

Economic outlook for 2007

Slides used in presentations to ANZ customers
and business groups around Australia

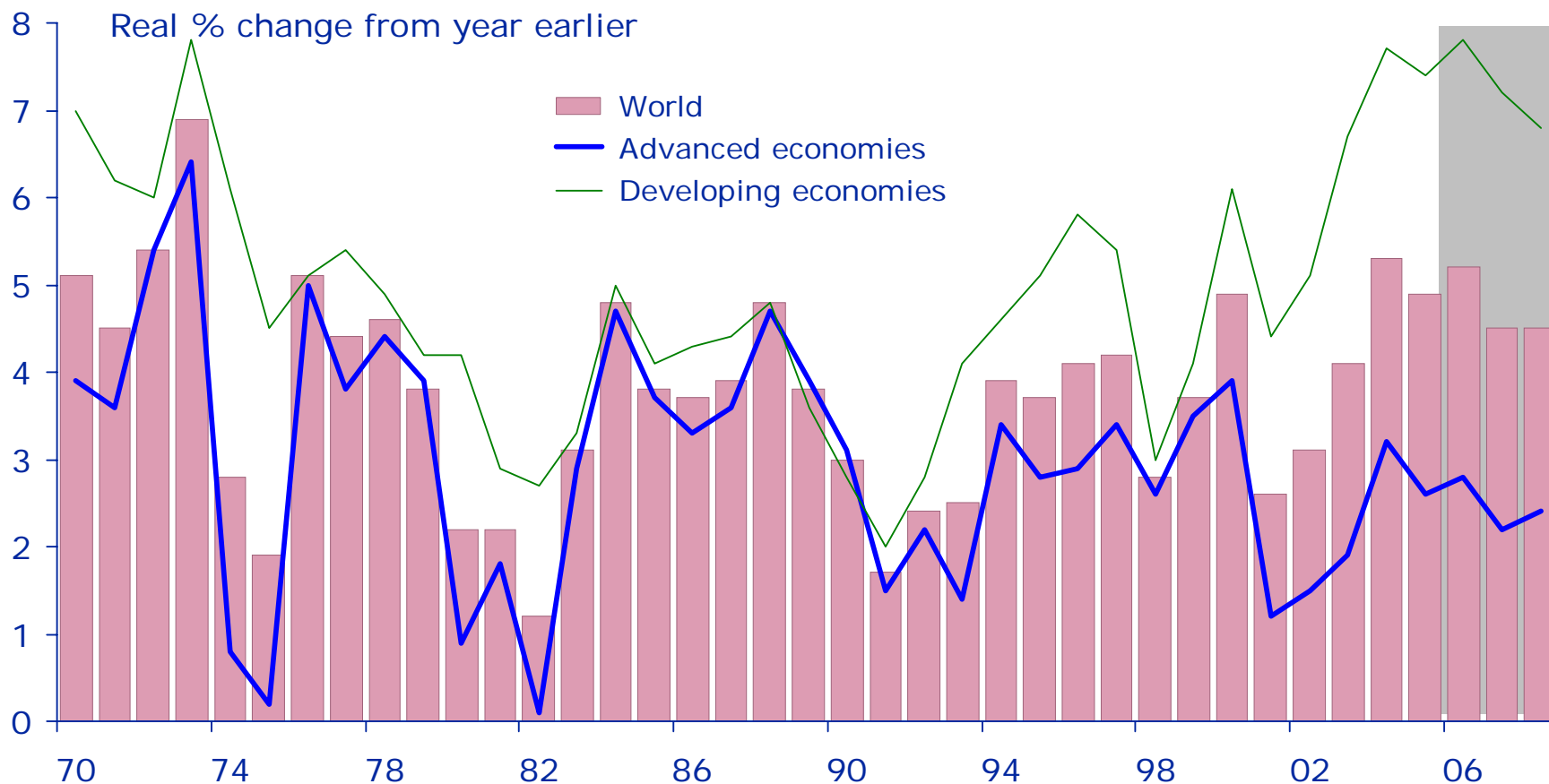
Saul Eslake
Chief Economist
ANZ

February-March 2007

www.anz.com/go/economics

World economy in what is likely to be its longest period of above-trend growth in over 30 years

Global economic growth

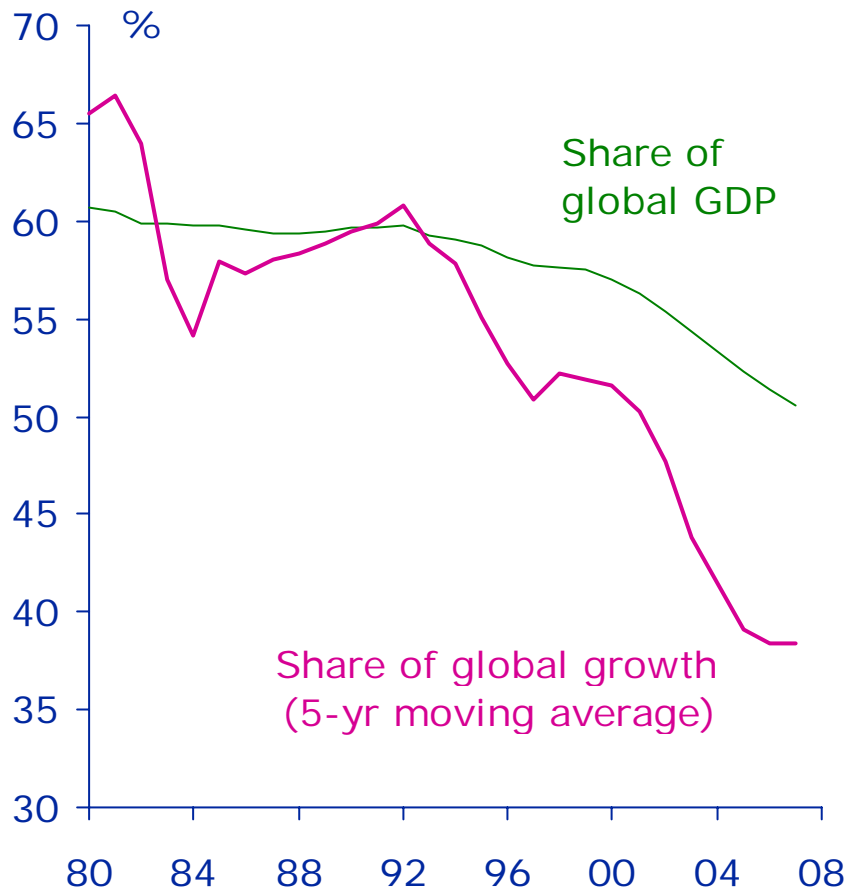


Note: GDP is measured in US\$ at purchasing power parities.

Source: IMF; Economics@ANZ.

Above-trend global growth is largely being driven by developing countries

Advanced economies



Developing economies

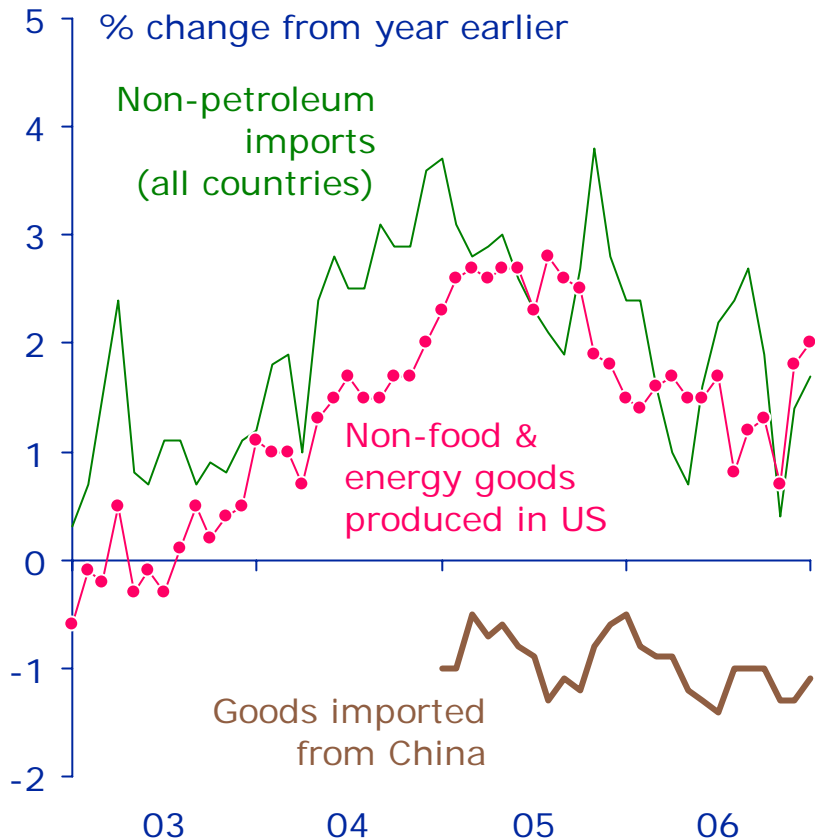


'Advanced' economies comprise the US, Western Europe, Japan, Canada, Australia, New Zealand, Korea, Taiwan, Hong Kong, Singapore and Israel.

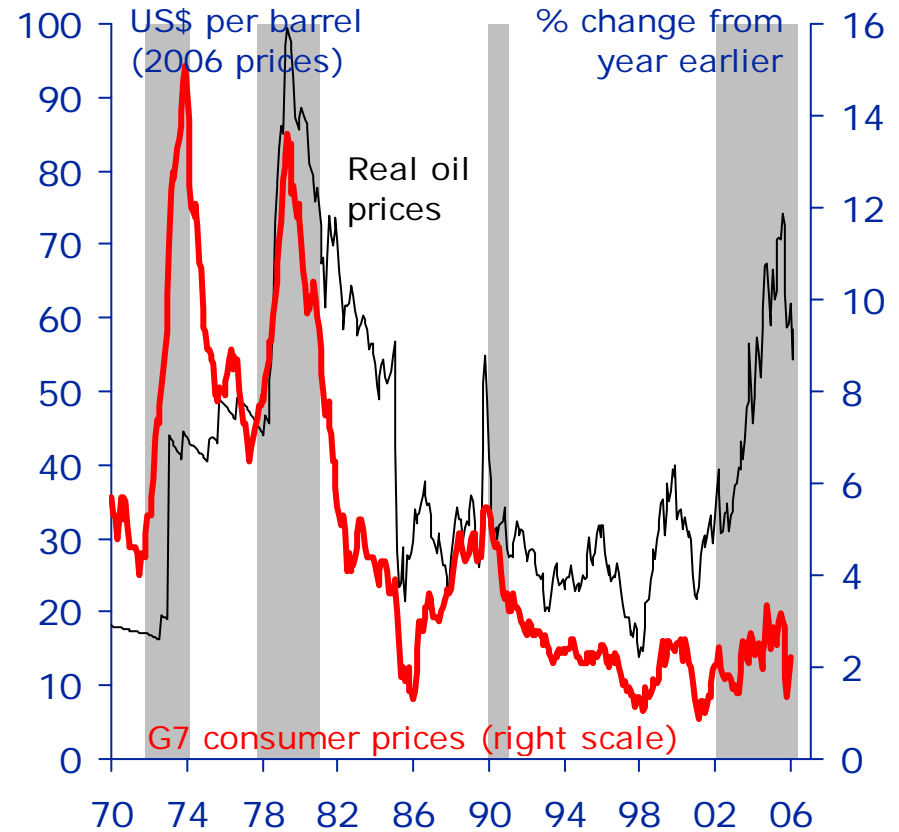
Sources: IMF, *World Economic Outlook*; Economics@ANZ.

Developing economies have provided a source of discipline on advanced economy prices and costs

Wholesale prices of goods in the United States



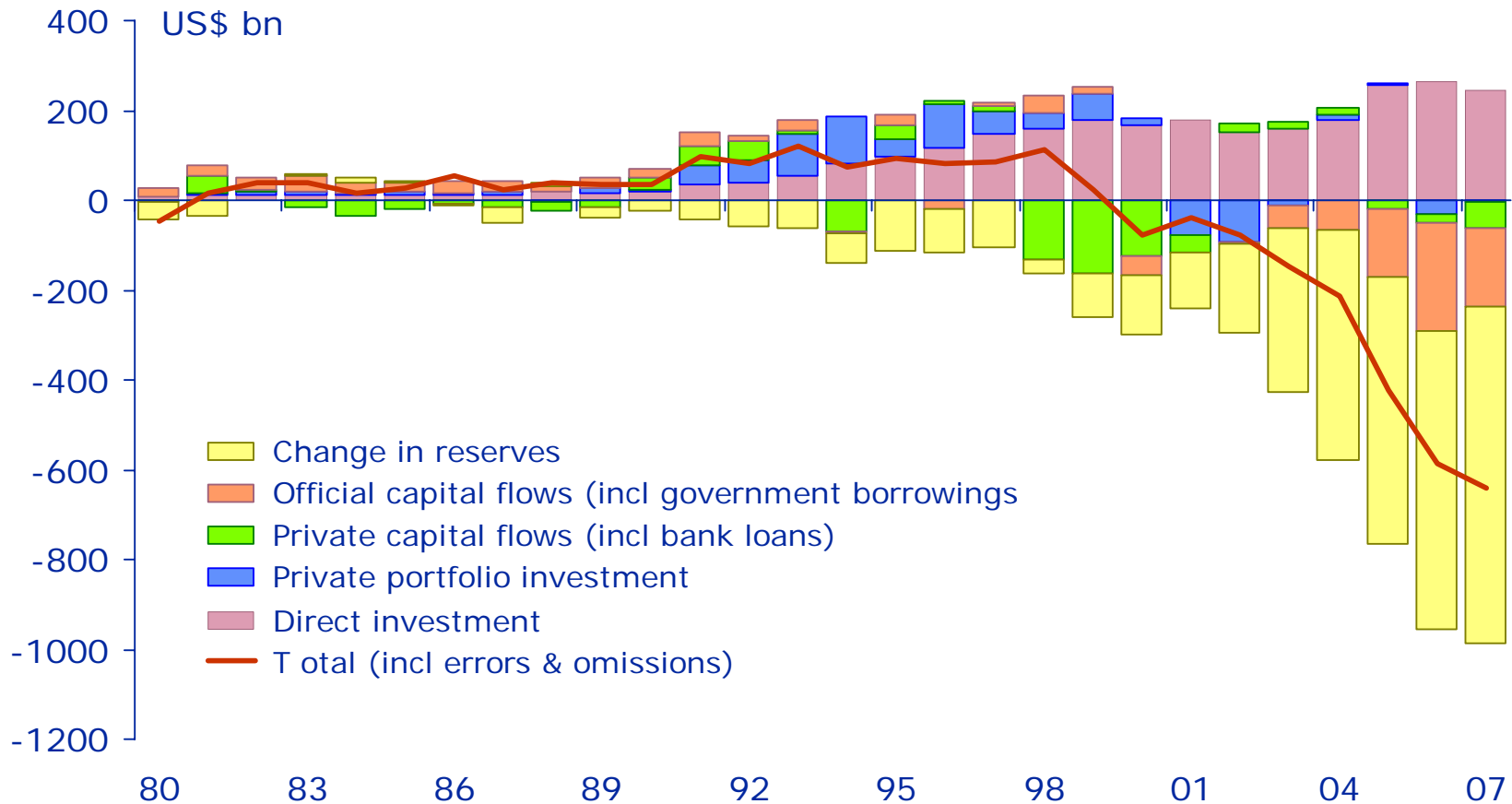
Oil prices and inflation



Sources: US Bureau of Economic Analysis; US Bureau of Labor Statistics; OECD; Datastream; Economics@ANZ.

Developing countries have exported massive amounts of capital to the industrialized world

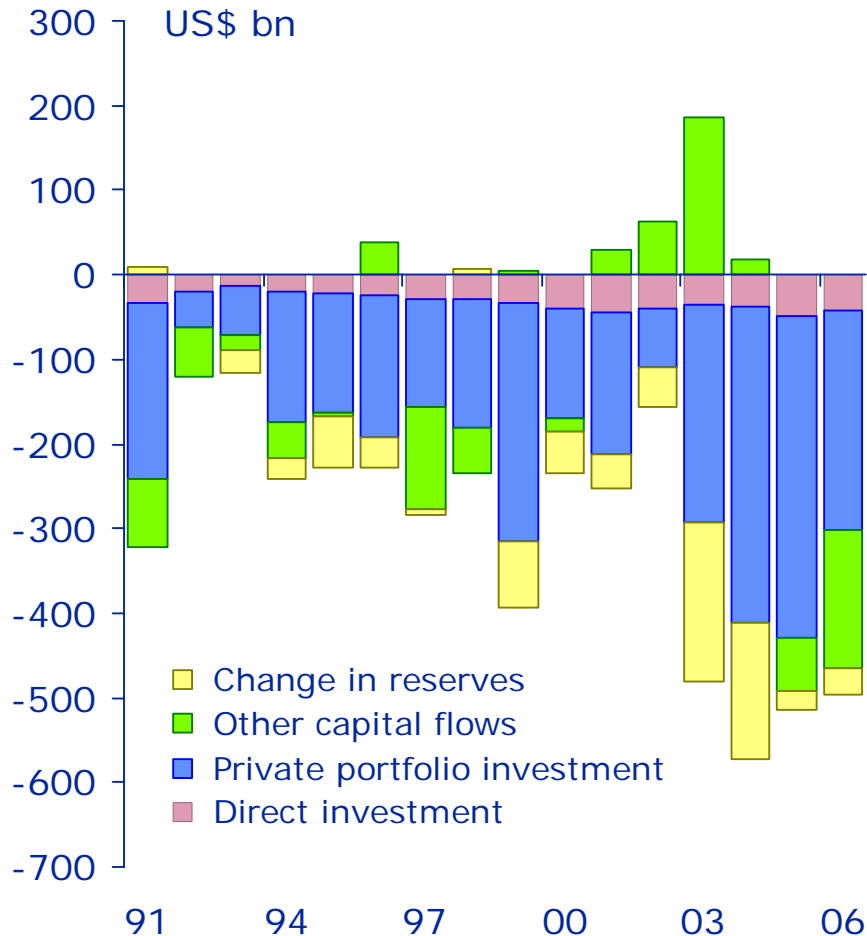
Capital flows to developing economies



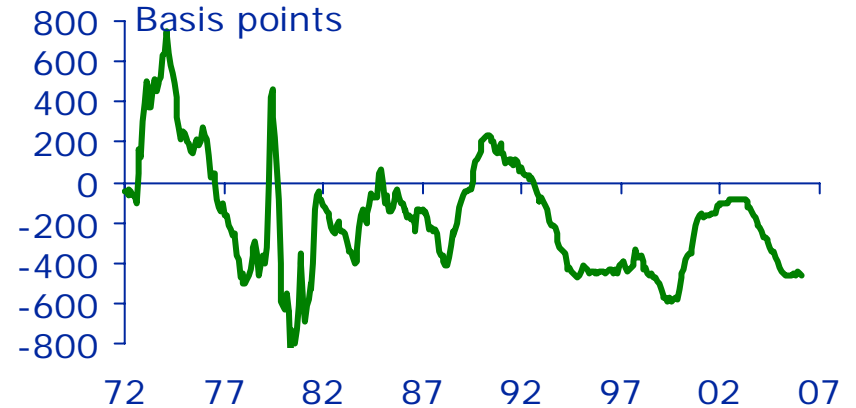
Note: 'Developing economies' in this chart includes Korea, Taiwan, Hong Kong, Singapore and Israel. All figures are net. Source: IMF; Economics@ANZ.

Japan is also exporting massive amounts of capital, keeping the yen weak

Capital flows from Japan



Japan-US 3-mth Libor spread



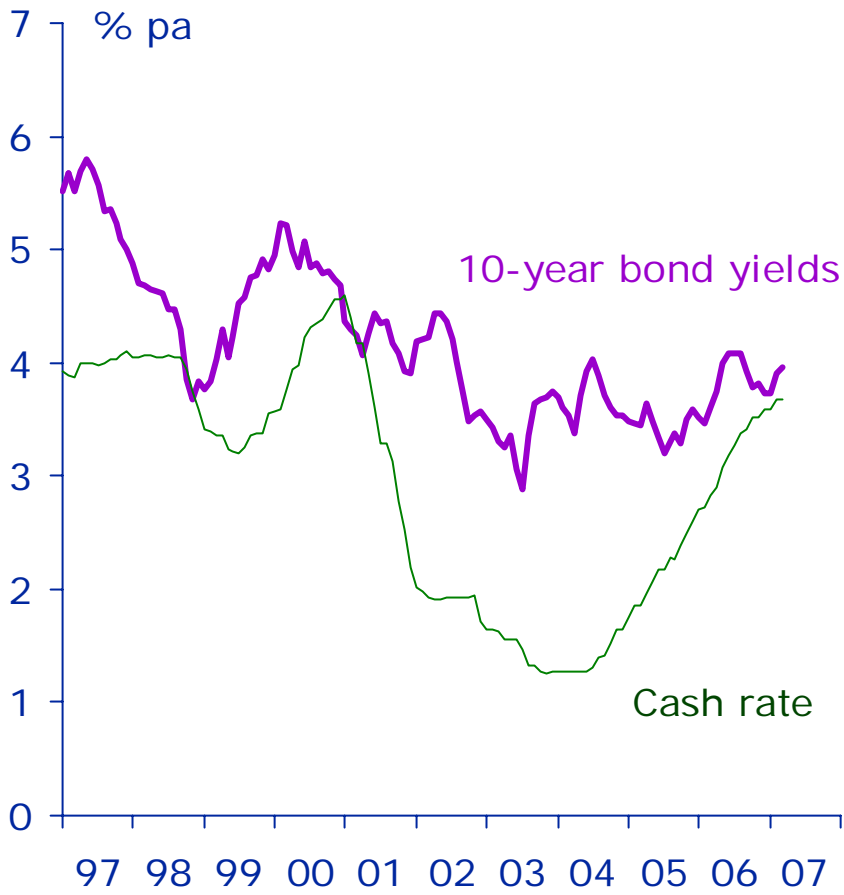
Real trade-weighted yen



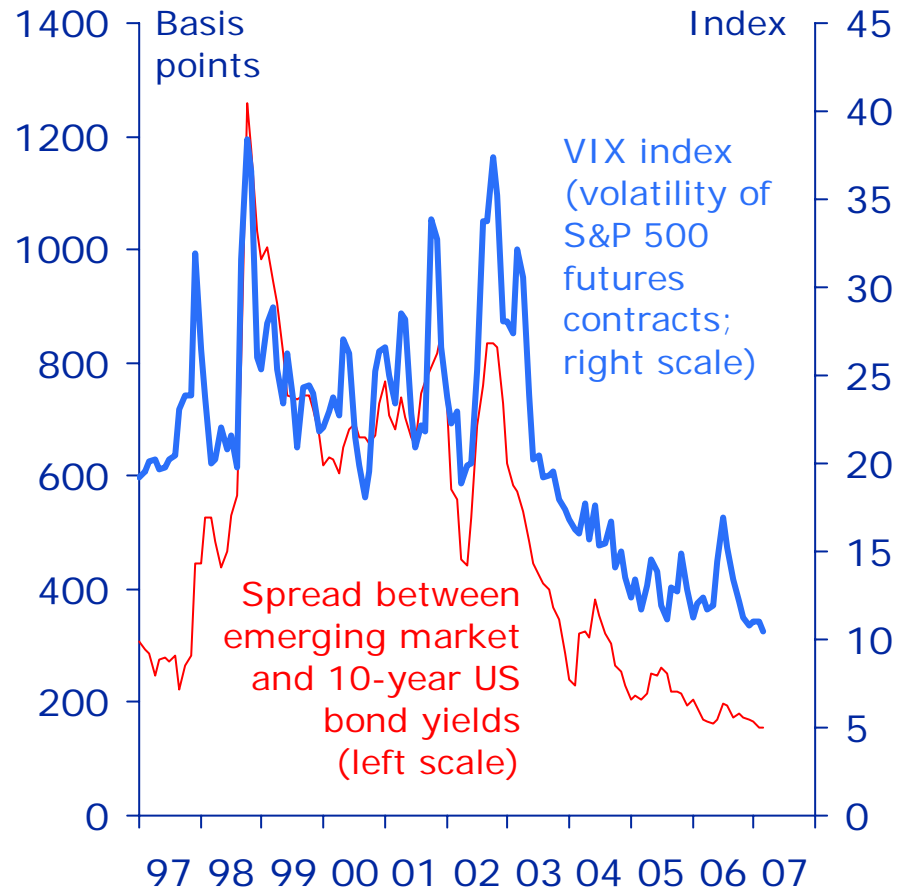
Sources: Bank of Japan; JP Morgan.

