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Open possibilities

# **Economics, interest rates and currencies chart pack**

**Presentation to ANZ Senior Management**

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## Summary of economic forecasts

	2007	2008f	2009f	2010f
	<b>World economy</b>			
Oil prices (US\$ per barrel)	72	100	42	58
US GDP growth (%)	2.0	1.3	-1 <sup>3</sup> / <sub>4</sub>	2
Euro area GDP growth (%)	2.5	1	-1 <sup>1</sup> / <sub>4</sub>	<sup>3</sup> / <sub>4</sub>
Japan GDP growth (%)	2.1	0	-1 <sup>1</sup> / <sub>2</sub>	1
China GDP growth (%)	11.8	9.1	6 <sup>3</sup> / <sub>4</sub>	8 <sup>1</sup> / <sub>2</sub>
World GDP growth (%)	4.7	3 <sup>1</sup> / <sub>2</sub>	<sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>
	<b>Australian economy</b>			
Real GDP growth (%)	4.0	2 <sup>1</sup> / <sub>4</sub>	0	2
Unemployment rate (year-end, %)	4.3	4 <sup>1</sup> / <sub>2</sub>	6	7
'Underlying' inflation (year-end, %)	3.6	3.7	3 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>2</sub>
Current account deficit (% of GDP)	-6.3	-4 <sup>1</sup> / <sub>2</sub>	-5 <sup>3</sup> / <sub>4</sub>	-6 <sup>1</sup> / <sub>2</sub>
Credit growth (calendar year-end %)	16.4	6.7	5 <sup>3</sup> / <sub>4</sub>	6 <sup>1</sup> / <sub>2</sub>
	<b>New Zealand economy</b>			
Real GDP growth (%)	3.1	<sup>1</sup> / <sub>2</sub>	-1 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub>
Unemployment rate (year-end, %)	3.4	4.7	6 <sup>1</sup> / <sub>2</sub>	7
'Underlying' inflation (year-end, %)	3.2	3.4	2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub>
Current account deficit (% of GDP)	-8.2	-9	-6 <sup>1</sup> / <sub>4</sub>	-7
Credit growth (%)	14.0	10	2 <sup>1</sup> / <sub>4</sub>	3

## Summary of financial market forecasts

	Dec 08	Jun 09	Dec 09	Jun 10	Dec 10
	<b>International markets</b>				
US Fed funds rate (% pa)	0.25	0.25	0.25	1.00	2.00
US 10-year T-note yield (% pa)	2.20	2.70	2.90	3.50	4.25
ECB refi rate (% pa)	2.50	1.25	1.25	2.00	2.50
€ - US\$	1.27	1.22	1.09	1.09	1.13
US\$ - ¥	96	99	102	107	111
£ - US\$	1.54	1.44	1.40	1.43	1.55
Yuan – US\$	6.84	6.85	6.84	6.77	6.64
	<b>Australian markets</b>				
RBA cash rate (% pa)	4.25	2.75	2.50	2.50	4.00
90-day bill yield (% pa)	4.15	2.80	2.80	3.85	4.70
10-year bond yield (% pa)	4.00	4.15	4.25	4.75	5.55
A\$-US\$	0.66	0.60	0.55	0.55	0.60
	<b>New Zealand markets</b>				
RBNZ cash rate (% pa)	5.00	2.50	2.50	3.00	5.00
10-year bond yield (% pa)	4.87	4.60	4.80	5.20	5.90
NZ\$-US\$	0.56	0.45	0.41	0.43	0.46
AS-NZ\$	1.20	1.29	1.32	1.30	1.27

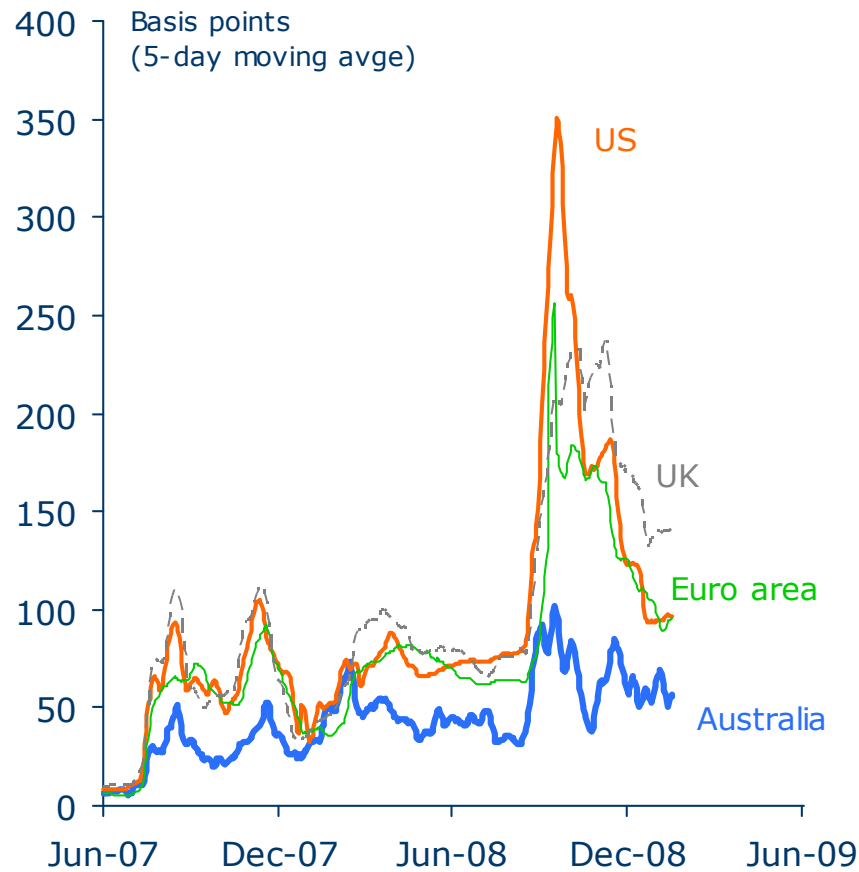
## The global credit crunch is moving into a new phase, with liquidity improving slowly but continued concerns about solvency

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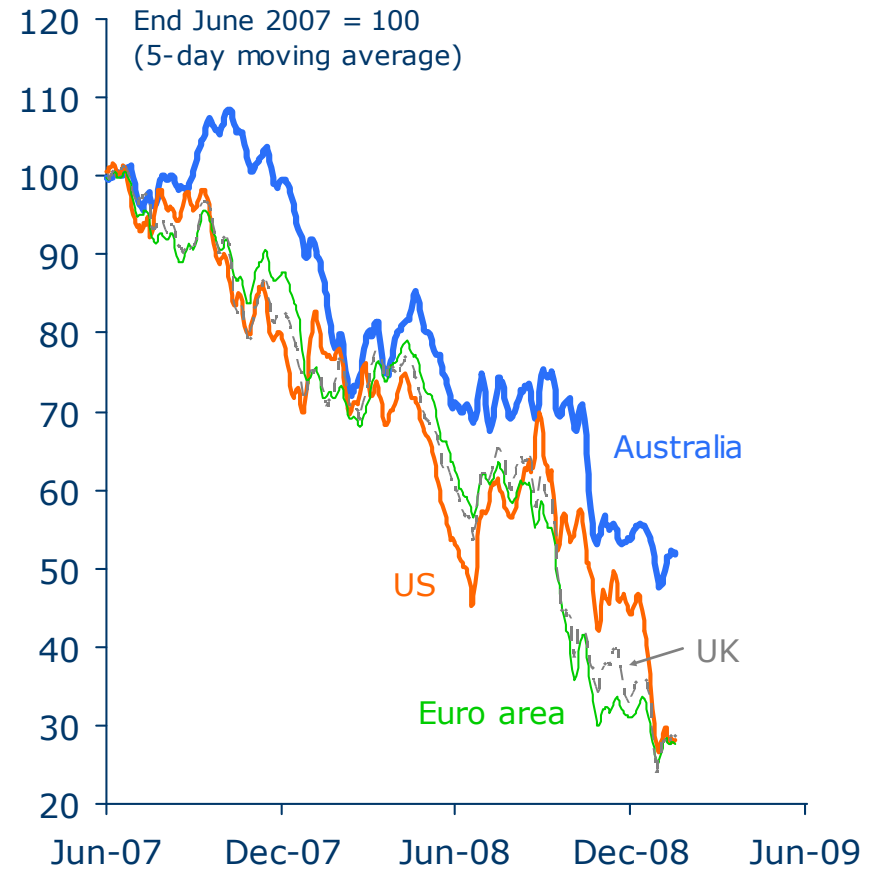
- **Measures taken since October last year (in particular government guarantees of wholesale borrowings and expansion of central bank balance sheets) have succeeded in shoring up the liquidity of the global banking system, and in re-kindling issuance in some limited areas of the debt securities markets.**
- **Bank funding cost spreads have retreated to around the levels prevailing just before the collapse of Lehman Bros in mid-September last year (though they remain elevated relative to pre July 2007 levels). With substantial support from the Fed, activity in the CP market has resumed. Around the world banks have issued around US\$305bn of government-guaranteed bonds since late last year. However very few corporates have been able to issue debt, and a growing number are instead raising new equity (usually at deep discounts).**
- **While liquidity may be improving, the solvency of many banks remains a continuing concern. As of end-January, banks had written off US\$743bn in losses on loans and securities (with losses at insurers and GSEs taking the total to US\$1,004bn). The IMF has revised up its estimate of the eventual total of losses from US\$1.4trn to \$2.2trn (with most of the upward revision attributable to losses on corporate and commercial real estate securities and business loans). To date, banks have raised US\$793bn in new capital, of which some \$356bn has come from governments (nearly all of it in the form of senior preferred equity).**
- **It seems inevitable that governments will need to commit further substantial sums (possibly as much as US\$1 trillion) by way of additional capital to banks, and/or purchasing 'toxic' assets from banks for transfer to a 'bad bank' agency (history suggests the latter might be a better option, but establishing the prices at which to transfer such assets remains a major problem). The terms on which any additional government capital might be provided are another source of uncertainty. These uncertainties, together with that over the continuing scale of eventual losses, continue to weigh on bank share prices.**
- **In other respects, financial markets appear to have reacted with surprising equanimity to the relentless tide of grim economic news. Mid-November lows in share prices have been tested but for the most part have held, suggesting that investors have already 'priced in' very poor outcomes for economic growth and corporate earnings, and/or set considerable faith in the adequacy and efficacy of the fiscal stimulus packages being brought forward by governments.**

# Governments & central banks have done enough to resolve concerns about bank liquidity, but not about bank solvency

### 3-month Libor-OIS spreads



### Bank share prices



Sources: Bloomberg; Thomson Financial Datastream.



Banks may need as much as another US\$1 trillion of capital – and most of it may have to come from governments

### Losses & write-downs announced since mid-2007

Country of origin	Total (US\$ bn)
United States	427.0
United Kingdom	118.0
Continental Europe	158.9
Canada	10.8
Japan	13.7
Other	14.1
<b>Total banks</b>	<b>812.0</b>
Other institutions*	258.7
<b>Total</b>	<b>1,038.5</b>

### Capital raised since mid-2007

Country of origin	Total (US\$ bn)
United States	411.1
United Kingdom	93.4
Continental Europe	218.7
Canada	15.8
Japan	14.1
Other	30.8
<b>Total</b>	<b>793.3</b>
Other institutions*	128.6
<b>Total</b>	<b>921.9</b>
of which, from governments	380.0

IMF says this total  
will ultimately reach  
US\$2,200bn

Banks may need another  
US\$800-\$1,000bn more  
in capital

\* 'Other institutions' include insurance companies and the US GSEs.  
Sources: Bloomberg; IMF; ANZ Economics & Markets Research.

# Markets have not breached their mid-November lows despite persistently awful economic data

### Share markets



### US share market volatility

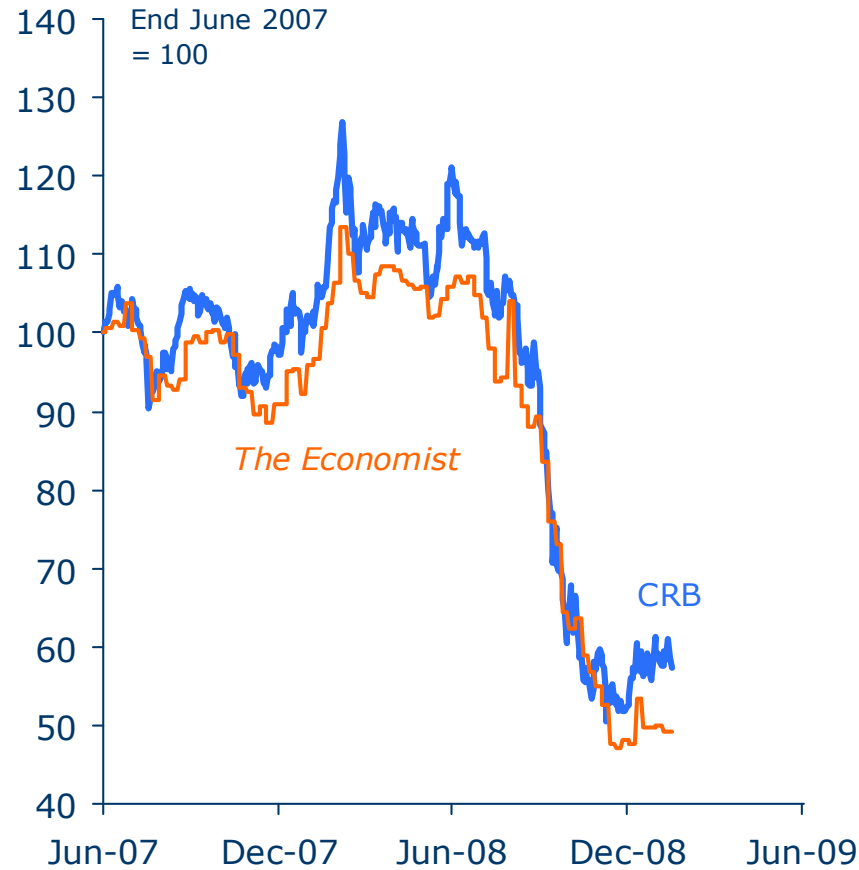


Source: Thomson Financial Datastream.



# Commodity markets have been noticeably resilient to the stream of bad news regarding industrial activity and trade

### Industrial commodity prices



### Baltic dry shipping costs



Source: Thomson Financial Datastream.





