

RBA's first move

08 October 2009

Inside:

Macroeconomic update	2
Forecasts	5

Authors:

Warren Hogan
Acting Chief Economist and
Head of Australian Economics and
Interest Rate Research
+61 2 9227 1562
Warren.Hogan@anz.com

Tony Morriss
Senior Rates Strategist
61 2 9226 6757
Tony.Morriss@anz.com

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

Shane Lee
Senior Economist
Shane.Lee@anz.com

Julie Toth
Senior Economist
+61 3 9273 6252
Julie.Toth@anz.com

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

Daniel Bae
Analyst
+61 2 9227 1272
Daniel.Bae@anz.com

Our Vision:

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.

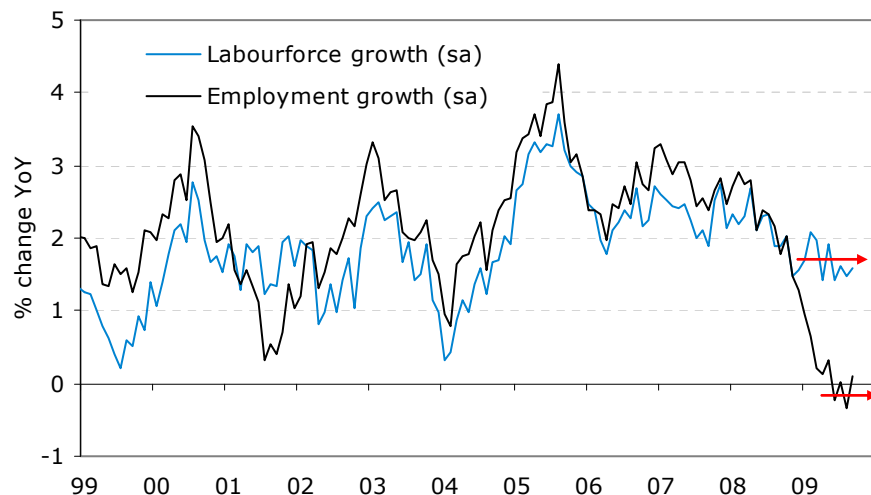
Macroeconomic update: RBA begins long road back to neutral

- This week's rate hike is the first move in taking monetary policy back to a more neutral or normal setting.
- The first phase is the removal of the 'emergency' policy setting of 3.00% and is likely to involve three further 25bp rate hikes spanning the upcoming summer period.
- The second phase will be a move in the cash rate back to a genuinely neutral setting, above 5.00%. We anticipate the economic conditions for this phase will not be in place until 2011.
- We therefore expect an extended pause in the monetary policy tightening cycle throughout much of 2010.

Chart of the week: jobs growth pace picks up in September, but unemployment risks remain

- **Australian labourforce growth** has slowed from around 2.5% p.a. through 2007 and 2008 to 1.5% p.a. through 2009. The participation rate has dropped from 65.5% last year to 65.2% today, as is normal through a downturn.
- **Employment growth** has fallen even more sharply, from 2.5 to 3.0% until mid 2008, to flat or sub-zero growth in 2009. September saw a small growth spurt in jobs of 0.1% p.a.
- **Unemployment** remains under pressure from this ongoing gap between labourforce growth (supply) and jobs growth (demand). The unemployment rate has stayed steady at around 5.8% for the last five months (see figure 3), but this gap is an ongoing risk to unemployment, at least until jobs growth gains enough strength to counter labour supply growth.