These capital flows are helping to keep long-term rates low and boosting investors' appetite for risk

G7 interest rates



Indicators of investors' appetite for risk

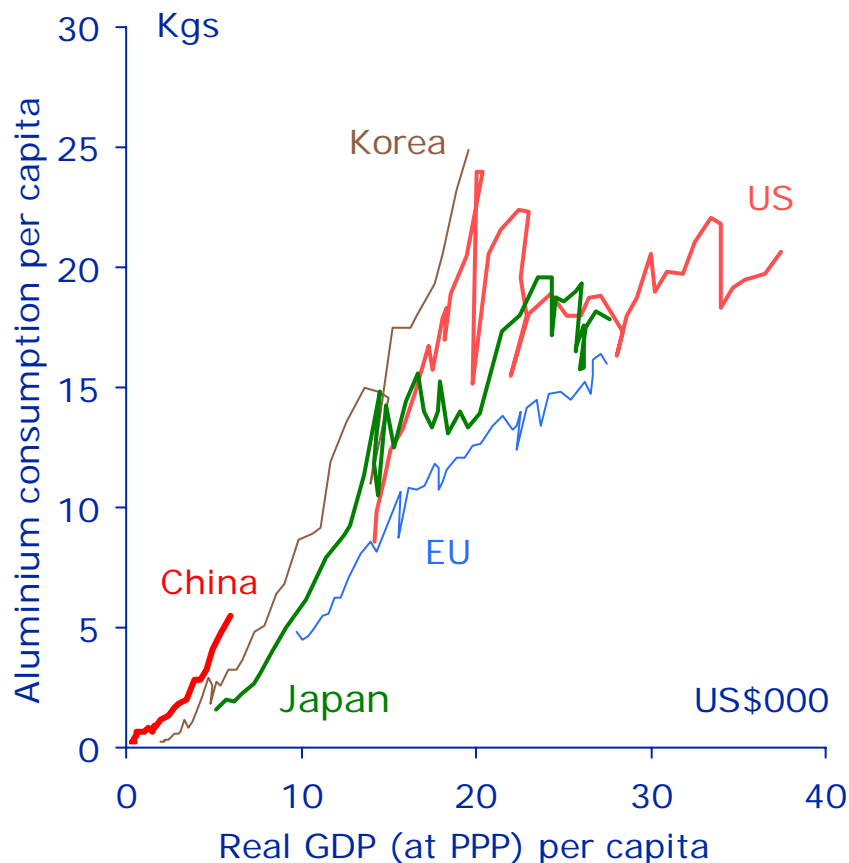


Source: Thomson Financial Datastream.

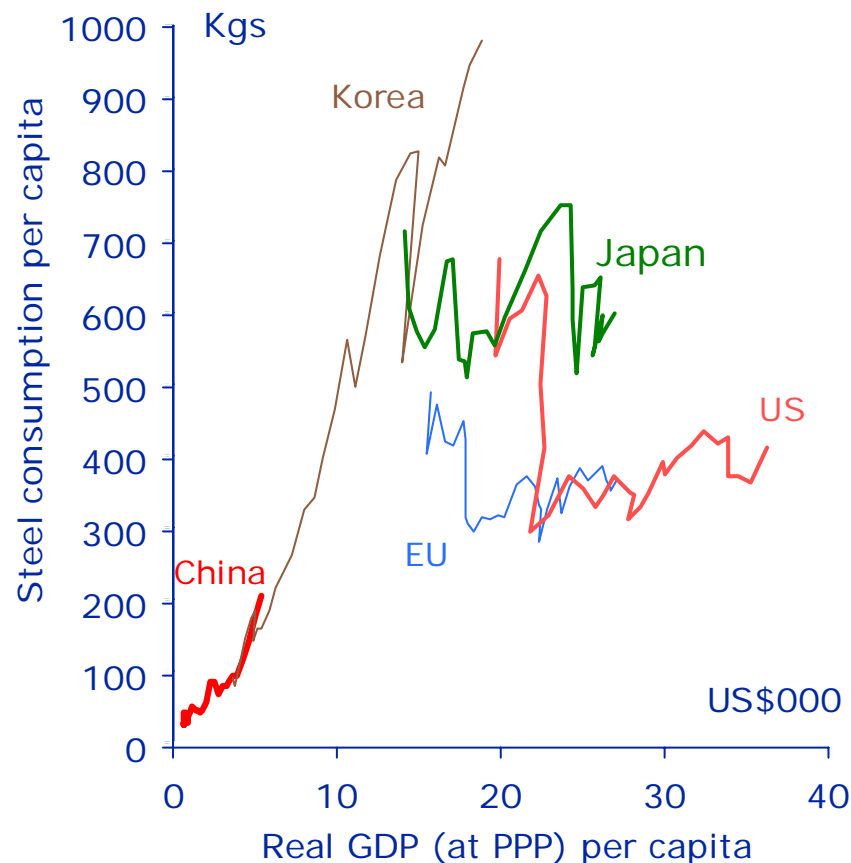
Metal demand from China (and other emerging markets) is likely to continue to grow rapidly

Metal consumption and GDP per capita, 1965-2005

Aluminium



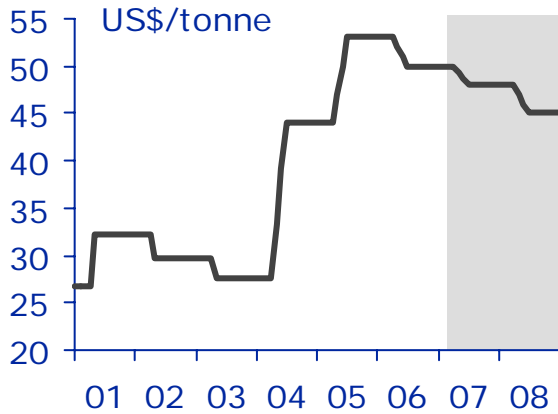
Steel



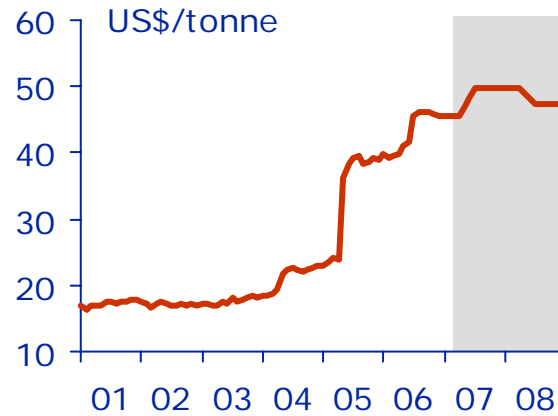
Sources: IMF World Economic Outlook September 2006;
(Figure 5.7); Economics@ANZ.

Commodity prices will thus remain high though easing as increased supply comes on stream

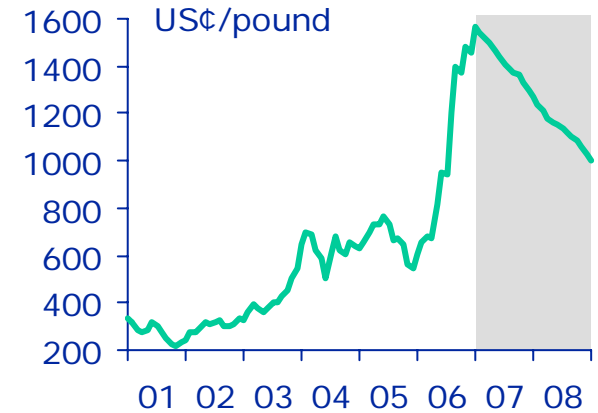
Thermal coal



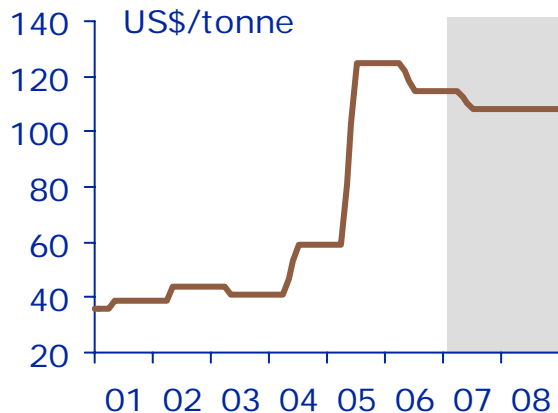
Iron ore



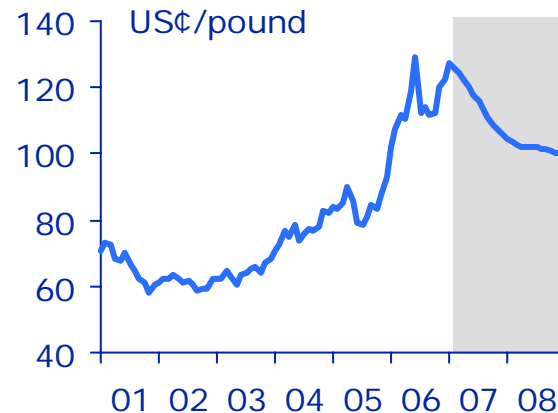
Nickel



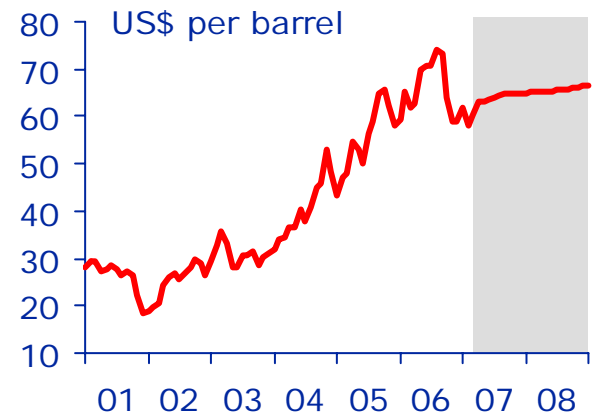
Coking coal



Aluminium

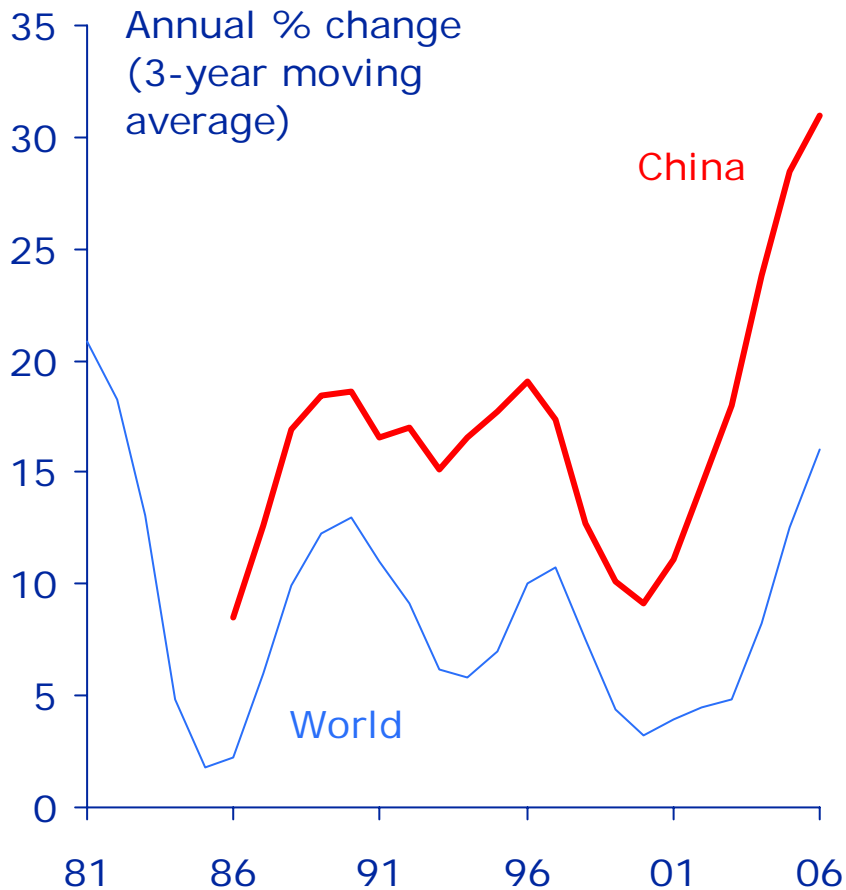


Oil

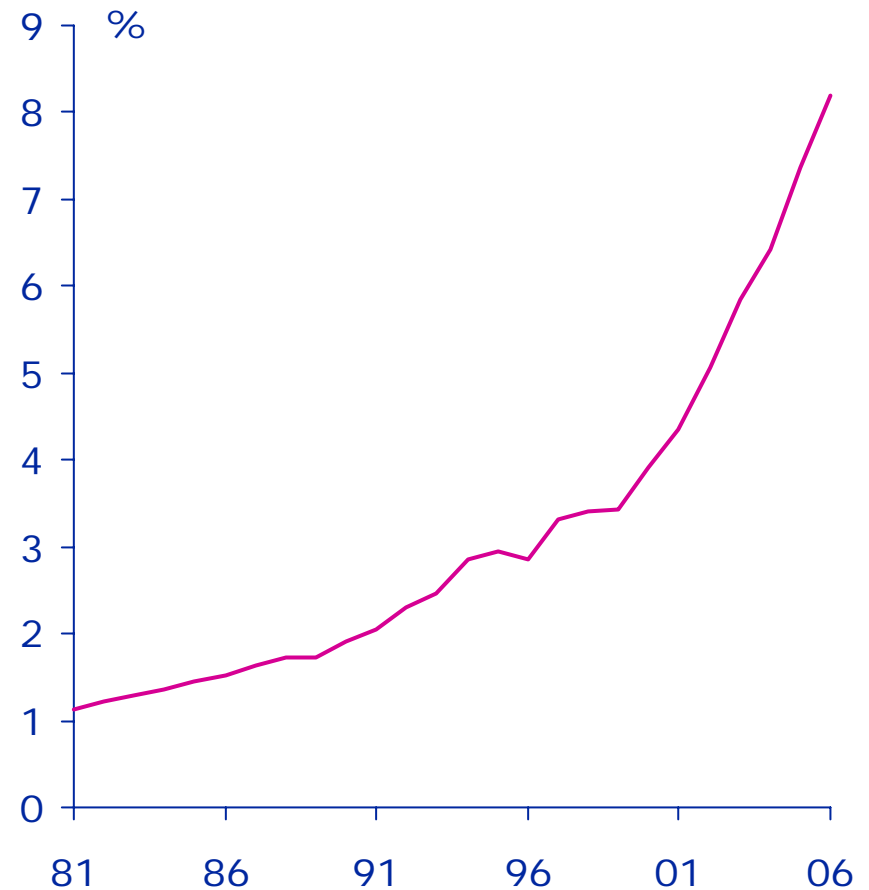


China's increasing share of global exports may trigger a protectionist backlash

Merchandise exports



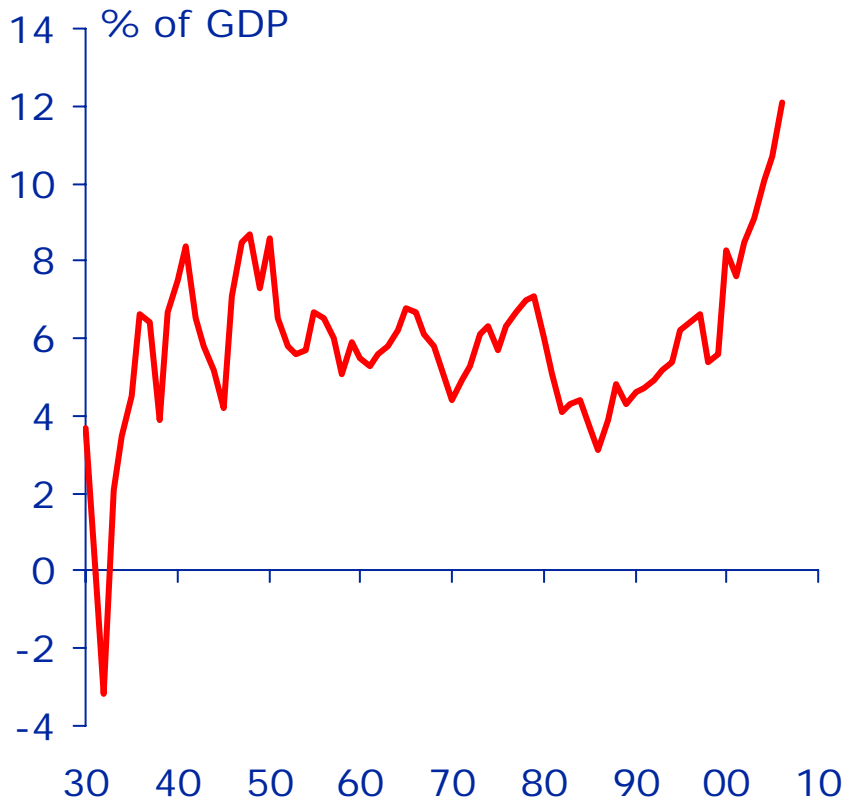
China's share of world exports



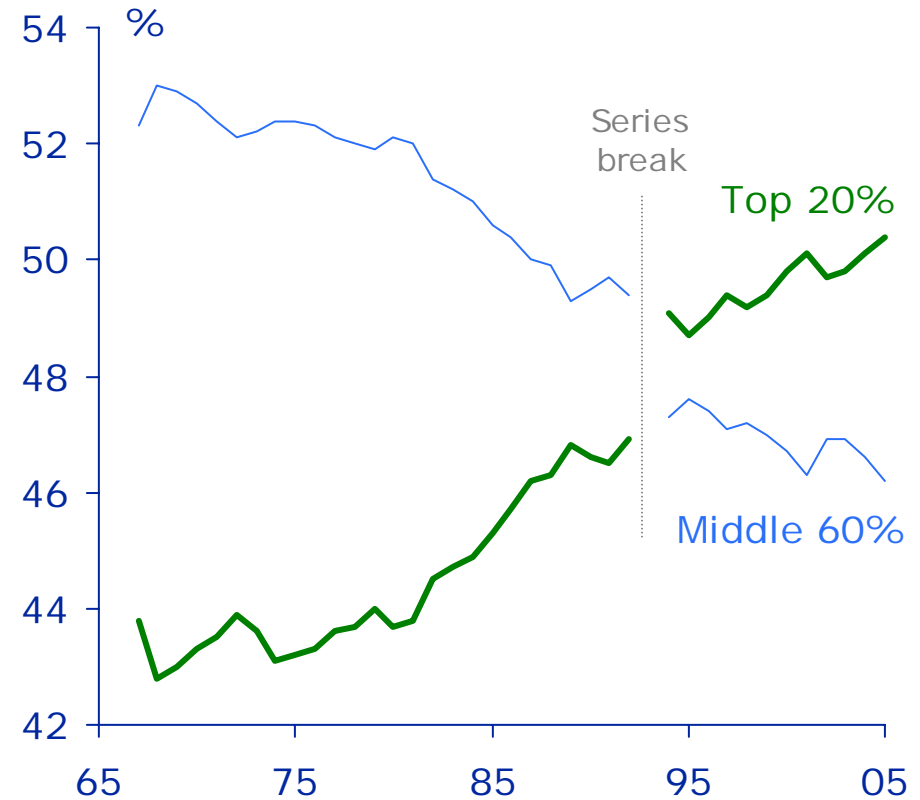
Sources: IMF, *Direction of World Trade Statistics*;
Economics@ANZ.

The risk of 'populist' policies in the US is heightened by trends in the distribution of income

US: after-tax 'book' profits as a share of GDP



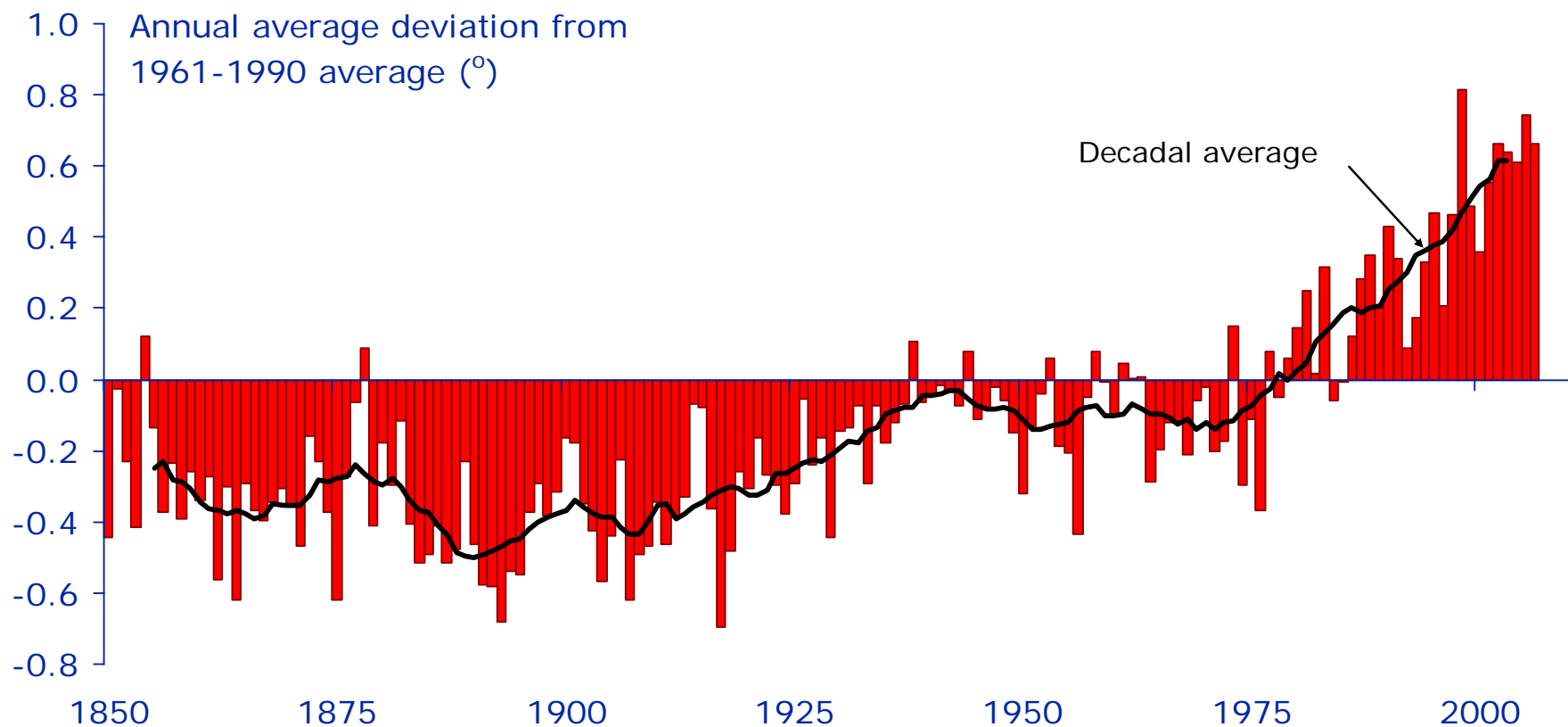
US: shares of selected income groups in total pre-tax income



Sources: US Bureau of Economic Analysis; US Census Bureau.