## The global economy turned down sharply in Q4 2008 and the outlook for at least the first half of 2009 is particularly grim

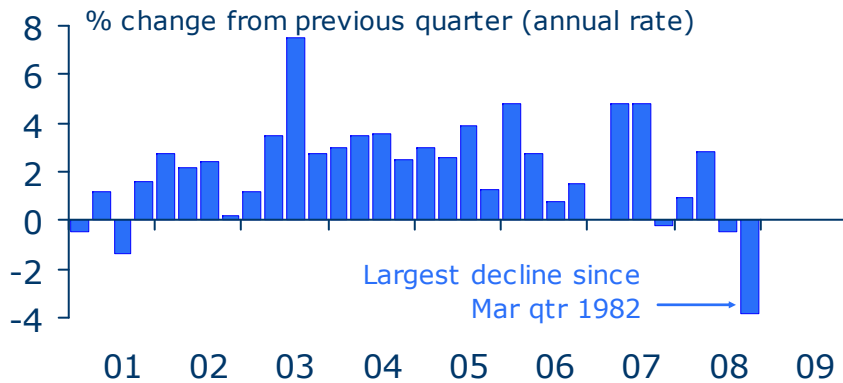
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- **Economic activity turned down sharply around the world last year, prompted by a dramatic loss of confidence following the collapse of Lehman Brothers and the seizing up of global credit markets. Households curtailed discretionary spending, manufacturing activity declined abruptly (leading in turn to sharp falls in international trade volumes, compounded by difficulties in accessing trade finance) and employers (especially in the US and UK) stepped up the pace of job-shedding.**
- **Although the downturn was initially concentrated in industrial countries, during the second half of last year it spread to most of the developing world, through trade linkages and (for countries with large external deficits) financial pressures. China in particular experienced a significant slowdown, in its case owing more to an abrupt downturn in fixed investment (partly induced by prior policy tightening) than to a slowdown in trade. Chinese imports have actually slowed more than its exports, so that its trade surplus has actually increased; however other Asian economies with significant export dependence on China as well as Western markets have experienced 20-30% declines in their exports.**
- **'Headline' inflation has fallen sharply around the world, largely reflecting abrupt falls in energy and other commodity prices. But 'core' inflation has also eased, and there is a significant risk of deflation in countries whose currencies have appreciated (including the US, Japan, China and some European countries)**
- **With the scope for conventional monetary policy responses to the downturn largely exhausted the focus has shifted dramatically to fiscal policy. Governments have foreshadowed stimulus packages of between 1 and 6 pc pts of GDP (in some cases, including the US, spread over two or more years). These measures will push budget deficits in advanced economies out to an average of 7% of GDP, and government debt (including the cost of financial bailouts) up by about 15-20 pc pts of GDP, this year; while emerging market government budgets will shift from a small surplus, on average, to deficits averaging about 3% of GDP.**
- **These policies carry some risks – although a rapid rise in inflation is not one of them (the Fed is not 'printing money' to finance the budget deficit, and Western governments had much higher debt-GDP ratios in the decades after World War II without experiencing high inflation). Higher taxes once a sustainable recovery begins are more likely. But the risks of not responding aggressively (including social unrest, protectionist pressures) are even greater.**

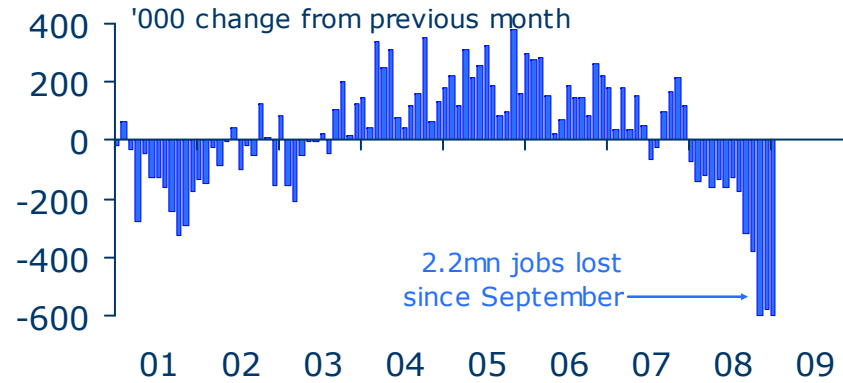
The US economy turned down sharply in the second half of last year – and the deterioration is continuing into 2009 <sup>10</sup>

### US economic activity and labour market

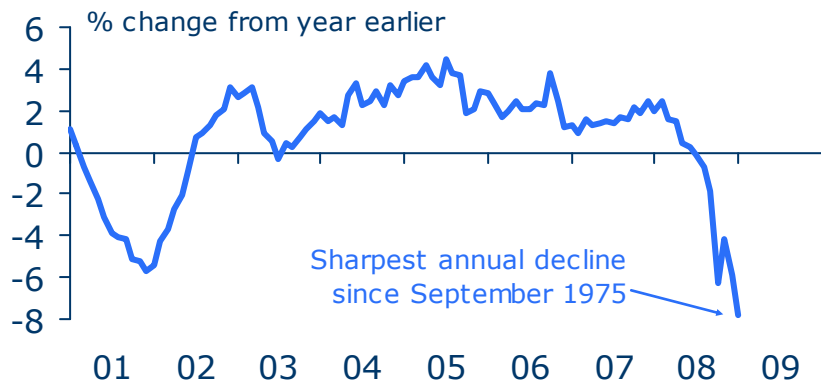
#### Real GDP



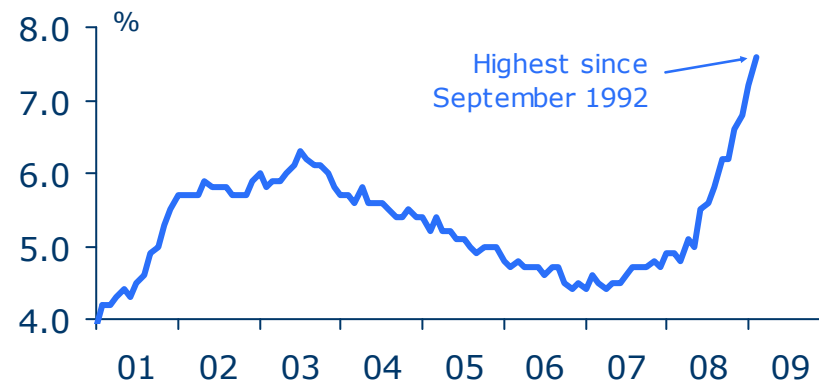
#### Employment



#### Industrial production



#### Unemployment rate



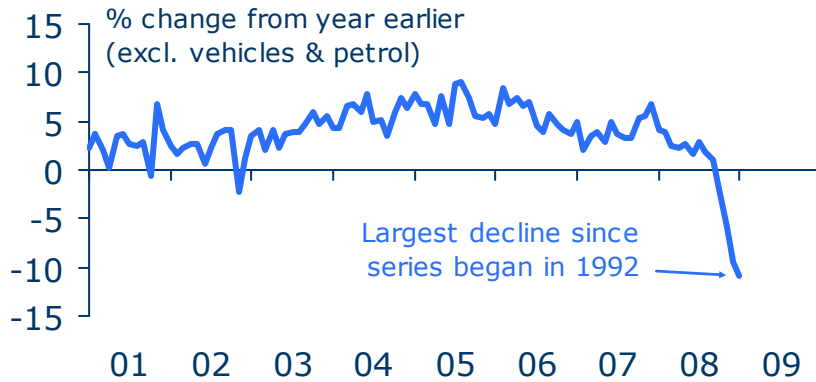
Sources: US Bureau of Economic Analysis; Federal Reserve; Bureau of Labor Statistics.



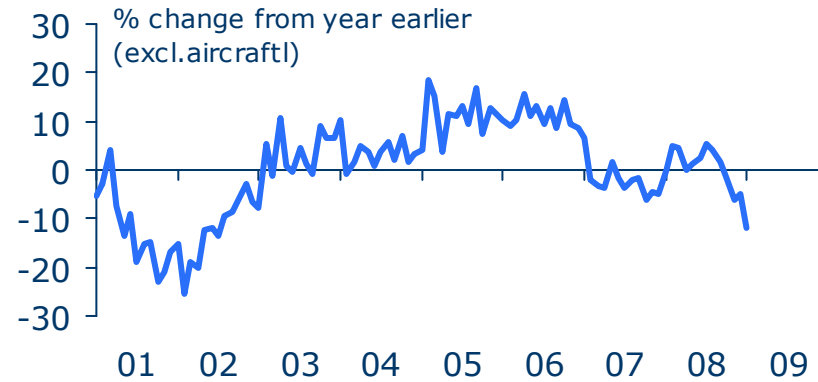
American consumers have been cutting back spending sharply  
– and businesses have started to cut back too

### US consumer and business spending

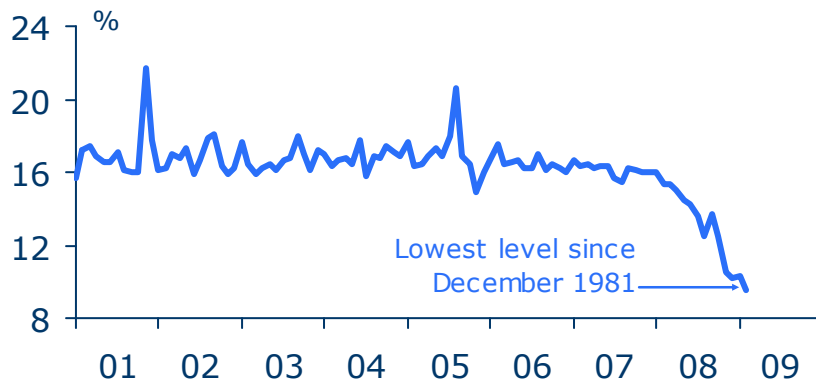
#### Real retail sales



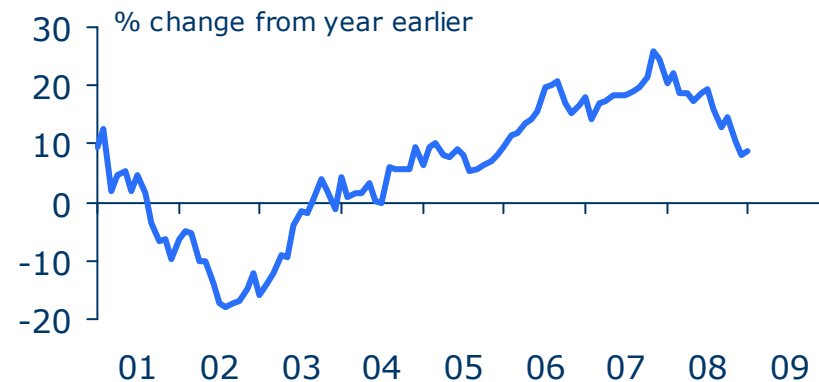
#### Non-defence capital goods orders



#### Motor vehicle sales



#### Non-residential construction



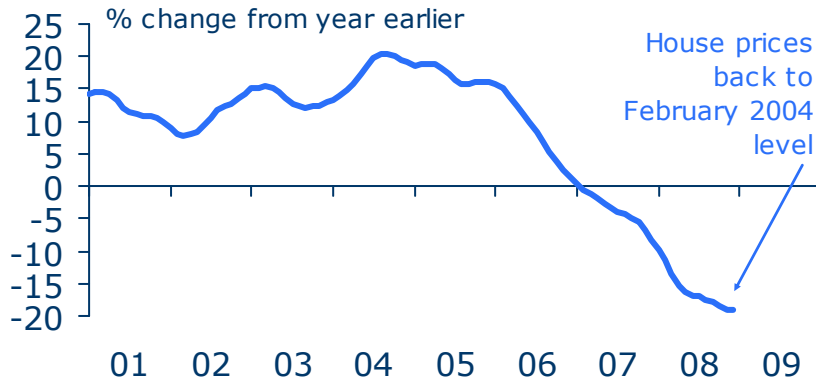
Source: US Commerce Department.



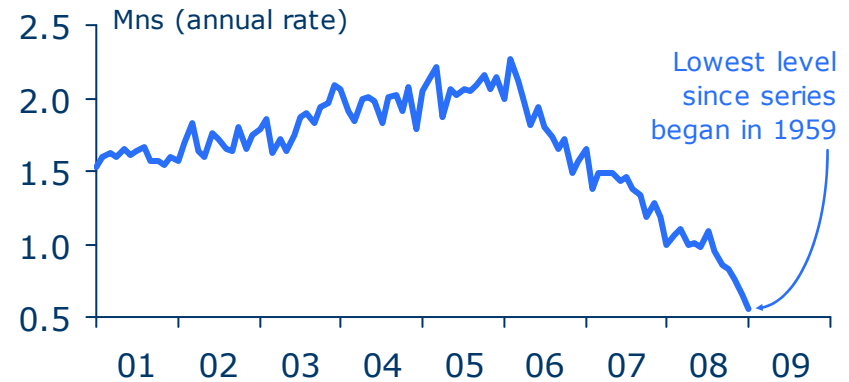
The US housing market remains exceptionally weak; but there is perhaps just a hint that the bottom could be in sight

### US housing market

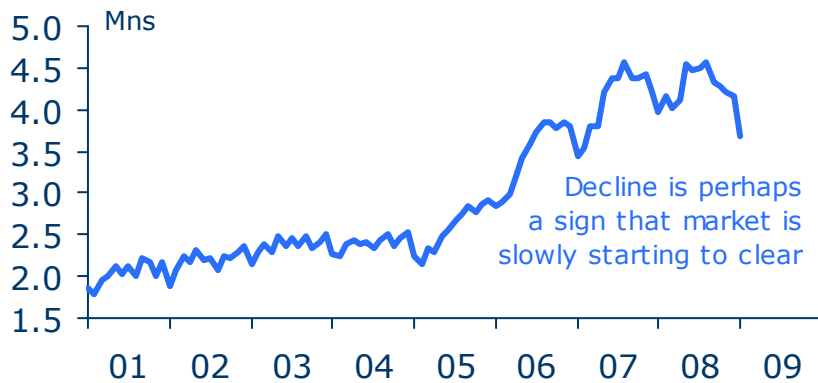
#### Established house prices\*



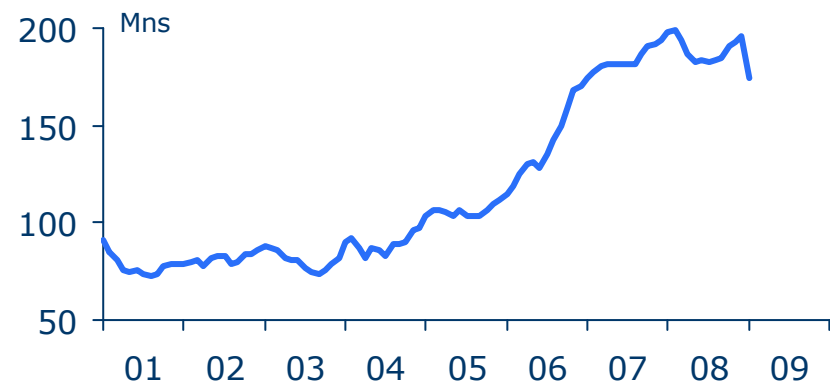
#### Housing starts



#### Established houses for sale



#### New homes for sale

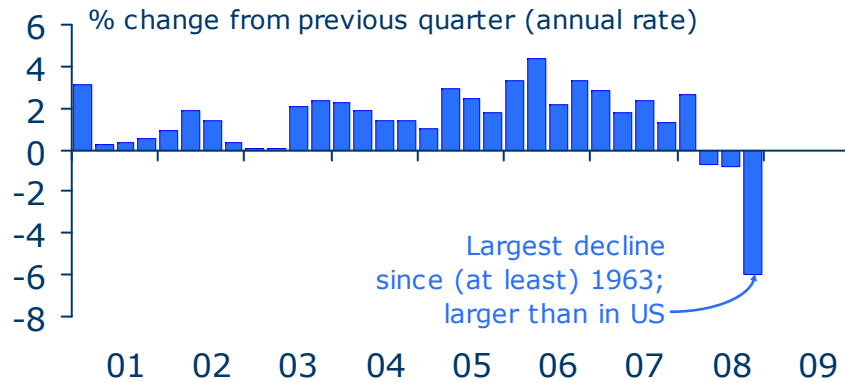


\* Case-Shiller index. Sources: S&P; Commerce Department; National Association of Realtors.

