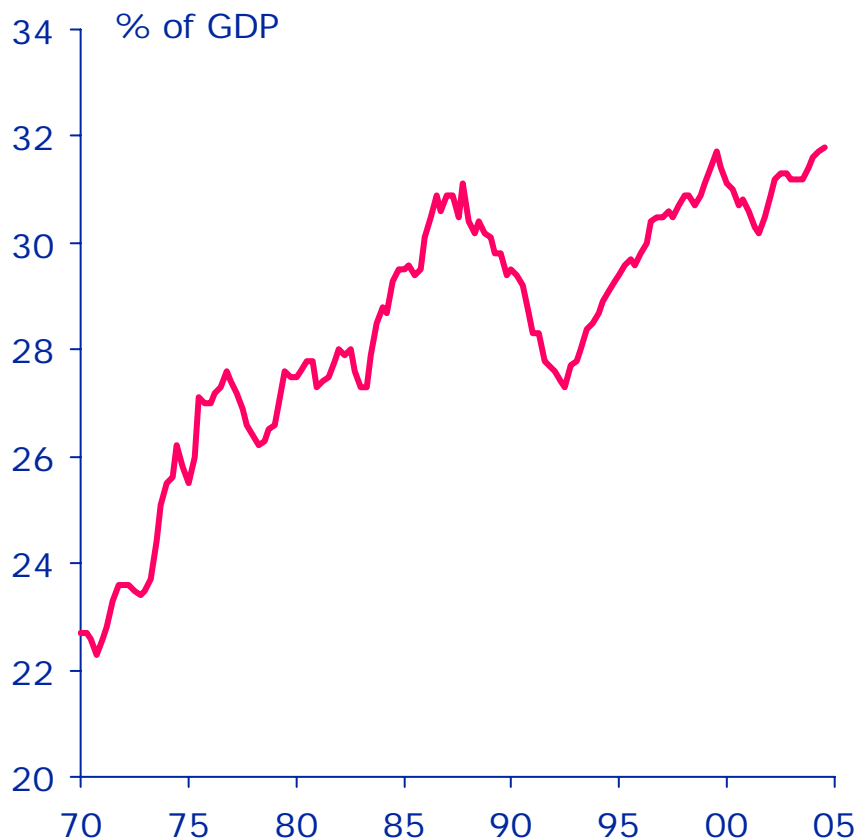
In some important respects the Australian economy is at a similar stage to where it was in 1960, 1973, 1981 and 1989 – just before each of the past 4 recessions

Three policy mistakes have traditionally been made at this stage of the business cycle -

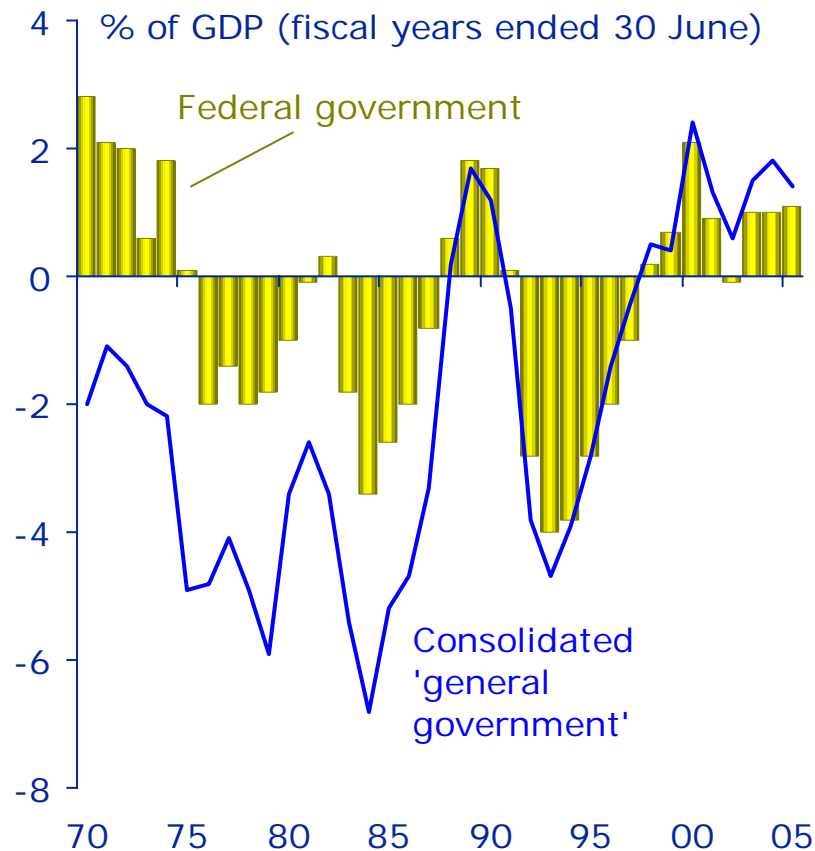
- **Allowing wages to grow faster than justified by productivity in a tight labour market**
 - much less of a risk now that centralized wage fixation is (almost) dead
- **Failing to allow the Reserve Bank to raise interest rates before inflation has begun to accelerate**
 - not a serious risk now that the RBA is 'independent'
- **'Giving away too much' of the revenue dividend in spending increases and tax cuts**
 - still a significant risk (as demonstrated in 2004)

Australian governments are rolling in cash thanks to sustained strong growth

Tax revenue as a pc of GDP



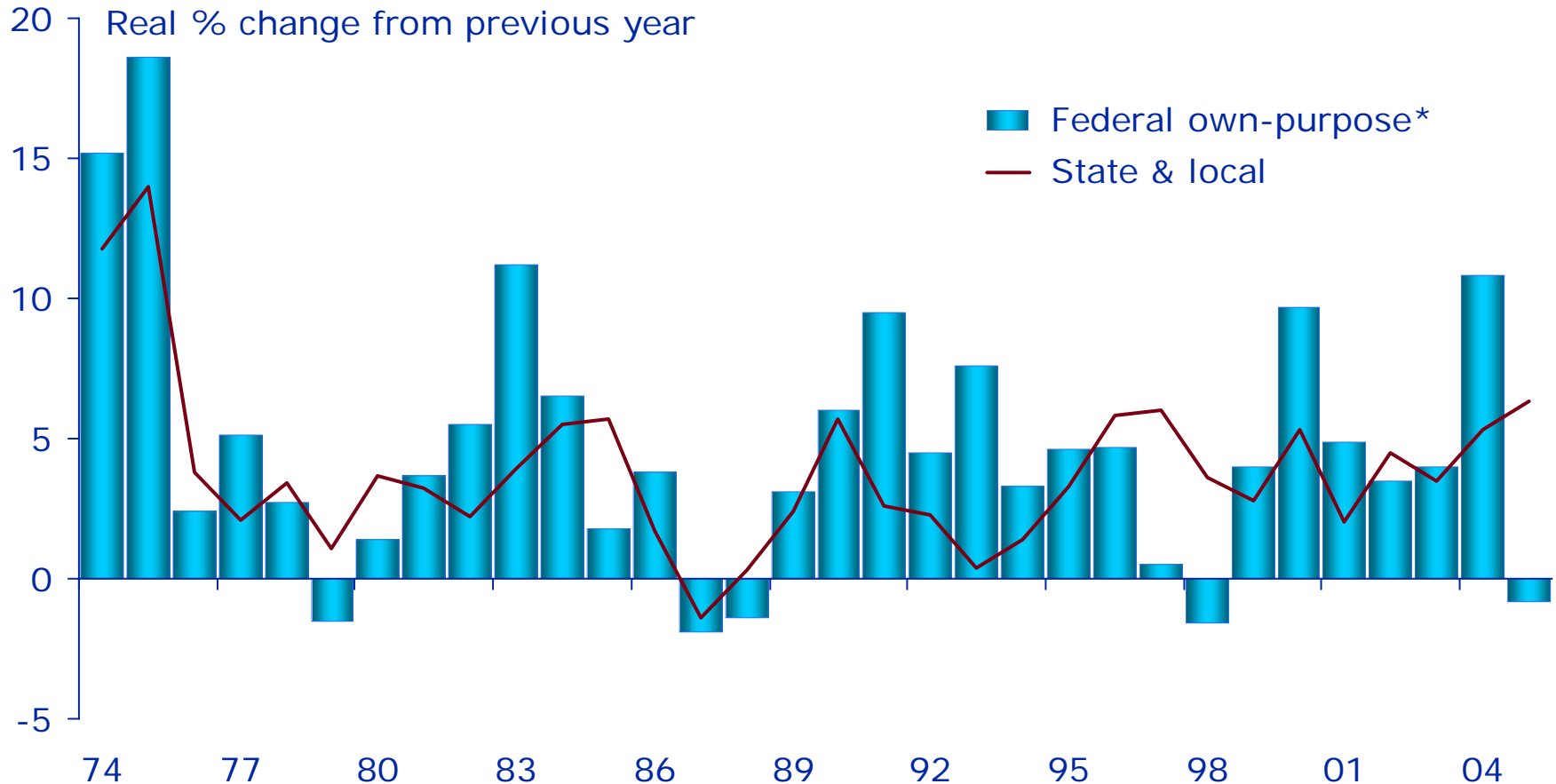
Budget balances



Sources: ABS; Australian Government Budget Papers.

