ANZ Australian Economics Weekly

External shocks helping the RBA, for now

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Inside:

Economic update 2
Data previews 4
Market wrap 5
ANZ Forecasts......................... 6
Contacts 8

Authors:

Warren Hogan
Co-Head of Australian Economics and Interest Rate Research
+61 2 9227 1562
Warren.Hogan@anz.com

Sally Auld
Co-Head of Australian Economics and Interest Rate Research
+61 2 9227 1809
Sally.Auld@anz.com

Katie Dean
Senior Economist
+61 3 9273 1381
Katie.Dean@anz.com

Riki Polygenis
Economist
+61 3 9273 4060
Riki.Polygenis@anz.com

Dr. Alex Joiner
Economist
+61 3 9273 6123
Alex.Joiner@anz.com

Patricia Gacis
Strategist
+61 2 9227 1272
Patricia.Gacis@anz.com

Phillip Hawkins
Graduate Analyst
Phillip.Hawkins@anz.com

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For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand. the Pacific and Asia.

Economic Update

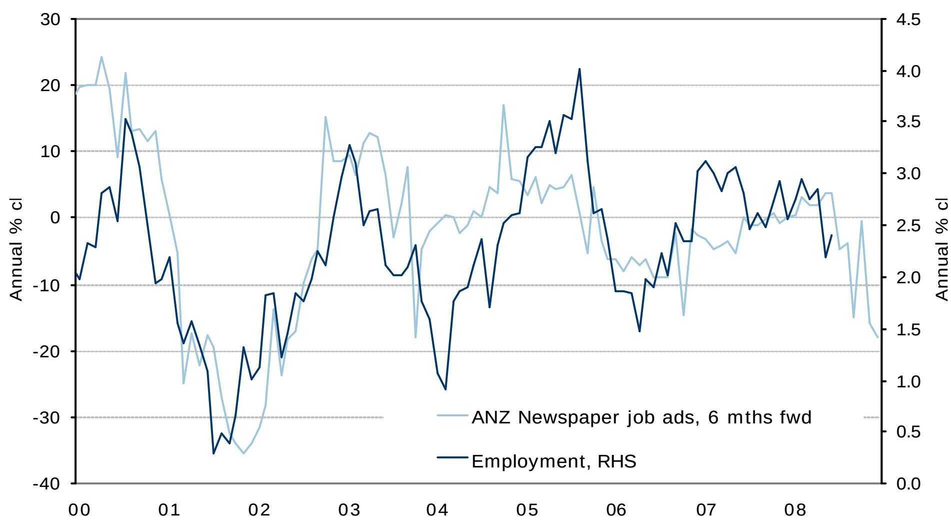
- A rate hike from the RBA in August is now looking less likely.
- There have been two key developments in recent months which we did not foresee and which are hurting the economy:
  - (1) the re-emergence of stresses in global credit markets, which has prompted some commercial banks to raise their lending rates in the last few weeks (outside moves by the RBA); and
  - (2) spiralling petrol prices which are stretching both household and business budgets.
- However, a rebound in employment in June suggests that the fundamental underpinnings of the economy remain relatively sound.
- Against a backdrop of record high inflation expectations, the next move in the official cash rate is still more likely to be up than down.

Market wrap

- A run of soft local economic data this week, especially a sharp drop in both consumer sentiment and housing finance, has seen local interest rate markets scale back expectations for more interest rate rises.
- Soft economic data led the AUD down in the early part of the week, but sentiment swung sharply back towards the AUD later in the week as the USD weakened and local jobs data printed stronger than expected.
- Australian equity markets fell for the 8th consecutive week largely driven by a fall in financial stocks.

Chart of the week

Employment will slow, but it won't fall off a cliff



Sources: ANZ, ABS

Riki Polygenis
Economist
+61 3 9273 4060
riki.polygenis@anz.com

Economic Update

External shocks helping the RBA, for now

The chance of a rate hike from the RBA in August has diminished...

A rate hike from the RBA in August is now looking less and less likely. There have been two key developments in recent months which we did not foresee and which are hurting the economy: (1) the re-emergence of stresses in global credit markets, which is keeping bank funding costs under pressure and has prompted some commercial banks to raise their lending rates in the last few weeks (outside moves by the RBA); and (2) spiralling petrol prices which are stretching both household and business budgets.