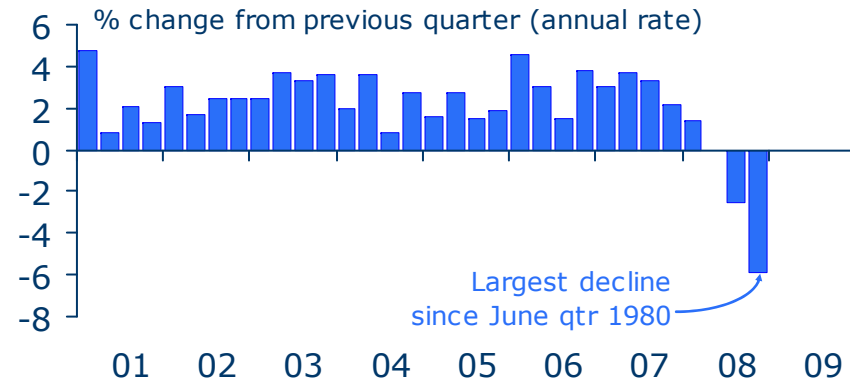


# The downturns in the euro area and the UK have been more severe than that in the United States

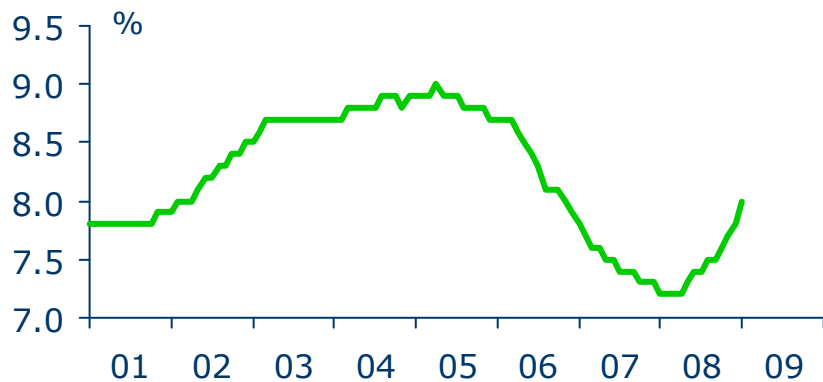
**Euro area**  
**Real GDP**



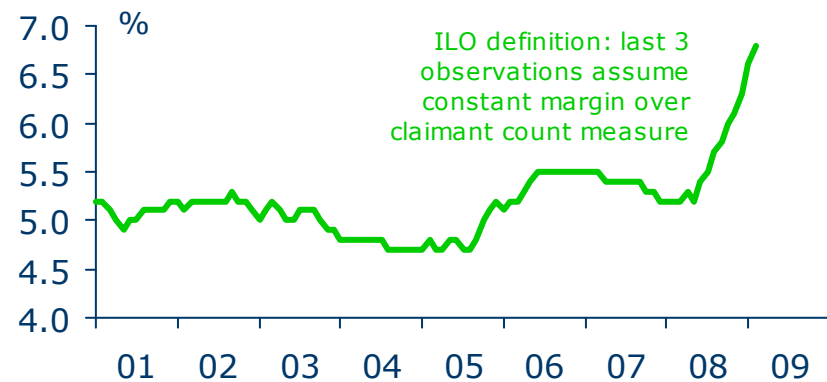
**United Kingdom**  
**Real GDP**



**Unemployment**



**Unemployment**



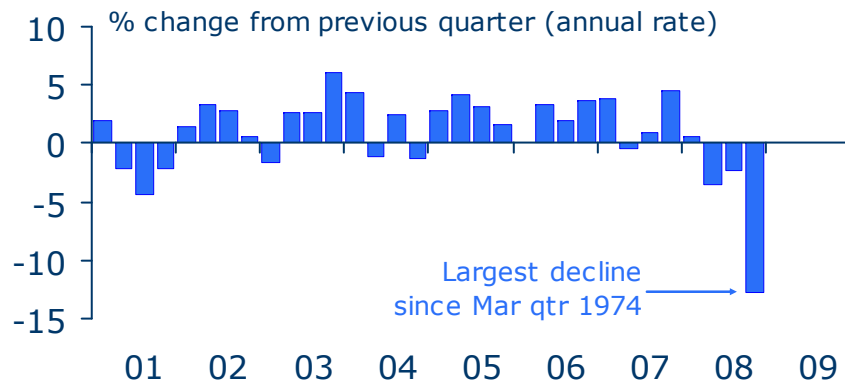
Sources: European Commission; Eurostat; Confederation of British Industry; UK Office of National Statistics; Datastream.



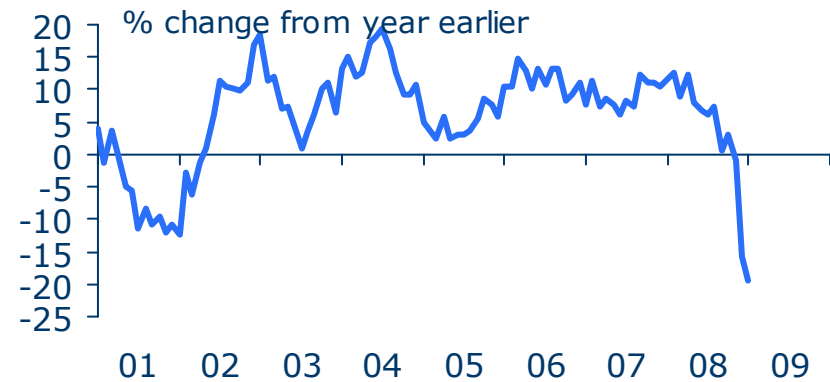
# Japan's economy experienced a dramatic downturn at the end of 2008

## Japan

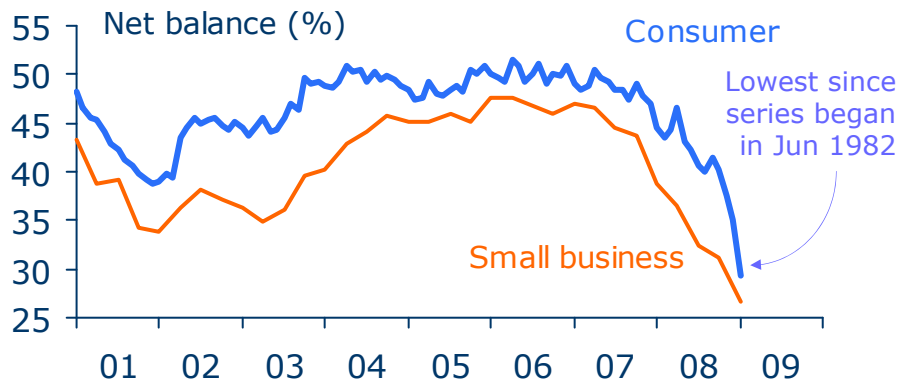
### Real GDP



### Export volumes



### Consumer confidence



### Unemployment



Sources: Japan Economic & Social Research Institute; Ministry of Economy, Trade and Industry; Japan Home Ministry.

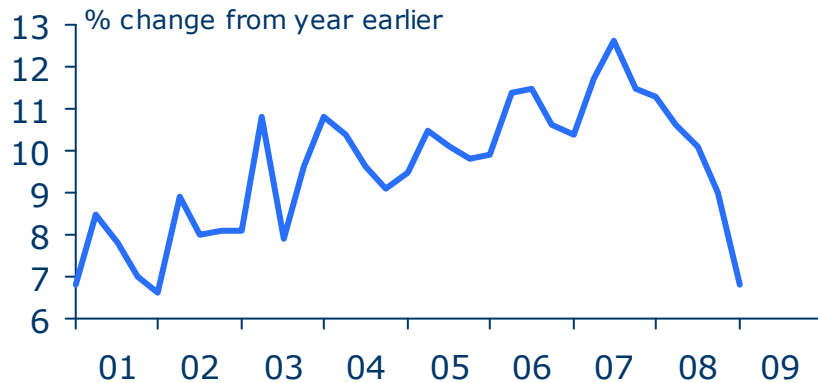


China slowed markedly late last year, only partly because of weaker exports, more because of a self-induced property collapse 15

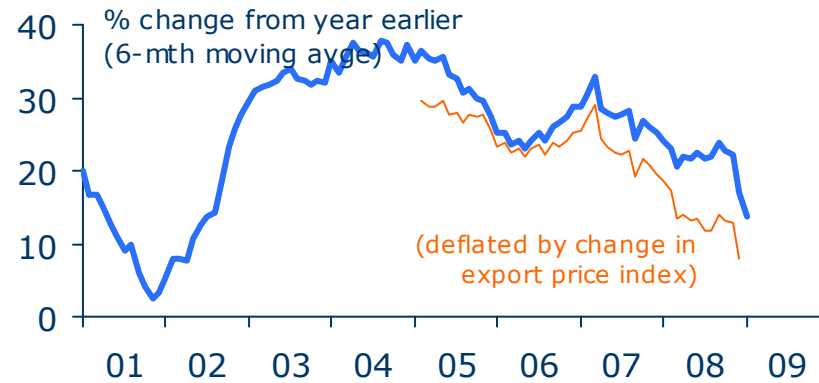
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### Chinese economic indicators

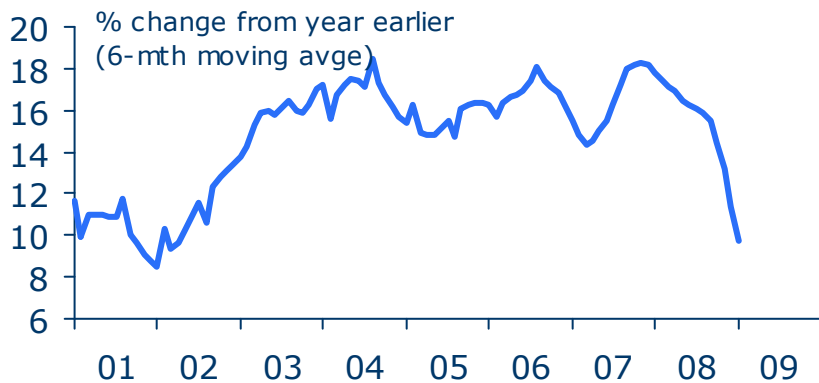
#### Real GDP growth



#### Exports



#### Industrial production



#### Real estate climate index



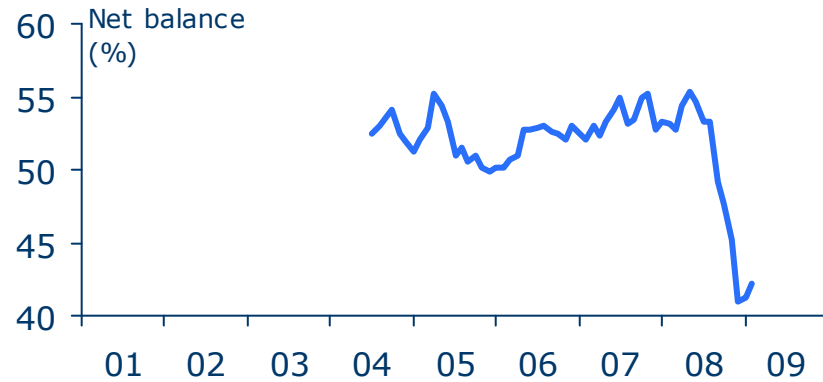
Source: China National Statistics Bureau; ANZ.



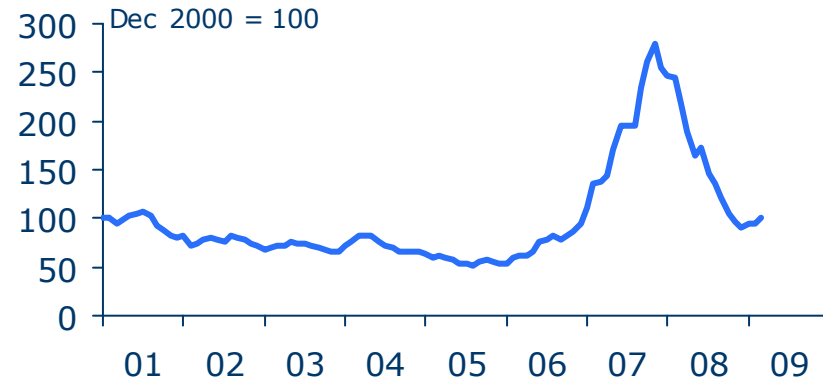
There are some 'straws in the wind' tentatively suggesting that China's strenuous efforts to revive growth may be taking hold <sup>16</sup>

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**Purchasing managers' index**



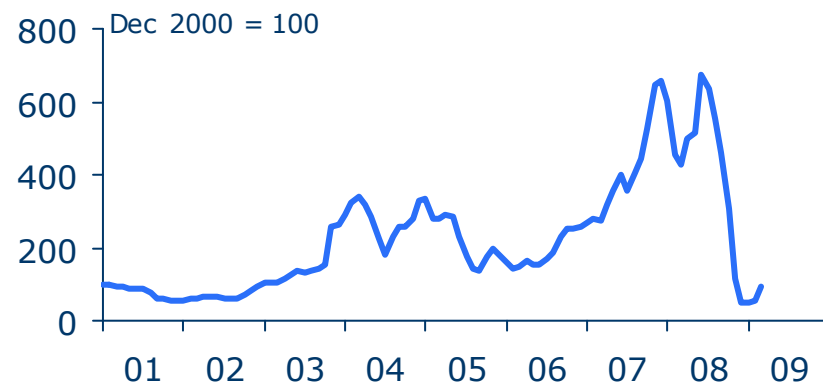
**Shanghai composite index**



**Bank lending**



**Shipping freight costs**



Source: CLSA; People's Bank of China; Datastream

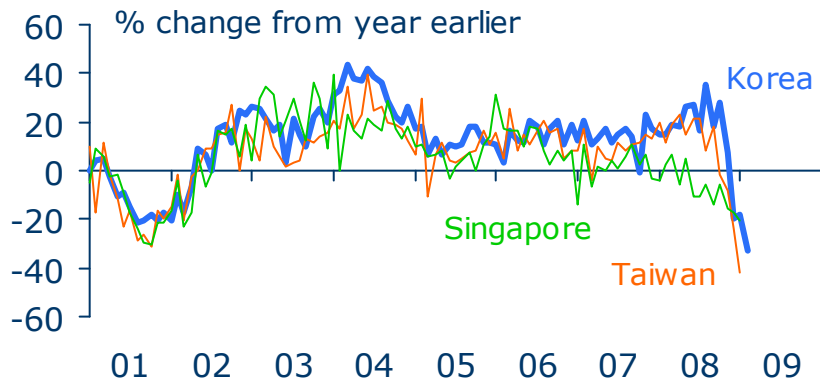




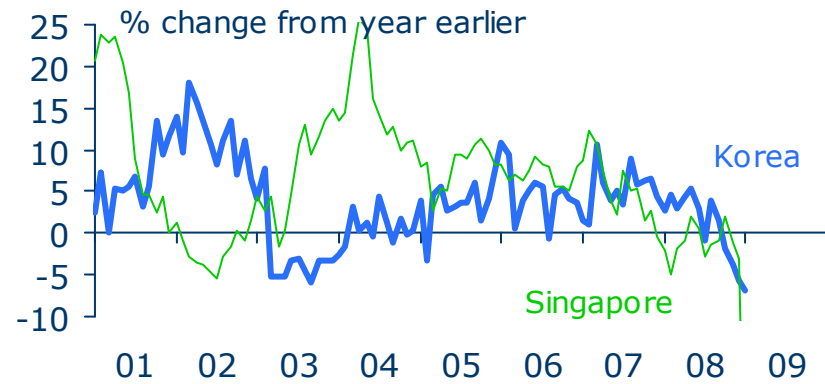
# Export-intensive smaller East Asian economies have been dragged into the global slowdown

