

The case for another rate rise builds

13 April 2007

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

Economic wrap

- Data released this week lend further support to the case for another interest rate rise in the near term.
- Housing finance, job advertisements and business confidence indicators point to continued strong growth in domestic demand in the period ahead, while ongoing tightness in the labour market raises the prospect of an acceleration in wages.
- Against a backdrop of capacity constraints and labour supply shortages, the risks to the inflation outlook have deepened. We expect the RBA to raise the cash rate by 25bp at its May meeting.

Market matters

- Financial markets and ANZ expect the RBA to raise interest rates in May, with futures pricing suggesting a 64% chance of a 25bp hike.
- The A\$ continued on its unrelenting bull-run this week, moving to a 17-year high against the US\$ and a 10-year high against the ¥.
- The ASX 200 was driven to a new record high, with takeover activity and rising base metal prices boosting local shares.

Economy in focus — Recent trends in international migration

Our spotlight on key issues and developments in the Australian economy.

- This week's article analyses recent trends in international migration.
- Australia's Migration Program has expanded significantly in recent years, with a shift towards younger, skilled workers. These trends are likely to continue for the foreseeable future, against a backdrop of growing skill shortages and an ageing population.

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Riki Polygenis
Economist, Australia

Economic indicators pointing to robust domestic demand are mounting

Business conditions and confidence are trending upwards

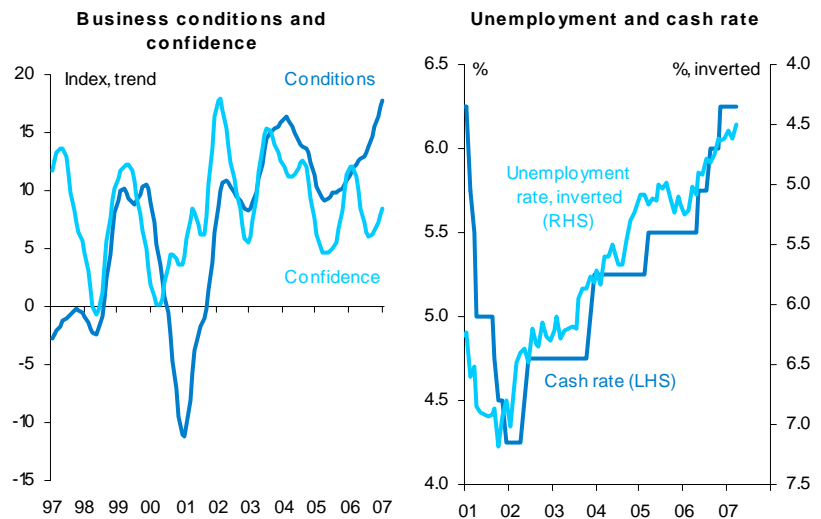
Economic wrap

Economic conditions buoyant all round

If you were of the belief that the case for another RBA rate rise had not yet been made, then this week's economic data may well have changed your mind. Not only did the housing finance, job advertisements, labour force and business survey data demonstrate buoyant conditions in the business and household sectors in February and March, they also point to further strength in domestic demand in the months ahead.

In trend terms, business conditions are now at their highest level since the monthly NAB survey began in 1997, with conditions improving in interest-rate sensitive sectors such as retail, wholesale, construction and personal and recreational services. Forward-looking indicators have also rebounded. After falling steadily since the May rate hike in 2006, business confidence trended upwards in the three months to March and forward orders are at the highest level since late 2004 in trend terms. Against a backdrop of high capacity utilisation, optimism in the business sector bodes well for investment going forward.

Business confidence and employment suggest further buoyancy in domestic demand



Sources: National Australia Bank, Australian Bureau of Statistics and Reserve Bank of Australia.

The unemployment rate returned to three-decade lows

With the business environment healthy, it is no wonder that businesses continue to hire extra workers. Employment rose by a further 10,500 jobs in March, with 28,400 jobs added in the March quarter as a whole. This has been driven by a surge in full-time employment, which increased by 60,600 jobs in the March quarter, more than outweighing a 32,200 fall in part-time employment. Further evidence of strong labour market conditions comes from the unemployment rate, which returned to its recent three-decade low of 4.5% in March.