In 2004 Federal outlays grew 10¾% in real terms – the fastest in over 20 years

Government outlays (excl. defence and interest)

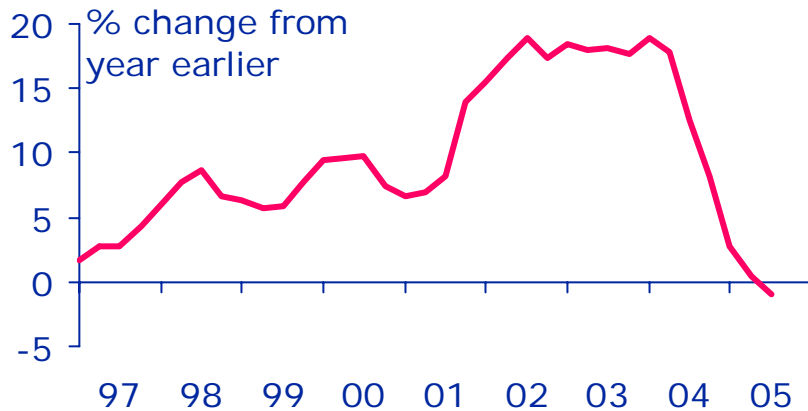


* ie, excluding payments to State & local governments.

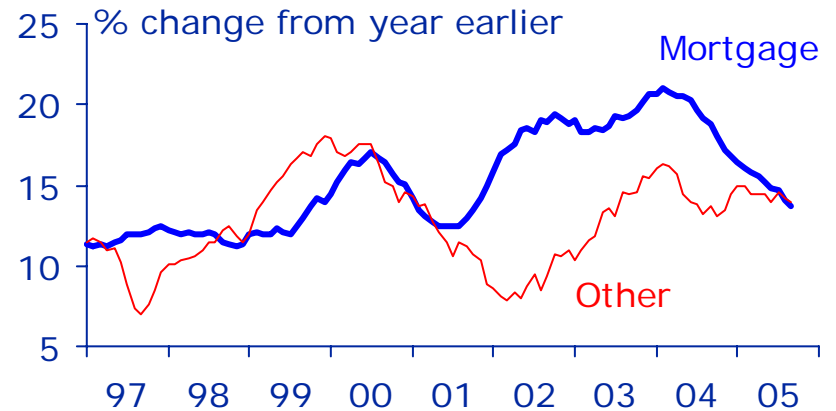
Source: ABS, quarterly national accounts; Economics@ANZ.

Australia's property boom has ended with a sigh, not a bang: but its passing will dampen spending

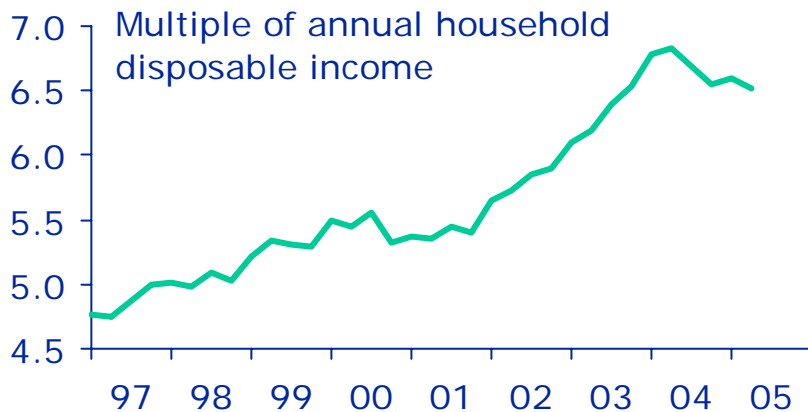
Capital city house prices



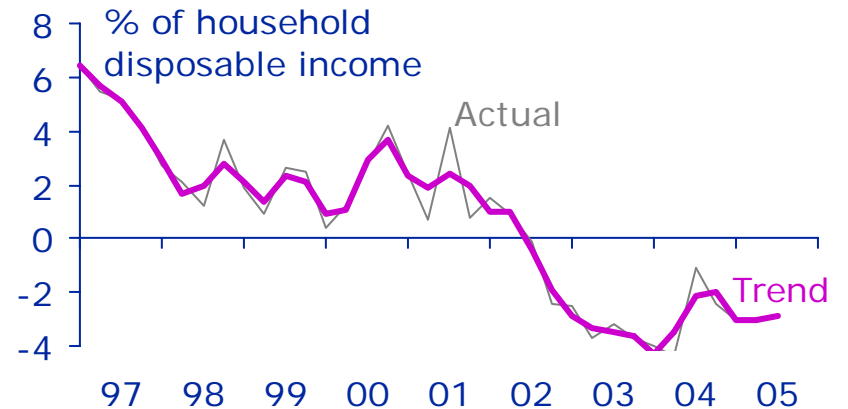
Household debt



Household net worth

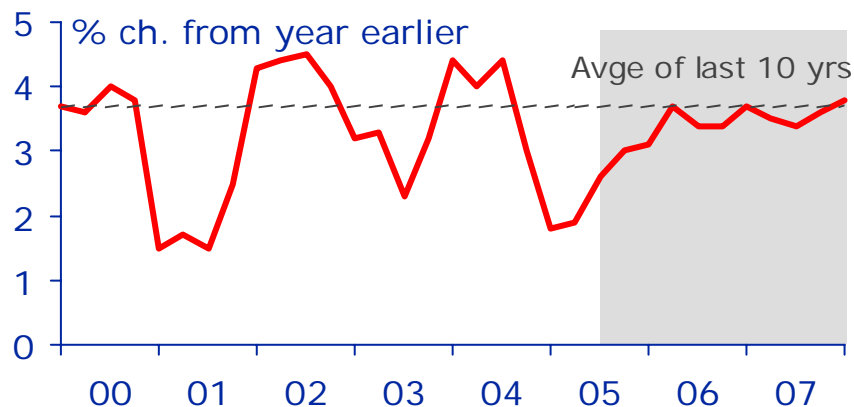


Household saving rate

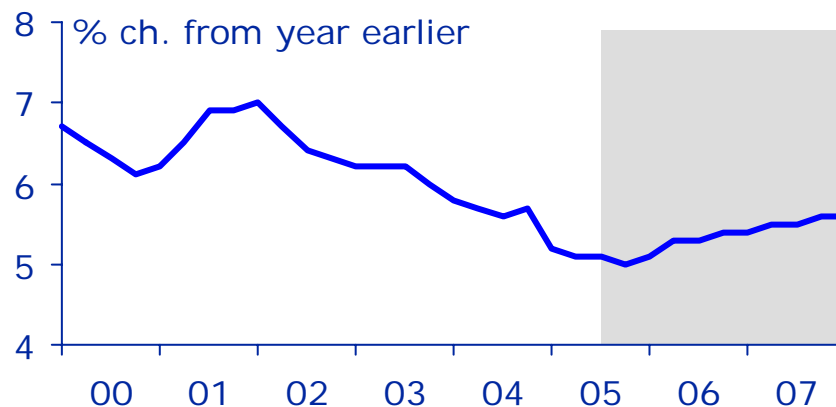


Australia's economy will grow more slowly over the next few years than over the past decade