## Smaller East Asian economies

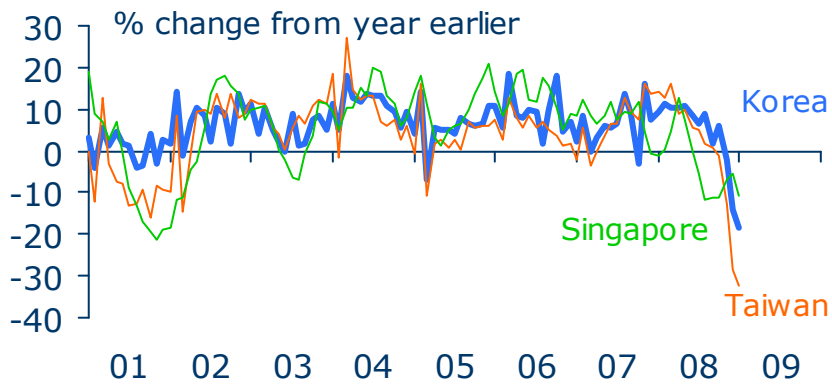
### Exports



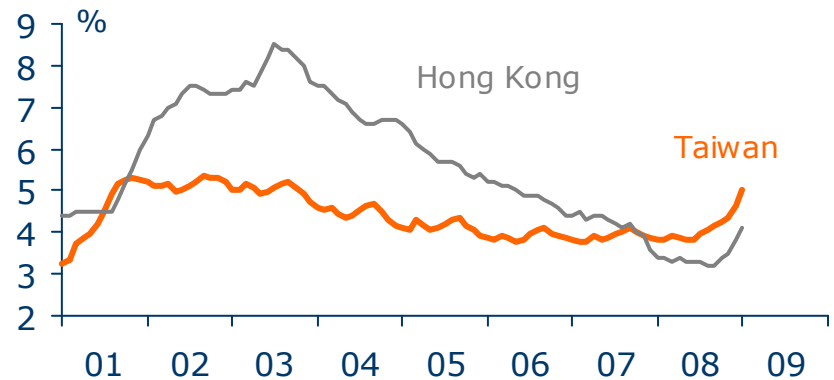
### Retail sales



### Industrial production



### Unemployment

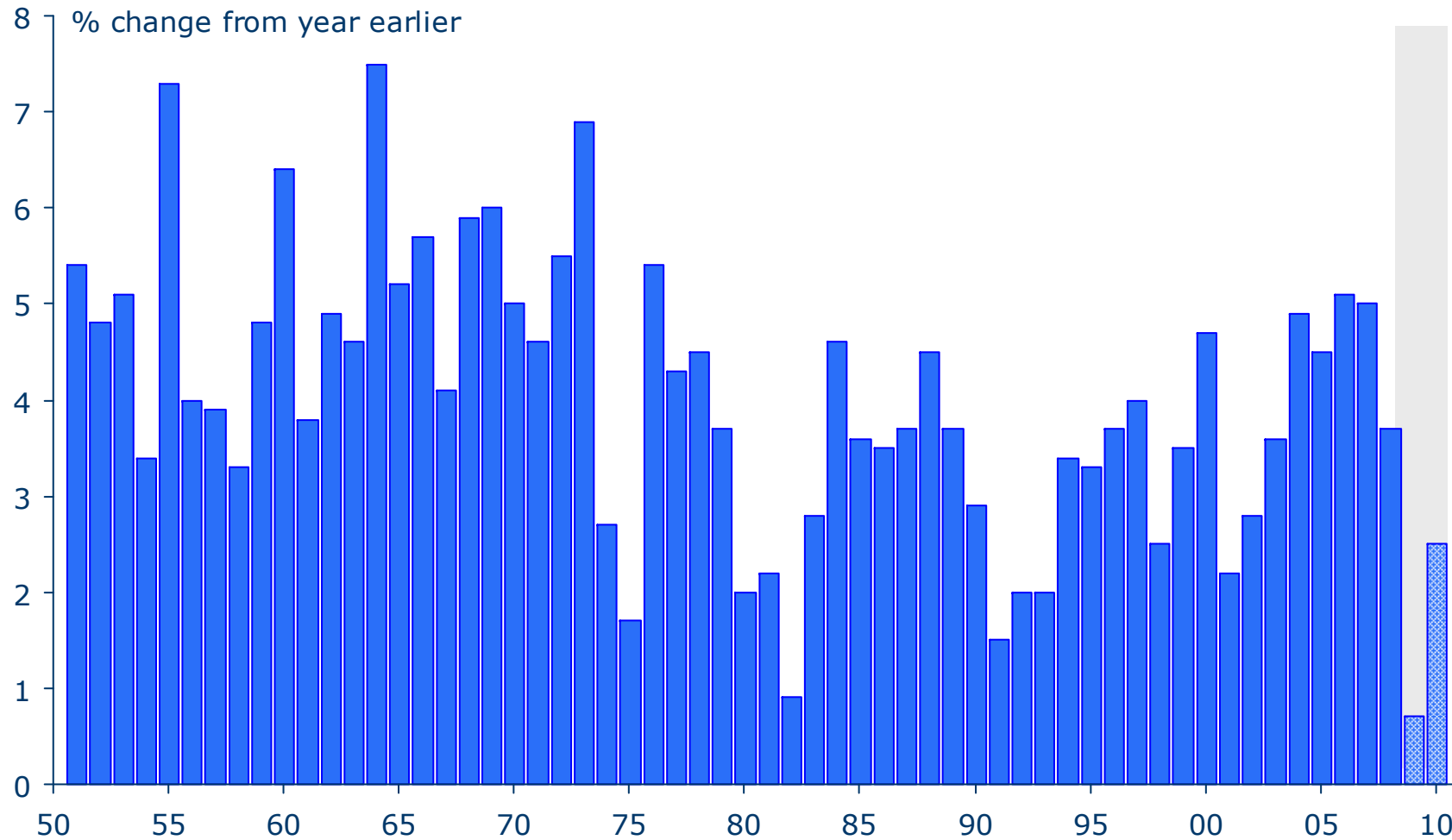


Sources: CEIC; Datastream; ANZ.



Global economic growth will be weaker in 2009 than in any year since the end of World War II<sup>18</sup>

### Global economic growth 1950-2010



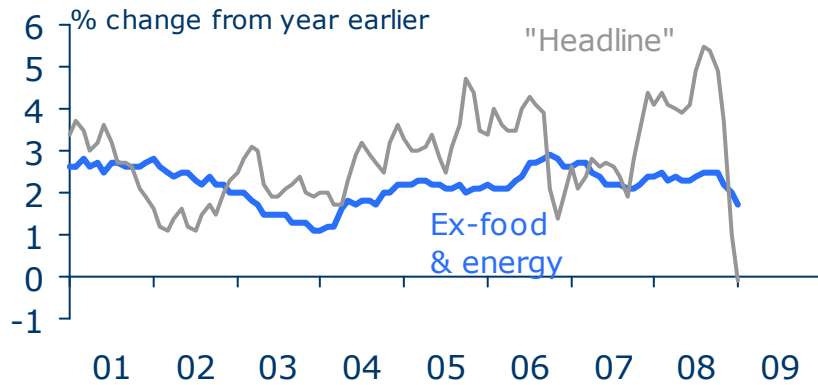
Sources: The Conference Board Total Economy Database (1950-70); IMF (1971-2008); ANZ (2009-10).



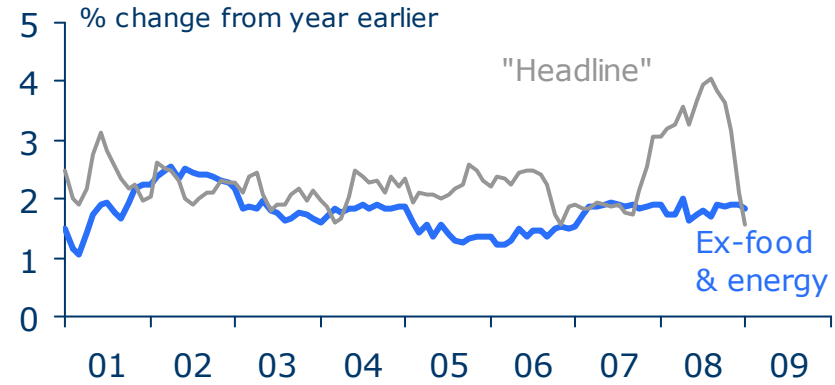
'Headline' inflation has fallen sharply in advanced economies, and core inflation is easing too – deflation is a risk for some

### Consumer prices – major industrialized economies

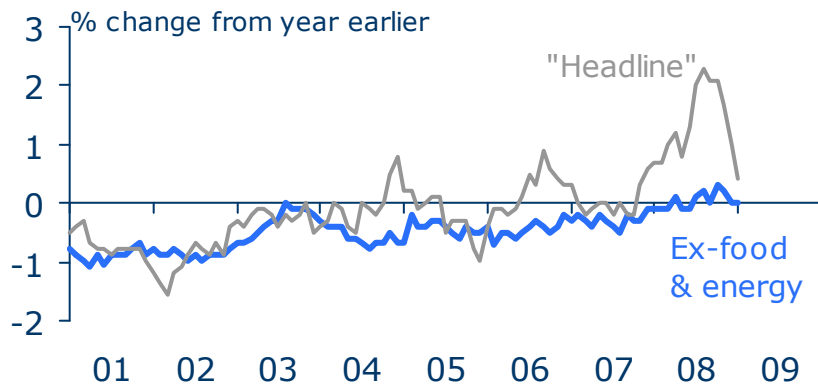
#### United States



#### Euro area



#### Japan



#### United Kingdom



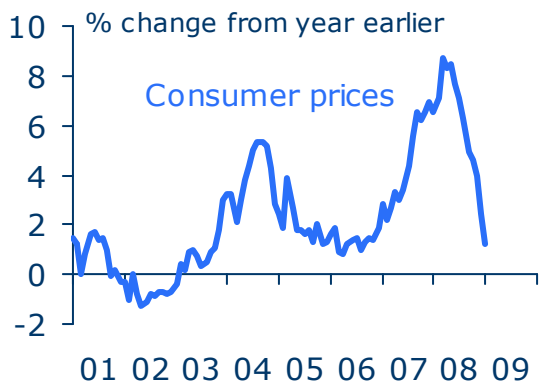
Sources: US Bureau of Labor Statistics; Eurostat; UK Office of National Statistics; CEIC.



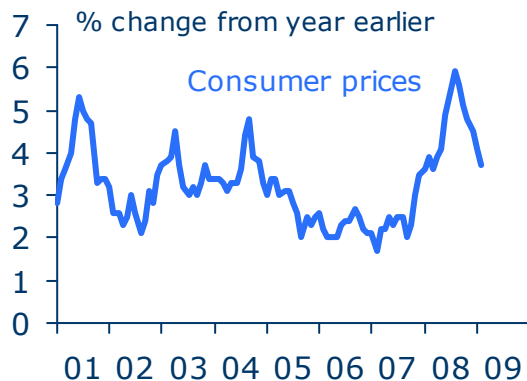
Inflation is also declining in most East Asian economies, and some (incl. China, Hong Kong, Taiwan) also risk deflation

### Inflation - Asia

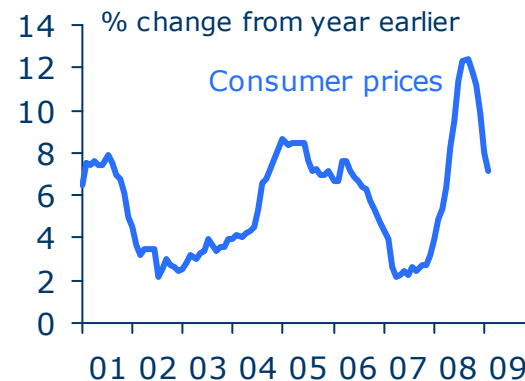
#### China



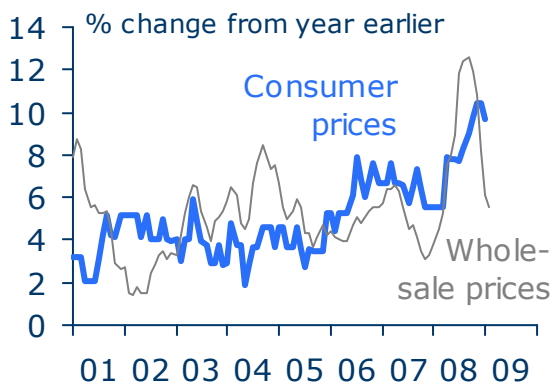
#### Korea



#### Philippines



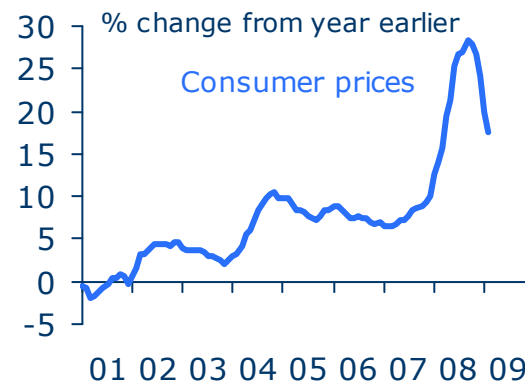
#### India



#### Indonesia



#### Vietnam

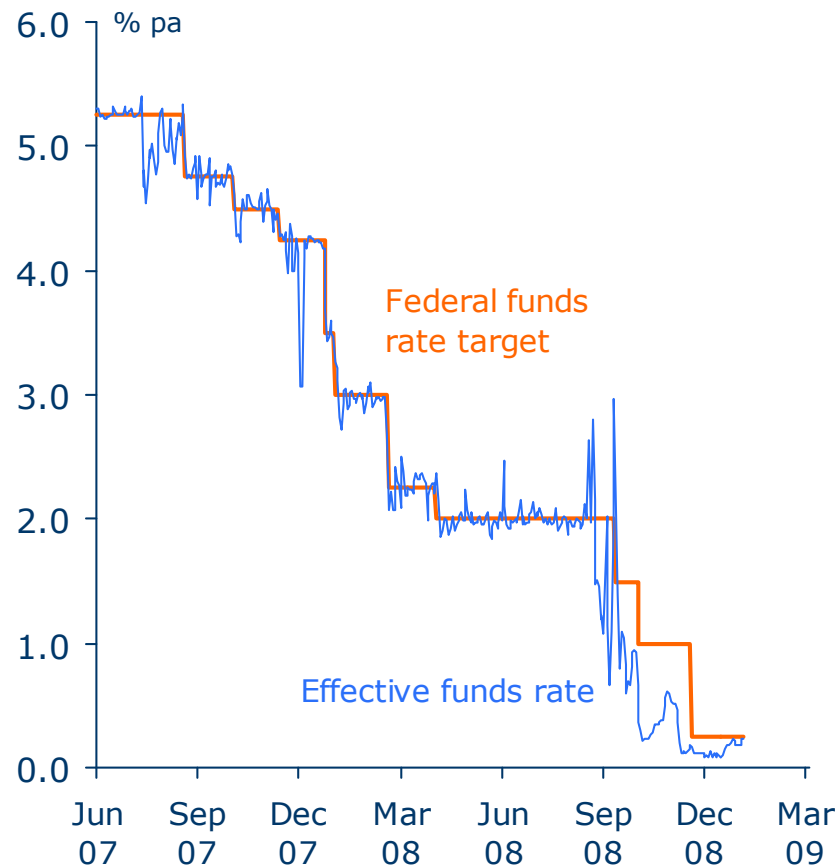


Sources: National statistical agencies or central banks; CEIC.

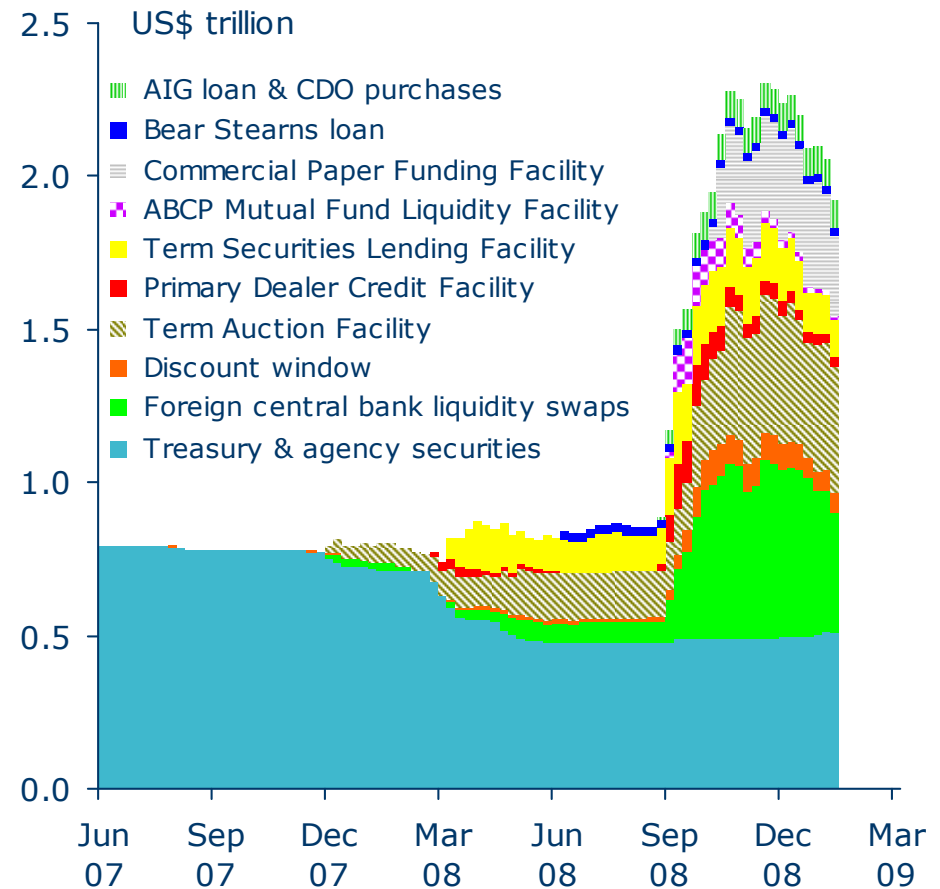


With its cash rate effectively at zero the Fed has resorted to a form of 'quantitative easing'

**Target and effective Fed funds rate**



**Assets on the Federal Reserve's balance sheet**

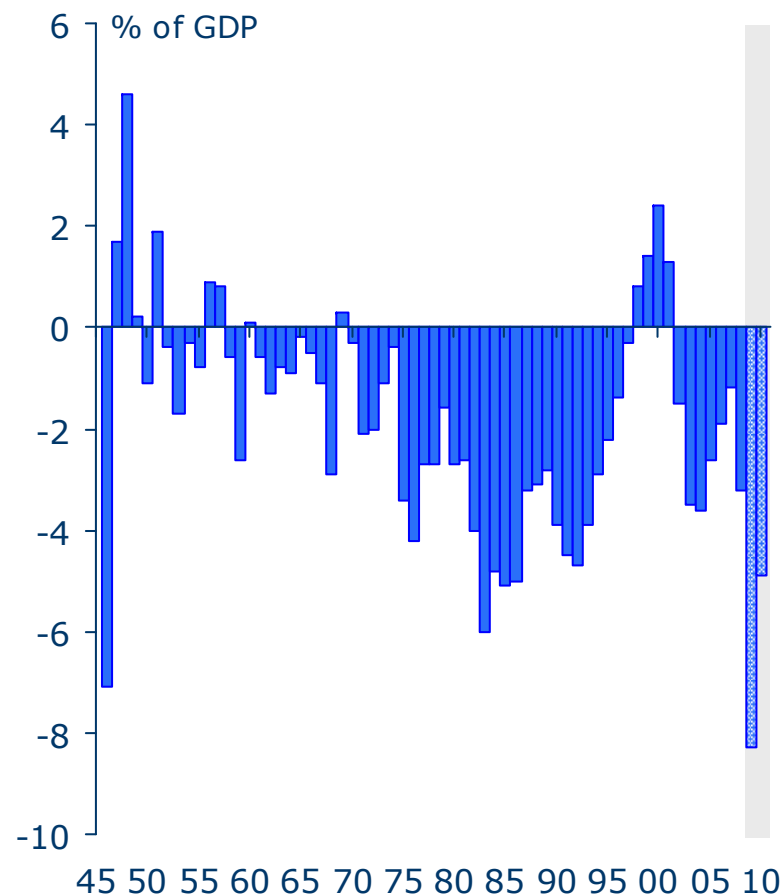


Source: US Federal Reserve Board H.4.1 Statistical Release, *Factors Affecting Reserve Balances*; Datastream.