Scientific consensus and growing public concern about global warming makes action more likely

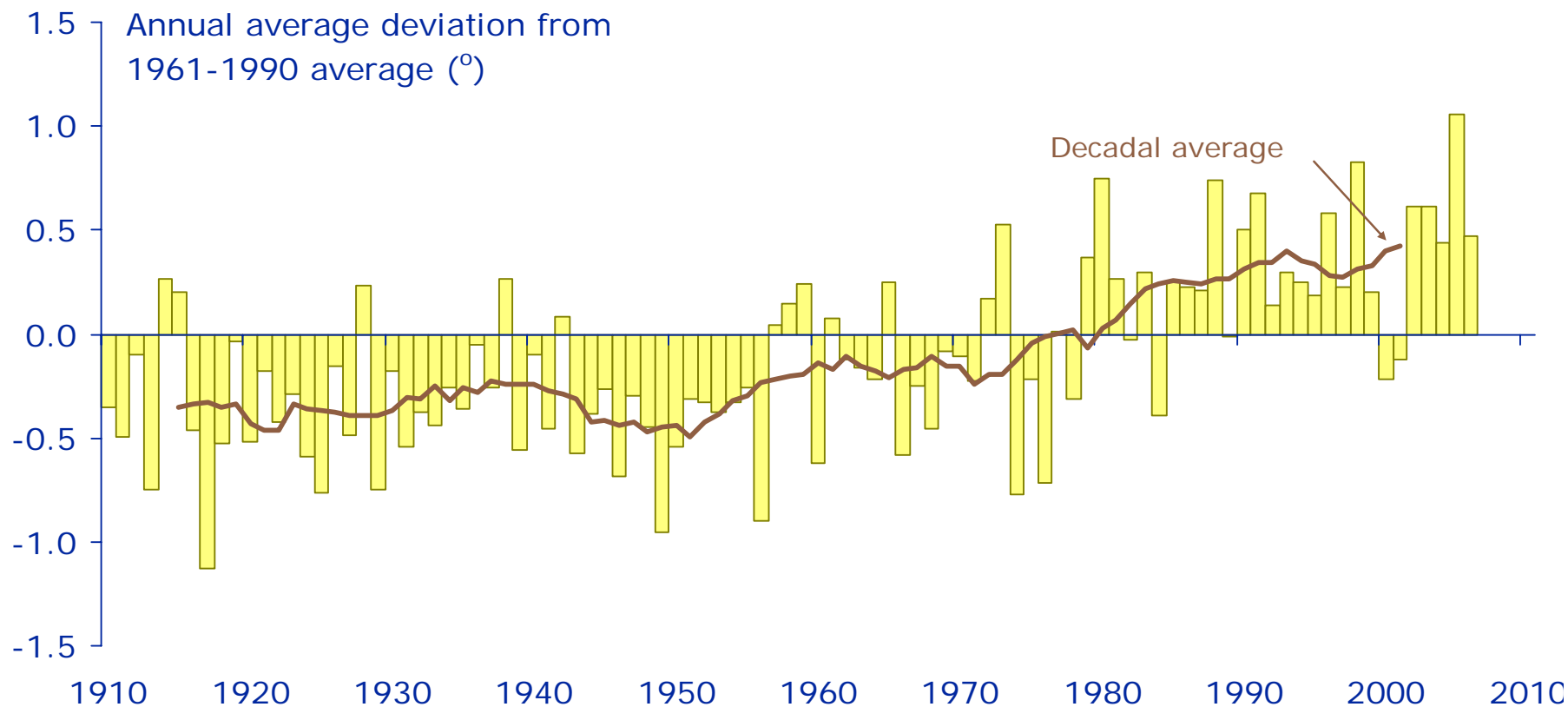
Global surface temperature anomalies



Source: Climatic Research Unit (CRU), School of Environmental Sciences, University of East Anglia (UK). Note that the CRU 'has an explicit policy of refusing to allow external examination of how they produce their global temperature series' (Carter et al, *World Economics* Vol. 7, No. 4, October-December 2006 p. 190).

Australian temperature data shows much the same picture regarding global warming

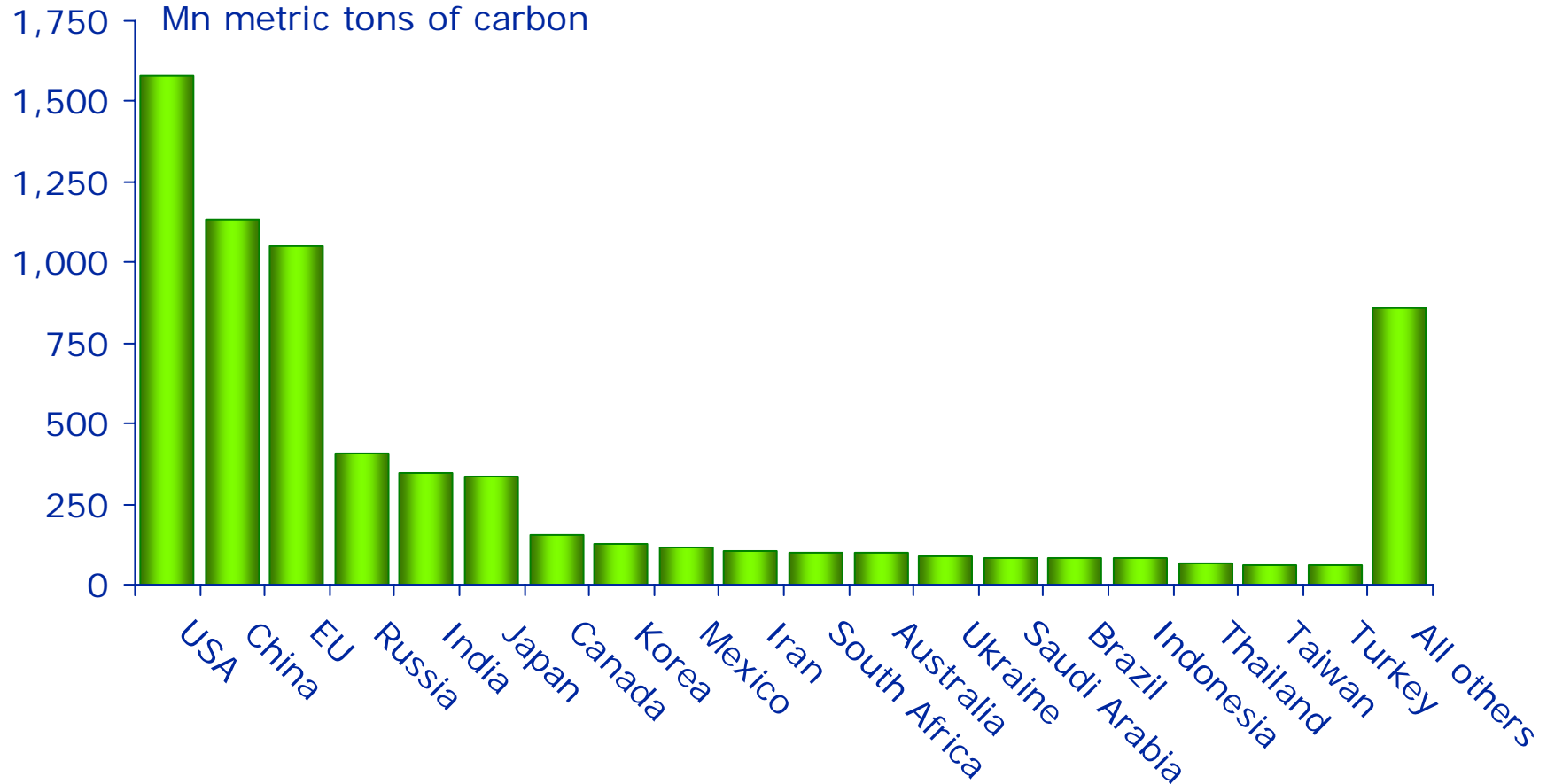
Australian surface temperature anomalies



Source: Australian Bureau of Meteorology.

Any serious effort at reducing GHG emissions has to involve non-Kyoto Protocol signatories

CO₂ emissions - 2003



Note: Includes emissions from fossil fuel-burning, cement production and gas flaring.

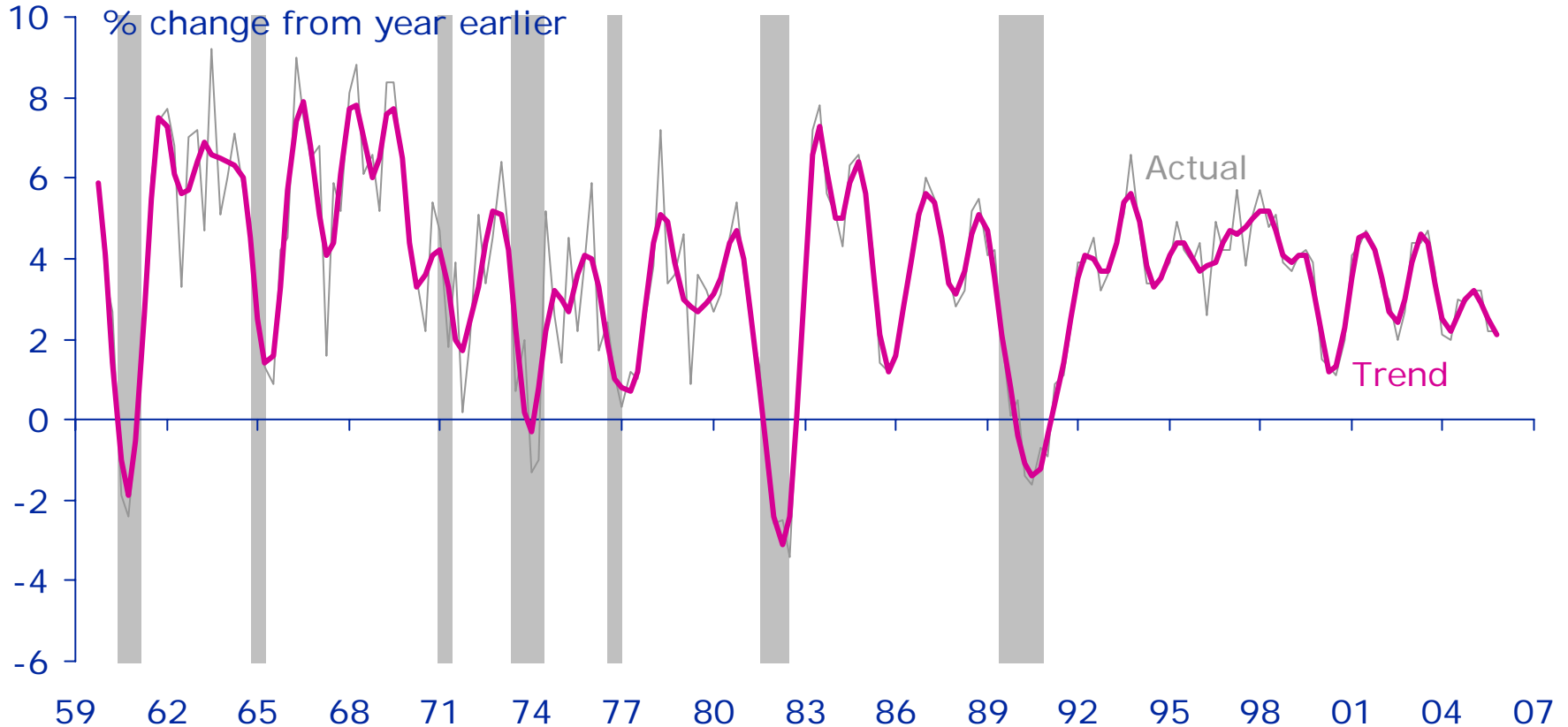
Source: US Department of Energy Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory

On many indicators Australia's economy has done very well over the past 15 years

- Economic growth has averaged 3¼% per annum
 - and Australia hasn't experienced two or more quarters in a row of negative growth for more than 15 years – the longest period without 'recession' for at least 106 years
- Australian per capita incomes are once again above the OECD average for the first time since the mid-1970s
 - in recent years Australia has ranked 7th or 8th among OECD countries in terms of per capita incomes, after having slipped from 6th or 7th in the 1950s to 19th in 1989 and 1990
- Unemployment is at its lowest level since 1976
 - the proportion of working age Australians in employment is at an all-time high
- Inflation and interest rates, though now rising, are very low by the standards of the 1970s and 1980s
- Corporate profits (as a share of national income) are at a record high – as is the sharemarket
- Public finances are in very sound condition by historical and international standards

Australia has now gone more than 15 years without recession, the longest in its history

Real GDP growth



Note: shaded intervals denote periods in which real GDP growth was negative for two or more quarters, or during which real GDP declined from the year-earlier quarter.

Sources: Australian Bureau of Statistics; Economics@ANZ.

Unemployment is at a 30-year low, while a record proportion of the population is employed

Unemployment



Employment-to-population ratio



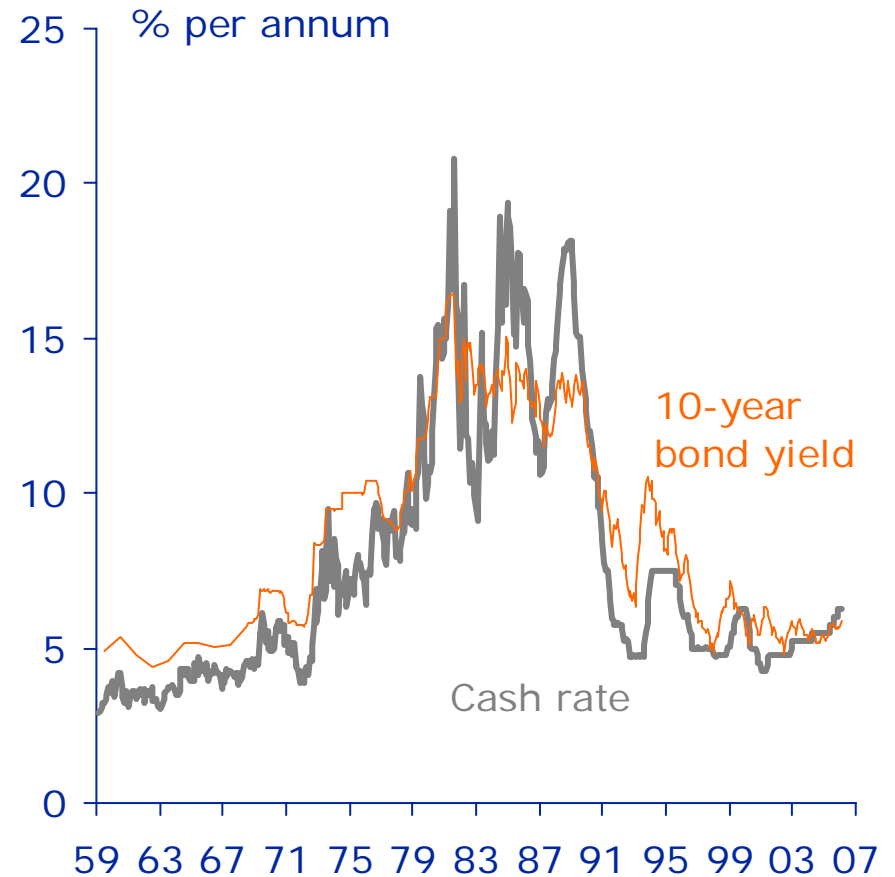
Sources: ABS; Economics@ANZ.

Inflation and interest rates, though rising, are still low by historical standards

Inflation



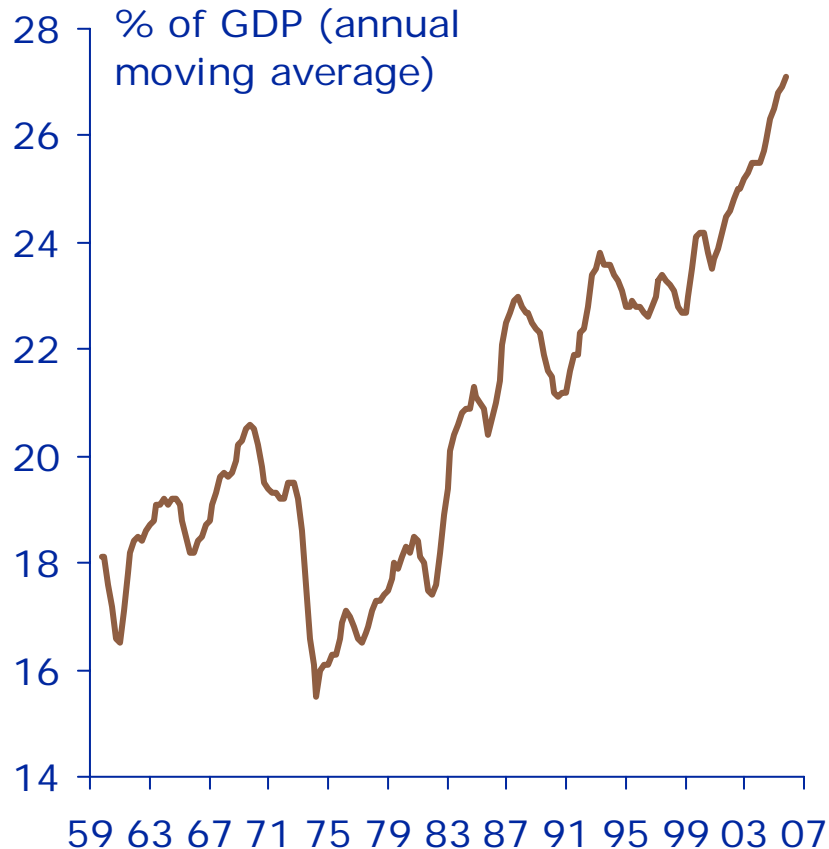
Interest rates



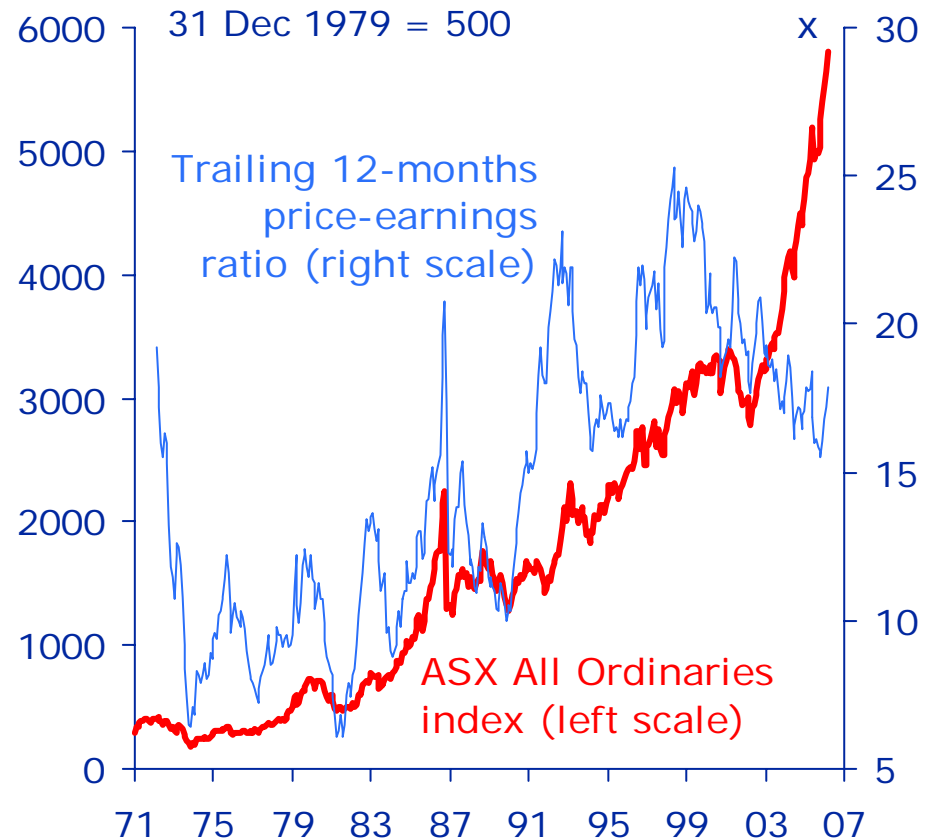
Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

Corporate profits and the share market are at record highs – but the market isn't 'over-valued'

Non-financial corporate gross operating surplus



Australian sharemarket



Sources: Australian Bureau of Statistics; Australian Stock Exchange; Thomson Financial Datastream.

Australian corporate finances are in a very sound condition compared with the 80s and early 90s

Non-financial corporate sector debt-equity ratio



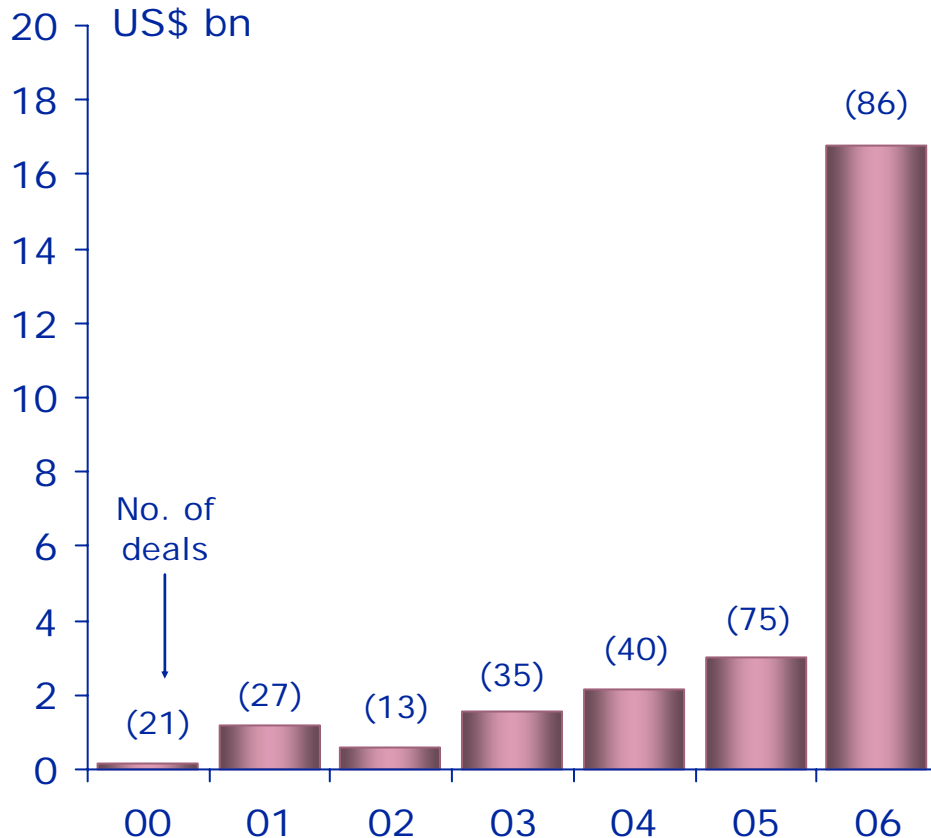
Non-financial corporate sector interest cover



Note: 'interest cover' is the ratio of gross operating surplus (roughly equivalent to EBITDA) to net interest paid. Sources: ABS; Economics@ANZ.