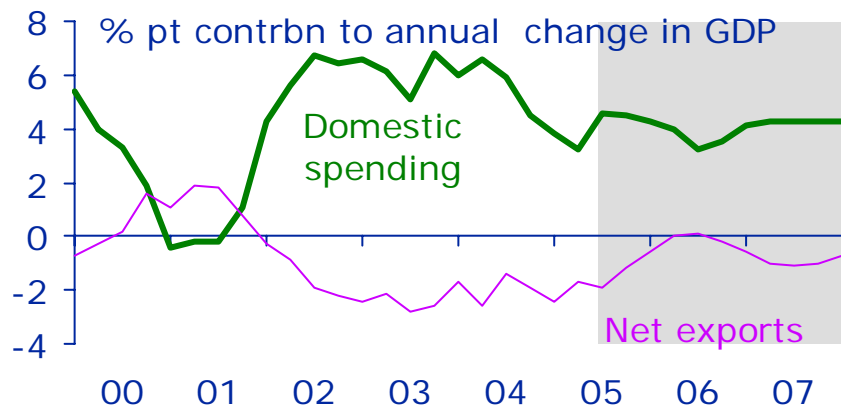
Real GDP growth



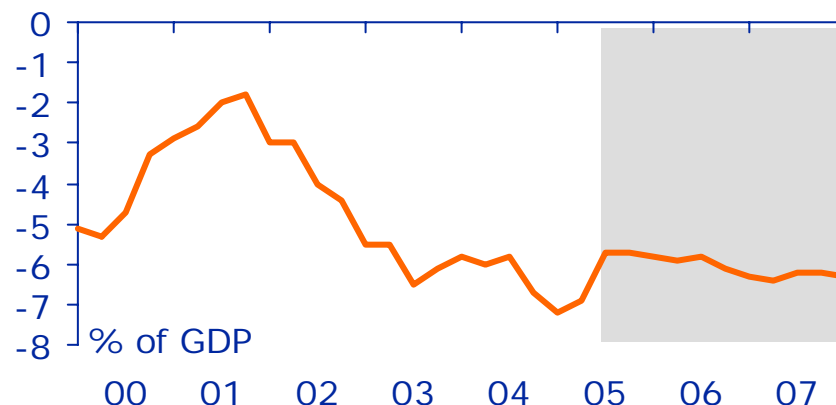
Unemployment rate



Drivers of GDP growth



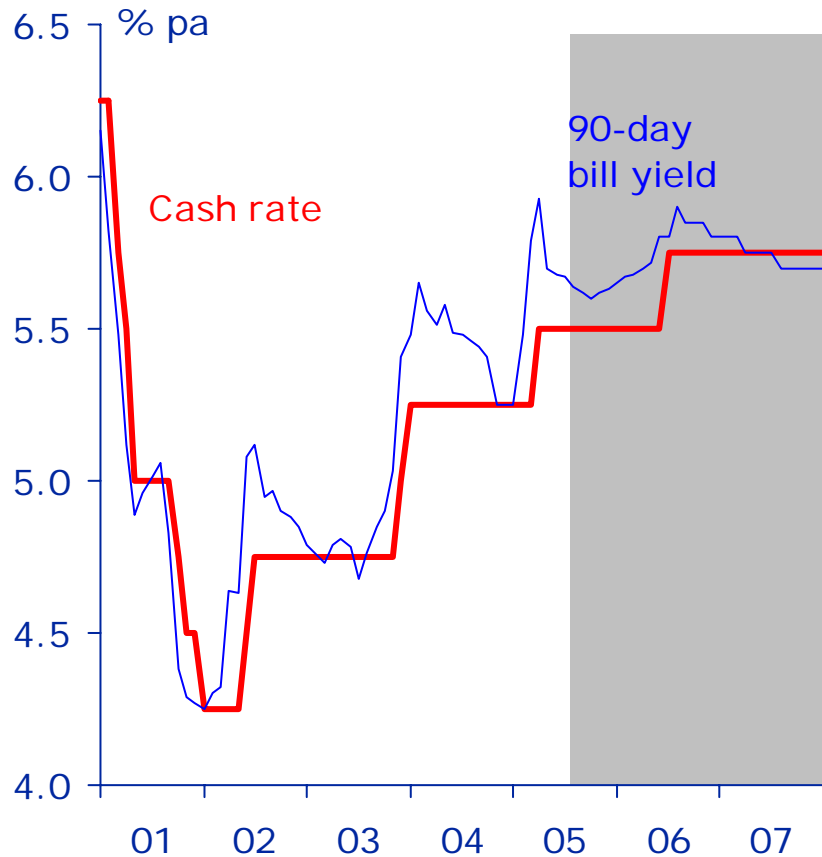
Current account balance



Sources: ABS; Economics@ANZ.

Australian cash rate is 'on hold' for the rest of 2005 but the next move will likely be up

Short-term interest rates

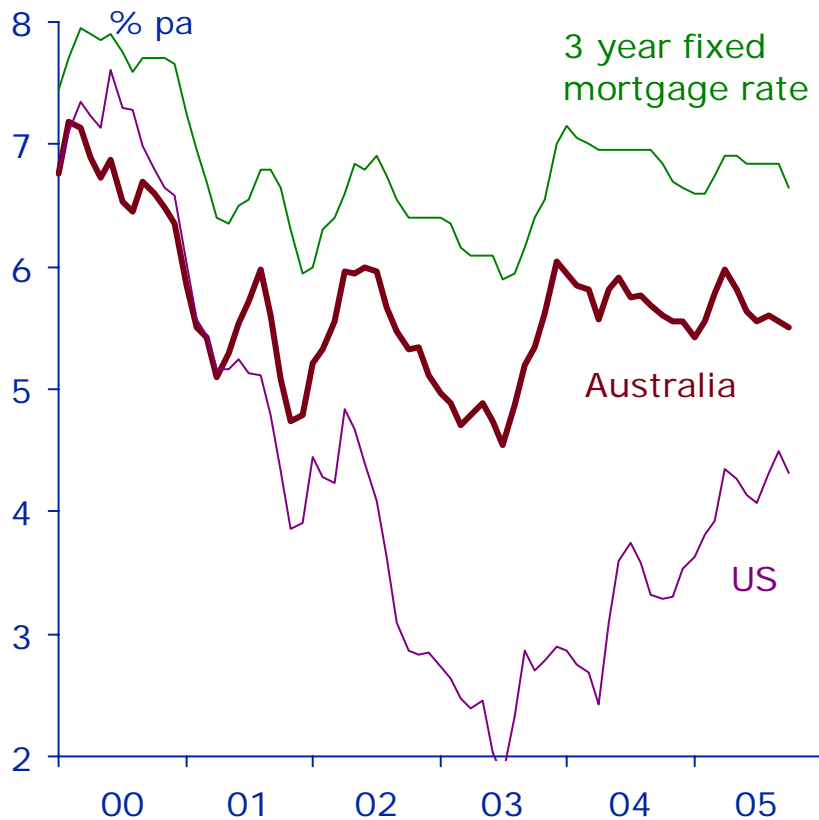


- The RBA's August Monetary Policy Statement dropped the previous mild tightening bias ('it would be surprising if rates did not move higher before the current expansion ends') ...
- ... and indicated that it saw the probabilities of the next change in rates being up or down as being equal
- It's hard to see anything which would cause the RBA to alter its 'no change' view on rates over the rest of 2005 ...
- ... although on our forecasts its easier to see changes which would cause the next move in rates to be up (in particular, labour costs and the A\$) than down