The tight labour market figures pose upside risks to the inflation outlook from two key channels. Firstly, it enhances the possibility of a further acceleration in wages. While a number of 'safety valves' such as high rates of participation and migration (see In Focus article on page 6) are helping to moderate labour supply shortages, the tighter the labour market gets, the more likely that wages growth will pick up as businesses offer greater incentives to attract the right staff.

Housing loan approvals are displaying renewed strength

The second channel relates to the positive effect that solid employment growth is having on consumer spending and borrowing. Sustained employment growth has helped fuel rapid growth in household incomes and has provided the household sector with an increased sense of financial security and confidence and the recent revival in retail sales, household credit and housing loan approvals is a clear reflection of this. For instance, housing loan approvals data for February released this week showed a rise of 3.3% in the value of housing loan approvals, following solid outcomes in November, December and January.

Further monetary policy
tightening is expected in May

Investor loan approvals have been driving the rebound, with monthly growth averaging over 5% in the four months to February.

All in all, this week's data add to the mounting evidence of strengthening domestic demand. Against a backdrop of capacity constraints and labour supply shortages, and with core inflation at the top of the RBA's comfort zone, the risks to the inflation outlook have deepened. As such, we expect the RBA to raise the cash rate by 25 basis points at its May meeting. The only cloud on the horizon is the economic outlook in the US. Rapid world growth has been the key driving force behind the Australian economy and any deterioration in the world's largest economy may prompt a more cautious approach from the RBA.

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

- The **ANZ Job Advertisements series** rose by 1.9% in March to be 24.7% higher over the year. Internet job advertisements rose by 1.9% in the month and newspaper job advertisements increased by 2.0%.
- The **NAB monthly business survey** reported robust business conditions, confidence and capacity utilisation. While falling slightly in seasonally adjusted terms in March, the three series are all rising in trend terms. Forward orders increased strongly in both seasonally-adjusted and trend terms in March.
- The value of **housing loan approvals** rose by 3.3% in March. This was driven by a sharp rise in investor loan approvals (8.9%), while owner-occupier approvals fell slightly (-0.3%). The number of new loan approvals for owner-occupiers rose by 0.3% in the month
- **Labour force data** pointed to a 10,500 rise in employment in March, building on the 23,200 jobs gained in February. In March, a rise in full-time employment of 31,700 was partly offset by a fall of 21,200 in part-time employment. The unemployment returned to its three-decade low of 4.5% and the participation rate fell slightly to 64.8%.

Data preview

20th April: Trade prices (Mar qtr)

Export prices: ANZ: -0.2% QoQ, +5.6% YoY, Last: +0.2% QoQ, +11.1% YoY

Import prices: ANZ: -2.2% QoQ, -3.5% YoY, Last: -3.2% QoQ, 0.0% YoY

Import prices are expected to fall for the third consecutive quarter in March by around 2.2%, largely reflecting the dampening effect of the high A\$ on imported goods. Export prices are expected to fall marginally with commodity price growth for the quarter relatively weak. The fall in commodity export prices is likely to have been partially countered by the strength of the A\$ pushing up prices of manufactured and other goods exports.

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We expect the RBA to raise
interest rates in May