'Private equity' deals have mushroomed over the past year

Australian announced private equity deals



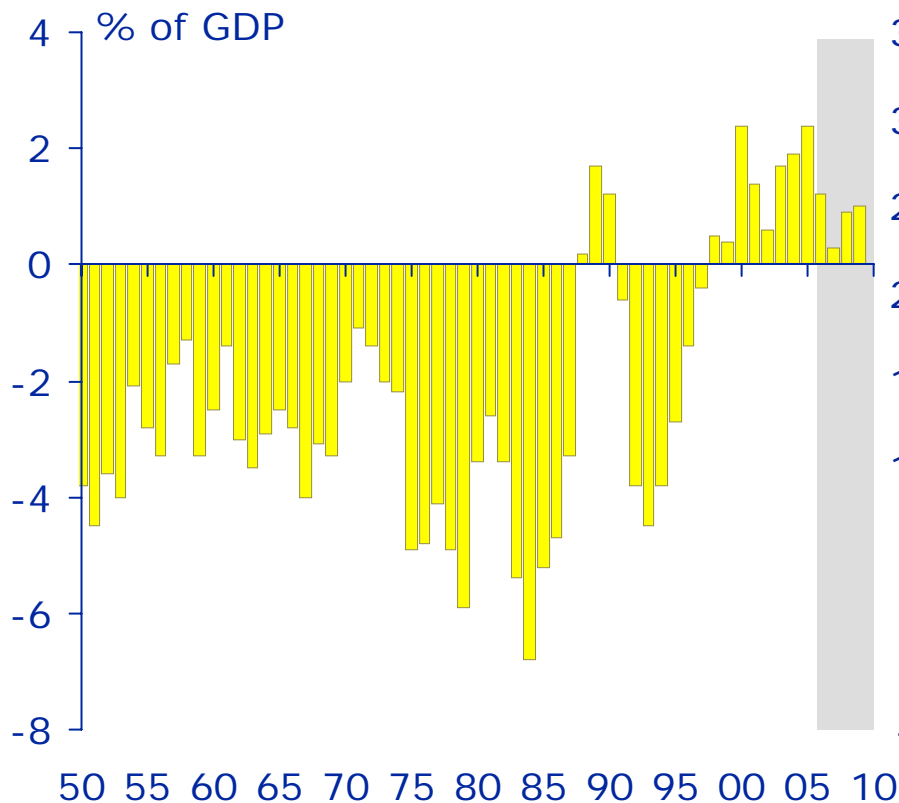
* Deals pending (including Qantas).

Sources: Thomson Financial Datastream; *Australian Financial Review*.

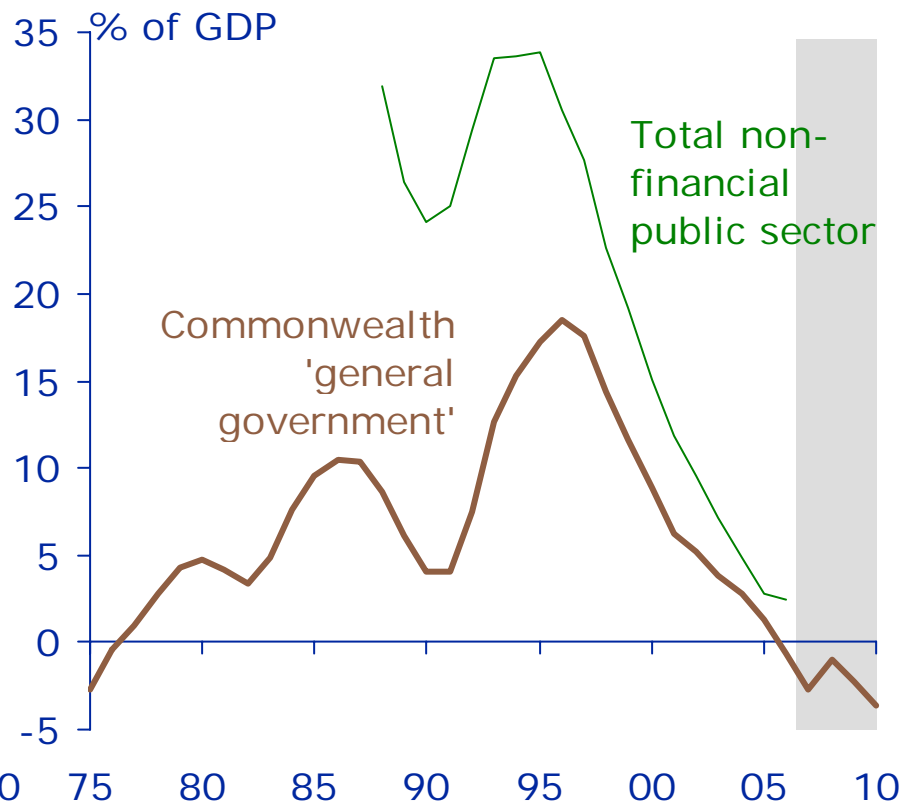
- In principle, there's little difference between today's 'private equity' deals and the 'entrepreneurial' takeovers of the 1980s ...
- ... except that today's bidders aren't crooks ... and they're not (so far it seems) being (largely) financed by domestic banks
- Reducing the regulatory burden on listed companies seems to be a factor in targets agreeing to deals
- Moreover the 'starting point' is a corporate sector in much better financial shape than it was in the 1980s ...
- ... although that could of course change if the private equity boom continued for a number of years

Australian public sector finances are among the strongest in the developed world

'General government' cash balance



Public sector net debt



Note: Shaded areas denote official forecasts. Figures are for financial years ended 30th June.

Sources: 2006-07 Commonwealth Budget Paper No. 1, Statement 12;

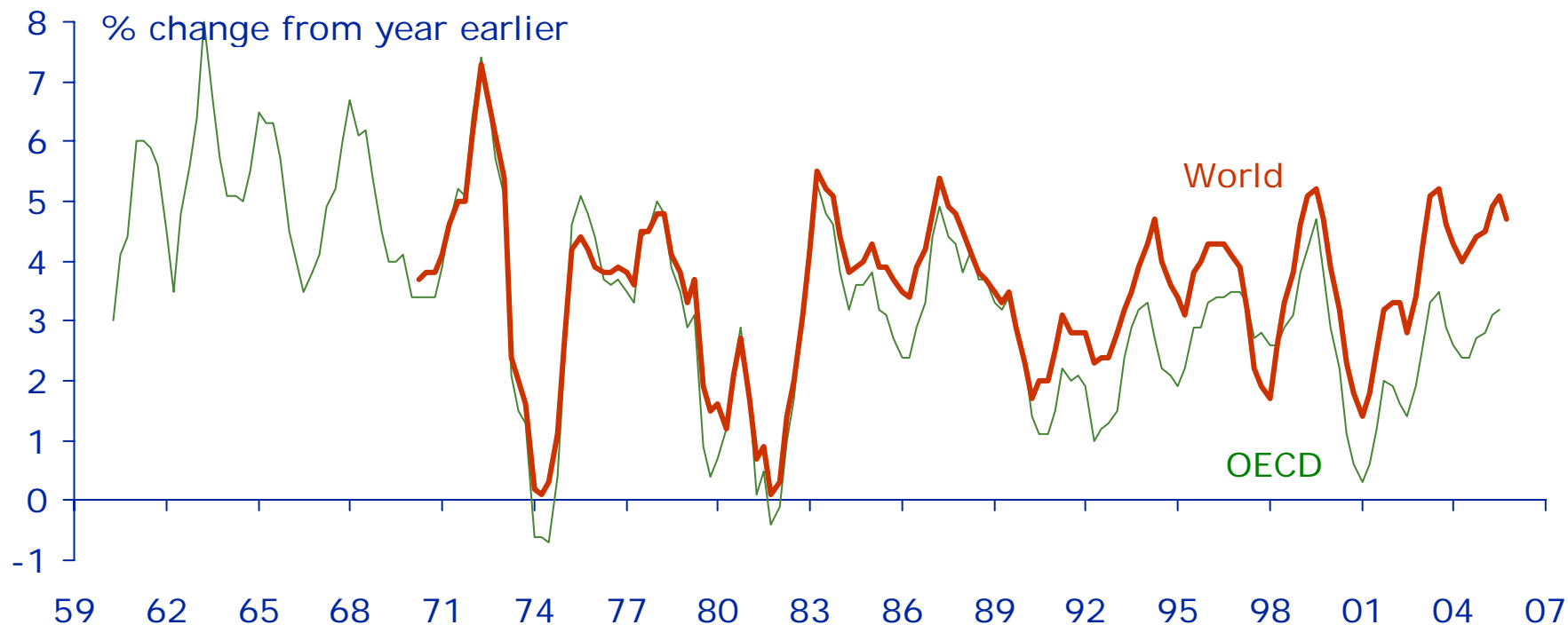
Reserve Bank *Statistical Bulletin*.

The global economic environment has been much 'friendlier' to Australia since the early 1990s

- Global economic growth – bolstered by the entry of developing and post-Soviet countries into the world trading system – has been stronger and more stable than during the 70s and 80s
 - the financial crises of the past decade have been less damaging to global growth than the oil shocks and global recessions of the 1970s and 1980s
- Inflation and interest rates have been lower and more stable all around the world, not just in Australia
 - Australian interest rates have been consistently above OECD averages (though mostly by smaller margins)
- The emergence of China as a major participant in the global economy has been particularly beneficial for Australia, boosting the prices of Australia's exports and cutting the prices of many of our imports
 - Australia's 'terms of trade' have been improving since the early 1990s, and spectacularly so over the past five years
 - 'terms of trade' gains have boosted Australian real incomes by 1 pc pt per annum, over and above what has been generated by increased output, this decade

Global economic growth has been stronger and less volatile since the early 1990s

Global real GDP growth

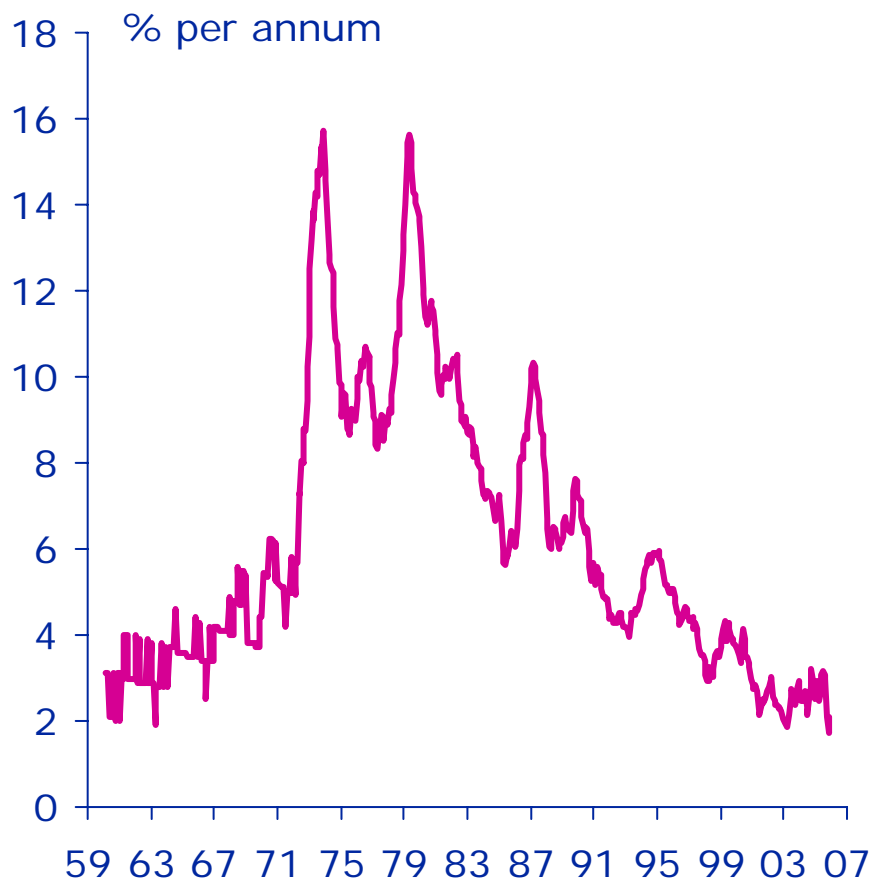


	Mean (% pa)				Standard deviation (pc pts)			
	1970s	1980s	1990s	2000s	1970s	1980s	1990s	2000s
OECD	3.4	3.0	2.6	1.8	2.0	1.4	0.9	0.9
World	2.9	2.8	3.2	3.4	1.7	1.4	1.0	1.2

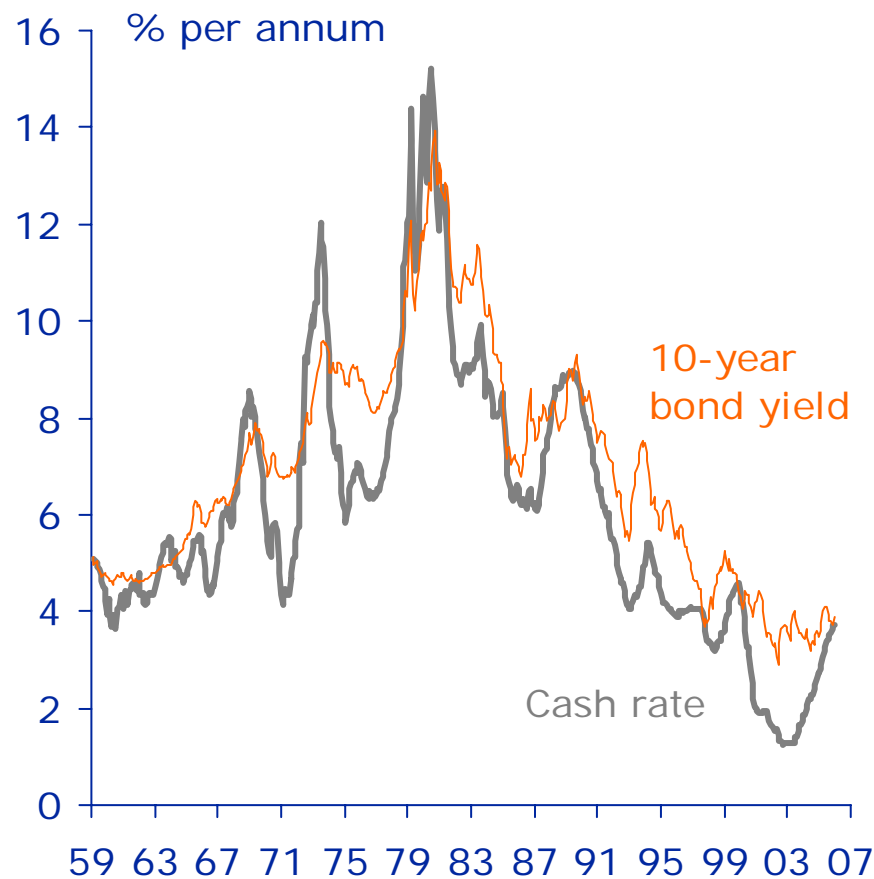
Sources: OECD; national statistical agencies and central banks; Thomson Financial Datastream; Economics@ANZ.

Inflation and interest rates have fallen around the world since 1990, not just in Australia

OECD inflation



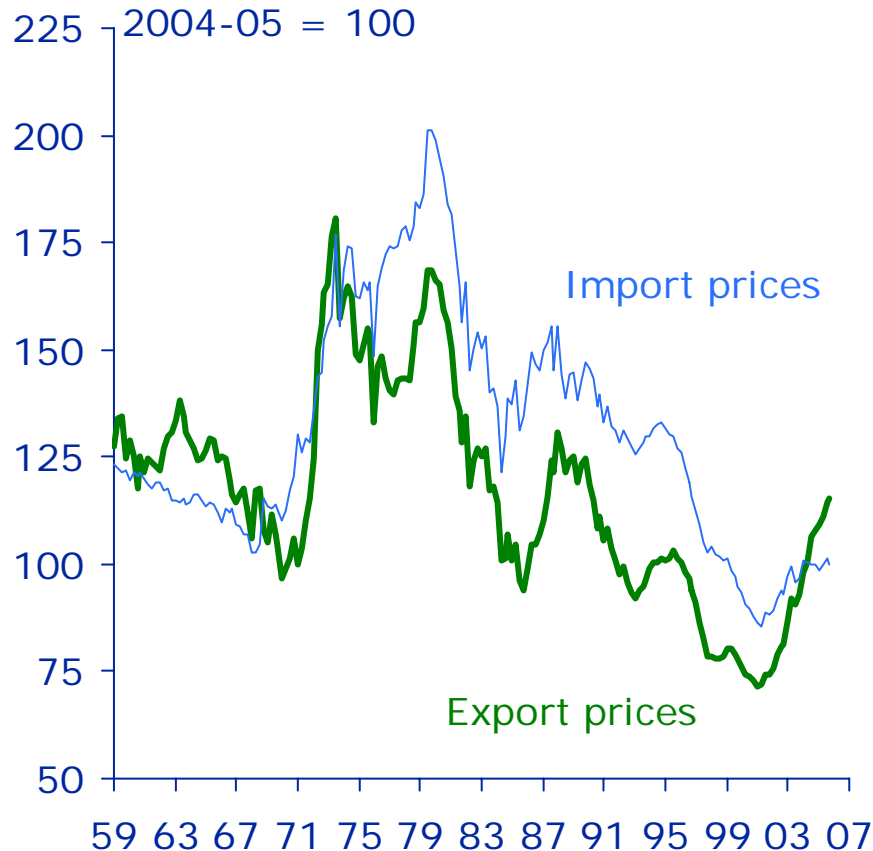
'G7' interest rates



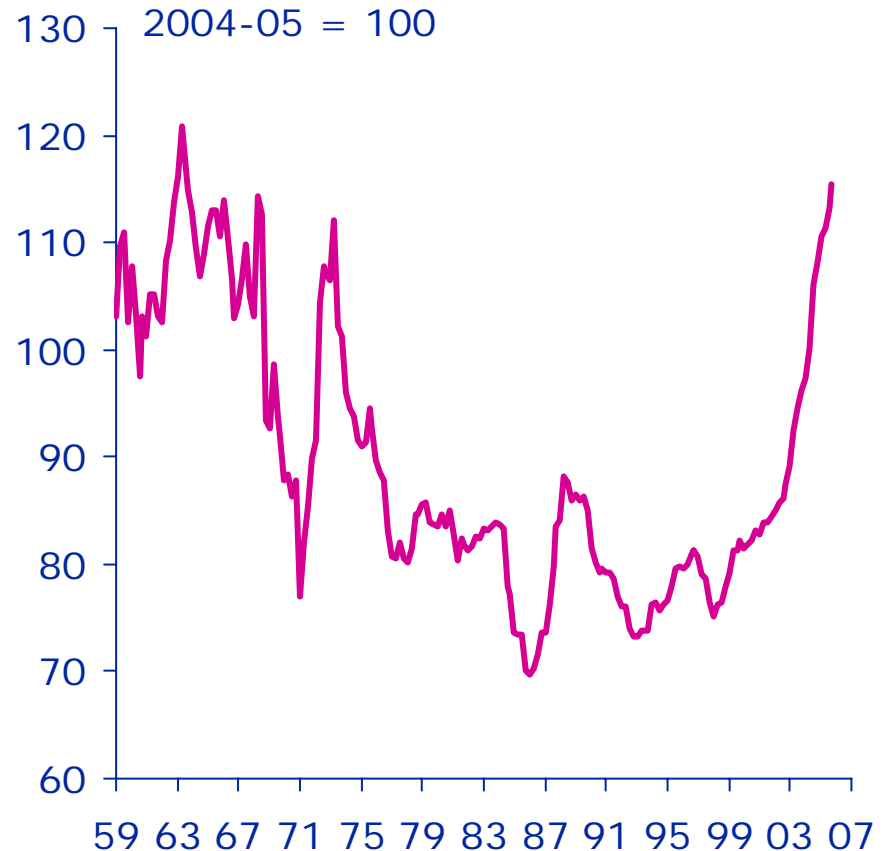
Note: G7 cash rate excludes France before January 1964; G7 bond yield excludes Japan before May 1966.
Sources: OECD; national central banks; Thomson Financial Datastream; Economics@ANZ.

Australia's terms of trade have improved since the early 90s, reversing the decline of the 70s and 80s

Australian export and import prices in real US\$ terms



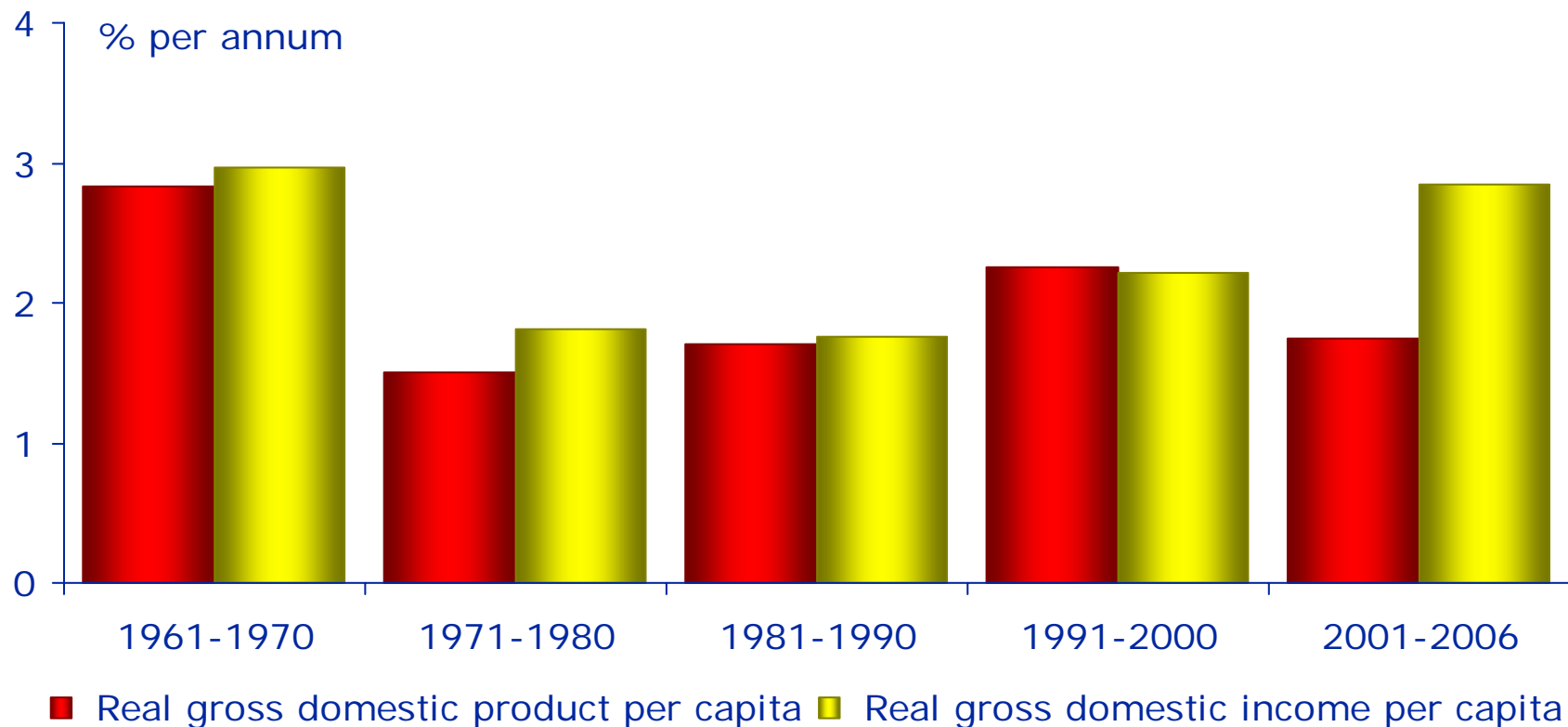
Australia's 'terms of trade'



Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ.