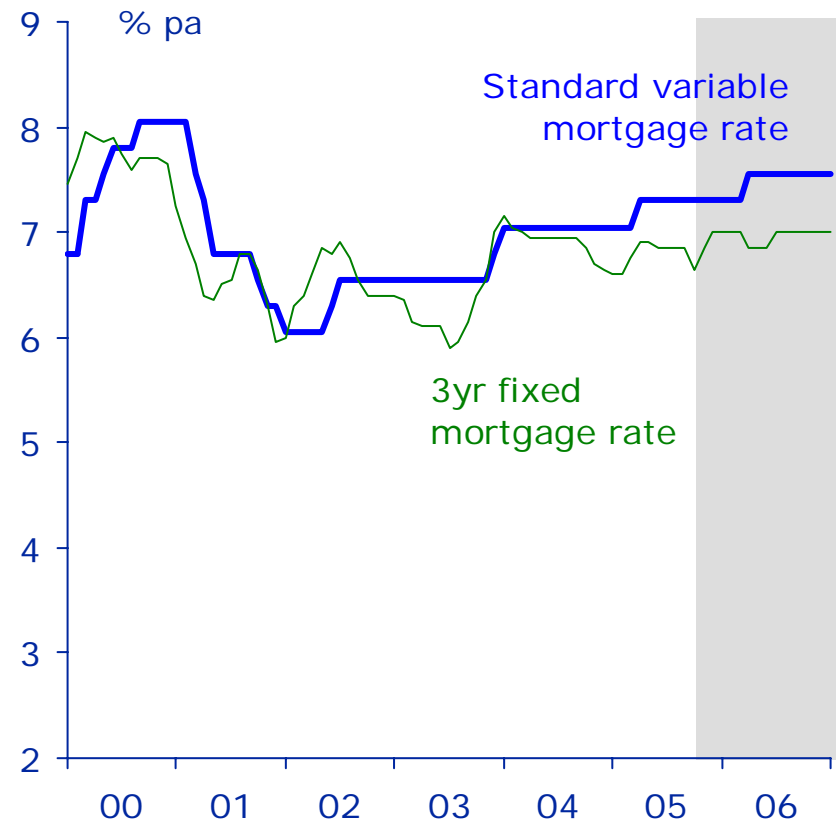
Sources: Datastream; Economics@ANZ.

Somewhat unusually, fixed rates are now significantly lower than variable rates

3-year swap yields and fixed-rate mortgages



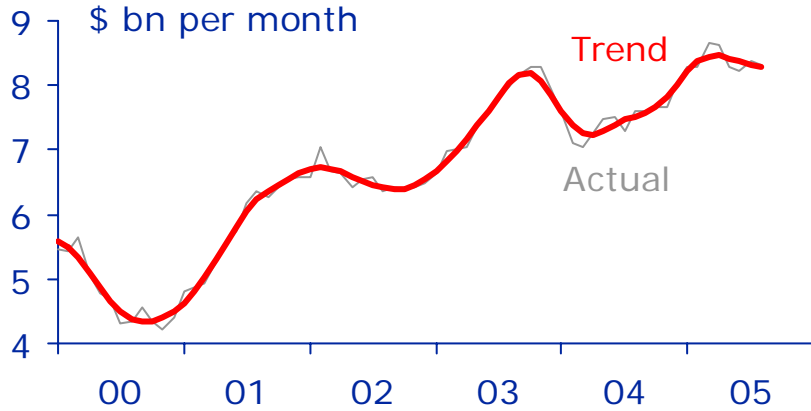
Fixed and floating mortgage rates



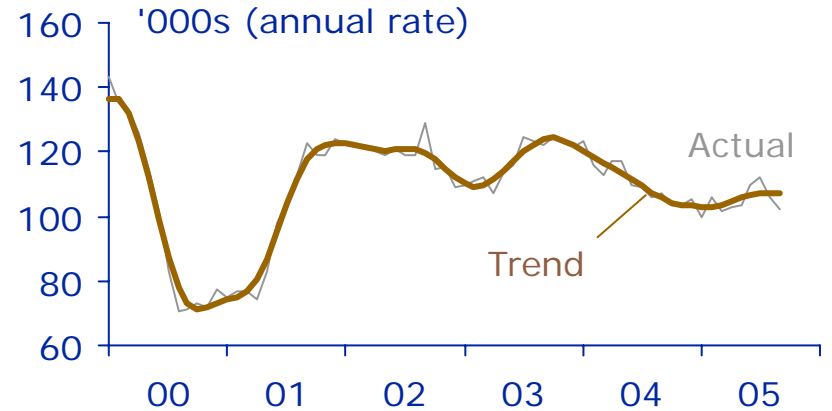
Sources: RBA; Economics@ANZ.

Housing activity has been remarkably little affected by the rises in rates since late 2003

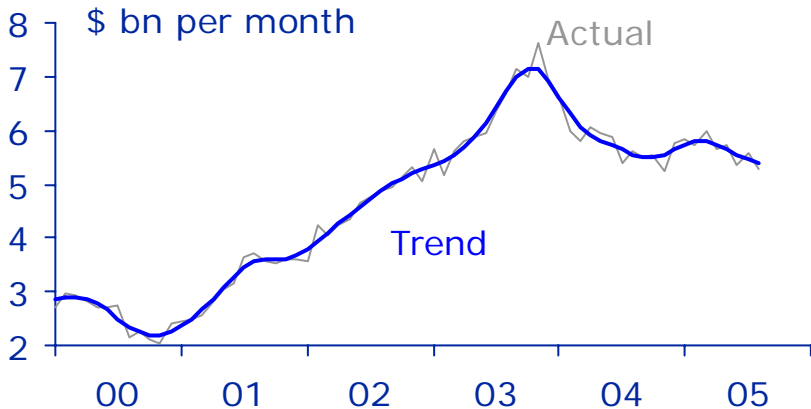
**Housing finance commitments*
- owner occupiers**



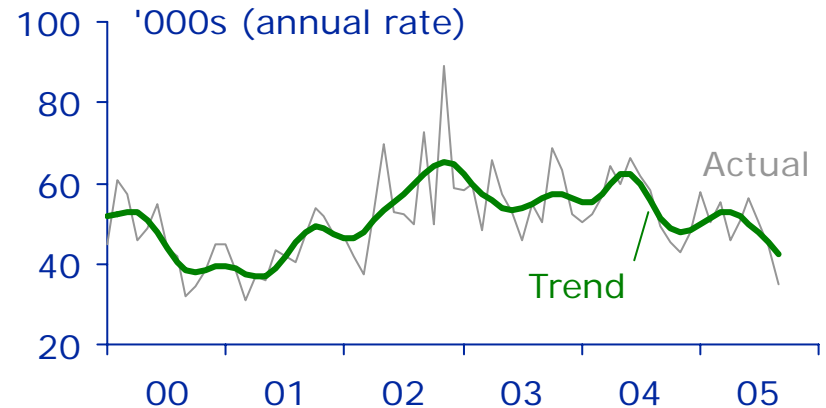
**Residential building approvals
- private houses**



Investors



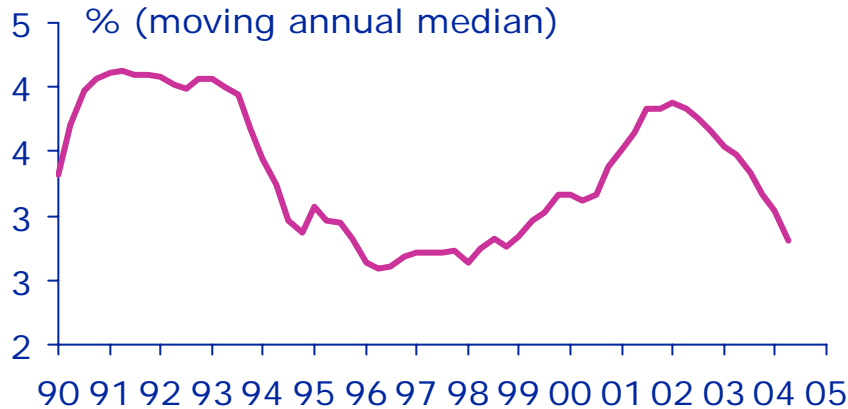
Units



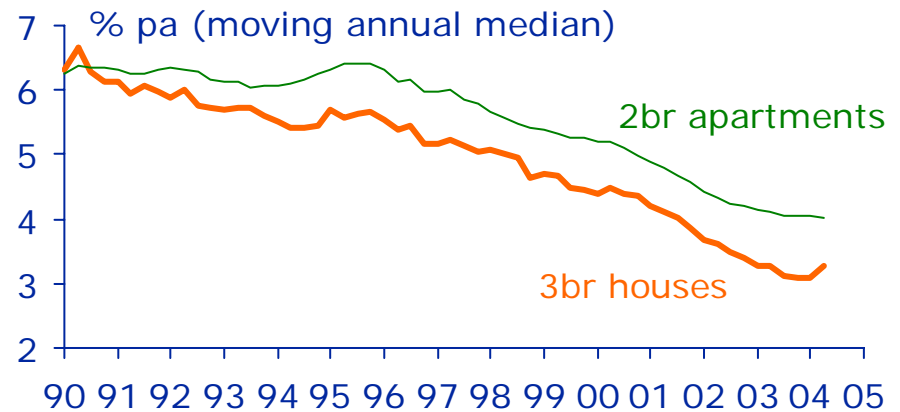
* Excl. re-financing. Sources: ABS; Economics@ANZ.