Figure 1: Labourforce growth is still strongly outpacing jobs growth



Source: ABS

Warren Hogan
 Acting Chief Economist
 +61 2 9227 1562
 Warren.Hogan@anz.com

Macro update: RBA begins long road back to neutral

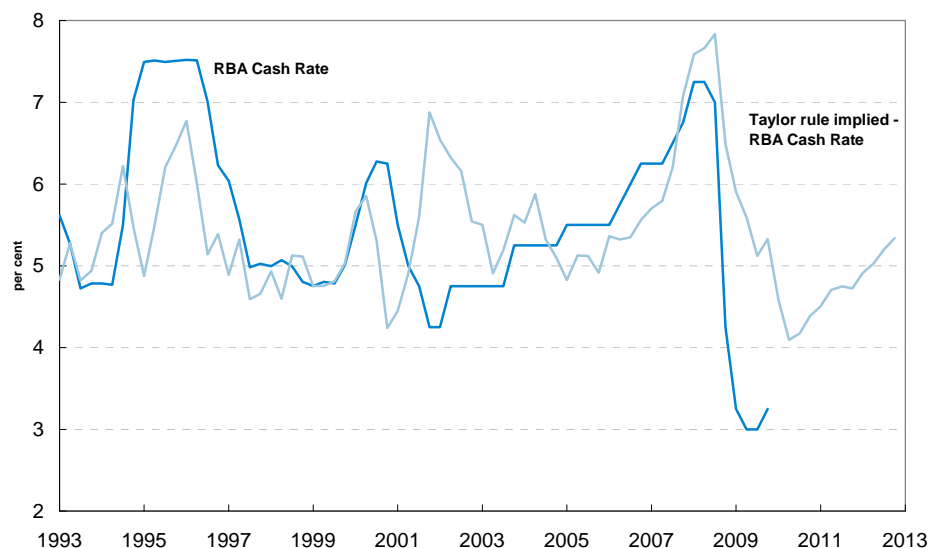
- This week's rate hike is the first move in taking monetary policy back to a more neutral or normal setting.
- The first phase is the removal of the 'emergency' policy setting of 3.00% and is likely to involve three further 25bp rate hikes spanning the upcoming summer period.
- The second phase will be a move in the cash rate back to a genuinely neutral setting, above 5.00%. We anticipate the economic conditions for this phase will not be in place until 2011.
- We therefore expect an extended pause in the monetary policy tightening cycle throughout much of 2010.

Taking rates back to neutral

Many economists and commentators have described this rate hike as the first move in taking monetary policy back to a neutral or normal setting. While that may well be the case, we believe that the return to a neutral cash rate will take a number of years and is likely to come in two phases.

In this context it is important to understand what the neutral rate is. Most economists, including the RBA, believe a neutral cash rate in Australia is around 5% to 6%. This static concept may well be relevant over the long-term but at any point in time the neutral rate can vary. In our view wider credit spreads and high levels of household debt imply that this neutral rate might be towards the bottom of this range over the years ahead. On this basis we expect 5.25% to be a neutral cash rate in Australia over the next three to five years.

Figure 2: Rate tightening from the current historic low has commenced. Rates are still lower than some standard indicators would imply.



Source: RBA and ANZ

Rate normalisation to happen in two phases

The first phase will remove the 'emergency' policy setting and is likely to involve three further 25bp rate hikes spanning the upcoming summer period. In our estimation a cash rate of around 4% in early 2010 is broadly appropriate. This is based on economic growth next year of around 2% and inflation of around 2%. While this is still expansionary monetary policy, we view this as appropriate given an economy growing below the potential rate (and thus unemployment still drifting up slowly) and our forecast for core inflation to be falling next year (and in 2011).

When the cash rate is along way from neutral the RBA is inherently uncomfortable. A policy error is more likely to occur when cash rates are substantially different to a long-run average rate. In this sense the RBA move this week, and our expectation that the cash rate will rise another 75bp over the next six months, can be seen as getting rate closer to a neutral setting in the context of an economy that is relatively stable and experiencing support from fiscal policy.

The second phase will be a move in the cash rate back to a genuinely neutral setting which we have in the forecasts as 5.25%. The RBA will want to see a sustained recovery in the global economy (and an upward trend for global interest rates) to be firmly in place; unemployment to have 'peaked' and even be falling (particularly if the unemployment rate rises to our forecast peak of around 7%) and for the economic outlook to be reasonably strong. We do not anticipate these conditions to be in place until 2011.

We therefore have an extended pause in the monetary policy tightening cycle throughout much of 2010.

Growing risk of a quicker removal of the 'emergency' setting

The latest employment figures highlight a growing risk that the economy is returning to a trend rate quicker than anyone had previously thought. The employment numbers are highly volatile and we should not read too much into one month's number. That said the unemployment rate has been stable at around 5.7% to 5.8% for the past five months. If this continues, the implication is that the economy is actually growing at something more like a 3% p.a. (trend) rate than the sub-trend rate of 1 to 2% p.a. we are currently forecasting. With inflation currently running around 3% and the economy growing at 3%, then a 3.25% cash rate looks well out of line with the underlying economy.

The economic data over the months ahead will be critical but continue upside surprises may give the RBA a greater urgency in removing the emergency policy setting which we define as getting the cash rate back to 4%. This may involve 25bp rate hikes at each meeting until 4% is reached in February or even a 50bp move at the next meeting. Much depends on the next round of monthly data, including retail sales, as well as the quarter inflation report due at the end of the months.