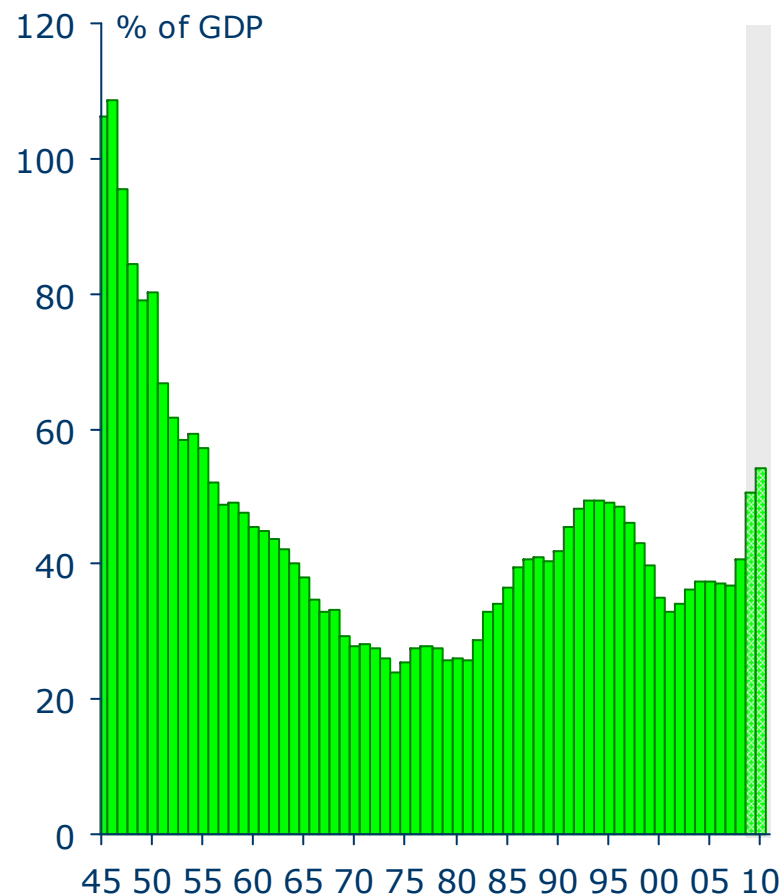


Fiscal policy has to shoulder a greater burden, pushing government debt up sharply but not to unprecedented levels

**US Federal budget balance**



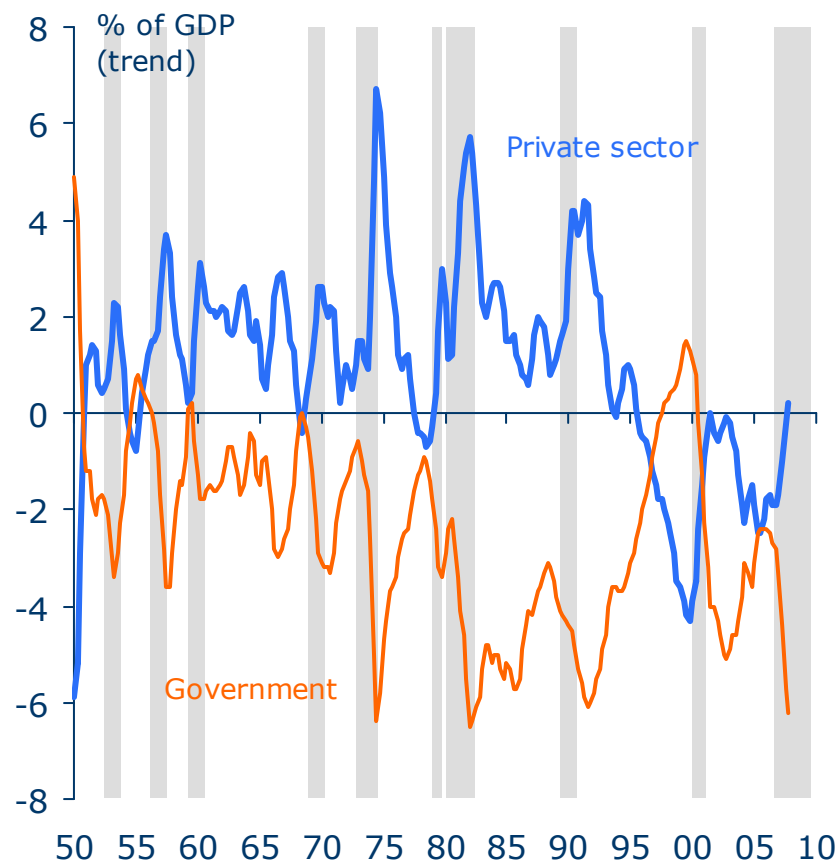
**US Federal Government debt**



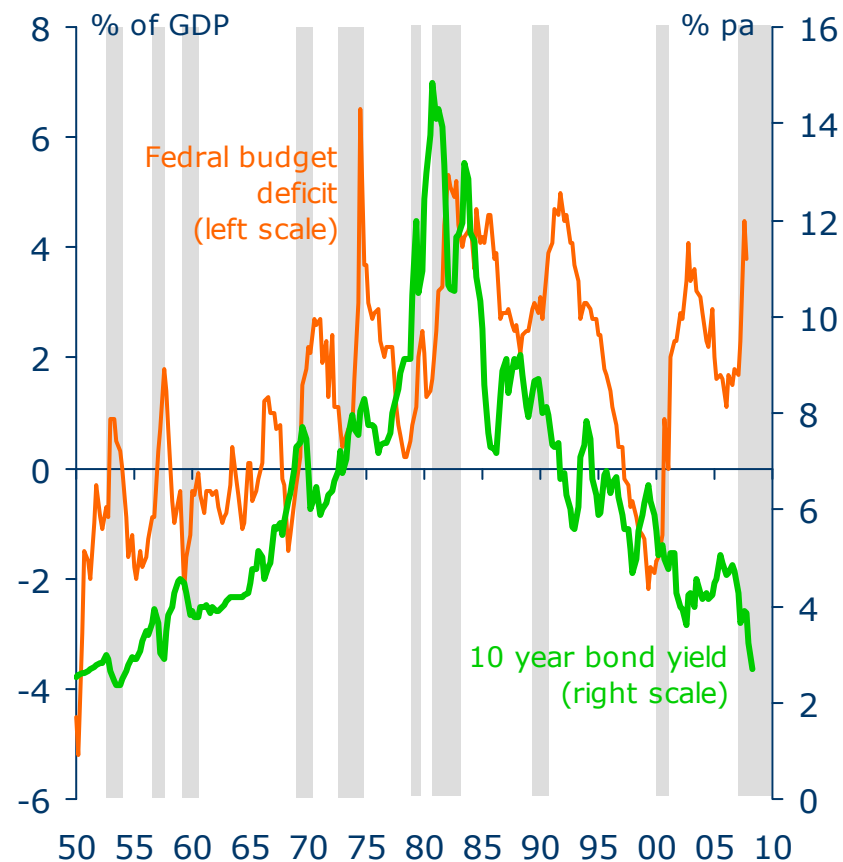
*Note:* Figures for Federal Government debt exclude debt held by other Federal agencies such as the Social Security Trust Fund. *Source:* Congressional Budget Office, January 2009.

Budget deficits in recessions are usually offset by declines in private sector net borrowing – that's why rates fall in recessions

**Private and government sector net lending**



**Federal budget deficits and long-term bond yields**



Note: 'Net lending' is gross saving minus gross investment. Shaded areas denote recessions as designated by NBER.  
Sources: US Bureau of Economic Analysis; Datastream; ANZ



## Australia's economy has proved remarkably resilient to date but is likely to experience recession this year

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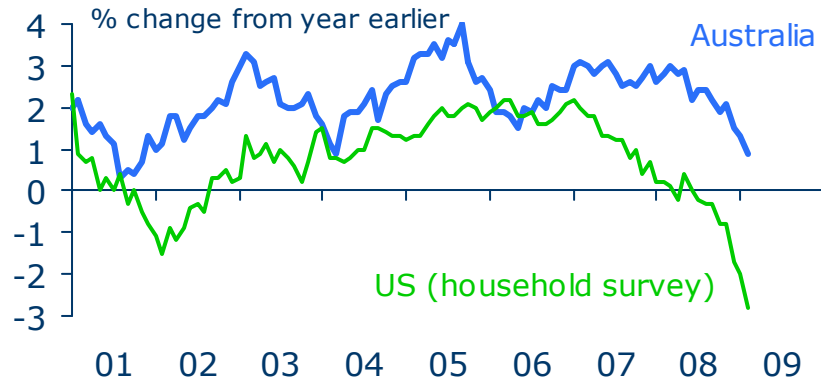
- **Australia's economy has so far proved remarkably resilient (and may have been one of very few not to have experienced any quarters of negative real GDP growth) during 2008. This resilience reflects its relatively stronger financial system, very limited declines thus far in housing prices, the lingering effects of the now-ended commodities boom, and the apparent effectiveness of abrupt changes in economic policy towards the end of last year.**
- **This resilience is likely to give way to the onset of recession as sharply lower commodity prices take a toll of incomes, investment spending and employment; household saving rates continue to increase; access to credit becomes more difficult, especially for businesses; and job-shedding accelerates.**
- **Economic policy has responded more quickly and aggressively to the turnaround in economic conditions than during previous Australian downturns, and thus should be more effective in reducing the severity of the recession than implied by a literal reading of history.**
- **To a greater extent than in most other countries, reductions in official interest rates have been passed on to end-borrowers (reflecting the healthier condition of Australian banks, and the preponderance of floating-rate borrowing in Australia).**
- **Fiscal policy measures announced thus far will provide a stimulus of almost 2½% of GDP in 2009, and about 1¼% of GDP in 2010. Some of the cash handouts which form a significant component of the latest measures will be saved rather than spent, and some appears inordinately directed towards preventing consecutive quarters of negative GDP growth; but the bulk of the measures will add directly to aggregate spending.**
- **The Australian Government will again become a significant borrower, with net debt forecast to reach 5.2% of GDP by mid-2012 (and will probably end up being higher than that). However these figures remain low by historical and international standards.**
- **Given the extent of the decline in the A\$ since July last year, and the expected further decline to ~US55¢ by year-end, deflation is a much smaller risk in Australia than other countries.**
- **Although the cash rate is now at a 44-year low of 3¼%, further reductions to ~2½% remain likely over the next few months (although the RBA is now eschewing statements hinting at the likely size of future moves). The yield curve is likely to steepen in response to increased government borrowing.**



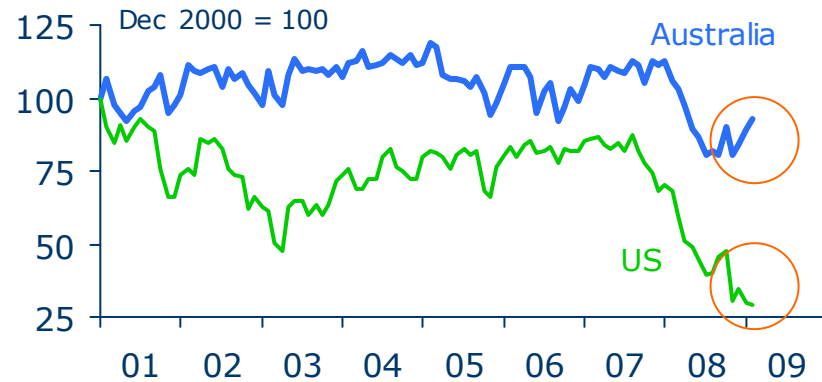
Australia's economy has thus far held up considerably better than America's ...

### Australian and US labour market and household spending

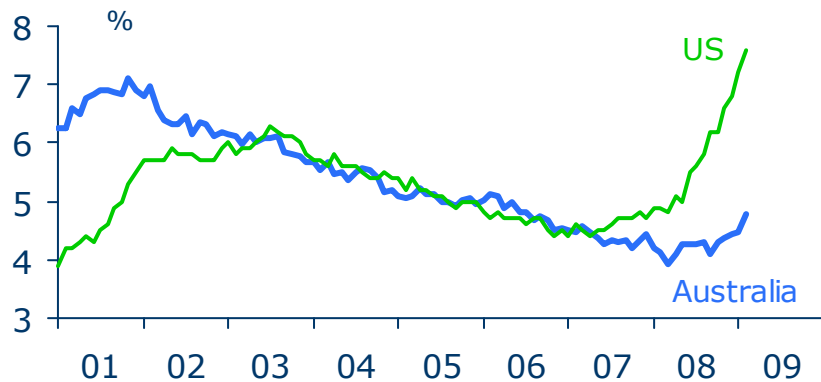
#### Employment



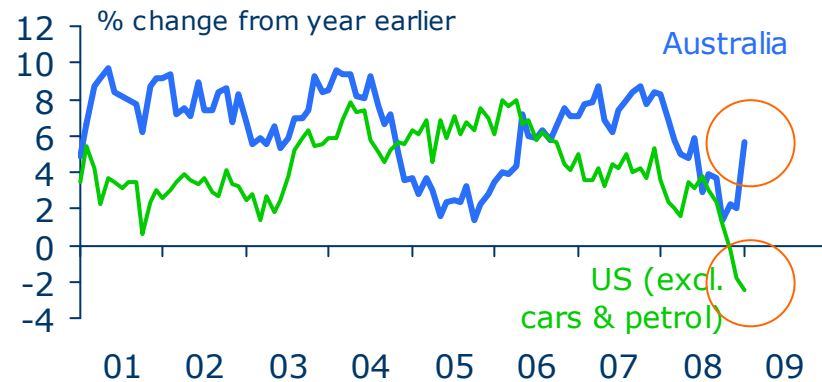
#### Consumer confidence



#### Unemployment rate



#### Retail sales



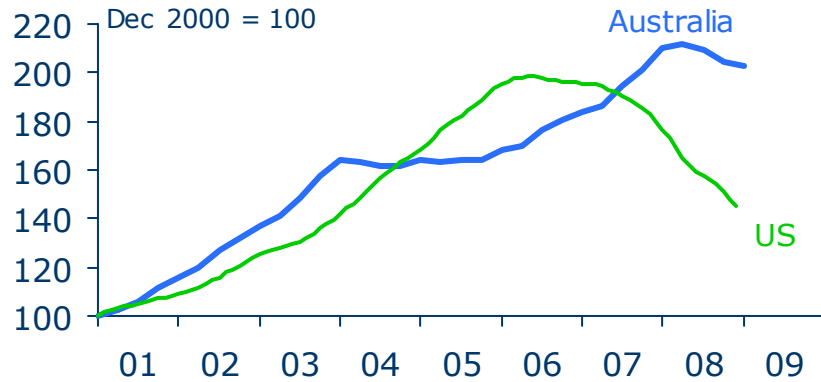
Sources: ABS; US Bureau of Labor Statistics; The Conference Board; Roy Morgan Research; US Commerce Department; ANZ.