Terms of trade gains have boosted Australia's real income by 1 pc pt pa so far this decade

Growth in real gross domestic product (GDP) and real gross domestic income (GDI) compared



Note: real gross domestic income is real gross domestic product adjusted for changes in the terms of trade (ratio of export to import prices).

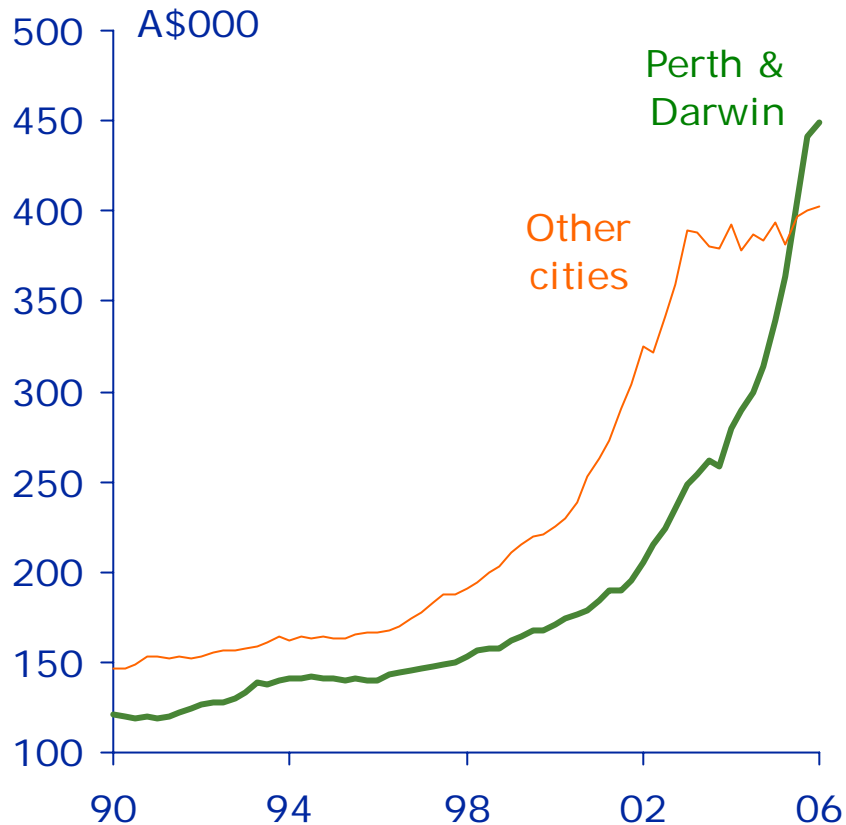
Sources: Australian Bureau of Statistics; Economics@ANZ.

Many of the major drivers of Australian economic growth over the past 15 years are now fading

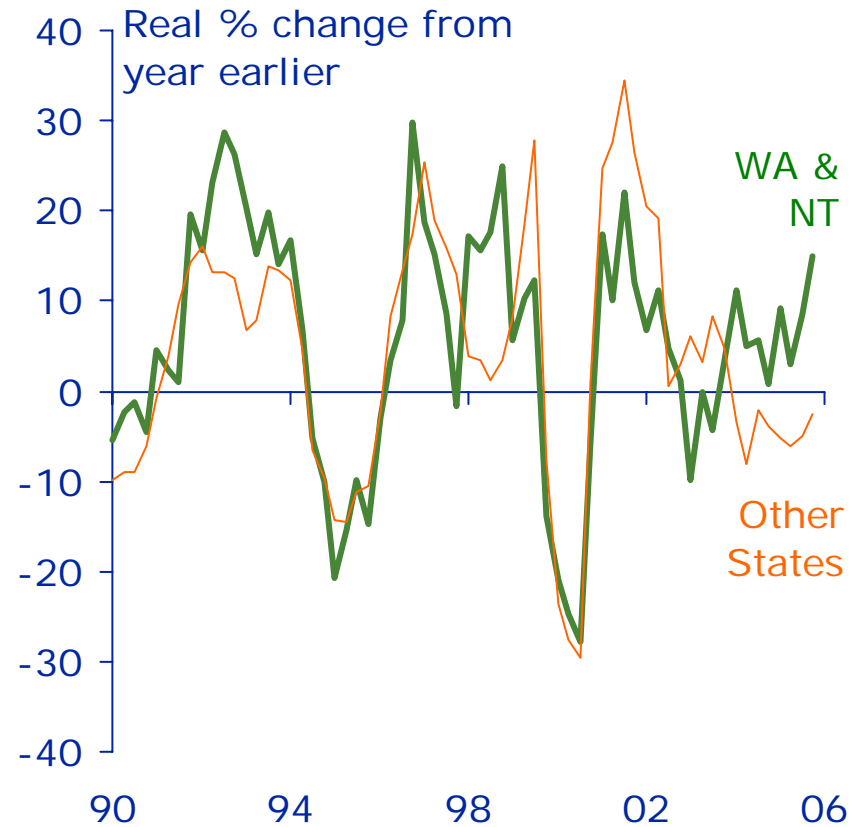
- The 'housing boom' ended in most parts of Australia in 2004
 - and is likely to end in Perth and Darwin fairly soon
- Since the end of the housing boom consumers have become more cautious about borrowing and spending
 - although there is no indication of any major retrenchment on the part of consumers
- Business capital expenditures look to have peaked after several years of exceptionally strong growth
- Australia's export performance has been dismal since the beginning of the present decade
 - in volume terms export growth has been weaker than at any time since the 1950s
 - slowly rising exports of mineral ores offset by falling exports of crude oil – this may change as major projects come on line
 - rural exports affected by drought, manufacturing and services exports hit by strength in the A\$
- Australia's 'productivity miracle' appears to be over
 - the improvement relative to the US during the 1990s has been entirely reversed

The housing boom is over, except in Western Australia and the Northern Territory

Established house prices



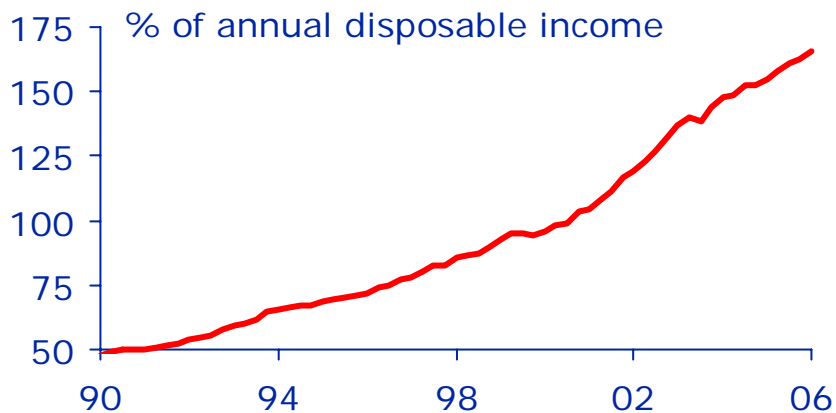
Dwelling construction



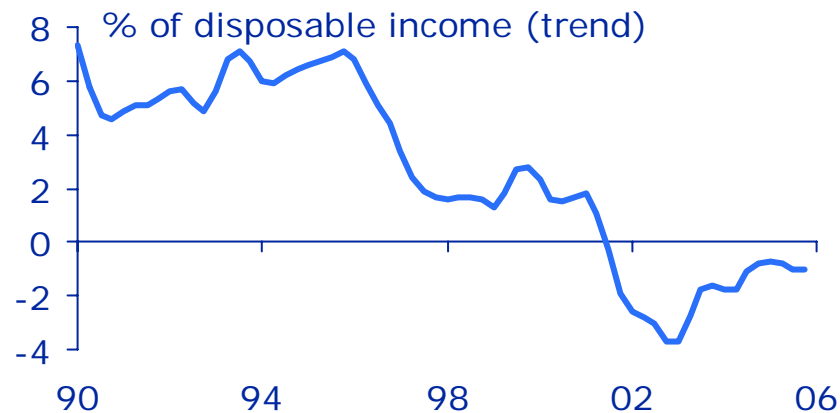
Sources: ABS; Economics@ANZ.

Higher interest rates and the end of the housing boom are making households more cautious

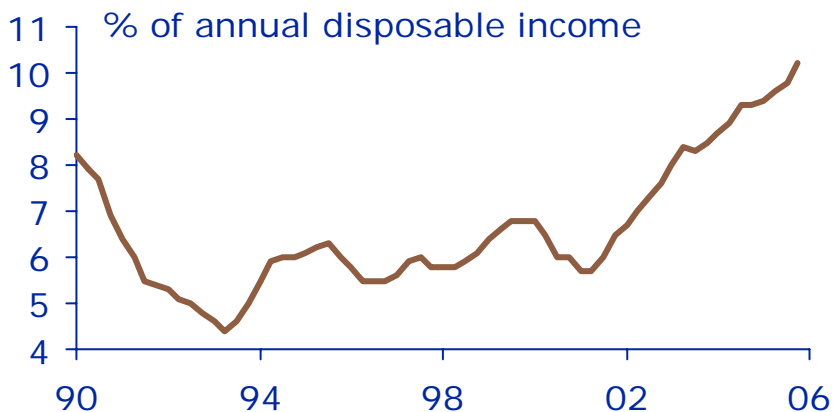
Household debt to income



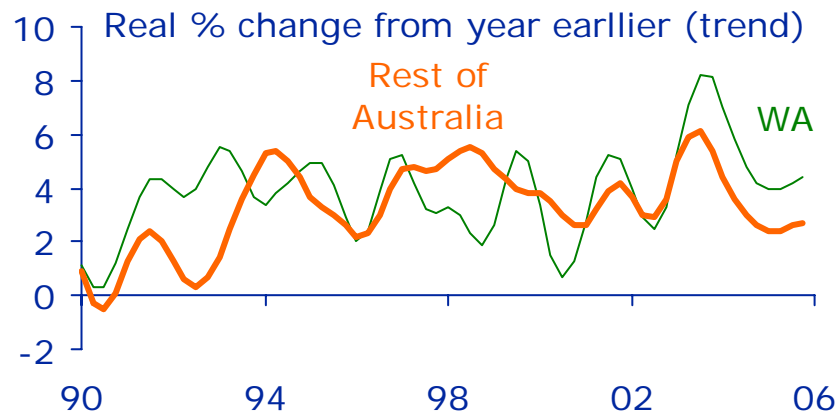
Household saving rate



Interest payments to income



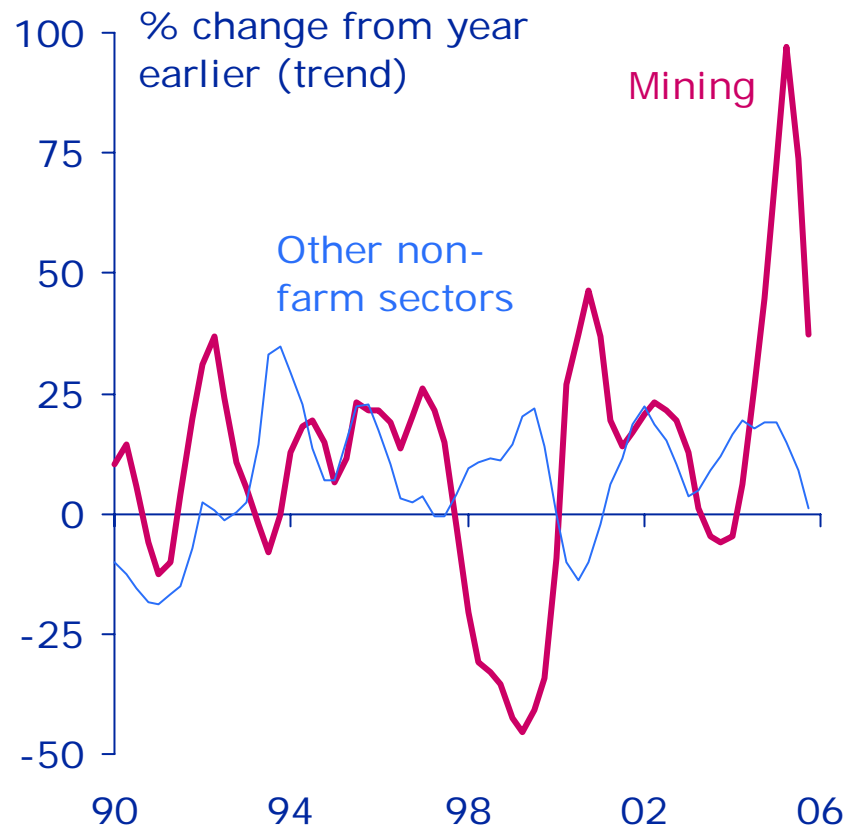
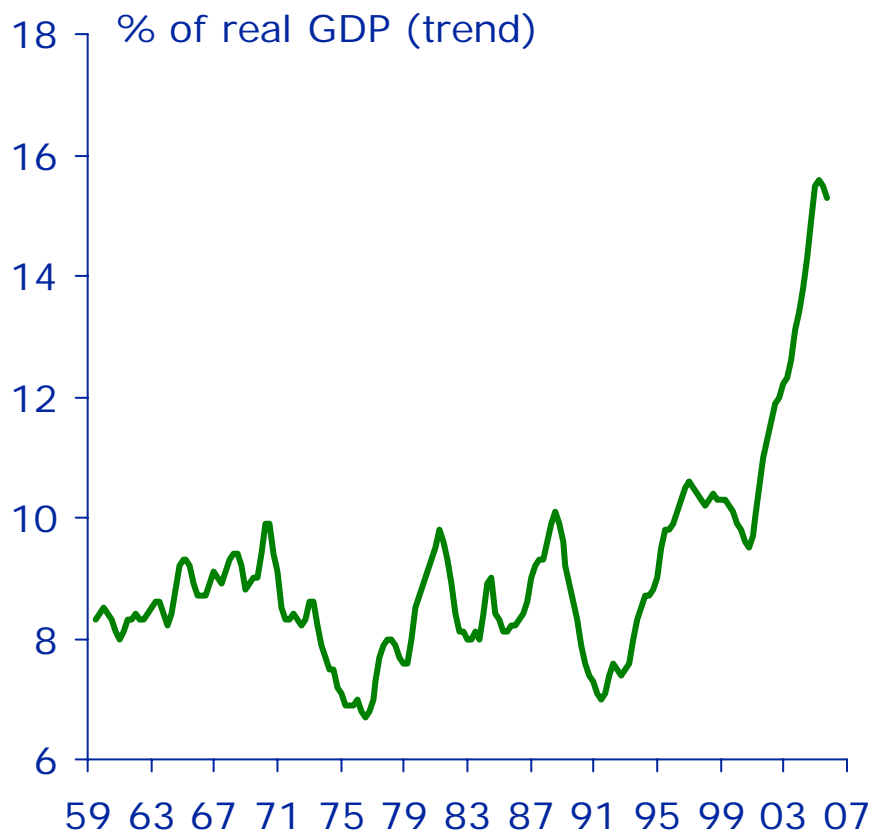
Consumer spending



Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

The business investment boom also appears to have reached a peak

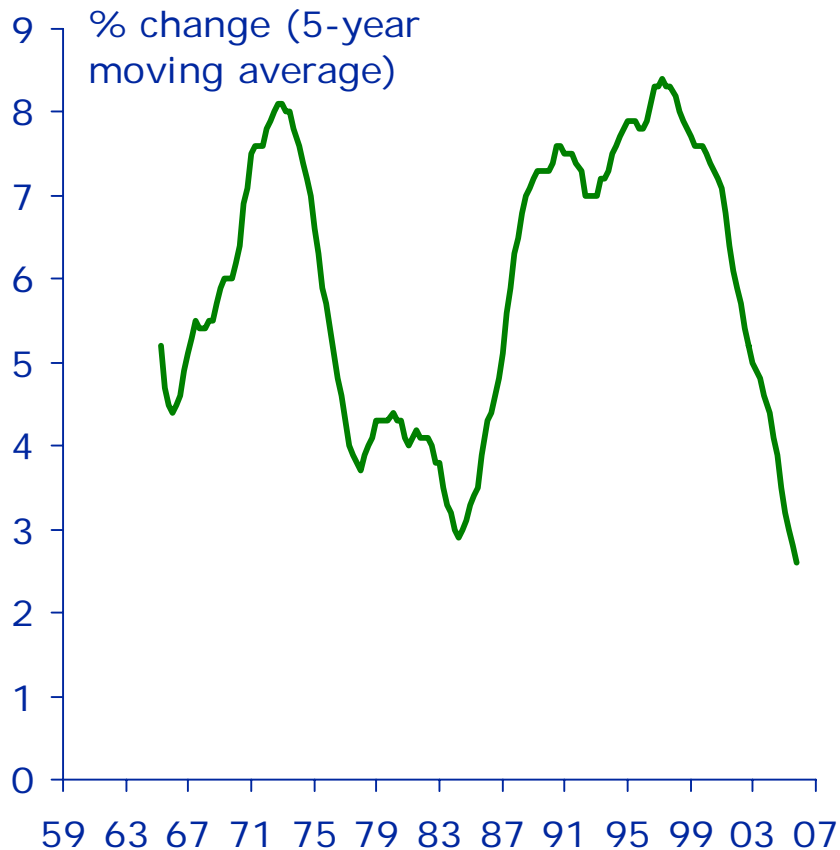
Business fixed capital expenditure



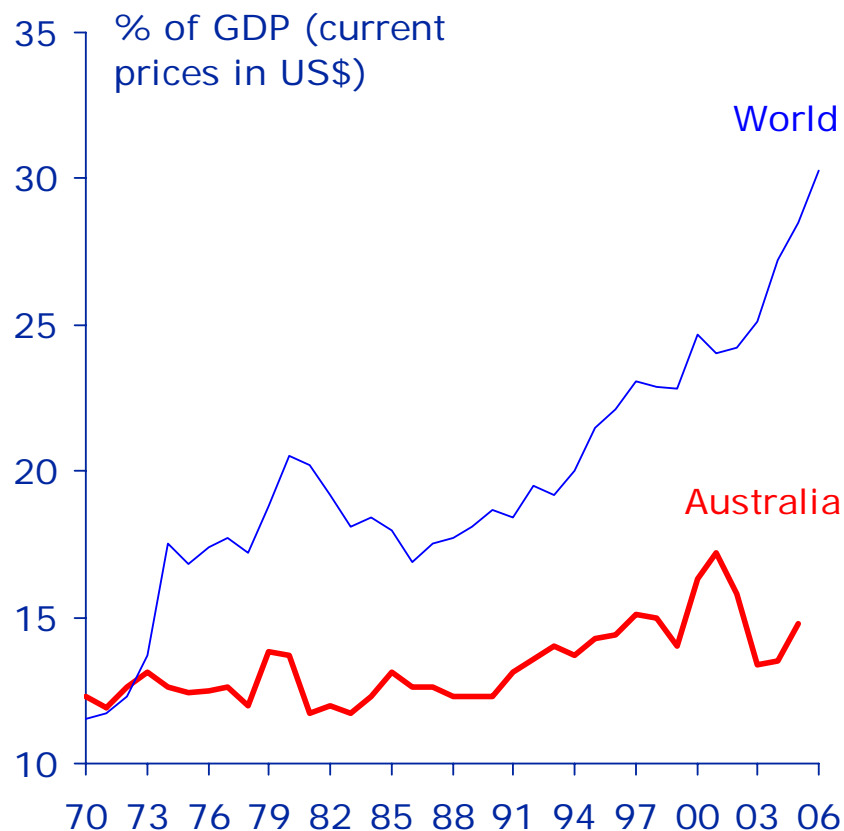
Sources: ABS; Economics@ANZ.

Australia's export performance since 2000 has been very poor

Export volumes



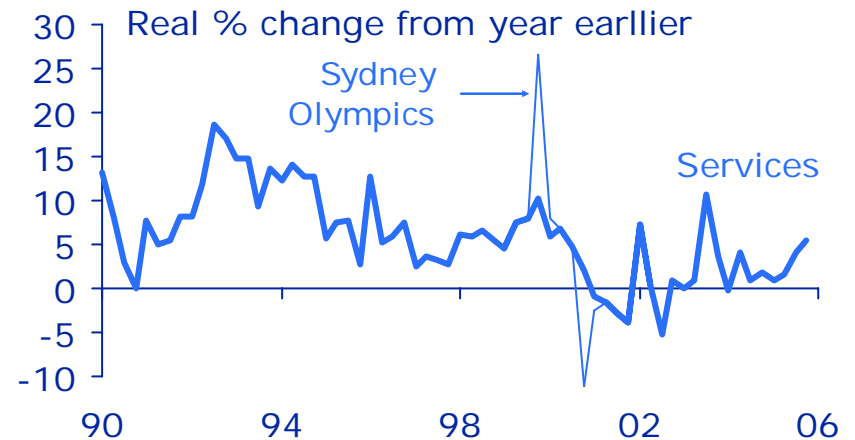
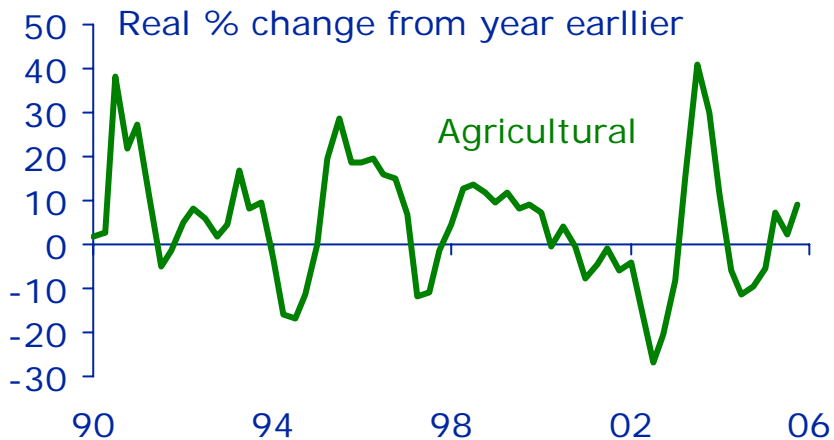
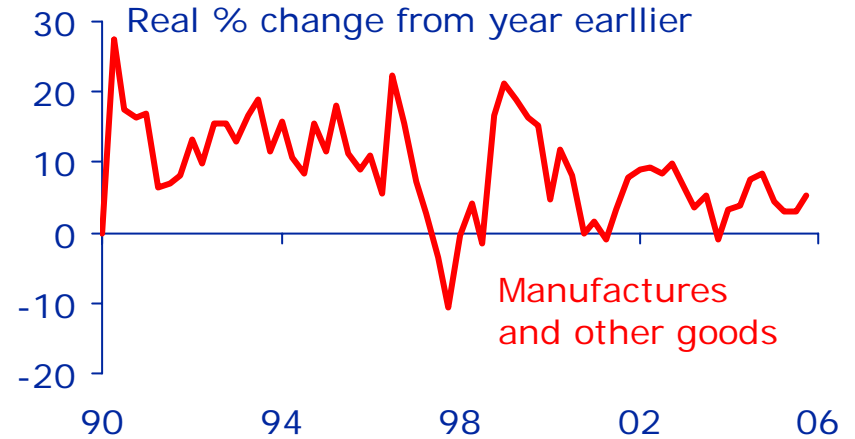
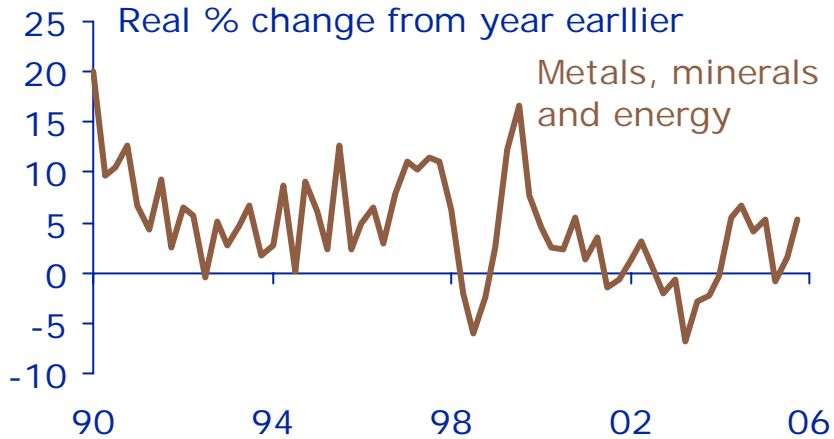
Exports as a pc of GDP



Sources: Australian Bureau of Statistics; International Monetary Fund *Direction of Trade Statistics* and *World Economic Outlook* database; Economics@ANZ.