Figure 3: Unemployment rate has stabilised at around 5.8% for now



Source: ABS

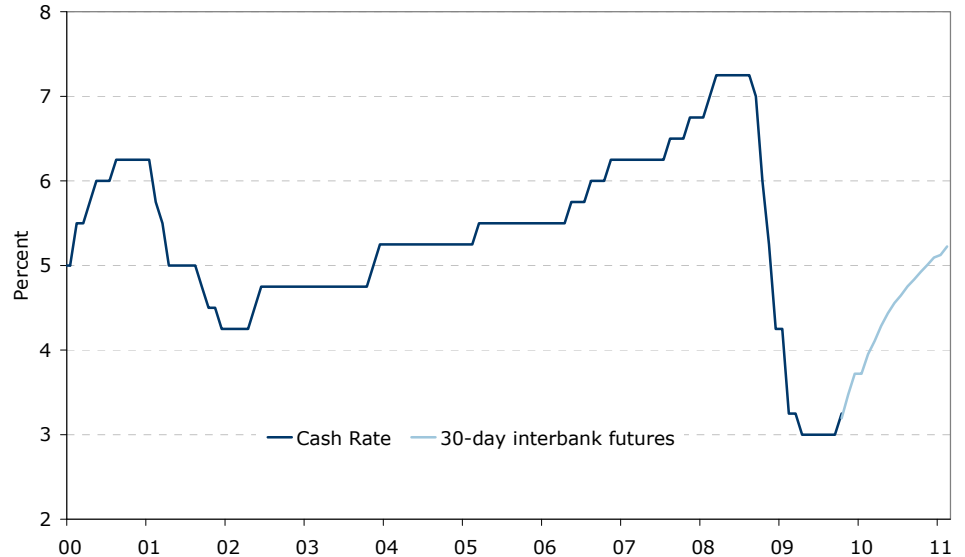
Market pricing and term rates

The market is 'pricing-in' a more aggressive tightening cycle than we expect. Our interpretation of yields from 2 to 3 years in maturity is that the market is

expecting a cash rate of around 5.5% to 6% by mid 2011. The market has priced in a full normalisation of interest rates over the next 18-months.

In our view, there still is a greater risk that this expectation will be disappointed on the downside than the upside. To fix floating rates out three years or more right now involves effectively locking a whole tightening cycle that may not be delivered. We would be more inclined to look at short-term fixes out to 12 to 15 months.

Figure 4: Market is pricing in a steep rate rise sequence from here



Source: RBA and Bloomberg.

Data wrap

- **Employment** went up 40.6K in September (+0.4% MoM and +0.1% YoY).
- The **unemployment rate** fell to 5.7% in September from 5.8% in August.
- The **participation rate** edged up to 65.2% in September from 65.1% in August.
- **Aggregate hours worked** grew 0.9% in September (but fell 1.4% YoY).
- **Housing finance commitments** fell 0.6% in August by number, but increased 0.7% by value. Excluding refinancing, the number of new approvals grew 1.3%. The proportion of first home buyers seeking approvals fell to 24.7%.
- **The RBA cash rate** rose to 3.25% from 3.00%.
- The **trade deficit** improved to \$1.5bn in August, from a revised \$1.8bn in July.
- The **ANZ Job Advertisement** series grew by 4.4% in September, but remained 44.9% lower than a year ago.
- Australian Industry Group's **Performance of Construction Index** increased to 50.8 points in September, from 42.4 in August.
- Australian Industry Group's **Performance of Services Index** increased to 49.3 points in September, from 48.0 in August.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.4	-0.1	1.8	3.8
Household consumption	2.6	1.4	1.7	3.0
Dwelling investment	2.8	-7.6	5.3	5.9
Business investment	13.9	-3.0	0.2	5.8
Public demand	6.2	2.6	7.1	4.4
Domestic final demand	4.8	0.5	3.0	4.0
Inventories (contribution to GDP)	-0.7	-0.3	0.6	0.0
Gross National Expenditure (GNE)	4.1	0.1	3.5	4.0
Exports	3.8	1.1	1.4	4.6
Imports	11.3	-9.6	6.9	9.5
Net Exports (contribution to GDP)	-1.8	2.6	-1.2	-1.2
Gross Domestic Product (GDP)	2.4	-0.4	2.0	3.1
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.4	2.1
Underlying*	4.4	3.7	2.4	2.1
Wages	4.2	3.6	2.9	3.3
Labour market				
Employment (annual % change)	-38.4	-133.8	0.4	1.4
Unemployment rate (%)	4.2	112.9	6.7	6.6
External sector				
Current account balance: A\$ bn	-54.5	-48.4	-55.8	-62.1
% of GDP	-4.6	-4.1	-4.4	-4.6