...but the next move is still more likely to be up than down

However a rebound in employment in June suggests that the fundamental underpinnings of the economy remain relatively sound. Yes, domestic demand is slowing now. But income tax cuts and export commodity price windfalls mean we could well see economic growth reaccelerate later this year, particularly if petrol prices and financial markets stabilise. Against a backdrop of record high inflation expectations, the next move in the official cash rate is still more likely to be up than down.

Confidence plunges...

Business and consumer sentiment are trending downwards

Australian households and businesses are increasingly pessimistic. The NAB business survey contained a significant deterioration in both business conditions and confidence in June. After showing some sign of stabilisation in May, it looks like business confidence and conditions have taken a turn for the worse. Profitability, forward orders, employment and trading conditions all fell.

Consumer confidence fell by 6.7% in the month of July to 79 points, the lowest level since the last recession in 1992. Pessimists now clearly outweigh optimists, with the index now well below the crucial 100 level for six straight months. A further illustration of increasing household caution was a fall in housing loan approvals. The value of approvals fell 6.2% in May (excluding refinancing) and are now at the lowest level since late 2005. Approvals for both owner-occupiers (-5.8%) and investors (-6.8%) fell sharply, portending further softness in the pace of housing credit growth.

But relatively strong employment growth should limit the downside to growth...

But a rebound in employment in June suggests economic fundamentals are sound

These developments suggest that household balance sheets are under more pressure than in recent years due to higher interest rates and higher prices for petrol, food and rent. But the labour market still holds the key. So long as employment growth does not slow too dramatically, this will limit the downside to consumer spending and economic growth, particularly if petrol prices subside.

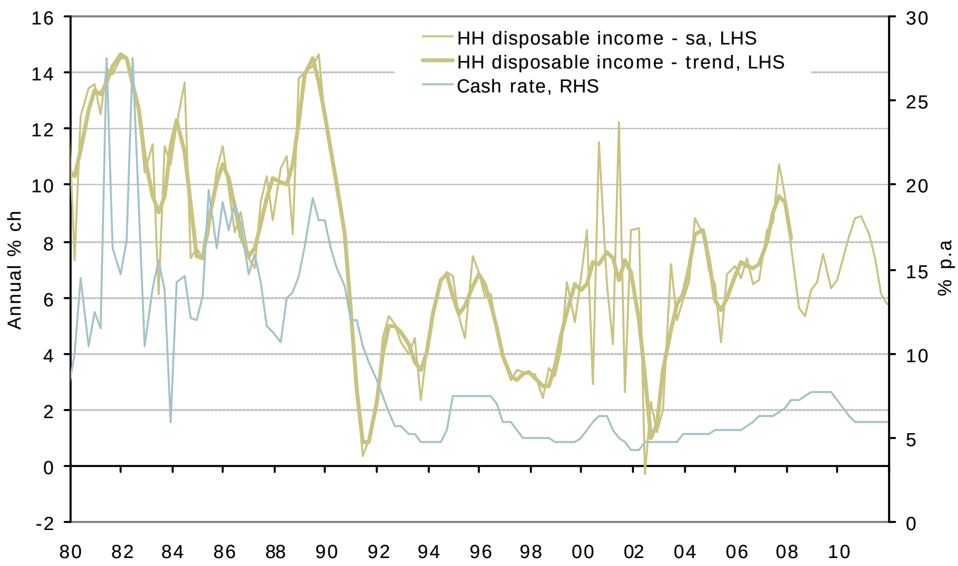
On this note, the bounceback in employment in June reported this week was encouraging. 29,800 new jobs were generated in the month, alleviating fears that May's 25,600 fall was the start of a slippery slope downwards. Employment growth has slowed in trend terms to 2.4% yoy (from a recent peak of 2.8% in February), but this can still be considered a strong pace of growth by historical standards.

But we know that employment is a lagging indicator of economic activity so it can be expected to fall further. The question is by how much? Forward looking indicators such as the ANZ job ads series have been trending downwards and point to a moderate slowing in employment growth to around 1½% yoy by the end of the year (see chart of the week on page 1). The NAB 'employment index' is also suggesting a similar pace of growth (notwithstanding June's sharp fall).

Employment growth of 1½% by December is consistent with the unemployment rate rising gradually to around 4½%. With inflation expectations at extremely high levels, the industrial relations system changing and skill shortages pronounced, it is not clear that an unemployment rate of 4½% is enough to take pressure off wages growth and hence inflation. Workers are requesting greater compensation for the higher cost of living, particularly when staples such as fuel, food and rents are rising.