There's no real evidence of an 'over-supply' of housing, at least not in aggregate

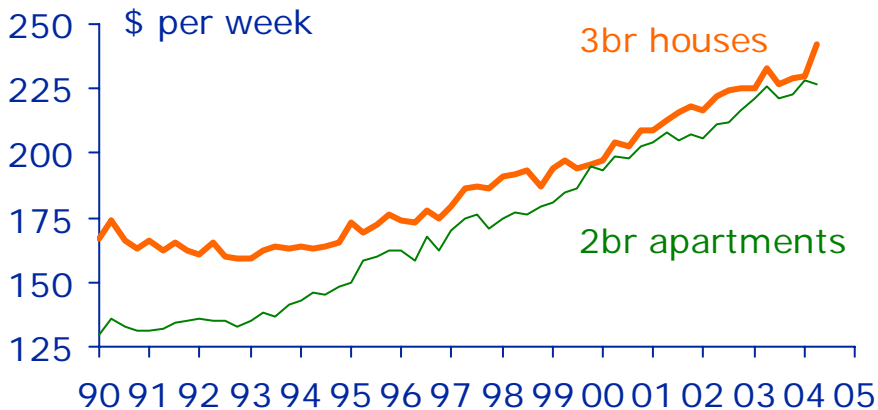
Rental vacancy rates*



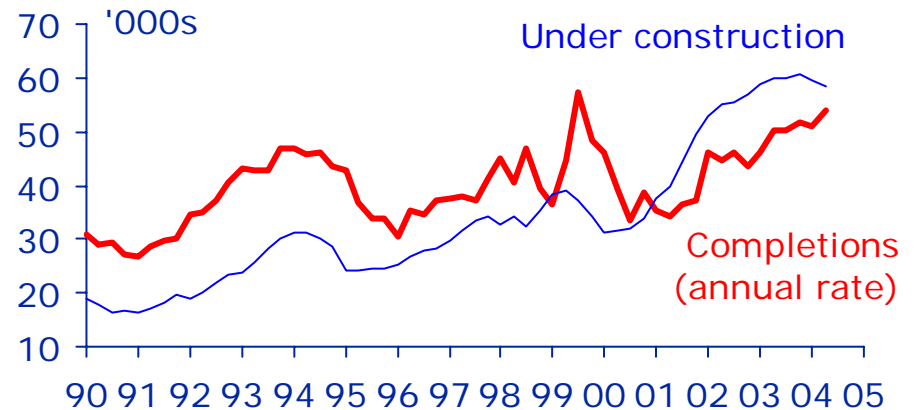
Rental yields*



Residential rents*



Apartment construction

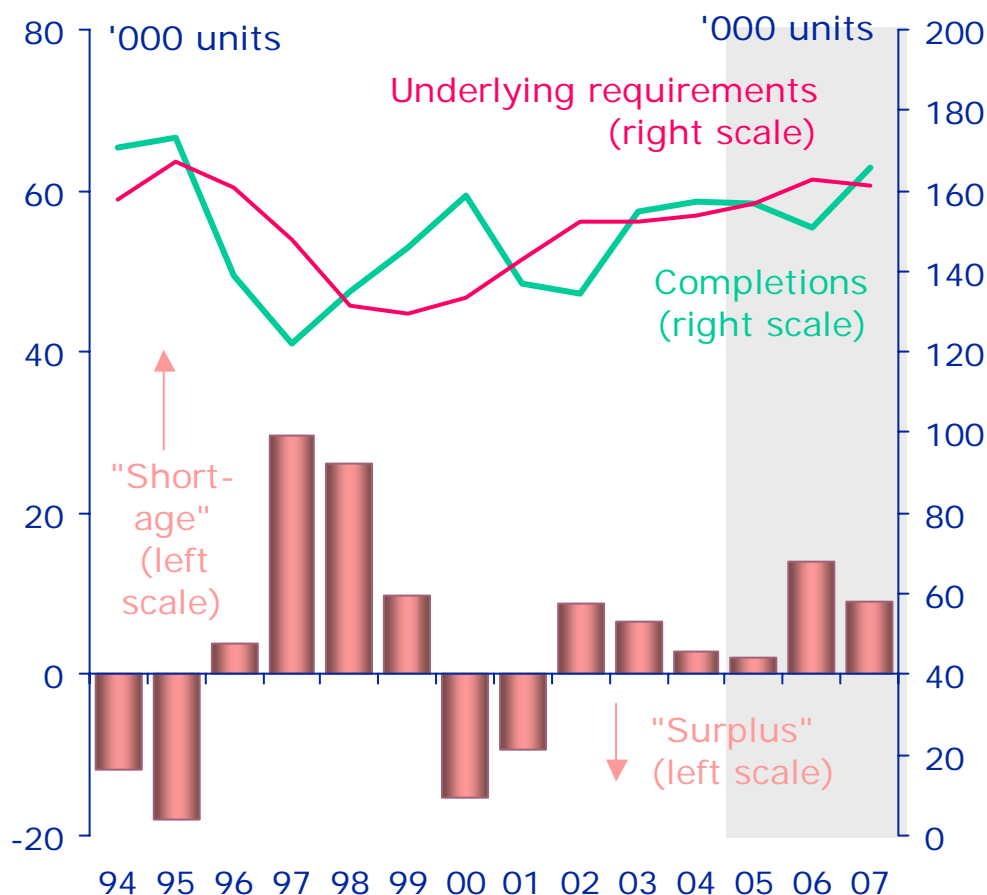


* Weighted average of all 8 capital cities.

Source: Real Estate Institute of Australia; ABS.