Commodity exports constrained by production shortfalls, manufactures and services by strong A\$

Australian exports by volume

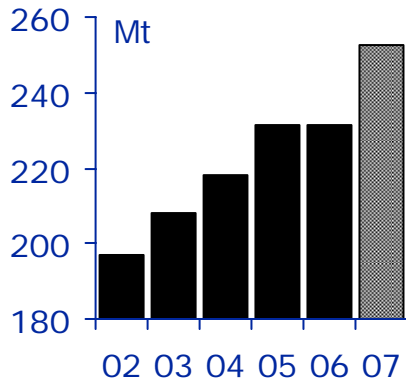


Sources: Australian Bureau of Statistics;
Economics@ANZ.

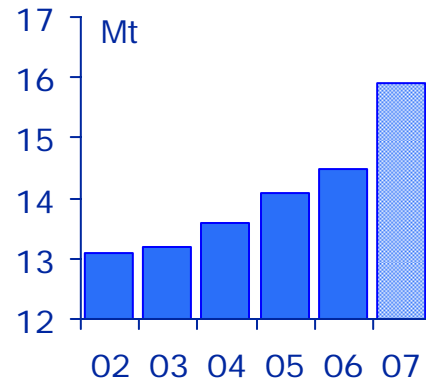
Growth in resources exports held back by falling oil exports and flat nickel

Volume of exports of mineral and energy commodities

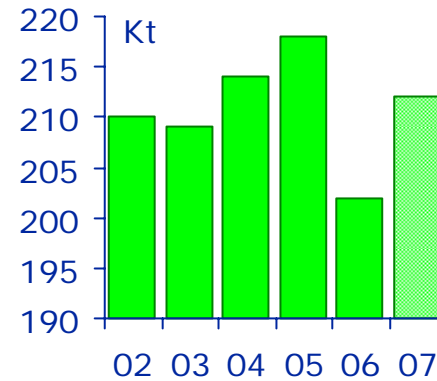
Coal



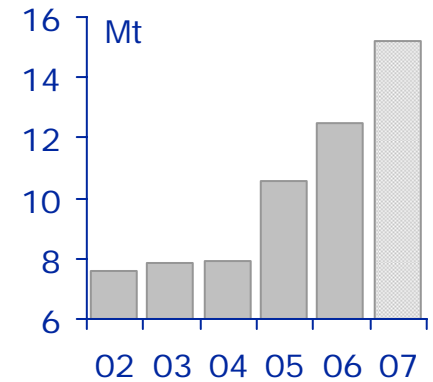
Alumina



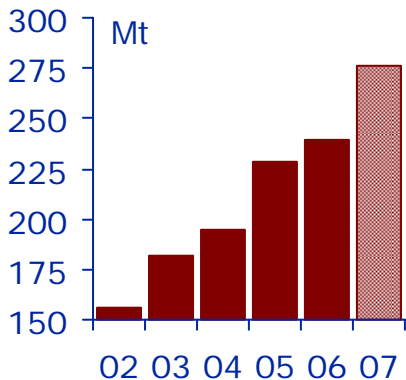
Nickel



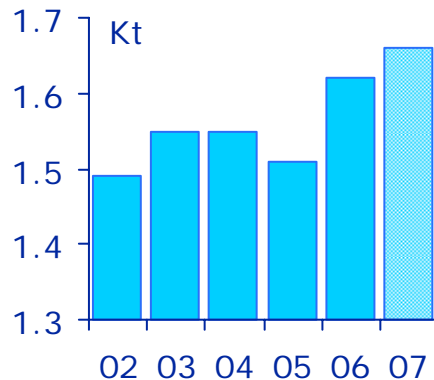
LNG



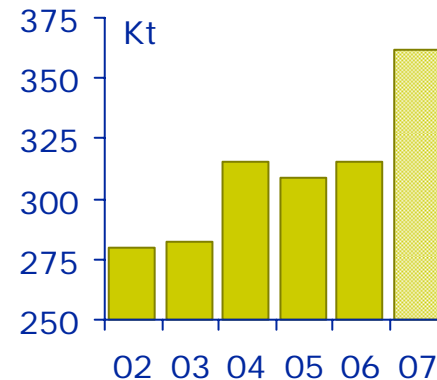
Iron ore



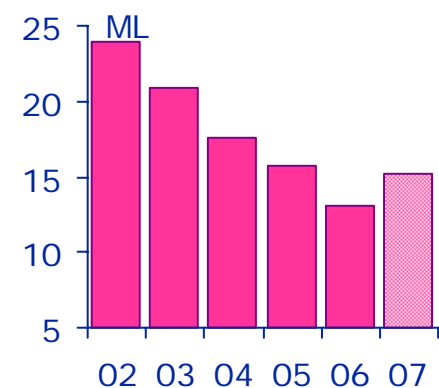
Aluminium



Gold

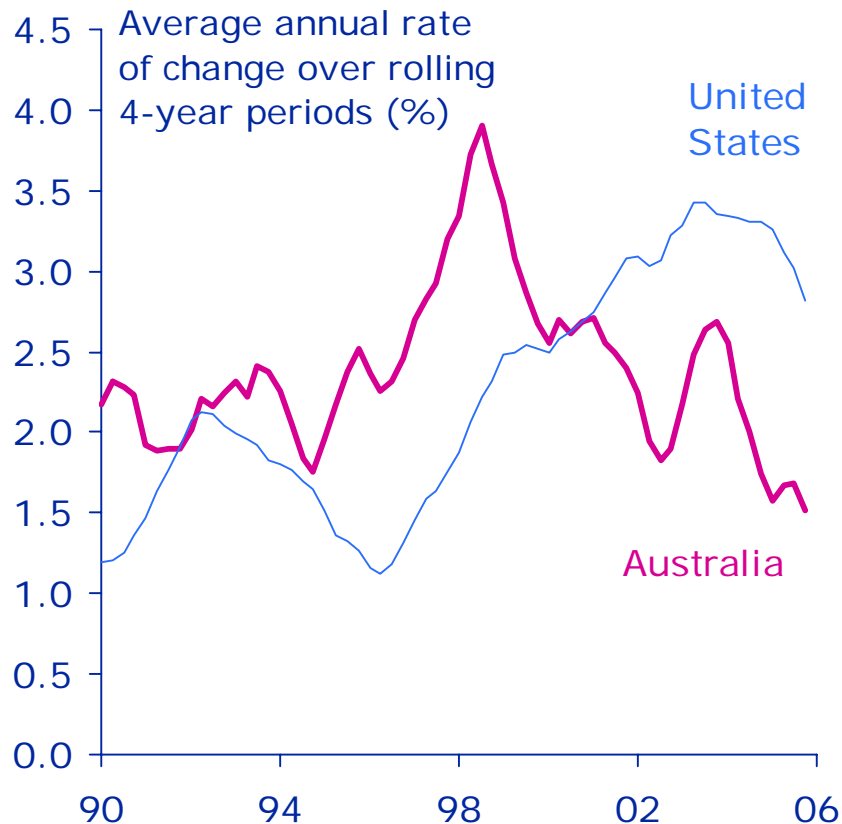


Crude oil

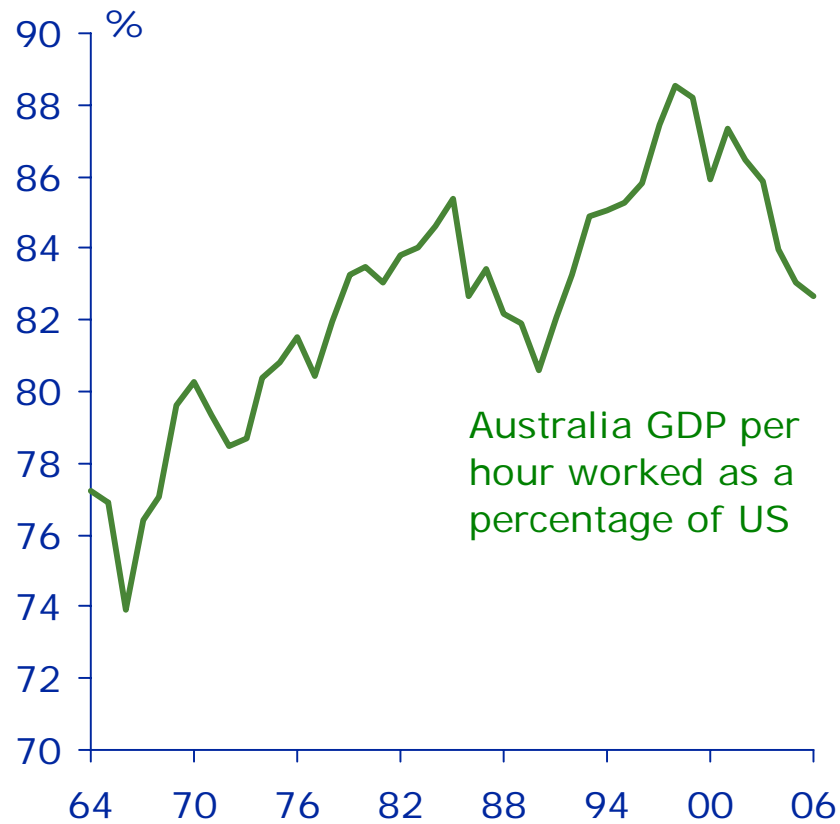


Australia's 'productivity miracle' appears to have evaporated

Labour productivity growth



Labour productivity level



Note: labour productivity is output per hour worked in the non-farm business or market sector.
Sources: ABS; US Bureau of Economic Analysis; University of Groningen Growth and Development Centre *Total Economy Database* January 2007.

Productivity is 'what you get out for what you put in' - and it matters

“Productivity is the prime determinant in the long run of a nation’s standard of living, for it is the root cause of per capita national income

High productivity not only supports high levels of income but allows citizens the option of choosing more leisure instead of working longer hours.

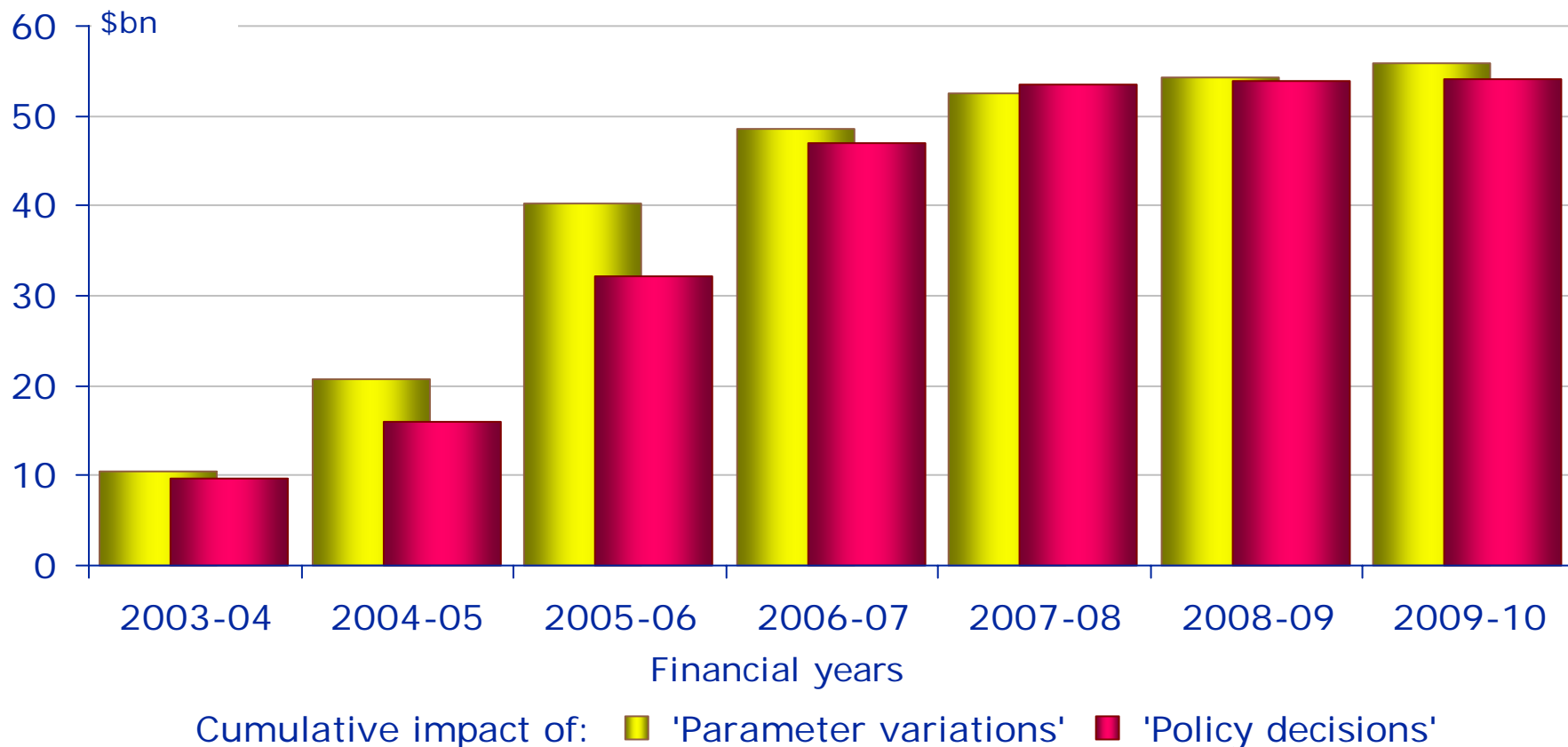
It also creates the national income that is taxed to pay for public services which again boosts the standard of living

The capacity to be highly productive also allows a nation’s firms to meet stringent social standards which improve the standard of living, such as in health and safety, equal opportunity and environmental impact”

– Michael E. Porter, *The Competitive Advantage of Nations* (1991), page 6

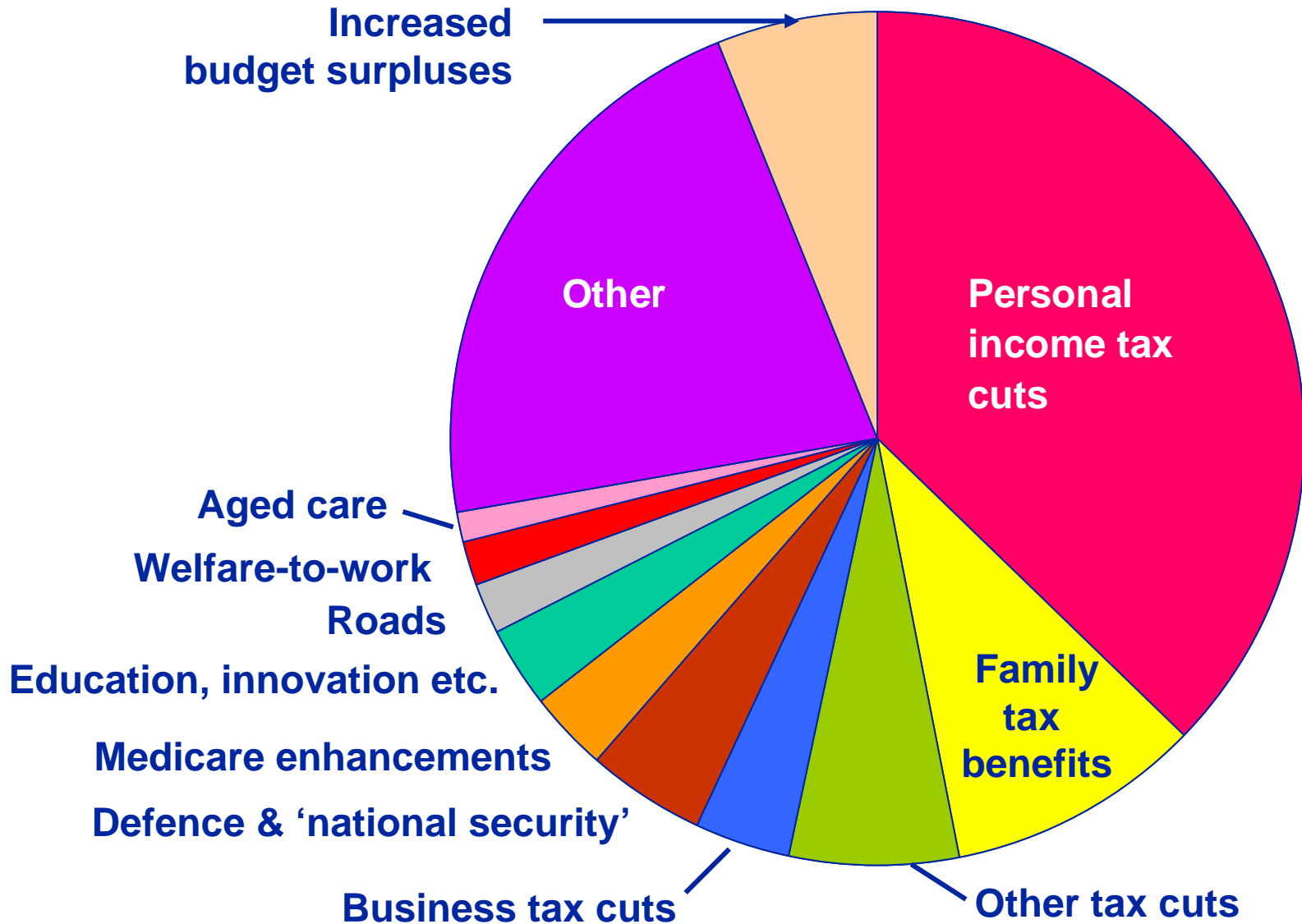
Nearly all of the revenue windfalls accruing from the commodities boom have been dissipated ...

Net 'bottom line' impact of 'parameter variations'
vs 'policy decisions' (tax cuts or spending increases)



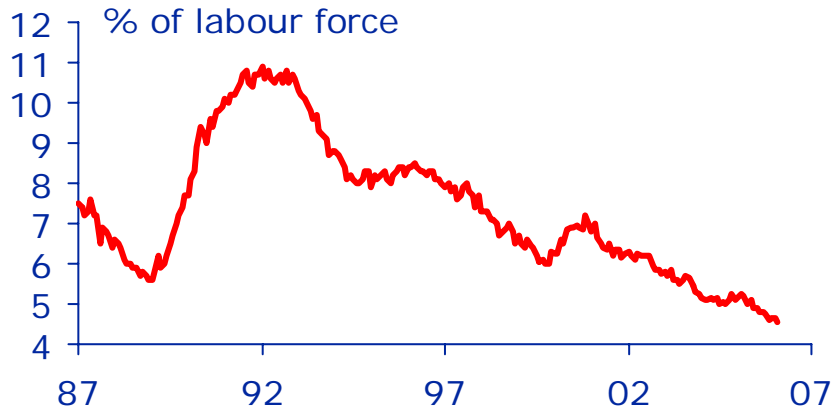
Sources: Budget Papers and Mid-Year Economic and Fiscal Outlook papers 2002-03 through 2006-07
And Economics@ANZ calculations.

... with little of lasting value to show for it



The Australian economy is bumping up against 'capacity constraints'

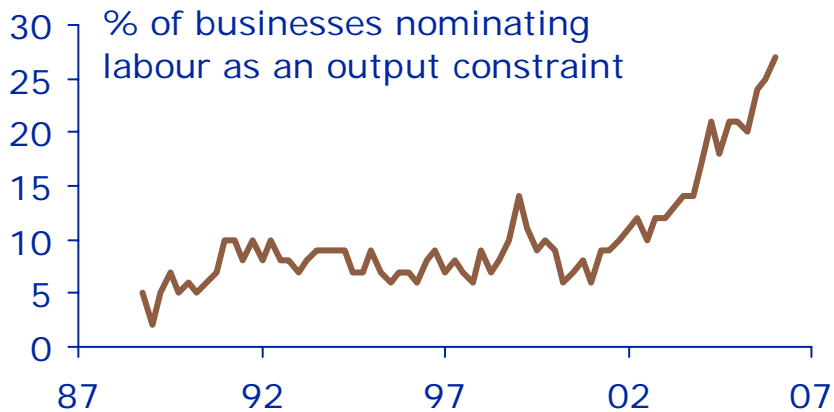
Unemployment rates



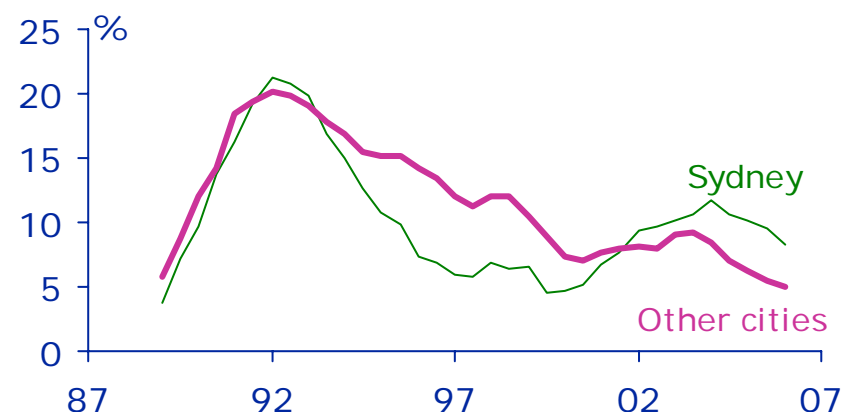
Capacity utilization



Labour shortages



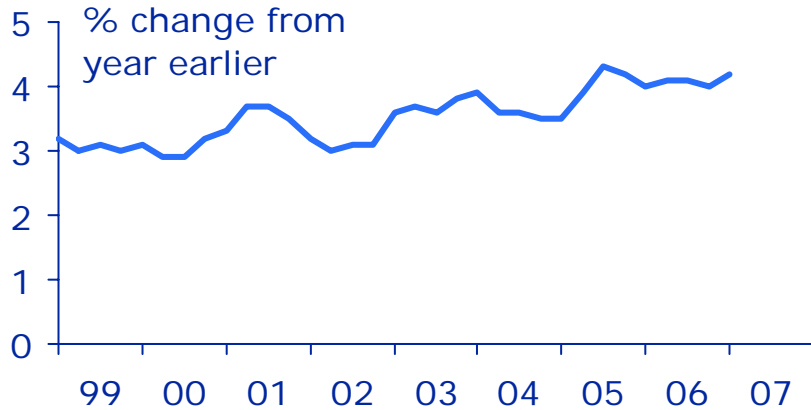
Office vacancy rates



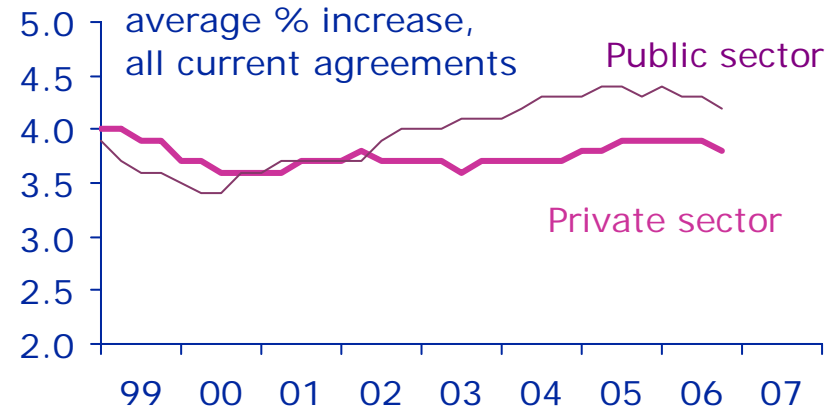
Sources: Australian Bureau of Statistics; National Australia Bank; Property Council of Australia.