The A\$ moved to a 17-year
high against the US\$

Market matters

Yields move higher in anticipation of RBA move

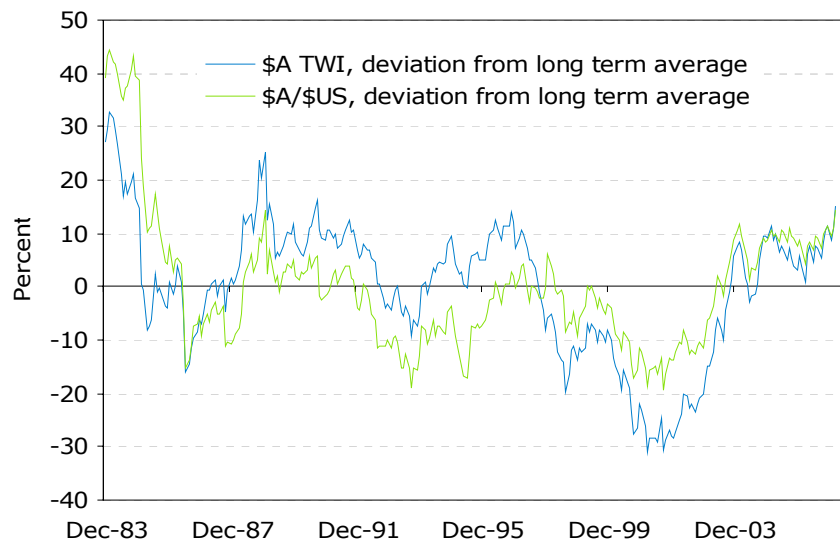
The RBA chose not lift interest rates in April, but the market has put a better than even chance on a rate hike next month. Futures pricing suggests there is a 64% chance of a rate hike in May and we too favour a move. This week's news of a 9% surge in the value of investor property loans in February added to the case for a rate hike while employment data and business sentiment remained solid. Over the week, 3-year yields rose 8 basis points to 6.23%; a near five year high, while 10-year yields rose 5 basis points to 5.94%.

The key to the near-term monetary policy outlook is the March quarter CPI data due on April 24. We think the bond market could weaken a little further into the inflation report, pushing yields even higher. But post May 2, when the RBA delivers its verdict on rates following its next monthly board meeting, we expect yields to fall. This should be the case whether or not there is a hike. If the RBA does lift the cash rate to 6.5%, then 3-year yields will fall as they did on each occasion that the RBA tightened policy last year, with the market believing that the rate hiking phase is over. If there is no change to the 6.25% rate hike, then the market is likely to pare back its expectations of another hike in the coming months. Many are convinced that the RBA will not move immediately after the Budget for fear that it is perceived as a reaction to Government budget policies. Post Budget, a rate hike would then be very close to the 2007 election, expected in the December quarter this year. Although a rate hike in this period is quite possible, the RBA has never hiked rates so close to an election. The case for lower yields is also strengthened by the fact that yields are already at the top of recent ranges.

A\$ bulls run rampant

The A\$'s unrelenting bull-run, continued with force this week, with the local currency moving to a 17-year high against the US\$ and 10-year high against the ¥. There have been a number of factors working in the A\$'s favour this week. Speculation of strong A\$ demand related to the bids for Australian companies Qantas, Coles Group and Rinker were big influences. Strong rallies on commodity markets including base metals, precious metals and oil also helped the A\$, as did continued speculation of a near term interest rate rise from the RBA. The US\$'s weakness was also a factor, with the greenback sliding due to concerns over the US housing market and a rising trade protectionism.

A\$ is more than 10% above long term averages against US\$ and TWI



Source: Economics@ANZ and Bloomberg.

The ASX 200 reached a new record high this week

There is a substantial amount of good news priced into the A\$ at current levels and some consolidation is overdue, but this has proven to be a powerful rally so far. There appears to be little scope for a major reversal ahead of the upcoming CPI data and RBA meeting without a correction in fortunes for the US\$.

Takeovers lift ASX 200 to new record

Takeover activity and rising base metal prices boosted shares to another fresh record this week. The ASX 200 moved to a record 6195.8 at the open on Friday and is now 2% above the level recorded just prior to the late February global equity market correction.

The most significant takeover was a successful revised \$17.5bn bid for Rinker from Mexican company Cemex after four months of hostile negotiations. The battle for Coles Group lifted that company's share price sharply to a new record high of \$17.55, while Airline Partners Australia's revised terms for its offer for Qantas pushed the airline's share price to a record \$5.40. Summit Resources shares jumped after Paladin Resources said it would lift its takeover offer.

Companies with links to the US, such as James Hardie Industries were lower this week. The outlook for that economy is precarious due to mixed signals from the US economic data and concerns about growth and inflation from the US central bank's policy meeting minutes this week.