Housing supply and demand fundamentals remain reasonably sound

National housing market balance

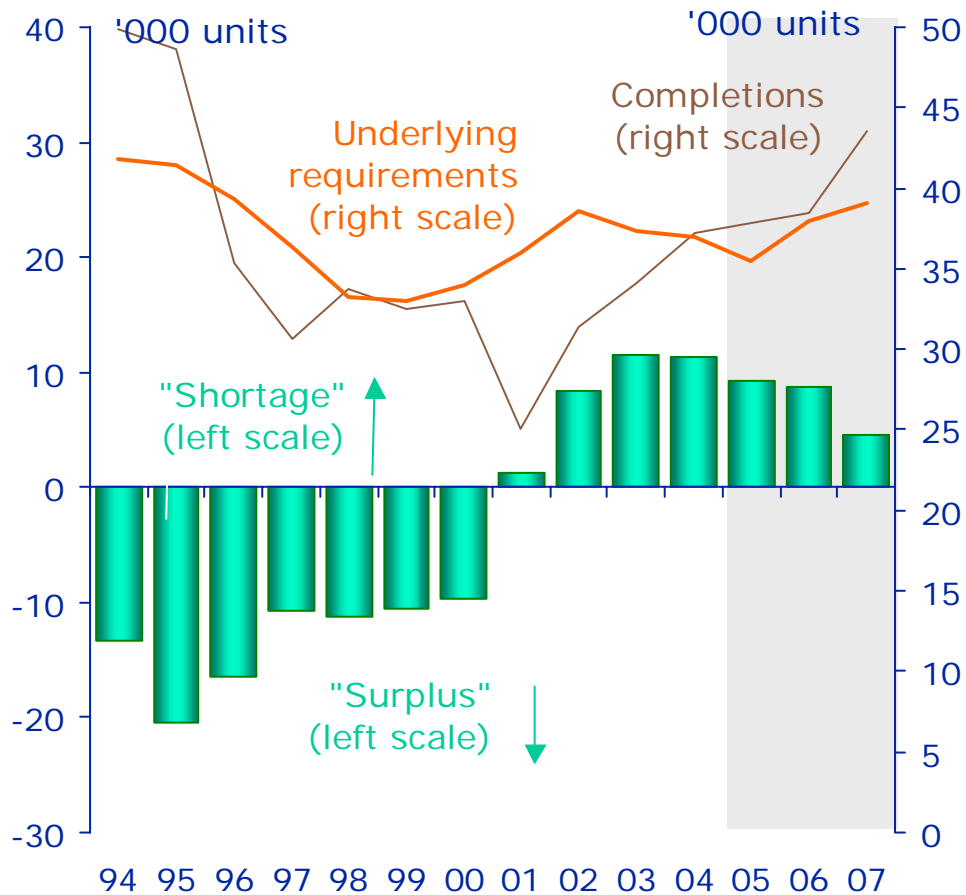


Note: 'Surplus' or 'shortage' is the cumulative difference between completions and underlying demand from an historical starting point. The direction of movements in this measure is more significant than the level. Sources: ABS; Economics@ANZ.

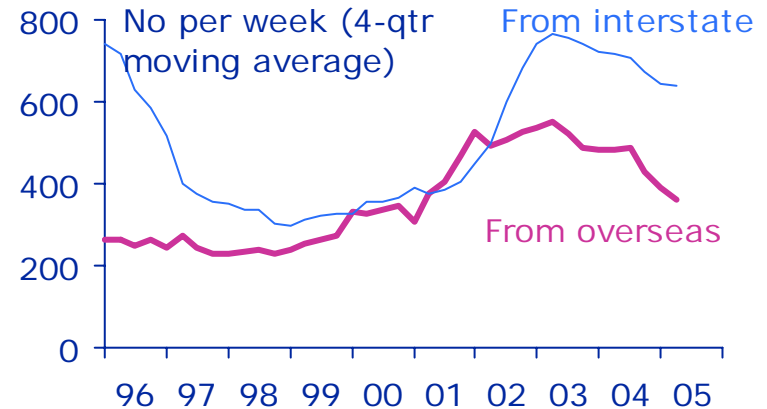
- Underlying demand for housing is running at around 165K units pa, driven by strong immigration and declining average household size
- Approvals and completions are running below this level, at around 150K per annum
- So the market remains in an 'underlying shortage' position
- In the absence of sharp rises in interest rates, we expect 160K starts in 2005-06, followed by 180K in 2006-07

Queensland housing market fundamentals also point to continued growth in housing activity

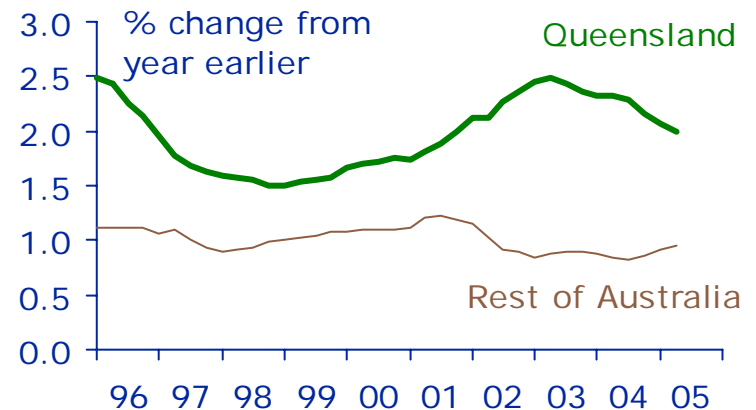
Queensland housing market balance



Migration to Queensland



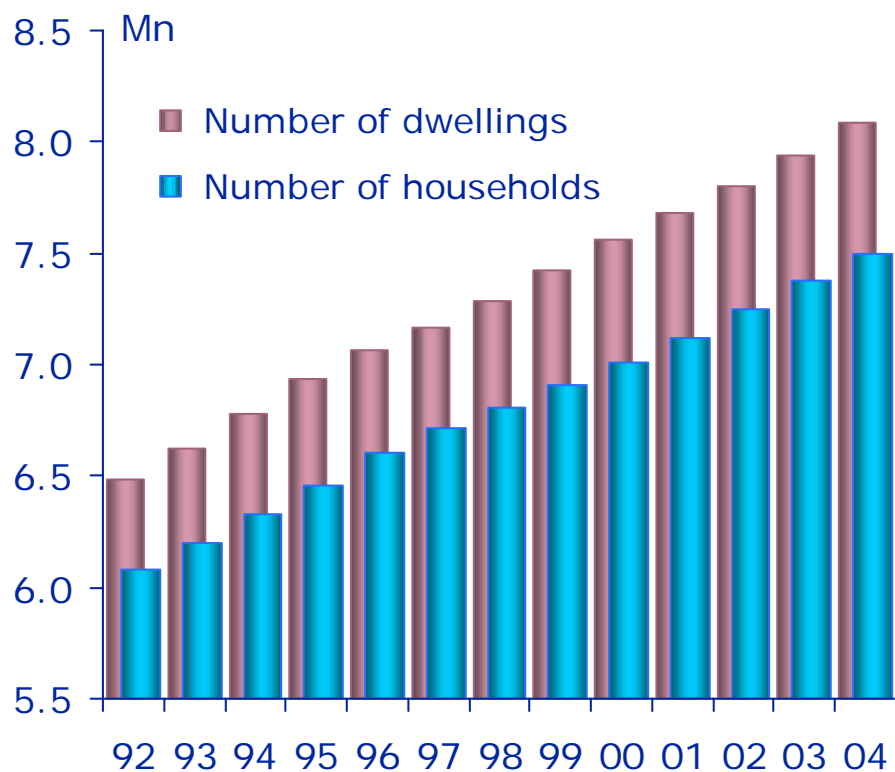
Queensland population



Note: 'Surplus' or 'shortage' is the cumulative difference between completions and underlying demand from an historical starting point. The direction of movements in this measure is more significant than the level. Sources: ABS; Economics@ANZ.

However the supply of housing has barely kept pace with the increase in underlying demand

Number of households and number of dwellings



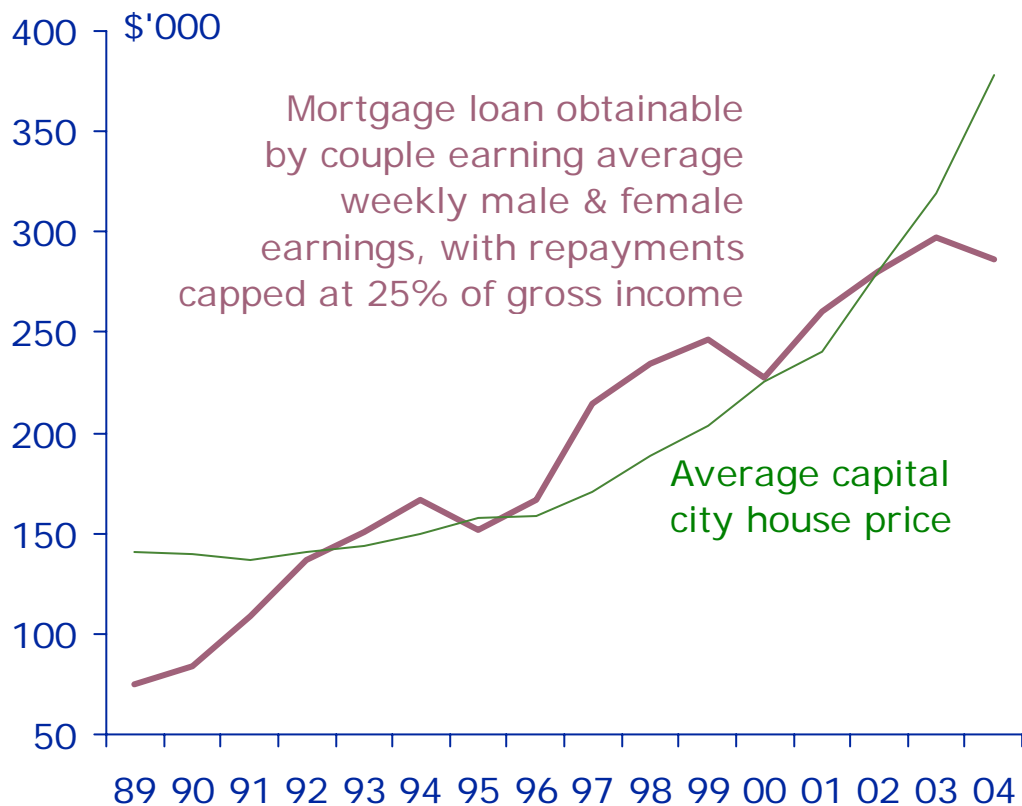
Note: Dwelling stock estimates for 1991, 1996 and 2001 based on census figures; other years interpolated using completions data.