Relatively solid growth in employment will also mean that household disposable income growth does not fall dramatically. On our current estimates, which incorporate the latest tax cuts and 50bps of rate rises above the current cash rate, it should fall to a nominal rate of around 5.5% yoy - this is quite a stark slowdown from over 10% in Q3 2007, but nowhere near recession territory (see chart below).

Household disposable income to ease, but only moderately



The outlook for household spending thus does not appear quite as weak as implied by this week's consumer confidence reading. With petrol prices to remain high in the near term, we do expect quite a stark slowdown in consumption – from 4.8% in Q4 2007 to around 2% by the end of 2008. However consumption growth could well reaccelerate further out, especially if financial market conditions and petrol prices steady.

The risk remains skewed towards further monetary policy tightening

With the economy to receive significant support from strong government infrastructure investment and the ongoing commodity price boom, such a pickup in consumption would not be good for the inflation outlook. Input costs for businesses continue to rise and a reacceleration in domestic demand will give them greater freedom to pass these on to consumers. In this environment, the next move in the official cash rate from the RBA is still more likely to be up than down.

Key data summary

Key points to note from this week's economic releases are:

- The **AiG Performance of Construction Index** rose by 3 points to 40.3, but remains below the breakeven level of 50.
- The **ANZ job advertisements series** fell by 3.0% in June, following a 1.7% decrease in May. Job advertisements in major metropolitian newspapers fell 3.5% and advertisements on the internet fell by 2.9%.
- The **NAB monthly business survey** showed sharp falls in both confidence and conditions in June. Business confidence slid in June (to -9) after improving in May (to -4) and business conditions fell to 0 from 7 in May. Profitability, forward orders and trading conditions all fell sharply. The employment index was negative for the first time since 2002, falling to -2.4 from +5.4. The labour costs measure eased slightly, but selling price expectations bounced back up after falling in May. Capacity utilisation picked up slightly to 82.5% but remains lower than the 84%+ rates recorded earlier in the year.
- **Consumer sentiment** fell by 6.7% in July to 79 points, the lowest level since 1992.

- The *value* of **housing finance approvals** fell by 6.2% in May (20.7% over the year). Within these figures, approvals for owner-occupier housing fell 5.8%, whereas investor loans slumped 6.8%. The *number* of owner occupied housing finance commitments fell by a further 7.9% in May to be down 21.5% over the year.
- WBC-MI **consumer inflation expectations** were unchanged at a record high of 5.9% in July.
- The **labour market** report for June showed that Employment rose by 29,800 in June, following a fall of 25,600 in May (revised down from -19,700). The unemployment rate ticked back down to 4.2% and the participation rate edged up to 65.3%.

Coming up

Please see ANZ's separate publication '*ANZ Data and Event Calendar'* for the schedule and previews of upcoming key local and global data events. Please email emr@anz.com if you would like to subscribe to this publication.

Key local releases next week

Date	Data/Event	ANZ	Last	Time (AEST)
Mon 14 Jul	Lending finance (May)	nf	nf	11:30
Tue 15 Jul	**RBA Minutes (Jul)**	nf	nf	11:30
	Building activity (Q1)	nf	nf	11:30
Wed 16 Jul	**RBA Governor Stevens speaks**	nf	nf	13.05
	WBC Leading Index (May)	nf	nf	11:30
Thu 17 Jul	RBA Bulletin	nf	nf	11:30
	Merchandise imports (Jun)	nf	nf	11:30
Fri 18 Jul	**Export price index (Q2)**	6.0%	5.1%	11:30
	Import price index (Q2)	4.0%	2.7%	11:30