Mark Rodrigues
Senior Economist, Australia

Economy in focus — Recent trends in international migration¹

Australia's Migration Program has expanded significantly since the trough in the early 1990s and its composition has shifted towards the Skill Stream. There has also been a marked increase in business sponsored temporary employment visas. Demands on Australia's migration program will remain high against a backdrop of a historically tight labour market, and may even intensify in coming years as demographic trends begin to restrain growth in the workforce.

International migration: a pressure valve

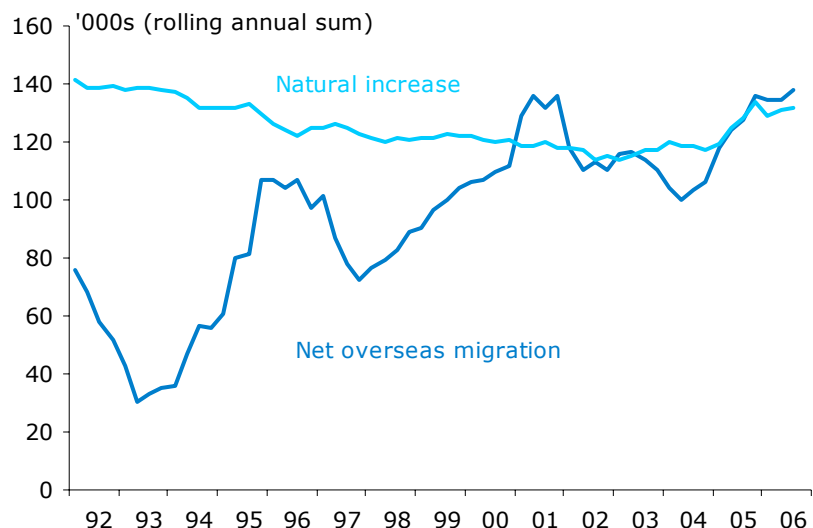
International migration acts like a pressure valve on the Australian economy. During times of strong demand and resulting labour shortages – an environment that has characterised most of Australia's post-WWII economic history – Australia's Migration Program has operated to ease these constraints with additional labour from overseas. Equally, during times of economic downturn and rising unemployment, the 'overseas labour tap' is dialled back, as occurred in the immediate aftermath of the early-1990s recession. In this sense, trends in migration can offer insights into the economic challenges of the day and the nature of the policy response.

Migration is on the rise

Net overseas migration (the excess of permanent and long-term arrivals over permanent and long-term departures) has been running at historically high levels in recent years. Over the year to the September quarter 2006, net overseas migration was 137,800 persons, the highest since the late 1980s. This represents over half (51%) of Australia's total population growth of 269,500 people over this period, with the remainder accounted for by natural increase (the excess of births over deaths).

Recent net migration outcomes are a step up from the long-term average rate of around 100,000 persons per annum, and plot an upward trend from the trough in the aftermath of the last recession in the early 1990s, when net overseas migration fell to as low as 30,000 per annum and accounted for less than 20% of total population growth.

International migration has been an increasingly important source of population growth



Source: Australian Bureau of Statistics

Not surprisingly, these trends mirror the tightening in the labour market, with the unemployment rate trending down since the early 1990s and currently hovering around 30-year lows at 4.5%.

¹ Data for this article are drawn largely from the Australian Bureau of Statistics' *Migration, Australia, 2005-06*, released on 29 March 2007.

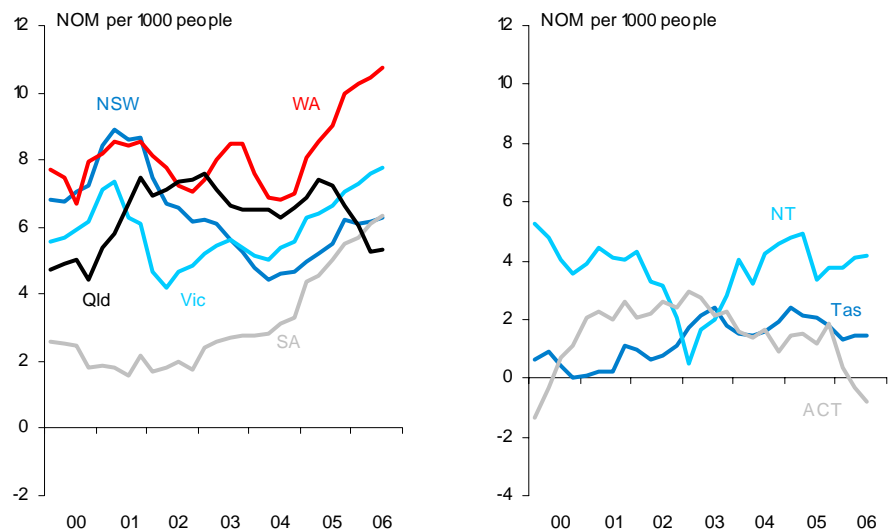
Net overseas migration accounted for half of Australia's population growth over the year to the September quarter 2006