Sources: RBA; ABS; Economics@ANZ.

- Over the twelve years to 2003-04, the number of households rose by 1.42 million or 23%
 - faster than the increase in population (15%) because of falling average household size
- Over the same period, the stock of housing increased by 1.60 million or 25%
 - 1.78 mn new dwellings were completed during this period, but around 180,000 old dwellings were demolished
- In effect, around 89% of the increase in the supply of housing was absorbed by increased demand

The rise in house prices over the past five years is thus 'fundamentally' justified, not a 'bubble'

Borrowing capacity and house prices



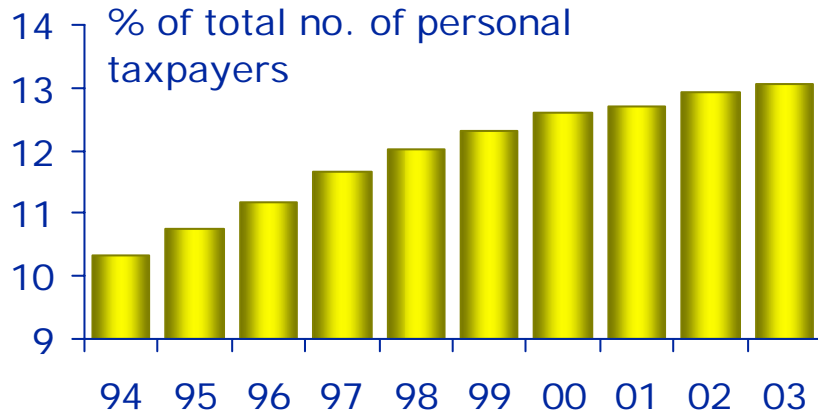
Note: data are for the June quarter each year.

Sources: ABS; REIA; Economics@ANZ.

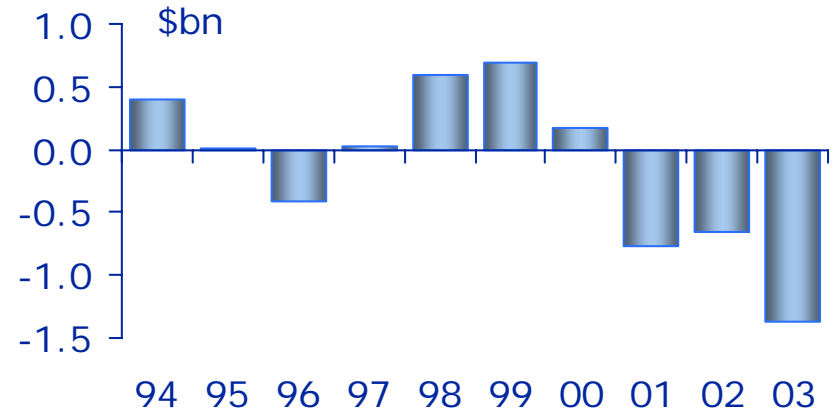
- Over the past 12 years average incomes have risen by two-thirds while the mortgage rate has fallen by about one-third
- The borrowing capacity of an average-income household has more than doubled as a result
- With little net increase in the stock of dwellings this increase in 'purchasing power' has been capitalized into prices
- However, this is one-time shift in the level of house prices – not a permanent increase in their rate of change

Australia's tax system has played a key role in encouraging investment in rental property