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

Australian interest rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
RBA cash rate	3.25	3.50	4.00	4.00	4.00	4.00
90 day bill	3.64	3.90	4.35	4.25	4.25	4.25
3 year bond	4.92	4.95	4.95	5.10	5.25	5.40
10 year bond	5.25	5.25	5.20	5.30	5.45	5.60
3s10s yield curve	0.34	0.30	0.25	0.20	0.20	0.20
3 year swap	5.45	5.40	5.40	5.55	5.70	5.85
10 year swap	5.91	5.85	5.80	5.85	6.00	6.15
International interest rates						
RBNZ cash rate	2.50	2.50	2.50	2.50	3.00	4.00
NZ 90 day bill	2.76	2.80	2.80	2.80	3.63	4.47
US Fed funds note	0.25	0.25	0.25	0.25	0.50	0.75
US 2 year note	0.87	1.00	1.10	1.50	2.00	2.35
US 10 year note	3.19	4.00	4.00	4.30	4.50	4.55
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.25
ECB refinance rate	1.00	1.00	1.00	1.00	1.00	1.25
UK repo rate	0.50	0.50	0.50	0.50	0.50	1.00

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

Foreign exchange rates	Current	Dec 09f	Mar 10f	Jun 10f	Sep 10f	Dec 10f
Australian exchange rates						
A\$/US\$	0.90	0.89	0.92	0.91	0.89	0.87
NZ\$/US\$	0.74	0.71	0.72	0.71	0.69	0.68
A\$/¥	79.6	78.3	79.1	80.1	80.1	80.0
A\$/€	0.61	0.60	0.61	0.61	0.60	0.59
A\$/£	0.56	0.53	0.55	0.55	0.54	0.53
A\$/NZ\$	1.22	1.25	1.28	1.28	1.29	1.28
A\$/CA\$	0.95	0.95	0.95	0.95	0.93	0.91
A\$/CHF	0.93	0.92	0.94	0.96	0.93	0.93
A\$/CNY	6.15	6.08	6.28	6.22	6.07	5.92
A\$ Trade weighted index	69.2	68.1	69.6	69.5	68.5	66.7
International cross rates						
US\$/¥	88.4	88.0	86.0	88.0	90.0	92.0
€/US\$	1.48	1.48	1.52	1.50	1.48	1.47
€/¥	130	130	131	132	133	135
£/US\$	1.60	1.67	1.67	1.65	1.64	1.65
€/£	0.92	0.89	0.91	0.91	0.90	0.89
US\$/CA\$	1.06	1.07	1.03	1.04	1.04	1.05
US\$/CHF	1.03	1.03	1.02	1.05	1.05	1.07
US\$ index	76.1	75.4	73.7	74.7	75.6	76.3
Asia exchange rates						
US\$/CNY	6.83	6.83	6.83	6.83	6.82	6.80
US\$/HKD	7.75	7.75	7.75	7.76	7.77	7.77
US\$/IDR	9366	9500	9500	9625	9500	9250
US\$/INR	46.3	47.0	46.5	46.0	46.0	45.0
US\$/KRW	1169	1125	1100	1150	1175	1050
US\$/MYR	3.40	3.41	3.34	3.37	3.40	3.40
US\$/PHP	46.5	47.0	46.0	46.5	46.0	45.0
US\$/SGD	1.39	1.40	1.39	1.40	1.41	1.41
US\$/THB	33.30	33.00	33.00	33.00	32.50	32.50
US\$/TWD	32.13	31.50	31.00	31.30	31.50	30.30
US\$/VND	17848	18500	18500	18500	18500	19300
Pacific exchange rates						
PGK/US\$	0.377	0.374	0.392	0.381	0.395	0.386
FJD/US\$	0.521	0.523	0.534	0.528	0.519	0.512

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

100 Queen Street, Melbourne, Victoria, 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 FINRA [www.finra.org] and SEC)

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

This document ("document") is distributed to you in Australia and the United Kingdom by Australia and New Zealand Banking Group Limited ABN 11 005 357 522 ("ANZ") and in New Zealand by ANZ National Bank Limited ("ANZ NZ"). ANZ holds an Australian Financial Services licence no. 234527 and is authorised in the UK and regulated by the Financial Services Authority ("FSA").

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of ANZ), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any securities referred to herein should contact ANZ S, not its affiliates.

This document is being distributed in the United Kingdom by ANZ solely for the information of its eligible counterparties and professional clients (as defined by the FSA). It is not intended for and must not be distributed to any person who would come within the FSA definition of "retail clients". Nothing here excludes or restricts any duty or liability to a customer which ANZ may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZ, ANZ NZ, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZ, ANZ NZ, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will directly or indirectly relate to specific recommendations or views expressed about any securities or issuers in this document. ANZ, ANZ NZ, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.