International migration supports regional population growth

The majority of migrants settle (at least in the first instance) in the largest states. Over the year to the September quarter 2006, net overseas migration was 43,137 in New South Wales (or 31% of Australian net overseas migration), 39,695 in Victoria (29%), 22,158 in Western Australia (16%) and 21,584 in Queensland (16%).

However, adjusting for differences in population size, Western Australia has taken in significantly more migrants in the last few years than any other state, with a net overseas migration rate of almost 11 people per 1,000 head of population. This compares with net overseas migration rates of 7.8 in Victoria, 6.3 in South Australia and New South Wales and 5.3 in Queensland. The smallest states and territories have significantly lower rates of net overseas migration, although it has been at elevated levels in the Northern Territory in recent years.

WA takes in relatively more migrants



Sources: Australian Bureau of Statistics and Economics@ANZ

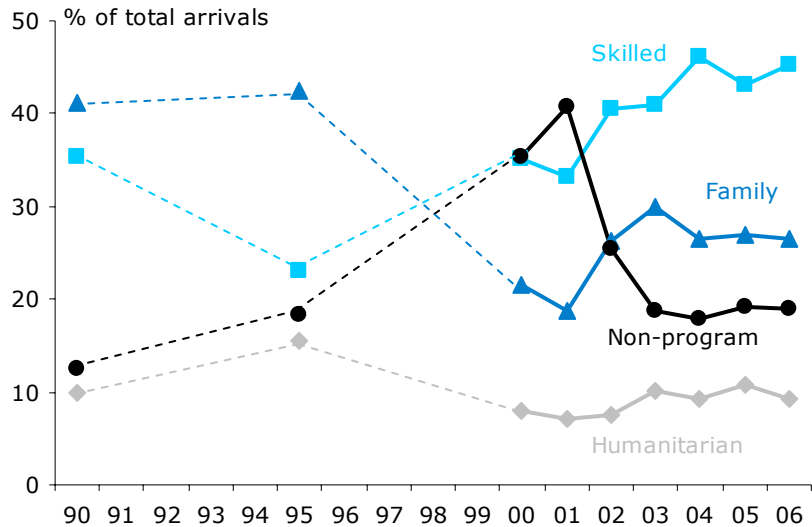
Again, it is easy to identify correlations between regions of economic strength and high migrant demand, with Western Australia being the obvious example. However, even those state economies that aren't faring so well at present have benefited from net overseas migration. In New South Wales and South Australia, for example, net overseas migration has accounted for around three quarters of total population growth in those states in recent years, offsetting the effects of negative net interstate migration. Economic outcomes in those states would have been much worse in the absence of positive net overseas migration.

Migrants are getting more skilled

Not only have we been taking in more migrants in recent years to address growing labour shortages, but we are being more selective about the nature of the labour being 'imported', with a marked shift toward the Skill Stream of the Migration Program since the late 1990s. In the first half of the 1990s, migrants entering under the Family Stream were the largest category of program migration, accounting for a little over 40% of permanent arrivals. By comparison, the Skill Stream accounted for between 25% and 35%. Today, those positions have been reversed, with the Skill Stream accounting for 45% of permanent arrivals while the Family Stream accounts for 26%. The remainder represents migration under the Humanitarian Program, which has been relatively stable at around 10% of permanent arrivals and non-program migration (largely New Zealand citizens), the level of which fluctuates according to relative economic conditions between the two countries.