Wage movements have been very restrained despite the tight labour market

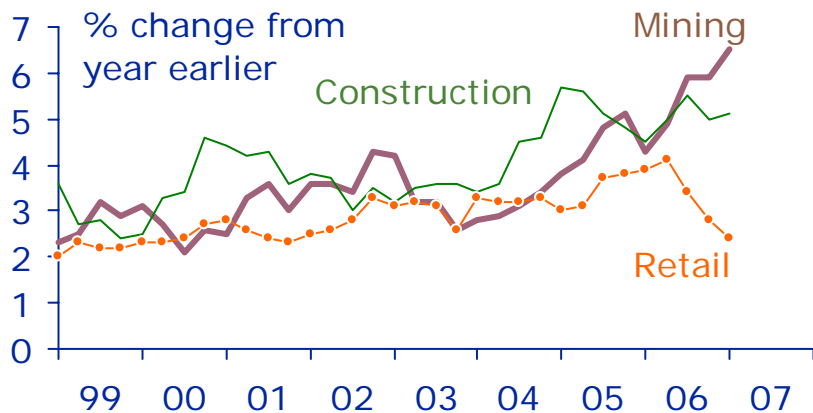
Wage cost index



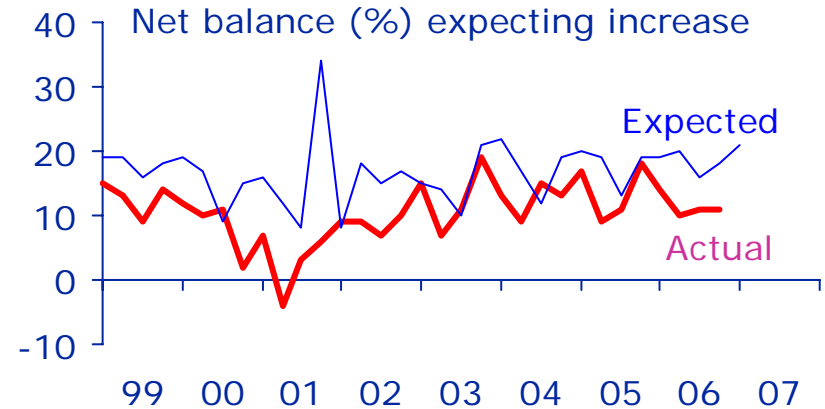
Enterprise bargaining



Wage costs: selected sectors



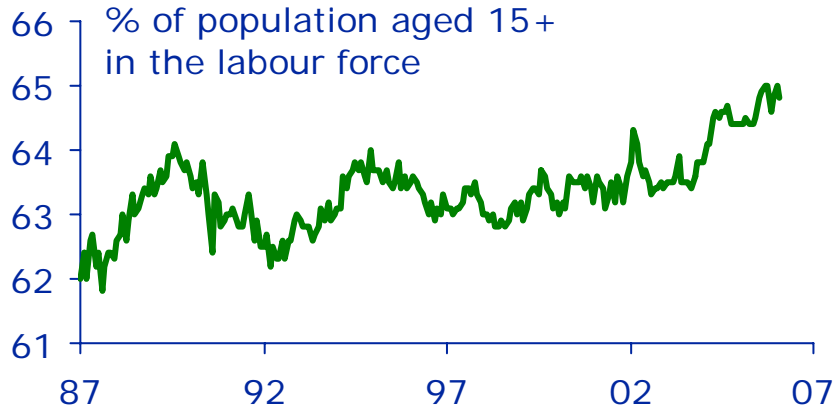
Small business wages bill



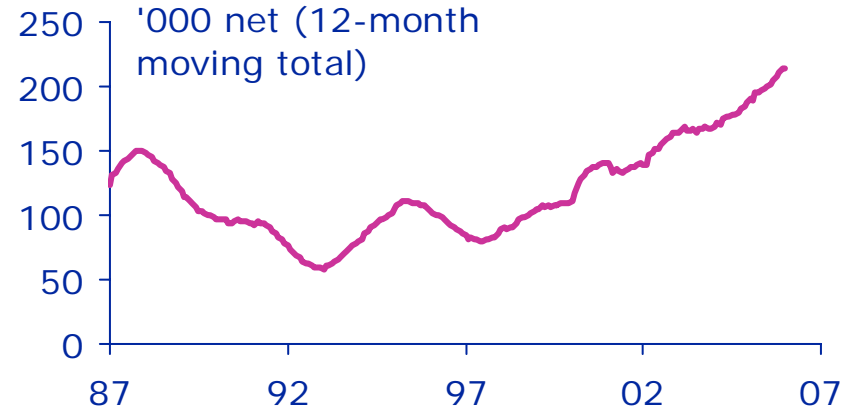
Sources: Australian Bureau of Statistics; Department of Employment & Workplace Relations; Sensis.

A number of 'safety valves' have increased the elasticity of labour supply

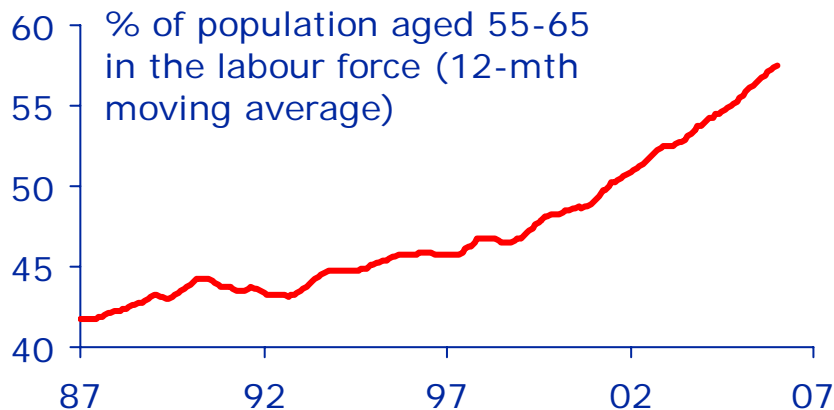
Labour force participation rate



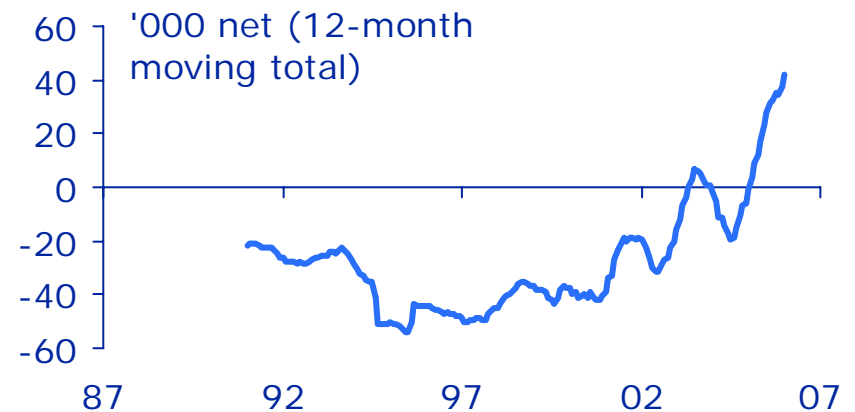
Permanent & long-term migration



Participation rate among 55-65s



Temporary migration 'for employment'



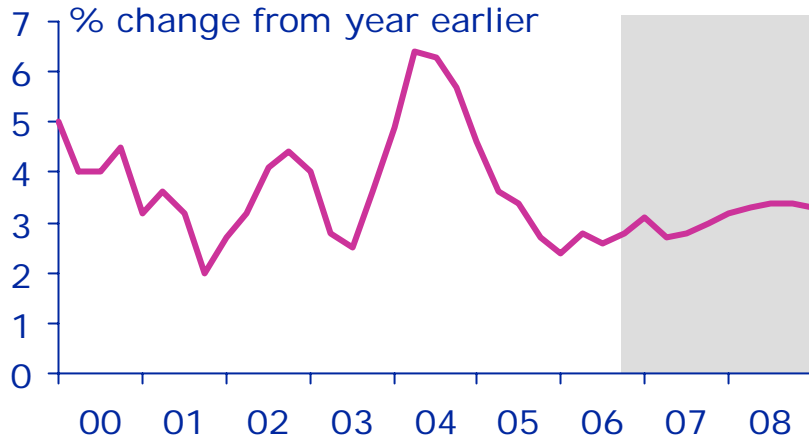
Sources: Australian Bureau of Statistics; Economics@ANZ.

So what does all this mean for the outlook for the Australian economy?

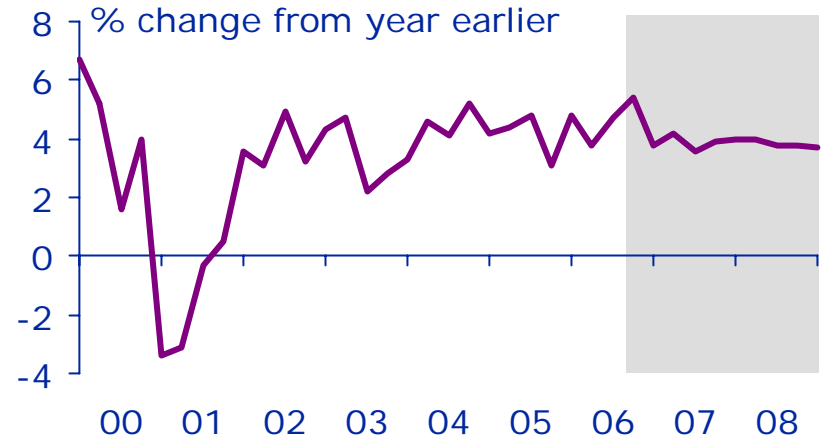
- There's no strong reason to expect a major downturn in the Australian economy any time soon
 - global economic conditions are likely to remain benign and real interest rates aren't high enough to induce a recession
 - indeed it's likely that interest rates have peaked, and that the next movement in rates (when it comes) will be down
- But, conversely, there's no obvious source of any renewed upturn in growth
 - aside from the lift in export volumes as major resource projects come on stream, recovery from drought and (in 2008) a modest upturn in housing construction
- With the economy operating at close to 'full capacity', and productivity growth having reverted to its (poor) long-term average, it's difficult to see the 'supply side' of the Australian economy growing at more than 3% pa
 - in the absence of specific policies to alter that prospect
- If monetary or fiscal policy seek to grow domestic demand at faster than 3% pa, the result will inevitably be higher inflation, a larger current account deficit (or both)

There are no obvious candidates for driving another spurt of rapid economic growth ...

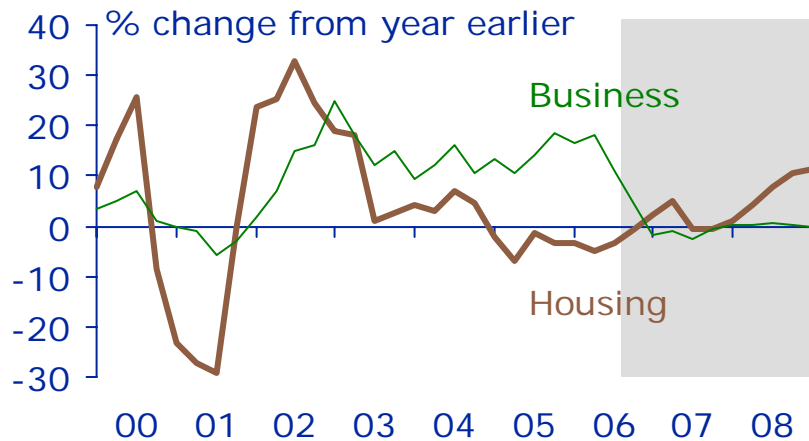
Household consumption



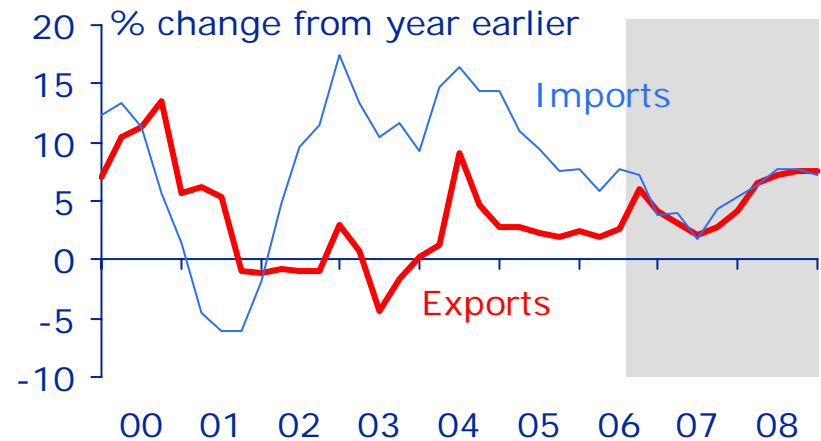
Public spending



Investment



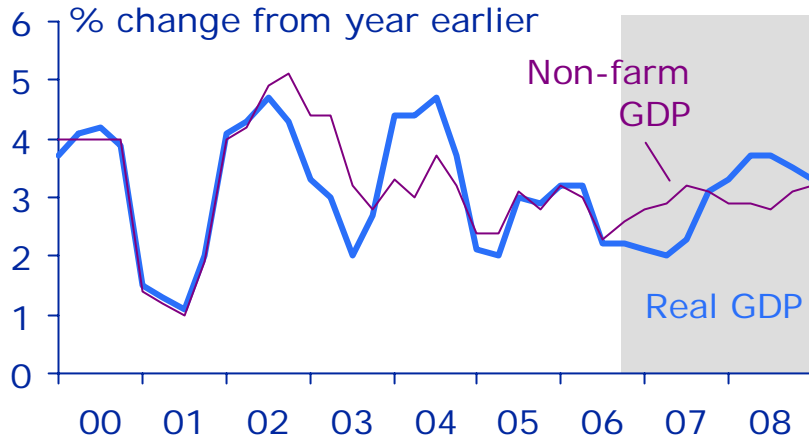
Exports and imports



Sources: ABS; Economics@ANZ.

... so the economy is likely to continue growing at close to its (reduced) potential rate

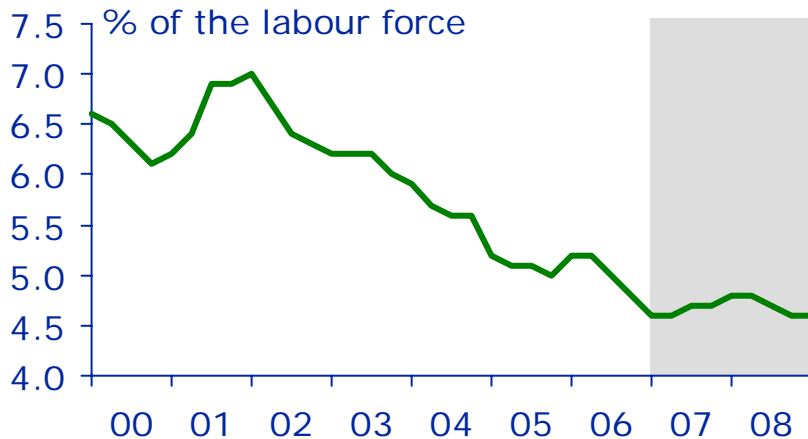
Real GDP growth



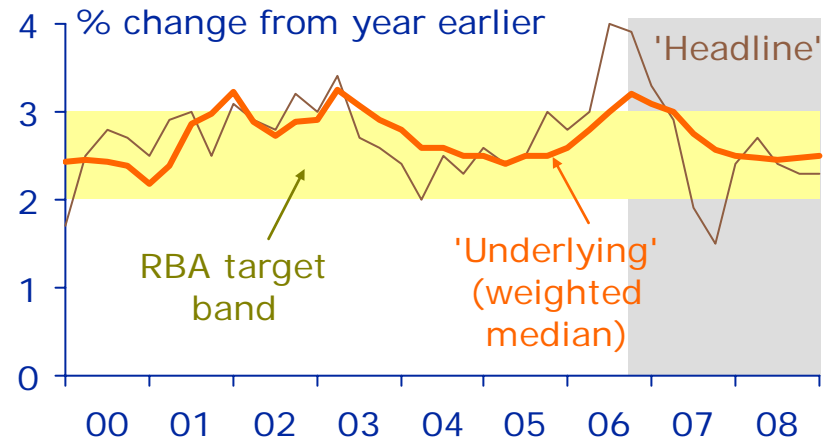
Current account balance



Unemployment



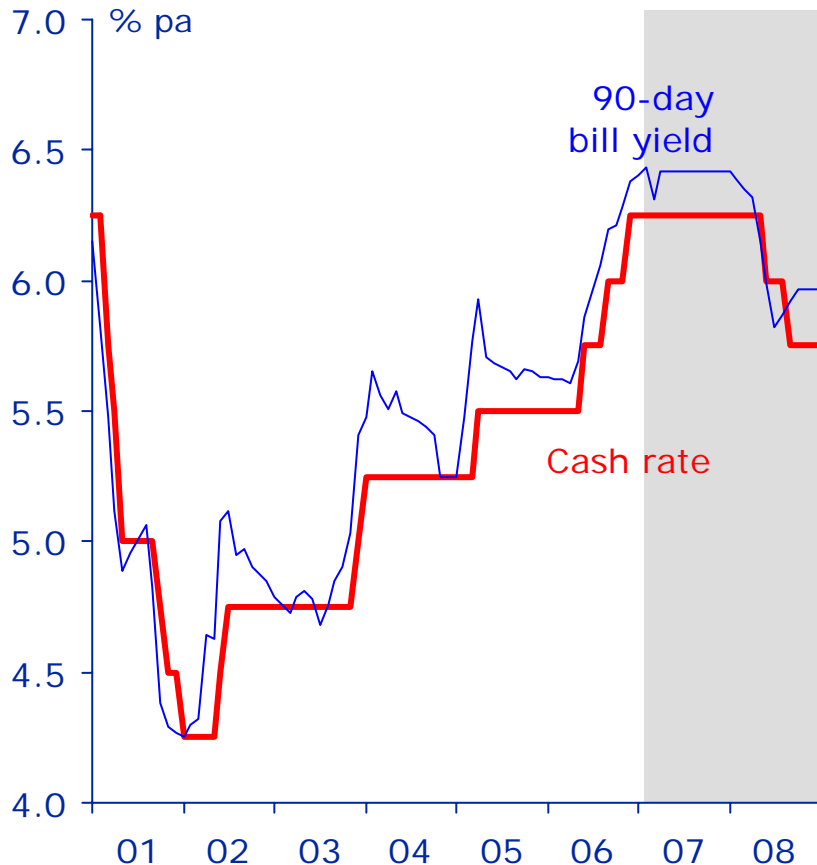
Inflation



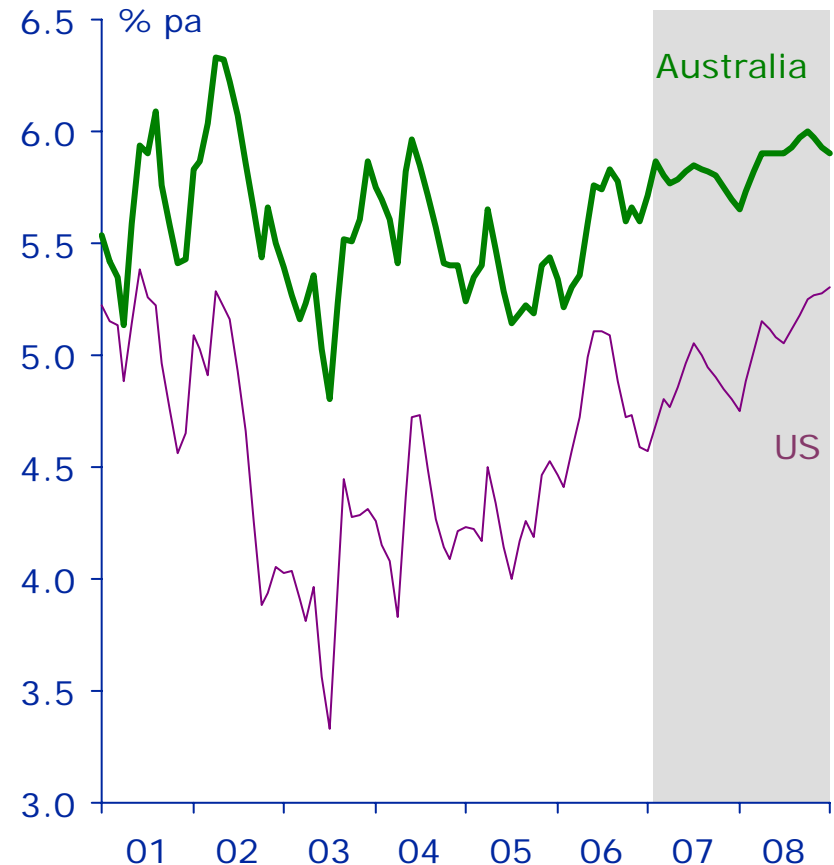
Sources: ABS; Economics@ANZ.

As a result Australian interest rates are likely to remain above 'neutral' for the next two years

Interest rates



Bond yields



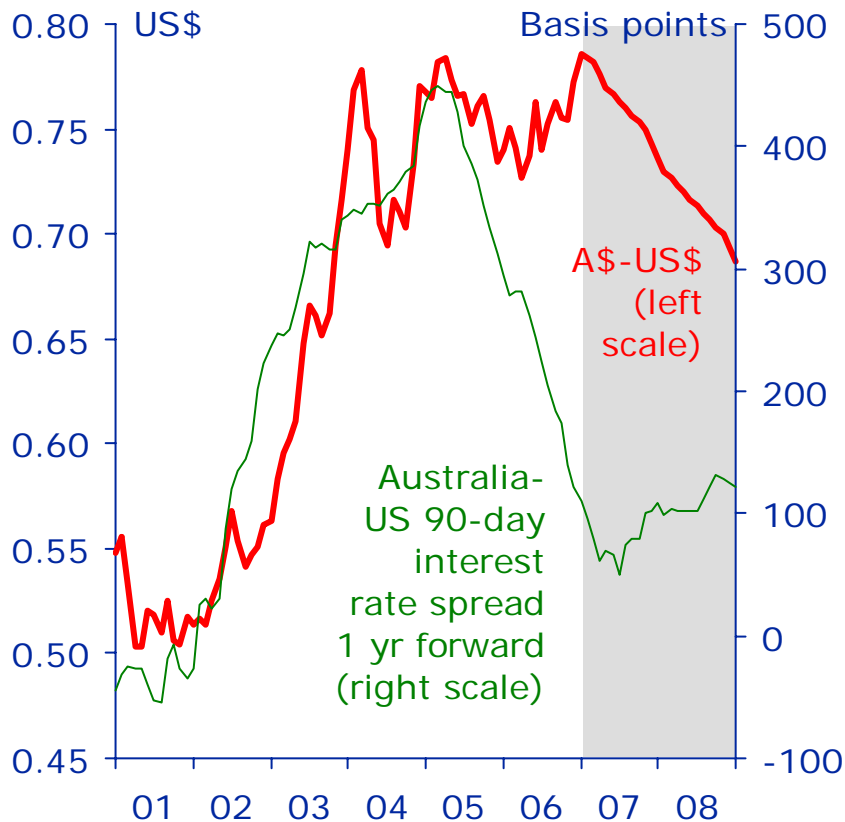
Shaded areas denote forecasts.

Sources: RBA; Datastream; Economics@ANZ.