Market Wrap

Chart 1: AUS 3-year yields

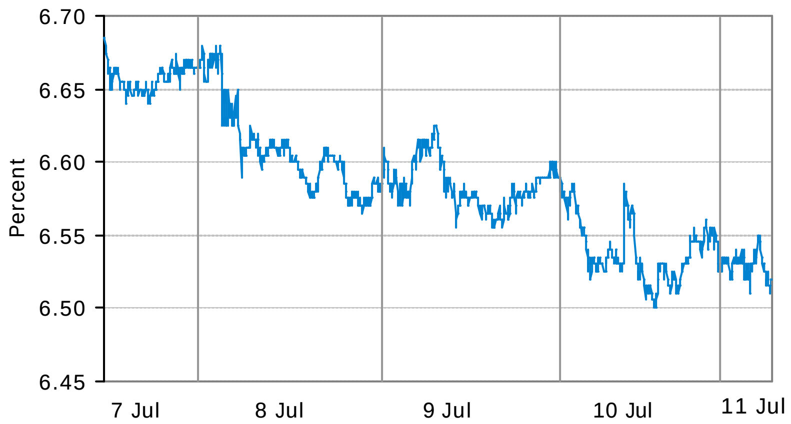


Chart 2: AUD/USD

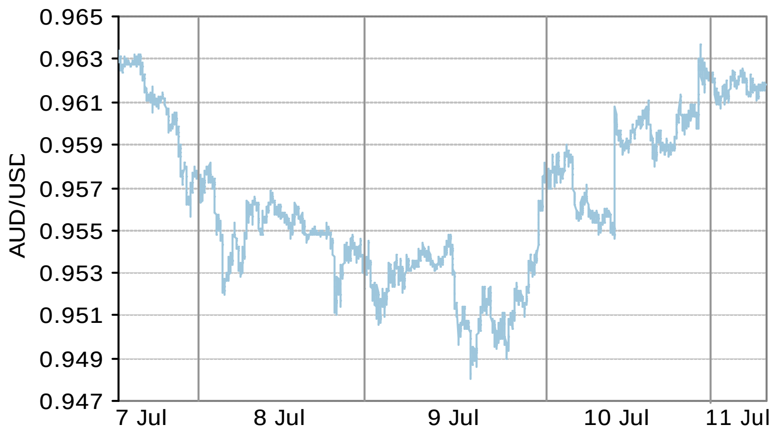
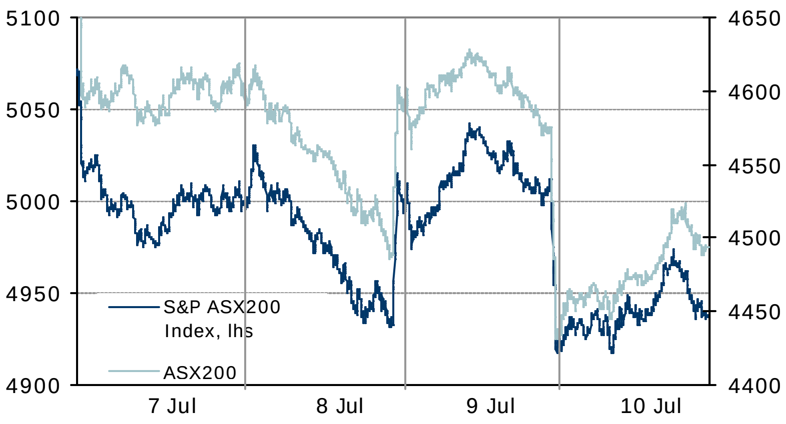


Chart 3:ASX200 and ASX Financials and Indices



Rates rally on weaker data

A run of soft local economic data this week, especially a sharp drop in both consumer sentiment and housing finance, has seen local interest rate markets scale back expectations for higher local interest rates.

Not even a strong rebound in the June employment figures could bouy the mood of rates markets, which are also being affected by more gloomy sentiment about the global economy.

A rally in term rates has seen the the yield on the 3-year Australian government bond fall 21bps since last Friday, from 6.72% to 6.51%. The OIS market is now pricing in just a 20% chance that the RBA will raise interest rates before the end of the year.

With the Q2 CPI likely to print uncomfortably high on 23 July, we still see some scope for term rates to sell off from current levels.

AUD finds good support

The AUD was sold down in the early part of the week as a raft of soft data on the economy saw markets scale back expectations for further local interest rate rises.

However mid-week sentiment swung sharply back towards the AUD, as the USD weakened and local jobs data printed stronger than expected.

The AUD continues to find good support just under the US$0.95c level, underpinned by the strong 'fundamentals' of higher export receipts and high relative yields.

However, with global risk aversion rising and local growth slowing, it looks like we may require another round of USD weakness before the AUD can attract sufficient support to break through recent highs.

ASX200 falls for 8th consecutive week

Australian equity markets fell for the 8th consecutive week largely driven by a fall in financial stocks. At the time of writing the ASX200 Index is down 2.9% for the week and down 22% since the start of the year.

Ongoing concerns over global credit markets and a slowing global economy continue to fuel bearish sentiment. Volatile commodities prices are also having a significant effect.

While we may see shares consolidate around current levels below 5000, expect the current bearish momentum to continue in coming weeks.