Skilled migration now accounts for almost half of all permanent arrivals

There has been a marked shift toward skilled migration



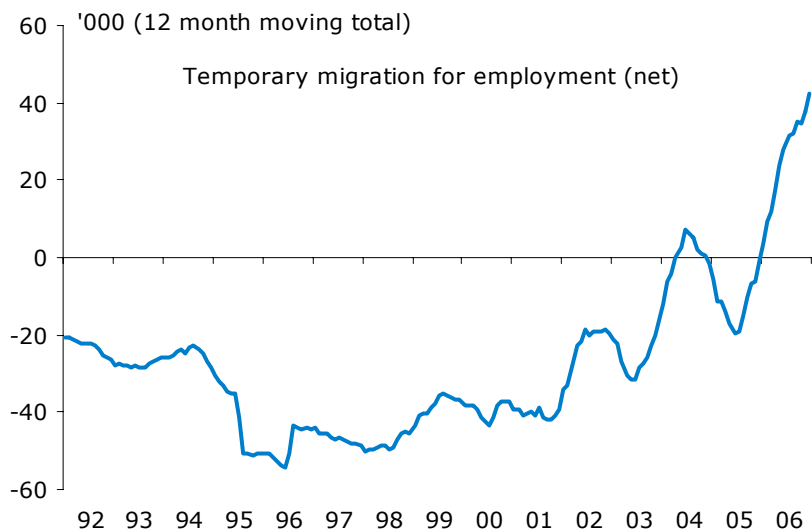
Note: Data are not readily available for all years. Data for missing years are represented by a dashed line drawn between the years for which we do have observations.
Source: Department of Immigration and Citizenship

Computing, engineering and medical professionals are in short supply, as are tradespeople

Entry via the Skill Stream is available for a broad range of occupations. However, entry is made easier and often fast-tracked if your occupation is on the Migration Occupations in Demand List. This is a list of occupations and specialisations identified by the Department of Employment and Workplace Relations as being in short supply. Occupations currently on the list are in the computing, medical and engineering fields, as well as a range of trades.²

In addition to the formal Migration Program, business is increasingly using temporary employment visas as a means of addressing skill shortages. This is a relatively recent phenomena, with the net flow of migration for temporary employment only moving from negative (that is, the inflow of workers under temporary employment visas is less than the outflow) to positive at the start of 2006. Anecdotally, these visas have been used to fill positions for various trades, particularly associated with construction, such as welding.

Business is increasingly using temporary employment visas to address skill shortages



Source: Australian Bureau of Statistics

² See <http://www.immi.gov.au/skilled/general-skilled-migration/skilled-occupations/occupations-in-demand.htm> for the full list.

The trend towards younger, more skilled migration has already made an impact on the fiscal gap associated with population ageing

Migrants are younger

The acceleration in migration is also helping the Australian economy prepare for the challenges associated with population ageing. Migrants are generally younger than the population at large, in part reflecting the age restrictions on some visas and the fact that younger people are generally more mobile and therefore more likely to apply. For example, in 2004-05, persons aged 15-34 accounted for 56% of net overseas migration compared with 28% of Australia's population. At the other end of the spectrum, persons aged 65 and over comprised just 2% of net overseas migration, compared with 13% of the Australian population.

We cannot expect the migration flows to completely solve the problems of population ageing – the size of annual migration flows is simply too small relative to the overall population to arrest the demographic transition already in train. However, at the margin, migration can mitigate the effects of population ageing, a point highlighted in last week's Intergenerational Report (IGR). It noted that the improvement in the projected fiscal gap since the first IGR was at least partly attributable to higher rates of skilled migration. The IGR goes on to note that, "the policy shift in recent years towards younger, skilled migrants is assumed to continue, partially offsetting the rate of population ageing."

The future of migration

The trend towards higher rates of migration, and in particular skilled migration, in recent years was set in train by the broader economic environment of growing skill shortages. With the economy expected to remain strong over the next couple of years, labour demand will continue to grow, maintaining pressure on an already tight labour market. Indeed, these pressures may even intensify in coming years as demographic trends begin to restrain growth in the workforce.