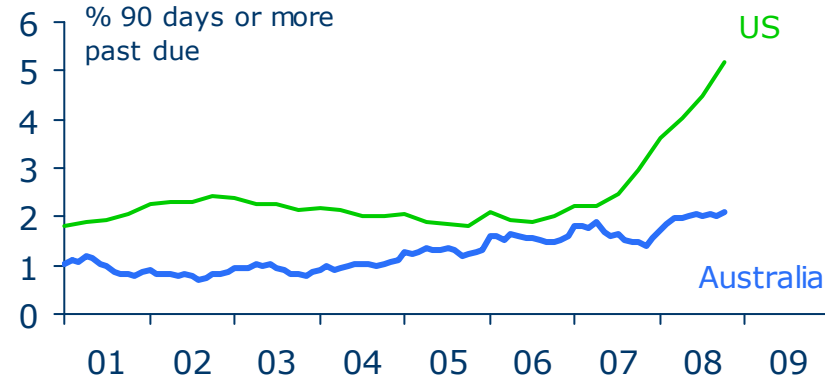
.. partly because Australia's housing market and banking system have remained stronger than America's

## Australian and US housing markets and household finances

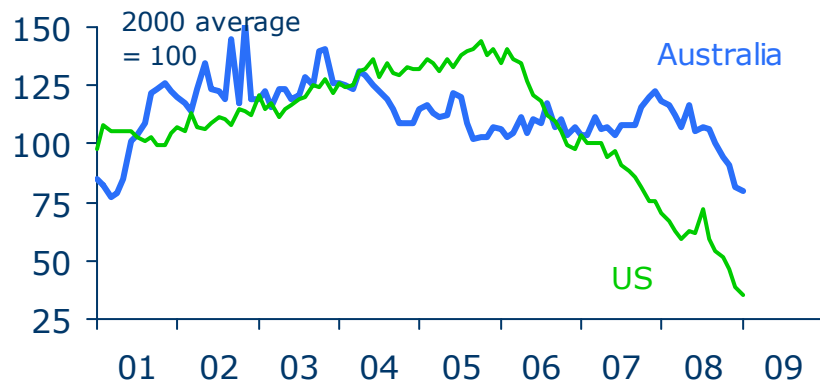
### House prices



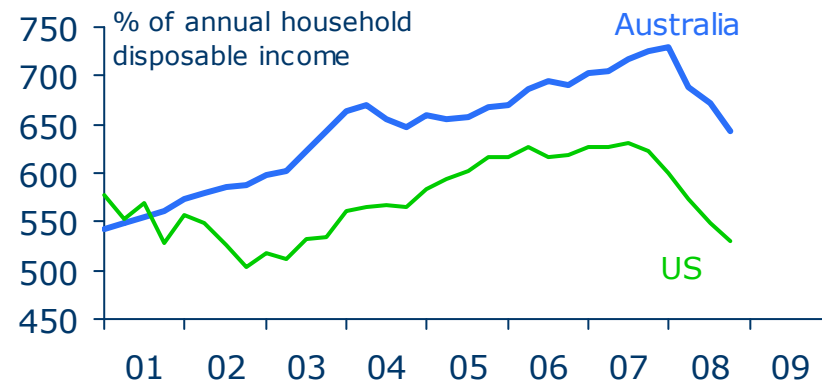
### Mortgage delinquency rates



### Housing approvals



### Household net worth

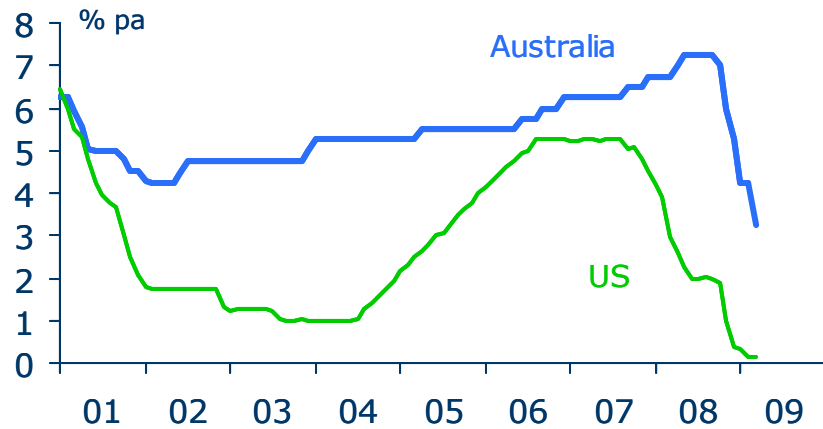


Note: Australian mortgage delinquencies are for securitized mortgages only. Sources: ABS; S&P; US Federal Reserve; Mortgage Bankers' Association of America; US Commerce Department; ANZ.

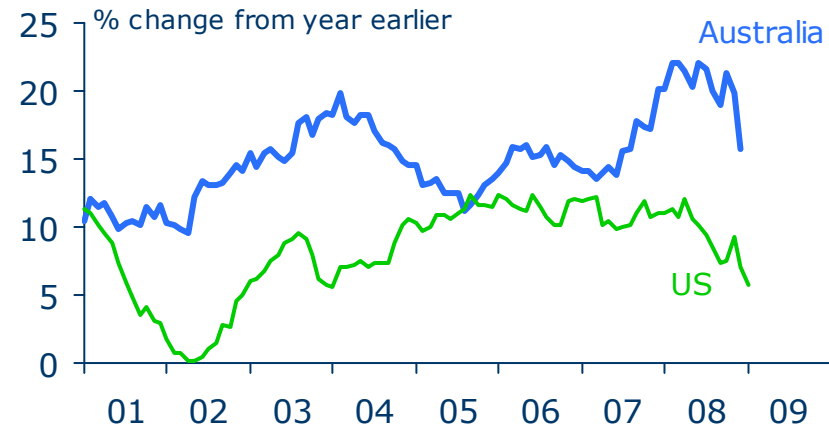


# Monetary policy is 'working' more effectively in Australia than in the US, in part because the banking system is in better shape <sup>27</sup>

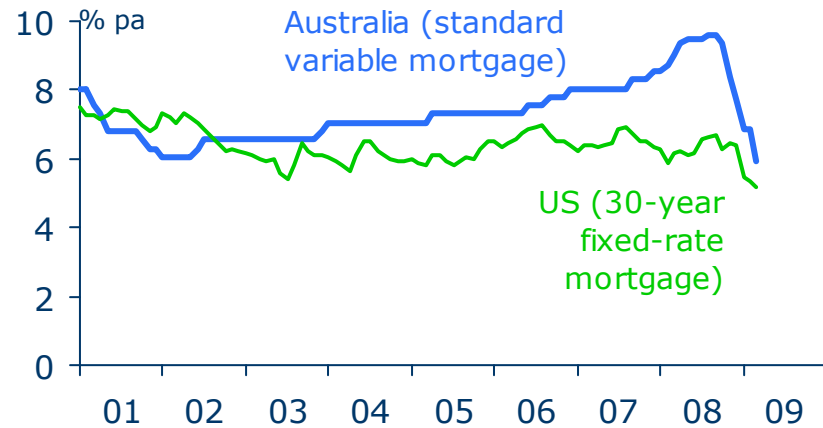
### Official interest rates



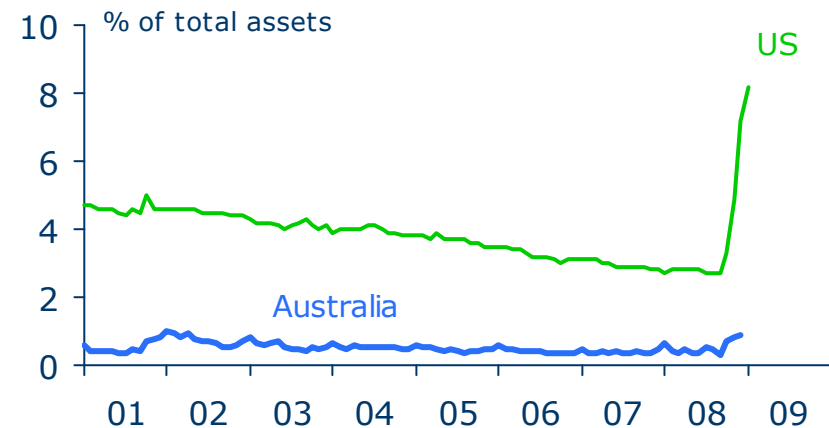
### Bank lending



### Most common mortgage rates



### Bank cash holdings



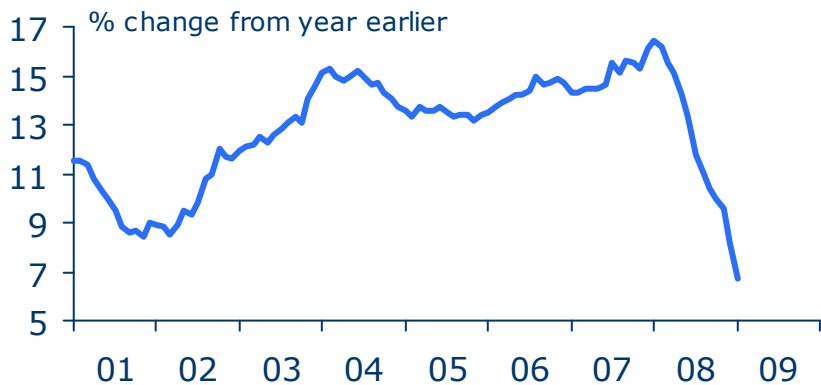
Note: 'Cash' includes deposits with the central bank. US banks are subject to required to hold cash reserves against their transactions account balances and thus typically hold a higher proportion of their assets in cash than Australian banks which are no longer subject to such requirements. Sources: RBA; US Federal Reserve; Datastream.



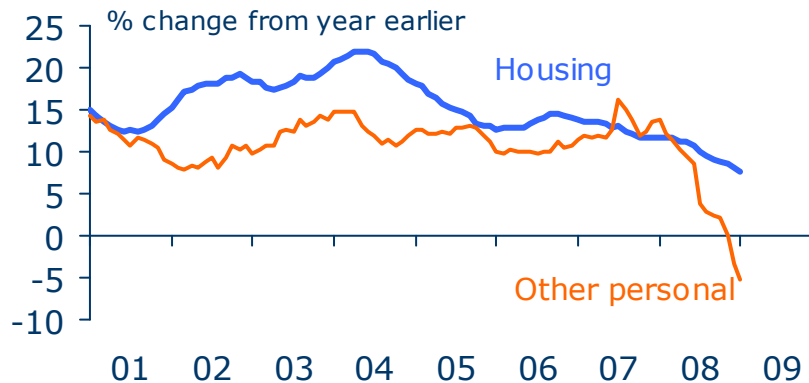
# Nonetheless both the demand for and supply of credit to Australian households and businesses is slowing

## Credit provided to the Australian private sector

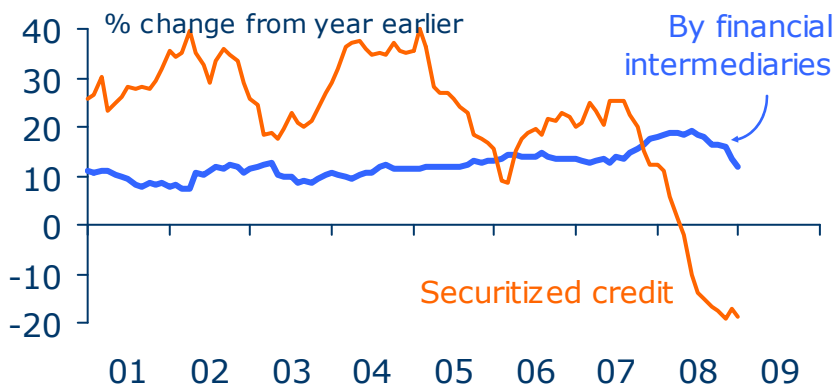
### Total credit



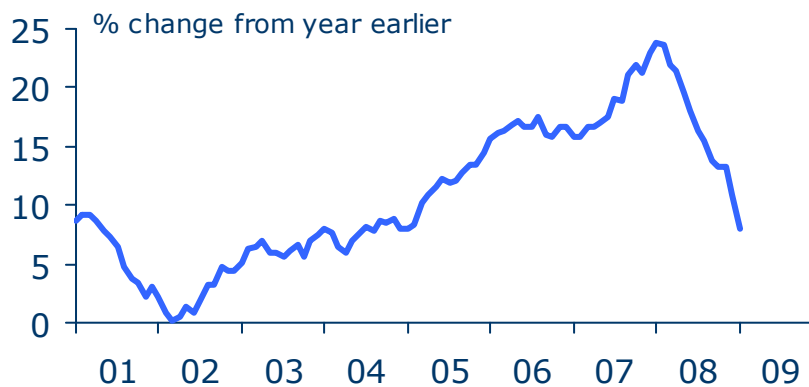
### Credit to households



### Credit by source



### Credit to business

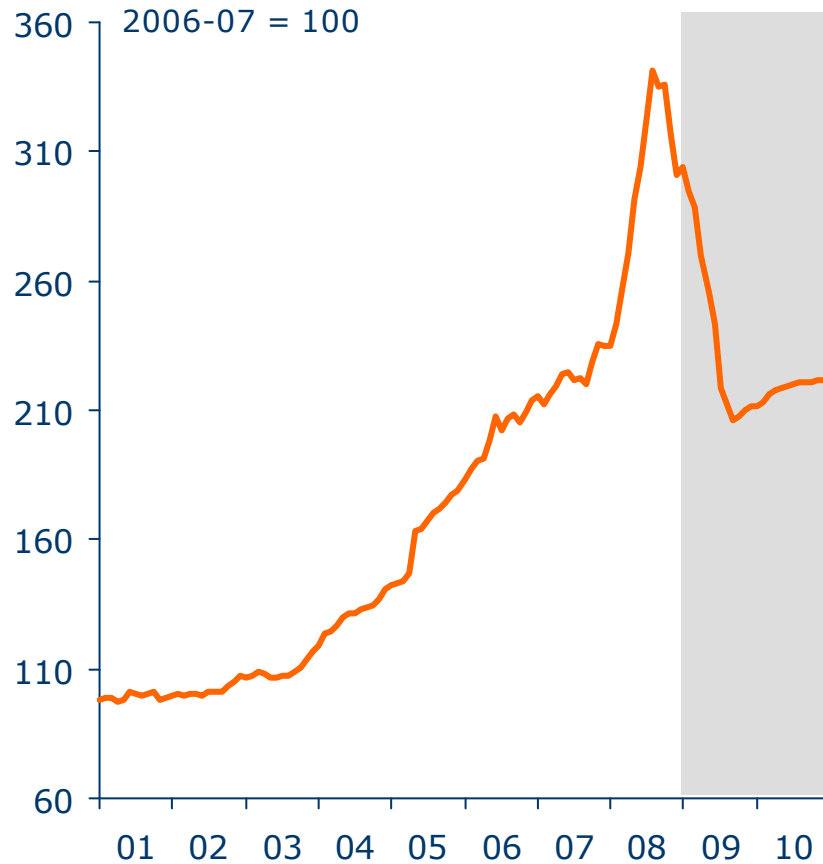


Source: Reserve Bank of Australia.