Katie Dean and Phillip Hawkins

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	5.9	3.3	2.4	3.4
Household consumption	4.6	3.3	1.9	2.6
Dwelling investment	3.1	-2.5	2.0	13.2
Business investment	12.0	6.4	4.2	2.8
Public demand	2.7	4.9	2.5	2.6
Domestic final demand	5.2	3.7	2.4	3.2
Inventories (contribution to GDP)	0.7	-0.1	-0.1	0.0
Gross National Expenditure (GNE)	5.9	3.6	2.3	3.2
Exports	3.2	4.0	6.7	4.9
Imports	10.6	10.5	5.0	4.2
Net Exports (contribution to GDP)	-1.7	-1.7	0.1	-0.1
Gross Domestic Product (GDP)	4.3	2.8	2.4	3.3
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	3.4	3.2
Underlying*	3.1	4.6	3.9	3.0
Wages	4.1	4.4	4.4	3.7
Labour market				
Employment (annual % change)	2.8	2.3	1.0	0.8
Unemployment rate (%)	4.4	4.3	4.9	5.3
External sector				
Current account balance: A$ bn	-66.4	-63.1	-54.4	-70.0
% of GDP	-6.1	-5.4	-4.4	-5.4

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Sep 08f	Dec 08f	Mar 09f	Jun 09f	Sep 09f
RBA cash rate	7.25	7.50	7.75	7.75	7.75	7.75
90 day bill	7.76	7.90	8.05	8.05	8.05	7.80
3 year bond	6.50	7.10	6.75	6.30	5.95	5.50
10 year bond	6.30	6.65	6.15	5.90	5.85	5.50
3s10s yield curve	-0.20	-0.45	-0.60	-0.40	-0.10	0.00
3 year swap	7.57	8.25	7.95	7.45	6.80	6.15
10 year swap	7.20	7.65	7.20	6.90	6.70	6.25
International interest rates						
RBNZ cash rate	8.25	8.00	7.50	7.00	6.50	6.00
NZ 90 day bill	8.46	8.23	7.68	7.13	6.58	6.20
US Fed funds note	2.00	2.00	1.75	1.75	1.75	2.25
US 2 year note	2.41	2.25	2.00	2.25	2.75	3.00
US 10 year note	3.80	4.50	4.10	3.85	3.85	3.85
Japan call rate	0.50	0.75	0.75	0.75	1.00	1.00
ECB refinance rate	4.25	4.25	4.25	4.25	4.25	4.00
UK repo rate	5.00	5.00	5.00	4.75	4.50	4.25

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Sep 08f	Dec 08f	Mar 09f	Jun 09f	Sep 09f
Australia and NZ exchange rates						
A$/US$	0.9607	1.01	1.04	1.00	0.94	0.89
NZ$/US$	0.7587	0.77	0.75	0.72	0.68	0.64
A$/¥	102.79	105.0	108.2	105.0	101.5	97.9
A$/€	0.6083	0.65	0.67	0.65	0.63	0.61
A$/£	0.4855	0.52	0.54	0.53	0.50	0.48
A$/NZ$	1.266	1.31	1.39	1.39	1.38	1.39
A$/CA$	0.9700	0.99	1.02	1.01	0.98	0.96
A$/CHF	0.9870	1.05	1.08	1.06	1.02	1.01
A$/CNY	6.567	6.87	7.02	6.70	6.26	5.87
A$ Trade weighted index	73.20	77.0	79.3	76.6	72.8	69.5
International cross rates						
US$/¥	107.0	104	104	105	108	110
€/US$	1.579	1.56	1.55	1.54	1.50	1.45
€/¥	168.9	162	161	162	162	160
£/US$	1.979	1.96	1.93	1.90	1.87	1.85
€/£	0.7981	0.80	0.80	0.81	0.80	0.78
US$/CA$	1.010	0.98	0.98	1.01	1.04	1.08
US$/CHF	1.027	1.04	1.04	1.06	1.09	1.14
US$ index	72.49	72.9	73.5	74.3	76.2	78.6
Asia exchange rates						
US$/CNY	6.836	6.80	6.75	6.70	6.65	6.60
US$/HKD	7.803	7.80	7.80	7.80	7.80	7.80
US$/IDR	9164	9200	9150	9125	9125	9000
US$/INR	42.97	43.30	43.80	43.50	43.10	42.70
US$/KRW	1001.35	1035	1030	1020	1010	1000
US$/MYR	3.2456	3.26	3.24	3.22	3.20	3.19
US$/PHP	45.8	44.50	44.00	43.80	43.60	43.40
US$/SGD	1.360	1.36	1.36	1.36	1.36	1.36
US$/THB	33.72	33.00	32.80	32.70	32.60	32.40
US$/TWD	30.43	30.30	30.00	31.00	31.50	31.50
US$/VND	16842	17200	17000	17000	16950	16900
Pacific exchange rates						
PGK/US$	0.385	0.40	0.42	0.40	0.39	0.37
FJD/US$	0.670	0.70	0.70	0.68	0.66	0.63