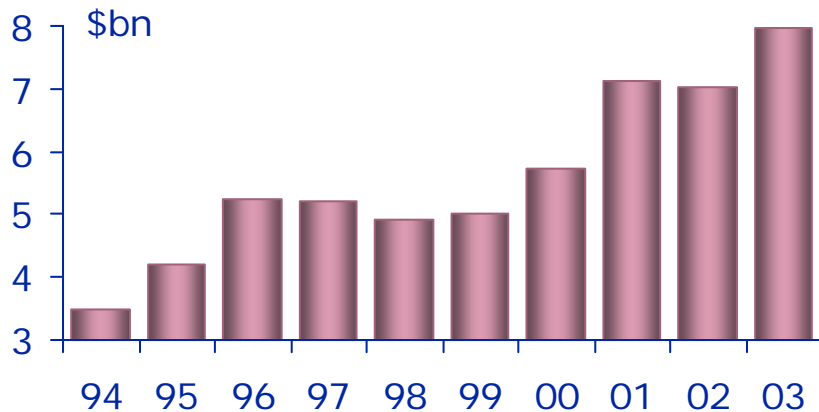
Taxpayers with rental income



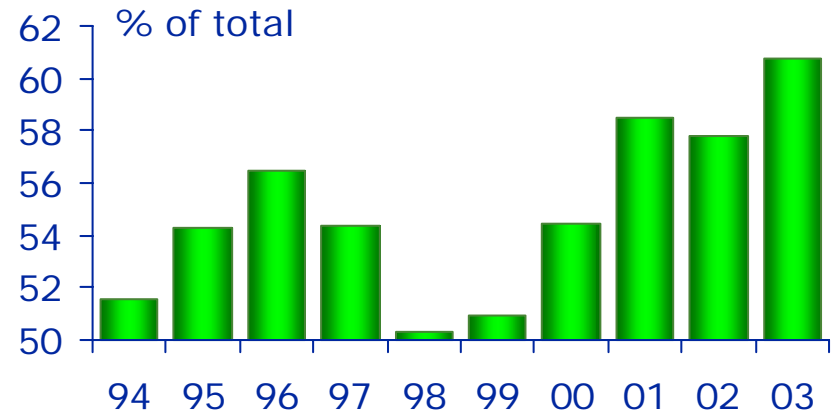
Net rental income



Interest paid by property investors



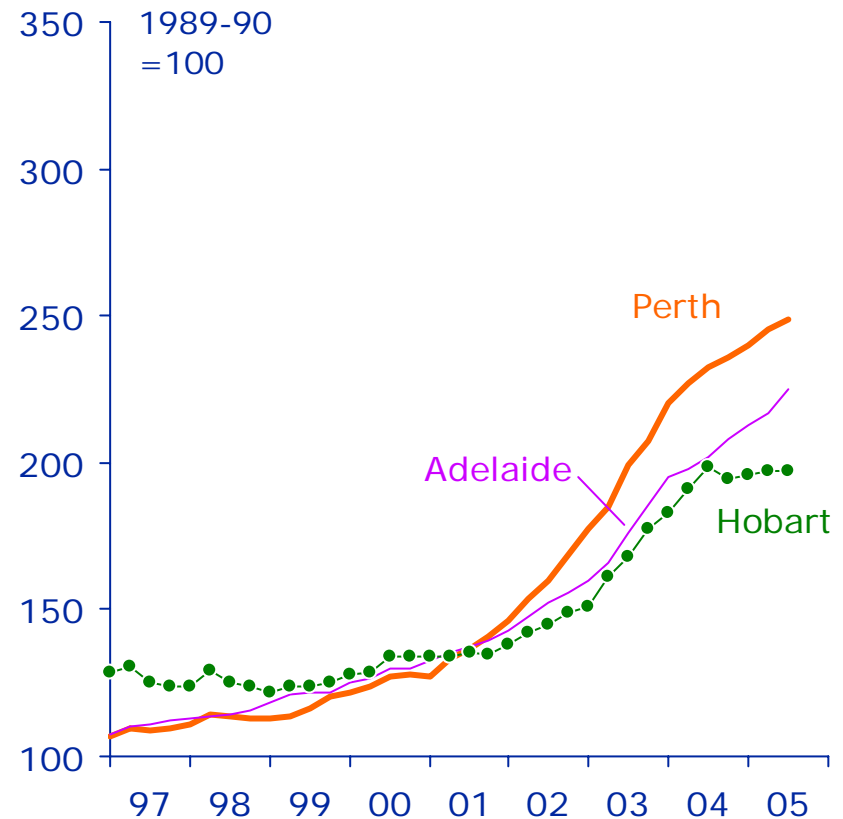
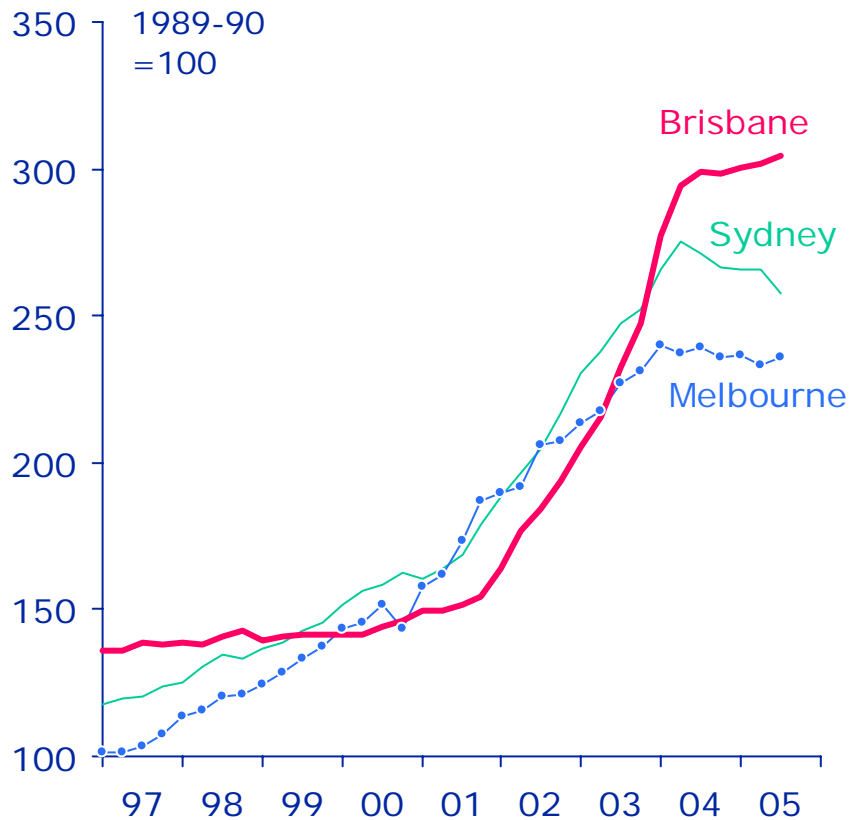
Loss-making property investors



Note: Data are for fiscal years ended 30 June.
Sources: Australian Taxation Office; Economics@ANZ.

House prices in major East Coast cities have peaked while smaller cities still catching up

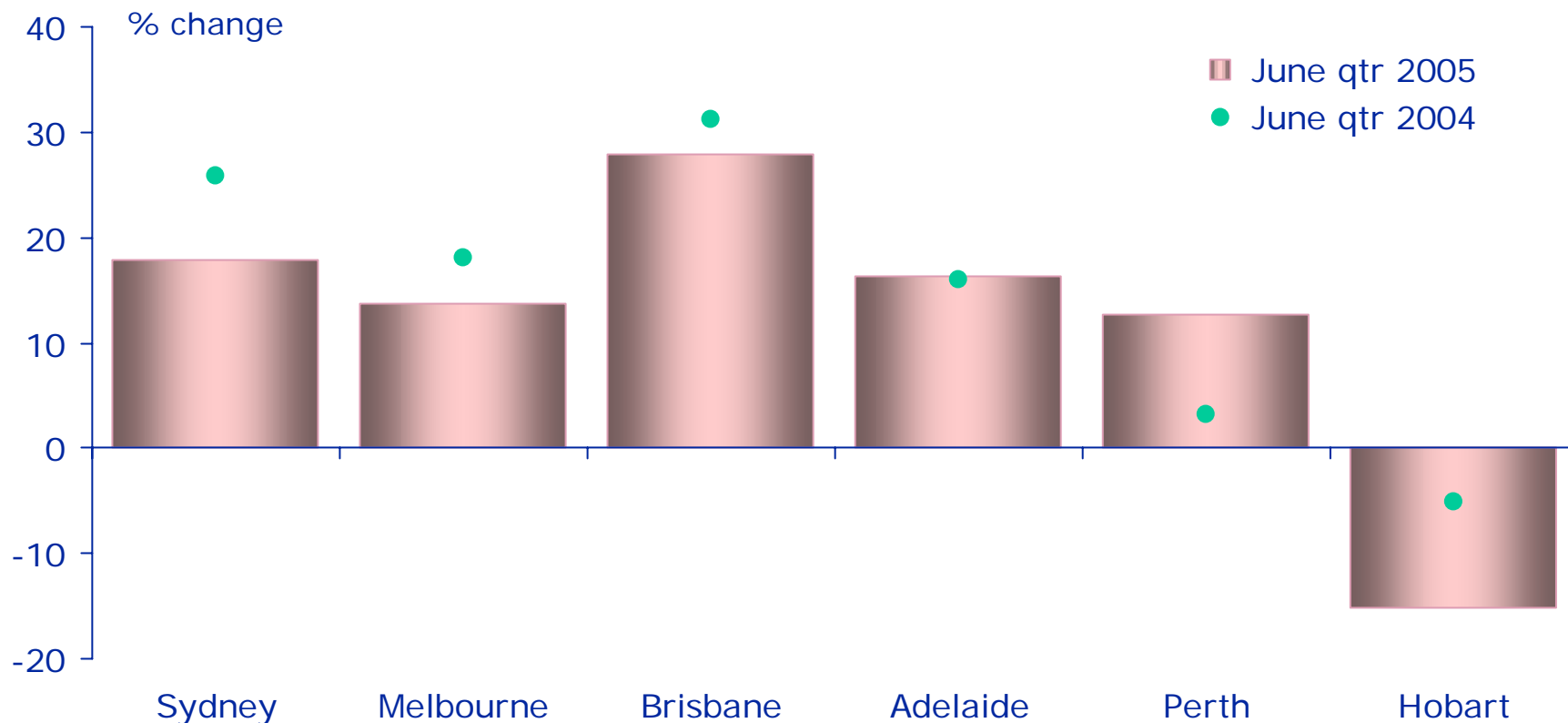
Capital city house prices



Sources: ABS; Economics@ANZ.

Brisbane house prices are now more 'over-valued' than in any other capital city

Capital city house prices – deviation from 'fair value'*



*'Fair value' based on interest rates and average disposable incomes. *Source:* ABS; Economics@ANZ.

Summary

- **World economy will continue to show reasonable growth at least until 2008**
 - despite higher oil prices and rising US interest rates
 - 'excess savings' in Asia and elsewhere are helping to keep long-term rates down and finance otherwise 'unsustainable' current account imbalances
- **Nearly 15 years out from the last recession, Australia's economy is beginning to encounter capacity constraints**
 - whenever the economy has previously been at this stage of the cycle, policy mistakes have led to recession within two years
 - it's dangerous to say, but 'this time it should be different'
- **Interest rates are 'on hold' for the remainder of this year, but will probably rise again in 2006**
 - unusually, fixed rates are lower than variable rates, presenting an opportunity to 'lock in'
- **There's unlikely to be a significant downturn in housing activity**
 - 160K housing starts nationally in 05-06, rising to 180K in 06-07
 - Queensland starts 41K in 05-06, rising to 48K in 06-07
- **Residential property prices have peaked in most capital cities**
 - Brisbane prices look more 'over-valued' than anywhere else