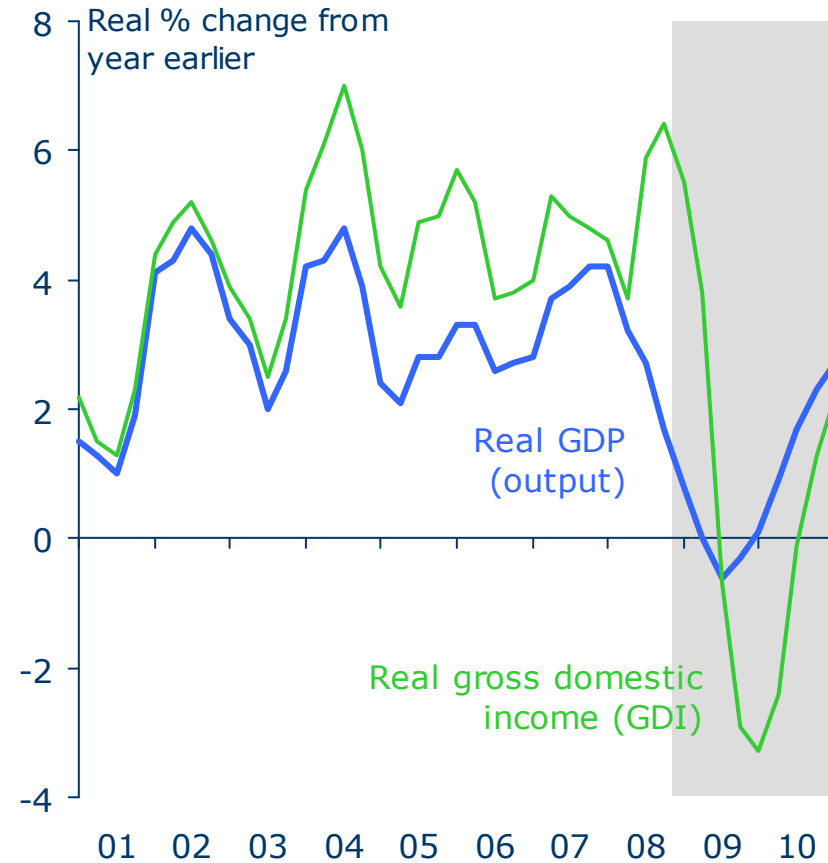


# The sharp fall in commodity prices will detract substantially from Australian national income in 2009 <sup>29</sup>

### Australian export commodity prices



### Real gross domestic income (GDI) and product (GDP)

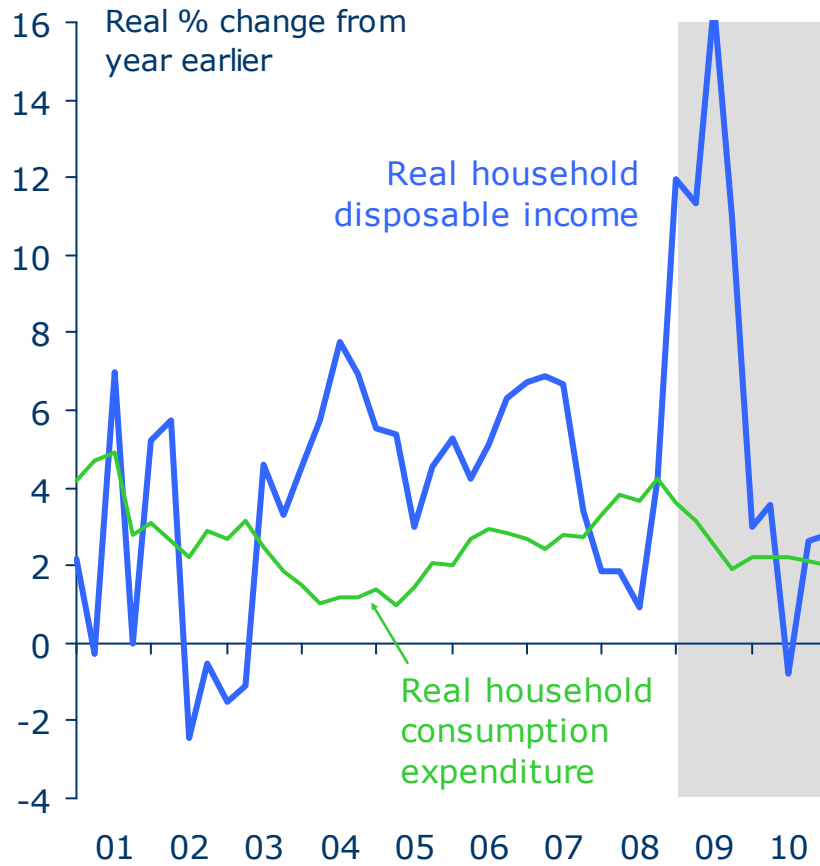


Note: real gross domestic income (GDI) is real GDP adjusted for changes in the terms of trade; it measures the 'purchasing power' of the income associated with producing the GDP. Sources: ABS; ANZ.

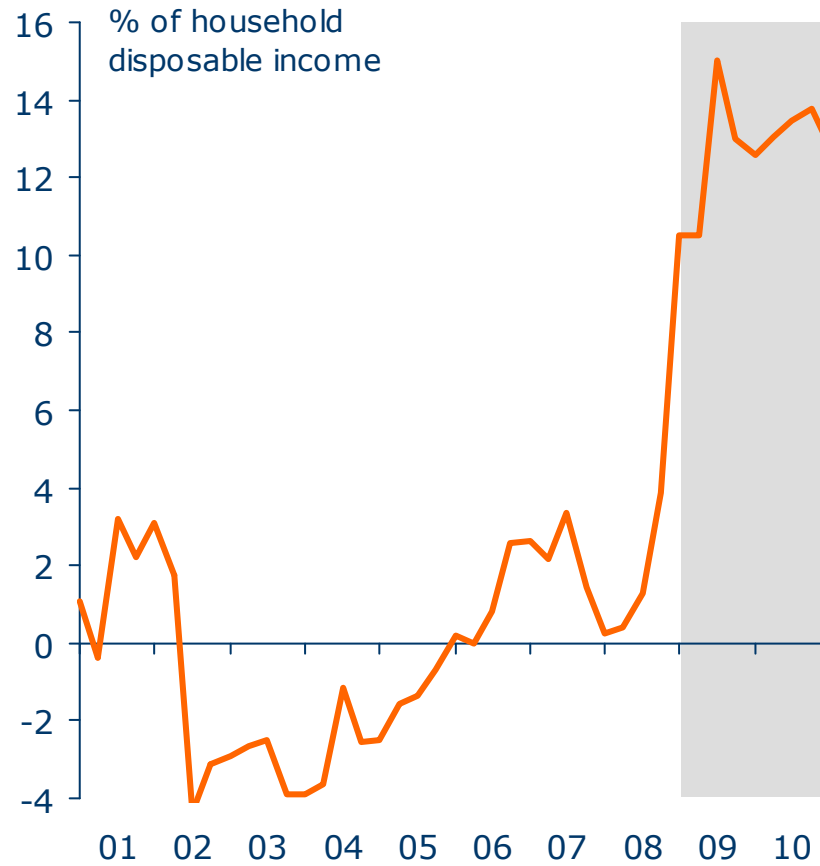


Cash handouts, interest rate cuts, and lower petrol prices will boost household incomes substantially – but a lot of it will be saved

### Household disposable income and spending



### Household saving rate

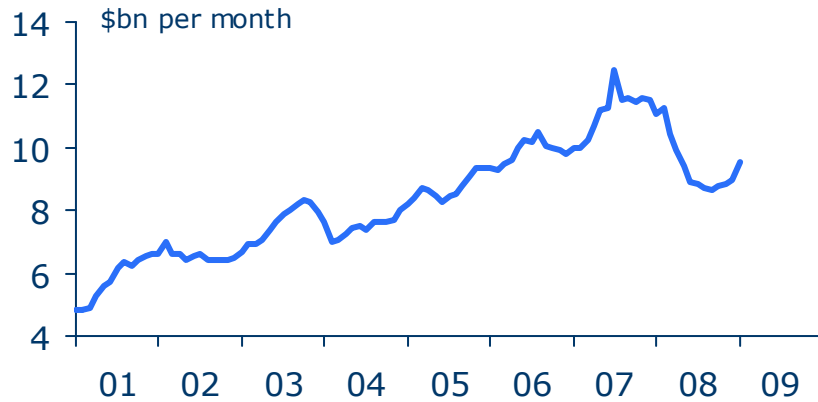


Sources: ABS; ANZ.



# Rising demand from first home buyers vs falling demand from (and lending to) investors will tend to put a floor under prices

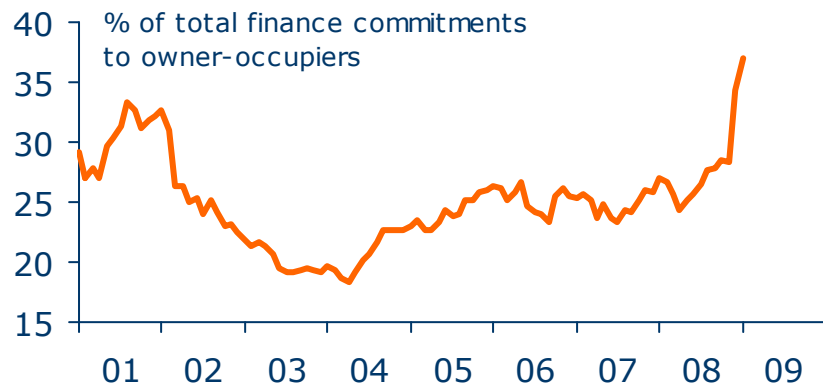
### Housing finance commitments to owner-occupiers



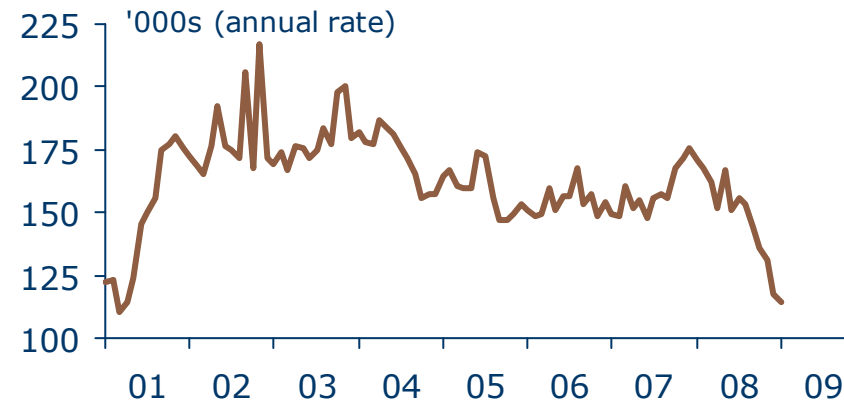
### Housing finance commitments to investors



### First-time buyers as a pc of total commitments to owner-occupiers



### Residential building approvals by local governments

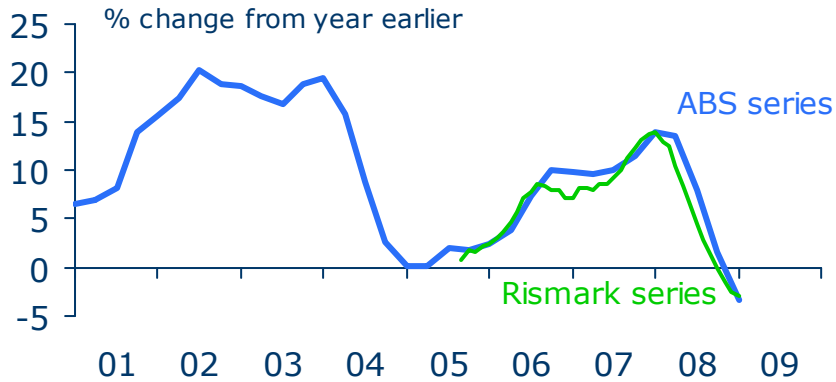


Sources: ABS; ANZ.

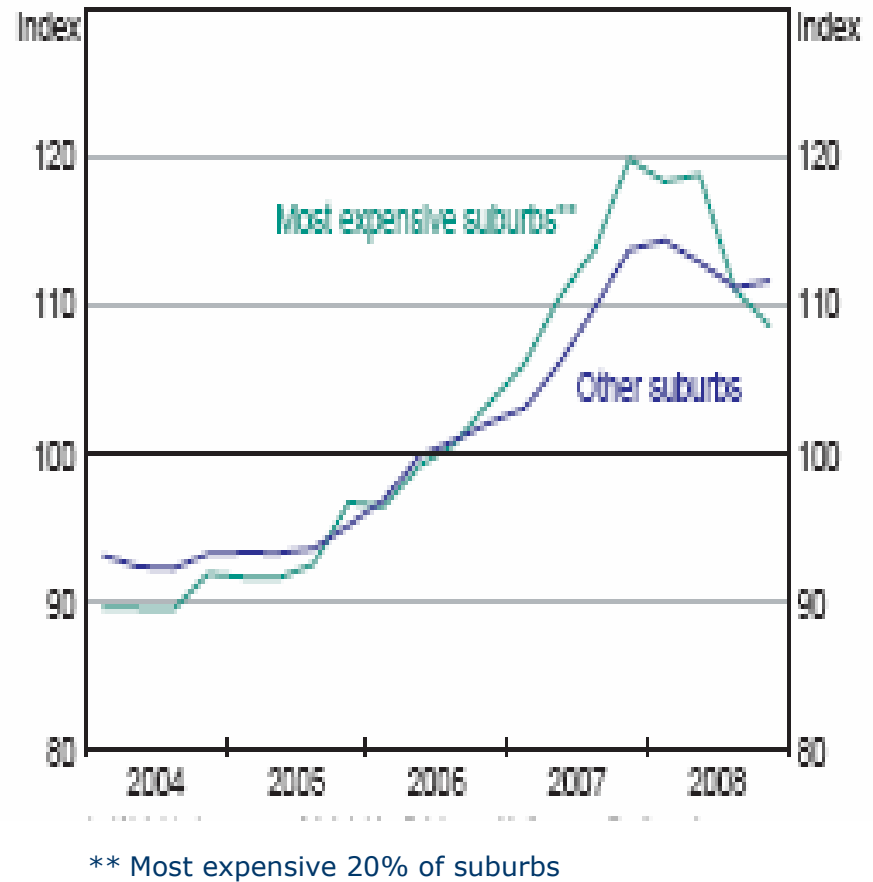


Relatively small house price declines reflect absence of 'forced' sellers; large declines concentrated in ritzier suburbs

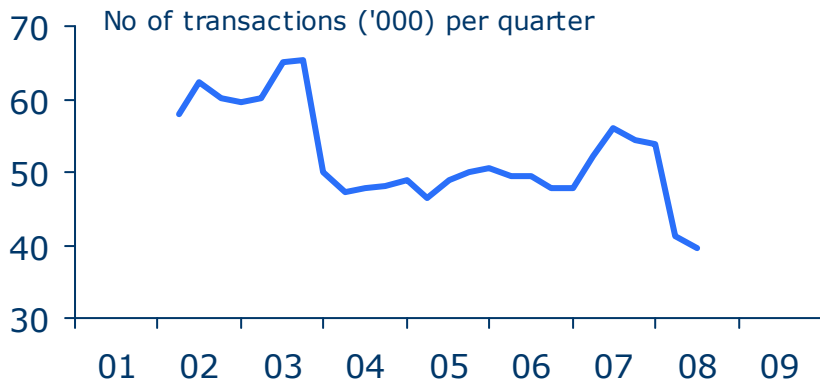
**Australian capital city house prices**



**House prices in 'expensive' vs other suburbs**



**Turnover of established dwellings**



Sources: ABS; APM; ANZ. Chart on right taken from RBA Statement on Monetary Policy (February 2009)