Against this backdrop, expect a continuation of high rates of migration, and new policies that increase the bias towards younger, skilled applicants.³

³ An example of this are the recent changes to the General Skilled Migration program to be introduced on 1 September 2007. See <http://www.immi.gov.au/skilled/general-skilled-migration/changes/index.htm> for more details.

Economic and financial market forecasts

Australian economic indicators	2006	2007f	2008f	2009f
Economic activity (annual % change)				
Private final demand	3.7	2.9	3.2	3.7
Household consumption	3.1	3.6	3.2	3.7
Dwelling investment	-1.6	1.5	3.6	9.6
Business investment	8.7	2.1	2.5	1.4
Public demand	5.0	3.8	3.9	3.9
Domestic final demand	4.0	3.1	3.3	3.8
Inventories (contribution to GDP)	-0.6	0.4	0.0	0.0
Gross National Expenditure (GNE)	3.4	3.5	3.3	3.8
Exports	3.5	3.2	9.4	6.3
Imports	7.6	6.5	6.8	7.2
Net Exports (contribution to GDP)	-1.0	-0.9	0.2	-0.5
Gross Domestic Product (GDP)	2.7	2.9	3.6	3.6
Prices and wages (annual % change)				
Inflation: Headline CPI	3.5	2.6	2.8	2.8
Underlying*	2.9	2.7	2.5	2.8
Wages	4.0	4.3	3.9	4.2
Labour market				
Employment (annual % change)	2.0	2.3	1.9	2.0
Unemployment rate (%)	4.9	4.6	4.5	4.4
External sector				
Current account balance: A\$ bn	-54.2	-59.1	-68.3	-82.1
% of GDP	-5.4	-5.5	-6.0	-6.7

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

Australian interest rates	Current	Jun 07f	Sep 07f	Dec 07f	Mar 08f	Jun 08f
RBA cash rate	6.25	6.50	6.50	6.75	6.75	6.75
90 day bill	6.52	6.75	6.75	7.00	6.97	6.97
3 year bond	6.28	6.60	6.65	6.45	6.65	6.40
10 year bond	5.93	6.25	6.25	6.15	6.45	6.30
3s10s yield curve	-0.35	-0.35	-0.40	-0.30	-0.20	-0.10
3 year swap	6.64	7.05	7.10	6.92	7.12	6.85
10 year swap	6.45	6.77	6.77	6.70	7.00	6.82
International interest rates						
RBNZ cash rate	7.50	7.50	7.50	7.50	7.50	7.50
NZ 90 day bill	7.98	7.75	7.65	7.65	7.65	7.65
US Fed funds note	5.25	5.25	5.25	4.75	4.75	4.75
US 2 year note	4.73	5.00	4.80	4.50	4.75	5.00
US 10 year note	4.73	4.95	4.90	4.75	5.15	5.15
Japan call rate	0.50	0.75	1.00	1.00	1.00	1.00
ECB refinance rate	3.75	4.00	4.25	4.25	4.25	4.25
UK repo rate	5.25	5.50	5.50	5.50	5.50	5.50

For additional information on interest rates please refer to ANZ's *Interest rate strategy weekly*.