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*

Contacts

ANZ Economics & Markets Research

Saul Eslake
Chief Economist
+61 3 9273 6251
Saul.Eslake@anz.com

Fiona Allen
Business Manager
+61 3 9273 6224
Fiona.Allen@anz.com

Tony Pearson
Deputy Chief Economist,
Industry and Strategic Research
+61 3 9273 5083
Tony.Pearson@anz.com

Mark Rodrigues
Senior Economist,
Industry and Strategic Research
+61 3 9273 6286
Mark.Rodrigues@anz.com

Julie Toth
Senior Economist,
Industry and Strategic Research
+61 3 9273 6252
Julie.Toth@anz.com

Warren Hogan
Co-Head of Australian Economics and Interest Rates Research
+61 2 9227 1562
Warren.Hogan@anz.com

Dr. Sally Auld
Co-Head of Australian Economics and Interest Rates Research
+61 2 9227 1809
Sally.Auld@anz.com

Katie Dean
Senior Economist,
Australian Economics and Interest Rates Research
+61 3 9273 1381
Katie.Dean@anz.com

Riki Polygenis
Economist,
Australian Economics and Interest Rates Research
+61 3 9273 4060
Riki.Polygenis@anz.com

Dr. Alex Joiner
Economist,
Australian Economics and Interest Rates Research
+61 3 9273 6123
Alex.Joiner@anz.com

David Croy
Strategist,
Australian Economics and Interest Rates Research
(London)
+44 20 7378 2070
David.Croy@anz.com

Patricia Gacis
Strategist,
Australian Economics and Interest Rates Research
+61 2 9227 1272
Patricia.Gacis@anz.com

Jason Hill
Credit Analyst
Jason.Hill@anz.com

Amy Auster
Head of Foreign Exchange and International Economics Research
+61 3 9273 5417
Amy.Auster@anz.com

Tony Morriss
Senior Currency Strategist,
Foreign Exchange and International Economics Research
+61 2 9226 6757
Tony.Morriss@anz.com

Jasmine Robinson
Senior Economist,
Foreign Exchange and International Economics Research
+61 3 9273 6289
Jasmine.Robinson@anz.com

Amber Rabinov
Economist,
Foreign Exchange and International Economics Research
+61 3 9273 4853
Amber.Rabinov@anz.com

Mark Pervan
Head of Commodities Research
+61 3 92733716
Mark.Pervan@anz.com

Amber Rabinov
Economist, Commodities Research
+61 3 9273 4853
Amber.Rabinov@anz.com

Paul Braddick
Head of Property and Financial System Research
+61 3 9273 5987
Paul.Braddick@anz.com

Ange Montalti
Senior Economist,
Property and Financial System Research
+61 3 9273 6288
Ange.Montalti@anz.com

Dr. Alex Joiner
Economist,
Property and Financial System Research
+61 3 9273 6123
Alex.Joiner@anz.com

Stephanie Wayne
Research Analyst,
Property and Financial System Research
+61 3 9273 4075
Stephanie.Wayne@anz.com

Paul Gruenwald
Head of Economics, Asia
+65 6419 7902
Paul.Gruenwald@anz.com

Ivy Tan
Associate Director, Credit Research, Markets Asia
+65 419 7914
Ivy.Tan@anz.com

Research & Information Services

Mary Yaxley
Head of Research & Information Services
+61 3 9273 6265
Mary.Yaxley@anz.com

Marilla Rough
Senior Information Officer, R&IS
+61 3 9273 6263
Marilla.Rough@anz.com

Manesha Jayasuriya
Information Officer, R&IS
+61 3 9273 4121
Manesha.Jayasuriya@anz.com

ANZ New Zealand Research

Cameron Bagrie
Chief Economist
+64 4 802 2212
Cameron.Bagrie@anz.com

Khoon Goh
Senior Economist
+64 4 802 2357
Khoon.Goh@anznational.co.nz

Philip Borkin
Economist
+64 4 802 2199
Philip.Borkin@anznational.co.nz

Steve Edwards
Economist
+64 4 802 2217
steve.edwards@anznational.co.nz

Kevin Wilson
Rural Economist
+64 4 802 2361
TKevin.Wilson@nbnz.co.n

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

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
Tel: +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