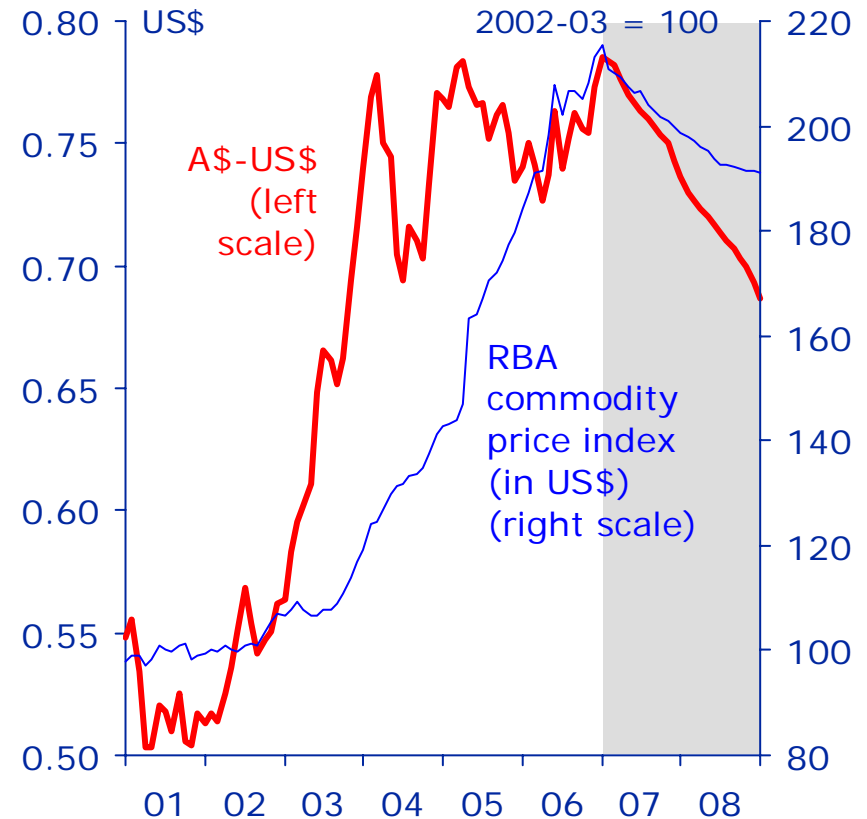
A\$ will ease in line with commodity prices though attracting some support from interest rate spreads

Economic influences on the value of the A\$

Interest rate spreads



Commodity prices



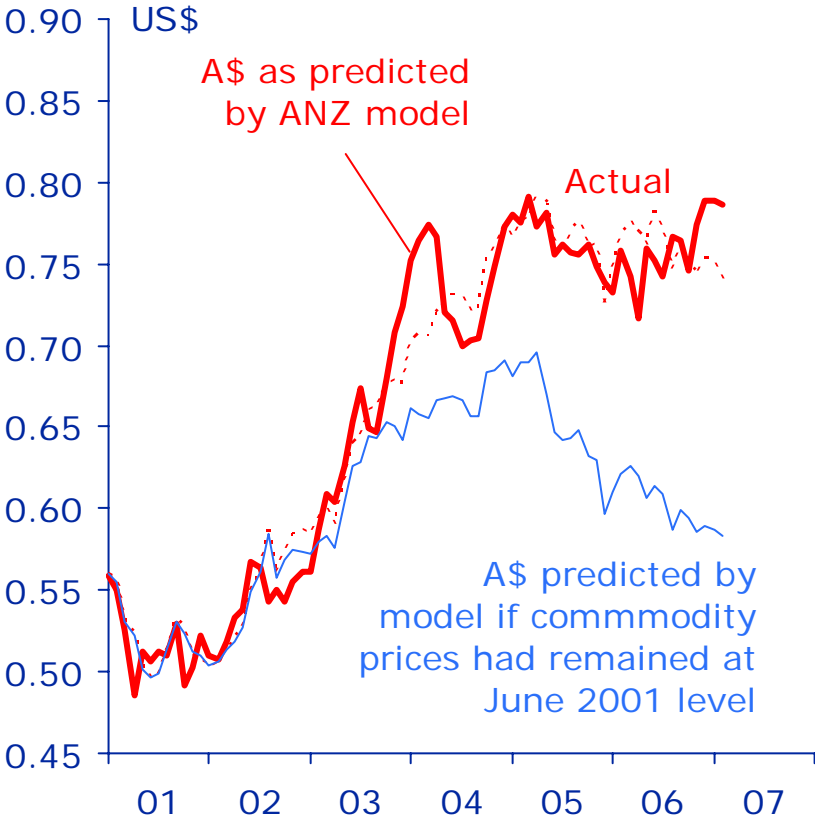
Shaded areas denote forecasts.

Sources: Datastream; RBA; Economics@ANZ.

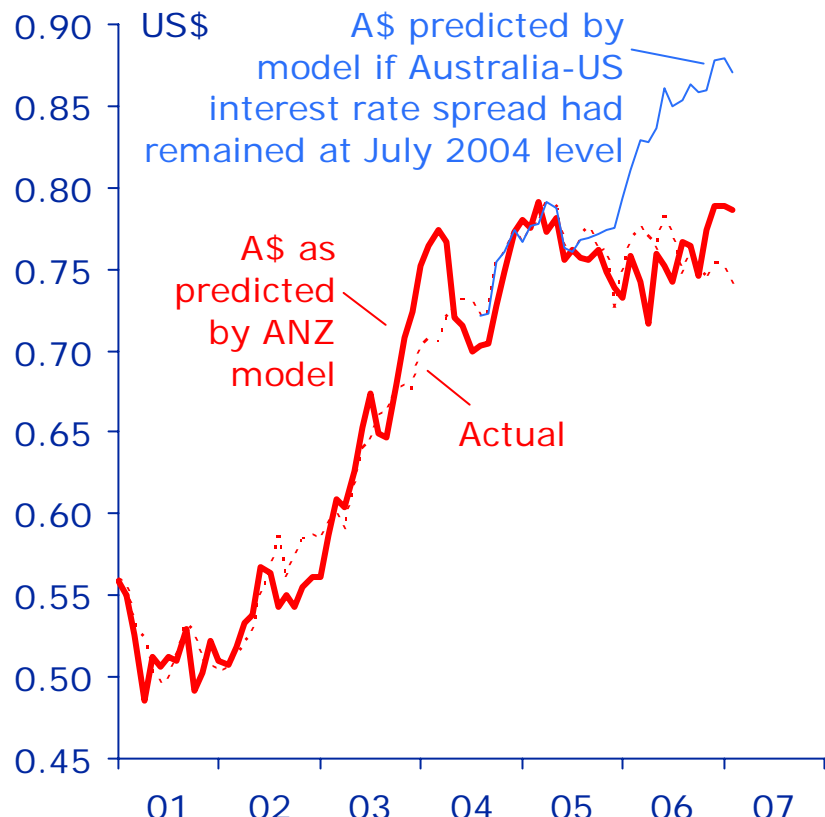
Commodity prices and interest rate differentials have been working in opposite directions on the A\$

Alternative hypothetical scenarios for the A\$

If commodity prices hadn't risen since June 2001



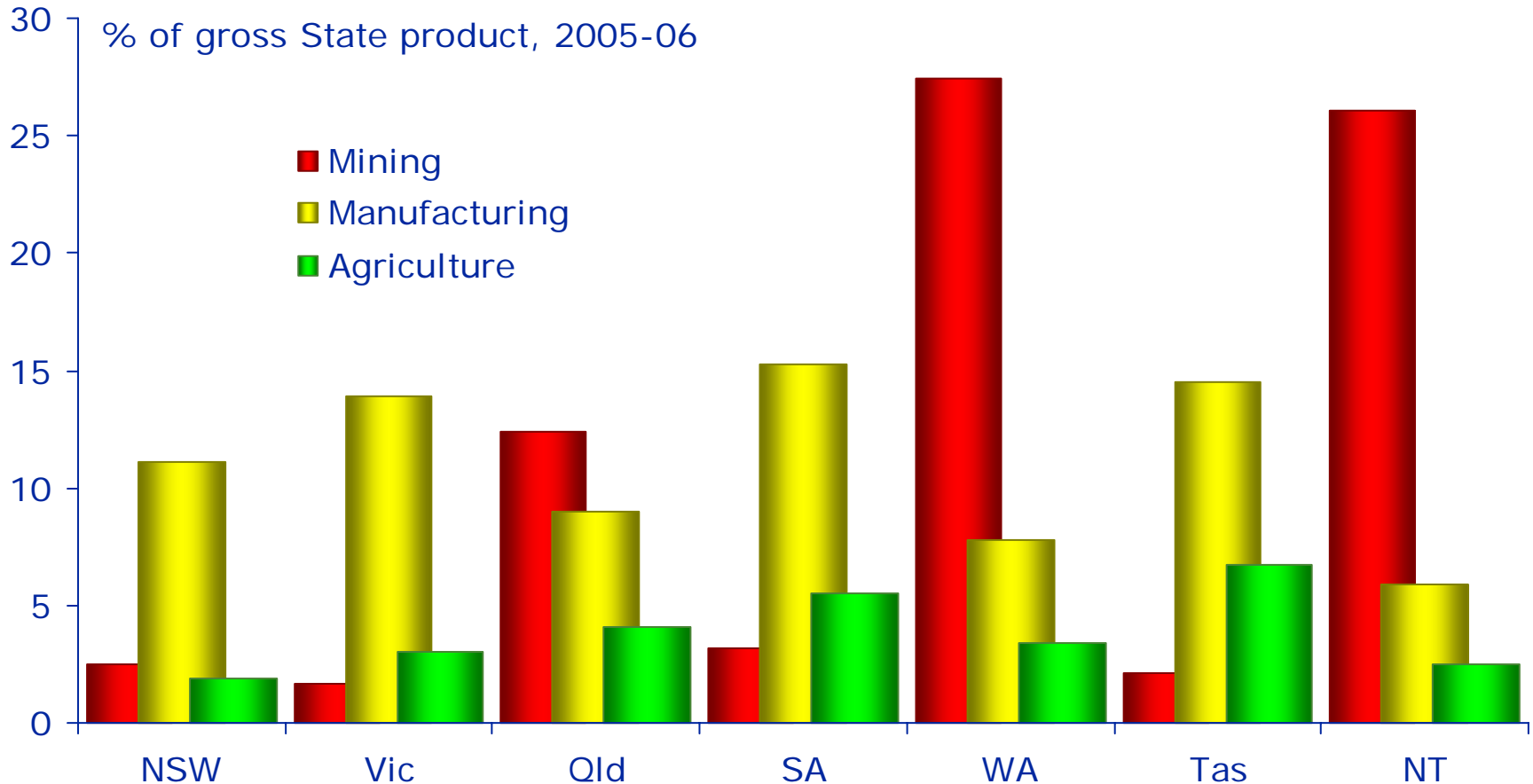
If the interest rate spread on the A\$ hadn't narrowed since July 2004



Sources: Datastream; Reserve Bank of Australia; Economics@ANZ.

It's inevitable that different States will grow at different speeds

Mining, manufacturing and agriculture as a share of State economies



Sources: ABS; Economics@ANZ.

Current differences between growth rates of different States are by no means unprecedented

Dispersion between fastest and slowest State economic growth rates

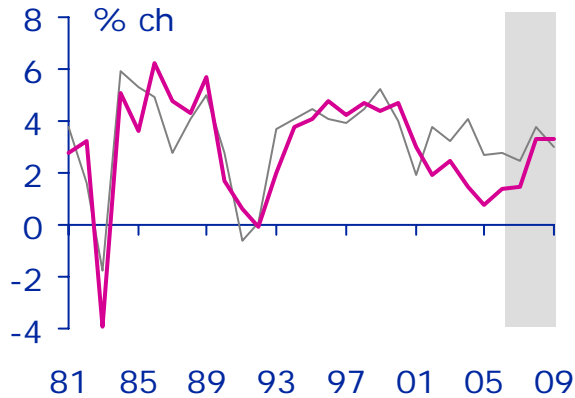


Sources: ABS State Accounts; State Budget Papers and Mid-Year Reviews 2006-07; Economics@ANZ.

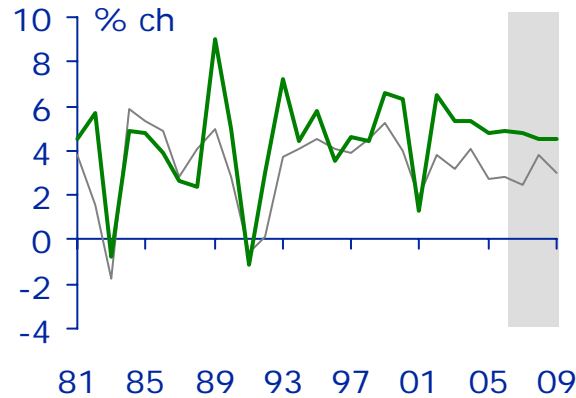
Different growth rates across the States aren't unusual: what is unusual is NSW coming last

State and national real gross product growth rates

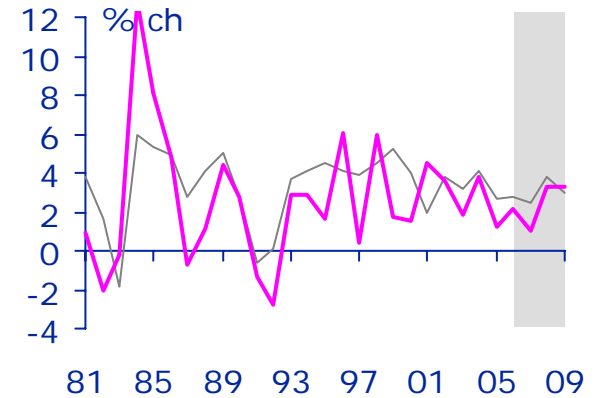
New South Wales



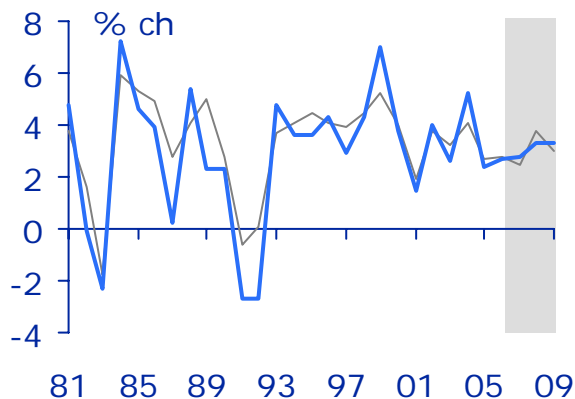
Queensland



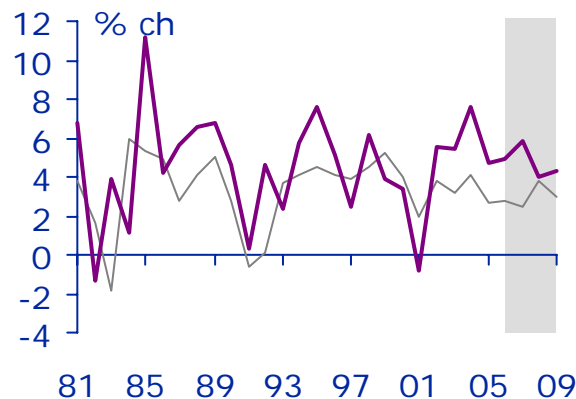
South Australia



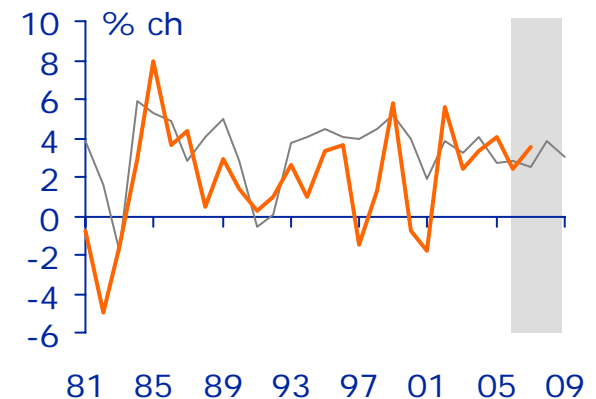
Victoria



Western Australia



Tasmania



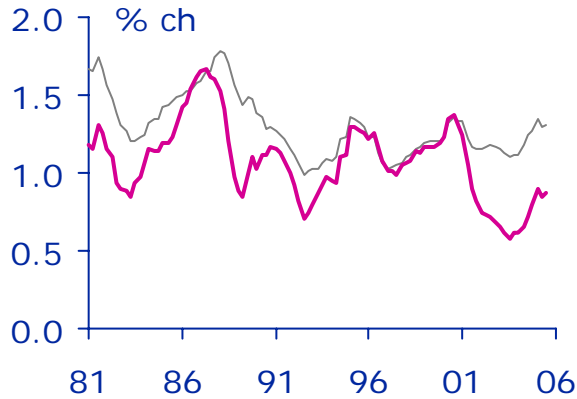
Note: Forecasts are from State Mid-Year Budget Reviews.

Sources: ABS; State Treasuries; Economics@ ANZ.

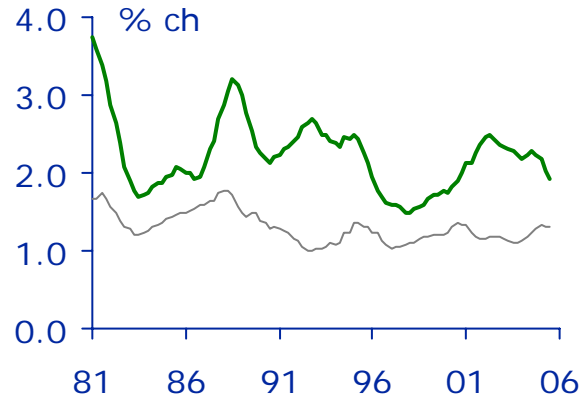
Below-average population growth is detracting from economic growth in NSW and SA

State and national population growth rates

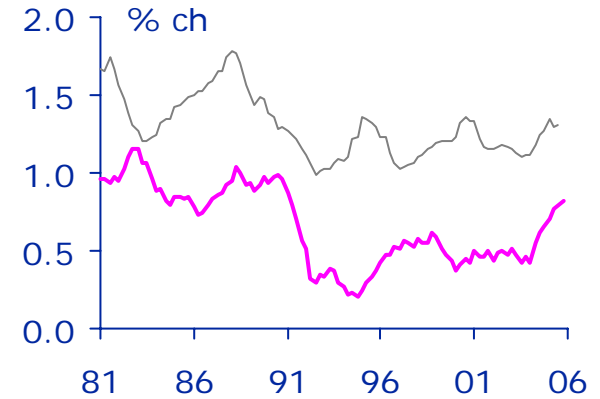
New South Wales



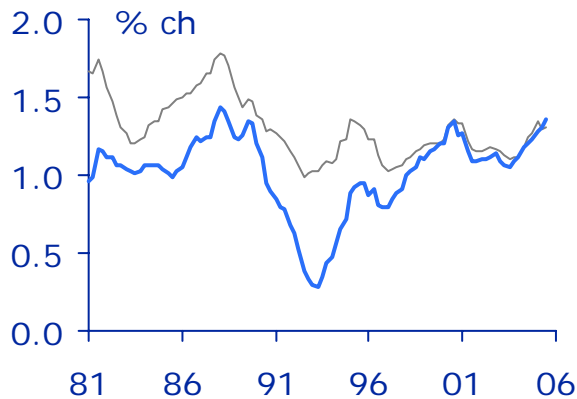
Queensland



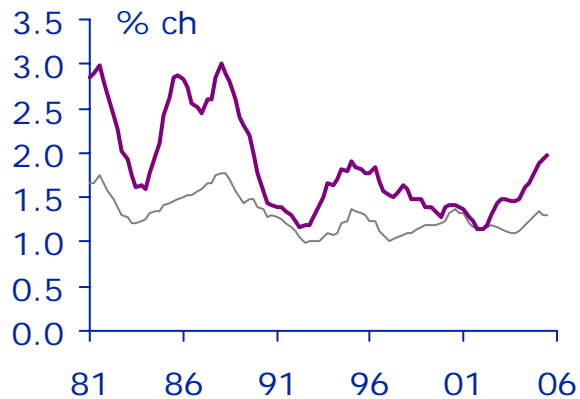
South Australia



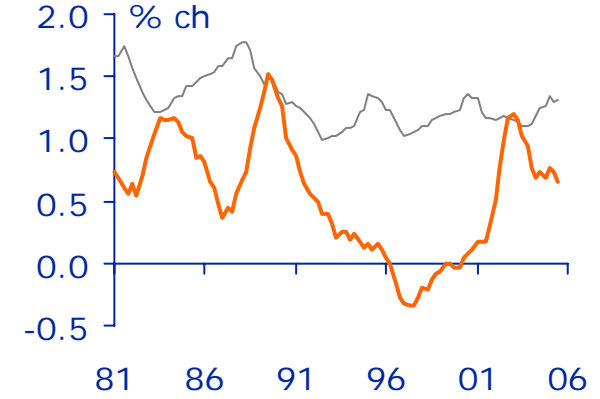
Victoria



Western Australia



Tasmania



Sources: ABS; Economics@ ANZ.

Summary

- The world economy is experiencing its longest run of above-trend growth in more than 30 years
 - driven largely by sustained growth in the developing economies
 - risks to this outlook are more geo-political than strictly economic
- Strong world growth, biased towards commodity-intensive activities, and a more globally consolidated mining industry, underpin a commodity boom that is likely to last longer than previous episodes
 - that doesn't mean commodity prices will keep rising – rather, that they will fall less and more slowly from their peaks
- The Australian economy looks exceptionally well situated ...
 - in global circumstances which have been very 'friendly' to Australia
- ... but it is now beginning to encounter a 'speed limit'
 - as it increasingly runs into capacity constraints
 - and as many of the growth drivers of earlier years fade away
- Provided government policy either accepts this speed limit (or seeks to lift it through productivity-enhancing reforms) inflation is likely to remain in the upper half of the 2-3% target band
 - so after three increases last year interest rates may have peaked
 - but it's unlikely that rates will fall until late this year
- There's nothing unusual about the 'two-speed' pattern of growth
 - Qld incomes should converge towards the national average over next four years

Summary of the economic outlook for Australia

	2005	2006	2007	2008
Real GDP growth (%)	2.8	2½	2¾	3½
Employment growth (%)	3.2	2.0	2¼	1¾
Unemployment rate (%) ^(a)	5.2	4.6	4¾	4½
Housing starts ('000s)	152	151	145	163
Motor vehicle sales ('000s)	992	1,000	1,010	1,030
CPI inflation (%) ^(b)	2.7	3½	2¼	2½
Wage cost (WCI) inflation (%) ^(b)	4.1	4	4¼	4
Current account deficit (\$bn)	54.1	51	54	48
Current account deficit (% GDP)	5.8	5	5	4¼
Net foreign debt (% of GDP) ^(a)	49	52	53	55

(a) December (b) Year to December quarter; all other forecasts are year-average

Australian currency and interest rate forecasts

	Dec 2006 *	Jun 2007	Dec 2007	Dec 2008
RBA cash rate	6.25	6.25	6.00	5.75
90-day bill rate	6.45	6.40	5.80	6.00
10-year bond yield	5.88	5.80	5.65	5.90
Standard variable mortgage rate	8.05	8.05	7.80	7.55
A\$ - US\$	0.79	0.76	0.74	0.69
A\$ - ¥	91.5	88.9	81.2	75.1
A\$ - €	0.60	0.59	0.57	0.56
A\$ - £	0.40	0.40	0.39	0.38
A\$ - NZ\$	1.12	1.12	1.19	1.29
Gold (US\$/ounce)	629	650	670	680

* actual