Foreign exchange rates	Current	Jun 07f	Sep 07f	Dec 07f	Mar 08f	Jun 08f
Australia and NZ exchange rates						
A\$/US\$	0.8320	0.81	0.78	0.76	0.75	0.73
NZ\$/US\$	0.7348	0.71	0.66	0.63	0.62	0.60
A\$/¥	98.95	94.8	89.7	85.1	82.5	78.8
A\$/€	0.6155	0.60	0.59	0.58	0.59	0.57
A\$/£	0.4196	0.41	0.40	0.40	0.40	0.39
A\$/NZ\$	1.132	1.14	1.18	1.21	1.21	1.22
A\$/CA\$	0.9433	0.95	0.93	0.92	0.92	0.91
A\$/CHF	1.0109	0.97	0.95	0.94	0.94	0.93
A\$/CNY	6.425	6.19	5.89	5.66	5.57	5.40
A\$ Trade weighted index	67.60	65.8	63.4	61.6	60.7	59.1
International cross rates						
US\$/¥	118.9	117	115	112	110	108
€/US\$	1.352	1.34	1.32	1.30	1.28	1.27
€/¥	160.8	157	152	146	141	137
£/US\$	1.983	1.97	1.94	1.91	1.89	1.86
€/£	0.6817	0.68	0.68	0.68	0.68	0.68
US\$/CA\$	1.134	1.17	1.19	1.21	1.23	1.24
US\$/CHF	1.215	1.20	1.22	1.24	1.25	1.27
US\$ index	82.27	82.4	83.3	84.0	84.8	85.3
Asia exchange rates						
US\$/CNY	7.724	7.64	7.55	7.45	7.43	7.40
US\$/HKD	7.815	7.82	7.82	7.81	7.81	7.81
US\$/IDR	9110	9000	8800	8700	8650	8600
US\$/INR	42.85	43.8	43.5	43.3	42.9	42.4
US\$/KRW	929.9	925	920	910	907	911
US\$/MYR	3.442	3.45	3.43	3.40	3.40	3.39
US\$/PHP	47.90	48.0	47.5	47.0	48.3	49.5
US\$/SGD	1.517	1.52	1.51	1.50	1.50	1.49
US\$/THB	32.70	33.8	35.5	36.0	36.5	37.0
US\$/TWD	33.09	32.77	32.44	31.25	31.19	31.13
US\$/VND	16032	16059	16091	16123	16156	16185
Pacific exchange rates						
PGK/US\$	0.3250	0.33	0.33	0.33	0.32	0.32
FJD/US\$	0.6182	0.61	0.59	0.58	0.58	0.57

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

What to watch — 4 weeks from Monday 16 April 2007

Mon 16 Apr	Tues 17 Apr	Wed 18 Apr	Thur 19 Apr	Fri 20 Apr
	11.30 NAB Quarterly Business Survey (Mar Qtr) AOFM Bond Issuance, A\$400mn (Apr 2012)	10.30 MI-WBC Consumer Confidence (Apr)	10.30 MI-WBC Consumer Inflation Expectations (Apr) 11.30 ABS, Merchandise Imports (Mar)	10.00 Conference Board Leading Indicator (Feb) 11.30 ABS, International Trade Price Indexes (Mar Qtr) <i>Export prices:</i> ANZ forecast: -0.2% QoQ, +5.6% YoY Last: +0.2% QoQ, +11.1% YoY <i>Import prices:</i> ANZ forecast: -2.2% QoQ, -3.5% YoY Last: -3.2% QoQ, 0.0% YoY ABS, Sales of New Motor Vehicles (Mar)
Mon 23 Apr	Tues 24 Apr	Wed 25 Apr	Thur 26 Apr	Fri 27 Apr
11.30 ABS, Producer Price Index (Mar Qtr)	11.30 ABS, Consumer Price Index (Mar Qtr)	Markets closed – Public holiday, ANZAC day (national)	10.30 WBC Leading Index (Feb) HIA New Home Sales (Mar)	
Mon 30 Apr	Tues 1 May	Wed 2 May	Thur 3 May	Fri 4 May
10.30 TD-MI Inflation Gauge (Apr) 11.30 RBA Private Sector Credit (Mar)	9.30 Ai Group-PwC PMI (Apr)	9.30 RBA interest rate announcement (May) 11.00 DEWR Skilled Vacancies (Apr)	9.30 Ai Group-CBA PSI (Apr)	11.30 RBA Quarterly Statement on Monetary Policy (May) ABS, International Trade in Goods and Services (Mar)
Mon 7 May	Tues 8 May	Wed 9 May	Thur 10 May	Fri 11 May
9.30 Ai Group Performance of Construction Index (Apr) 11.30 ANZ Job Advertisements series (Apr)	11.30 ABS, Retail Sales (Mar) ABS, Building Approvals (Mar) NAB Business Survey (Apr) 19.30 Federal Government Budget	11.30 ABS, House Price Index (Mar Qtr)	11.30 ABS, Labour Force (Apr)	11.30 ABS, Housing Finance (Mar)

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