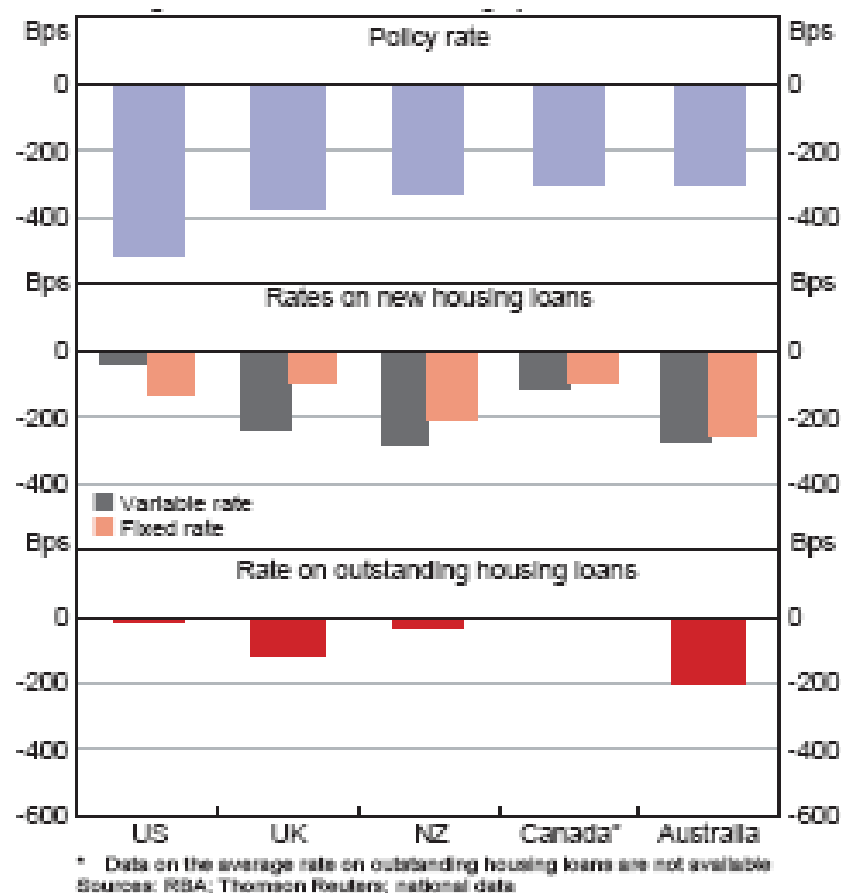
# Changes in monetary policy have had a greater impact on end-borrowers' interest rates in Australia than elsewhere

### Changes in lending interest rates (% pa)

	Level at end Jan 2009	Change since:		
		End Oct 2008	End Aug 2008	End Jul 2007
Cash rate	4.25	-1.75	-3.00	-2.00
Housing loans				
Prime-full doc				
Banks	6.17	-1.54	-2.76	-1.27
Credit unions and building societies	6.20	-1.69	-2.63	-1.17
Mortgage originators	6.38	-1.69	-2.72	-0.97
Prime low-doc				
Banks	6.75	-1.45	-2.64	-0.94
Mortgage originators	7.22	-1.33	-2.61	-0.58
Non-conforming	10.23	-1.51	-1.51	0.60
Personal loans				
Margin loans	8.92	-1.10	-1.65	-0.04
Standard credit cards	18.67	-1.08	-1.25	0.88
Low-rate credit cards	12.67	-0.56	-0.27	1.50
Unsecured term loans	14.10	-0.74	-0.80	1.48
Home equity loans	6.93	-1.30	-2.65	-1.29
Small business				
Term loans				
Residentially secured	8.28	-1.13	-1.81	-0.02
Other security	9.01	-1.00	-1.68	0.12
Overdraft				
Residentially secured	9.10	-1.13	-1.81	0.05
Other security	9.93	-1.00	-1.66	0.21
Average actual rate <sup>(a)</sup>	8.37	-1.13	-1.80	-0.26
Large business				
Average actual variable rate <sup>(a)</sup>	6.44	-1.84	-2.53	-1.12
Average actual bill rate <sup>(a)</sup>	5.10	-2.55	-3.28	-1.99

(a) RBA estimate  
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

### Changes in cash and housing loan rates up to Dec 2008\*



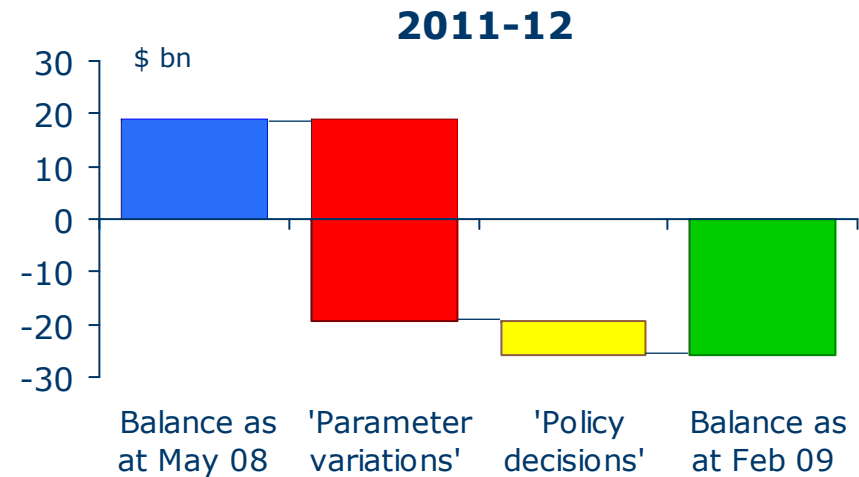
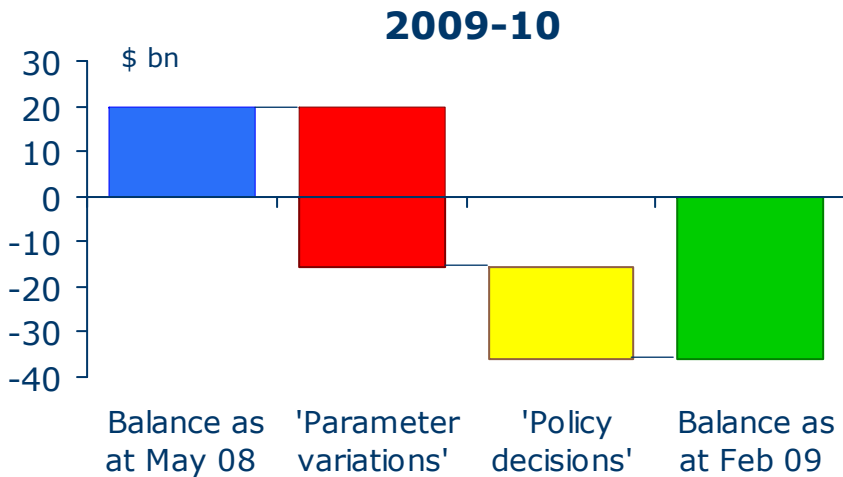
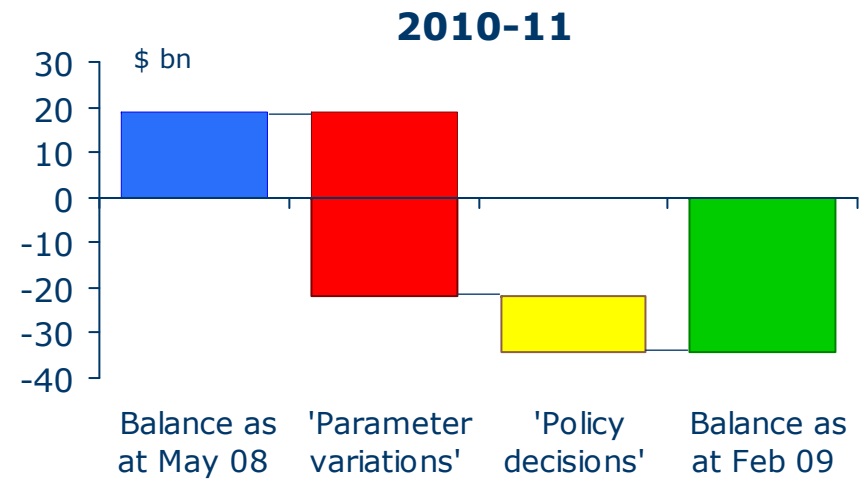
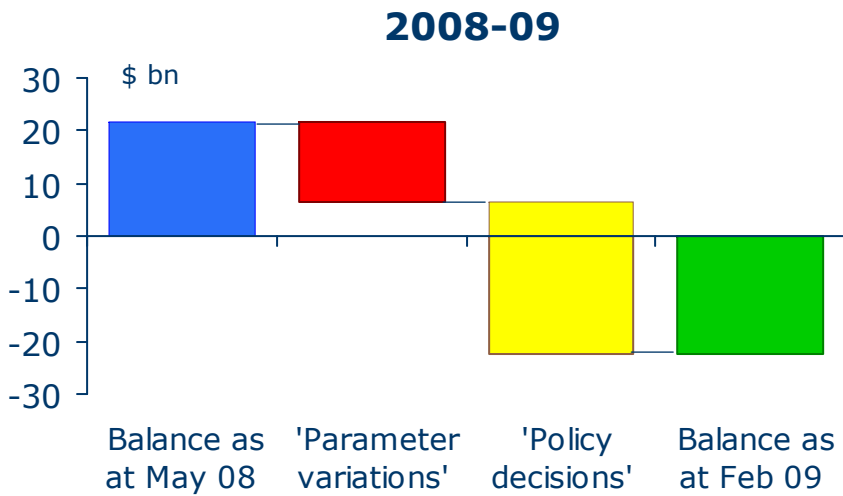
\* from start of easing cycle.

Sources: Table and chart taken from RBA Statement on Monetary Policy (February 2009).



Of the \$202bn deterioration in budget over four years, \$120bn is due to the collapse in revenues and \$70bn to specific stimulus

**Sources of changes in estimates of the Budget cash balance**

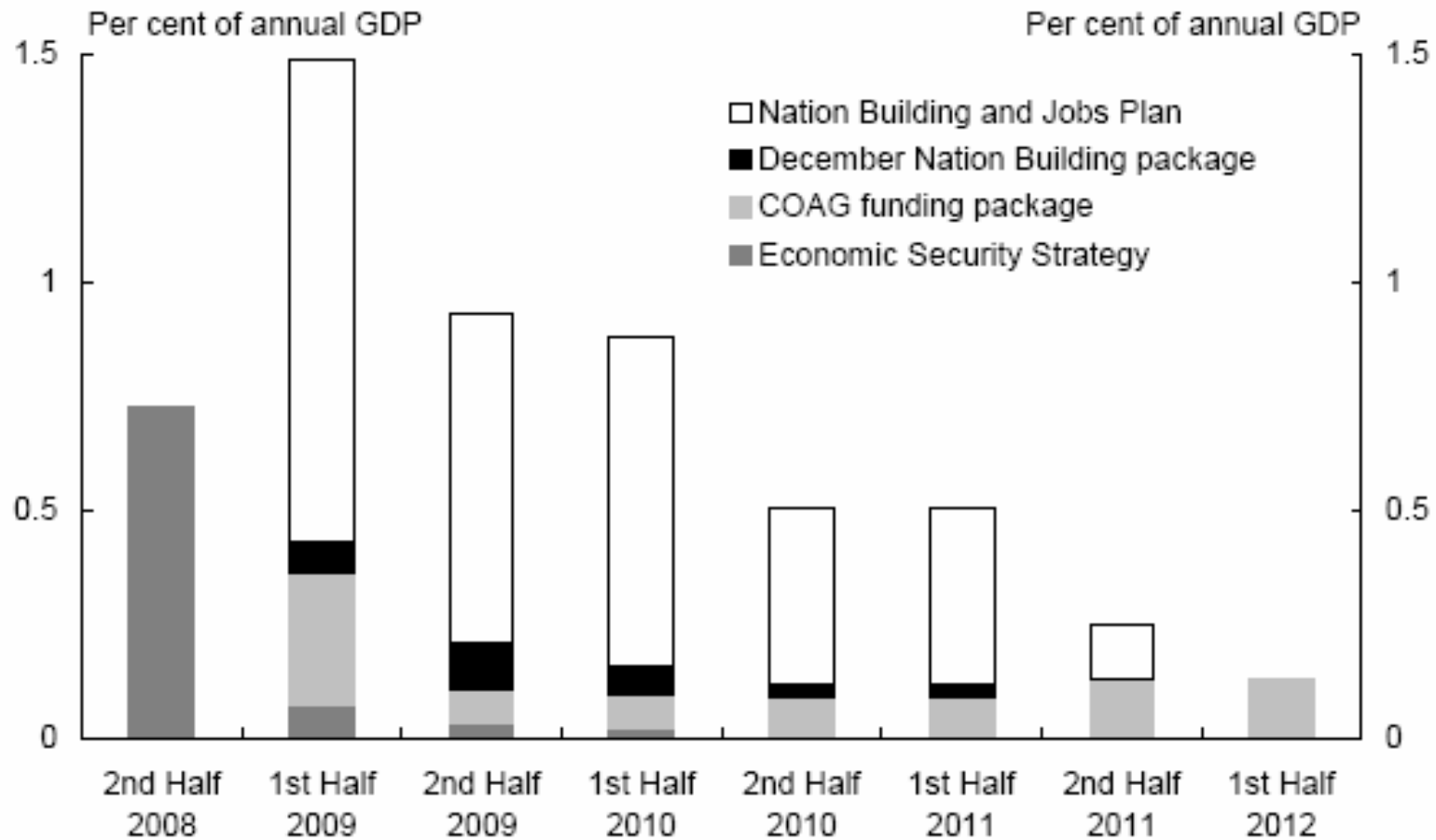


Note: 'Parameter variations' are changes in the cash balance due to changes in economic and other forecasts or assumptions. Source: Mid-Year Economic & Fiscal Outlook (November 2008); Updated Economic & Fiscal Outlook (February 2009); ANZ.



# Government measures will provide substantial fiscal stimulus in the current half year, continuing into 2010 <sup>35</sup>

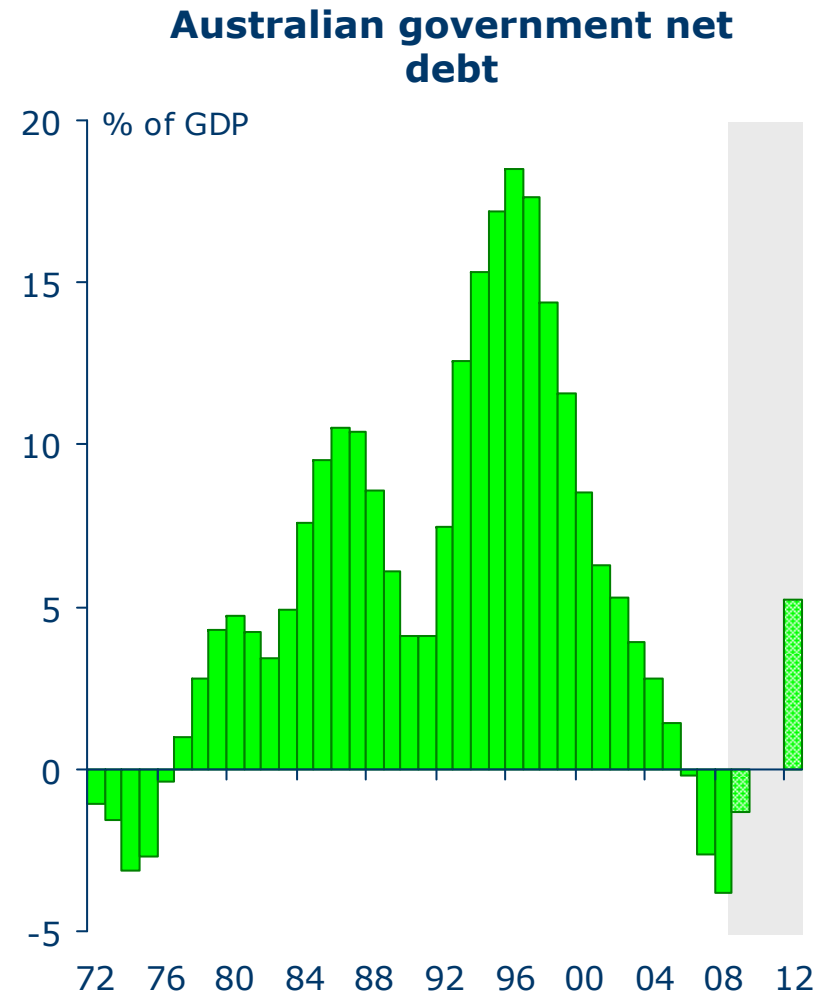
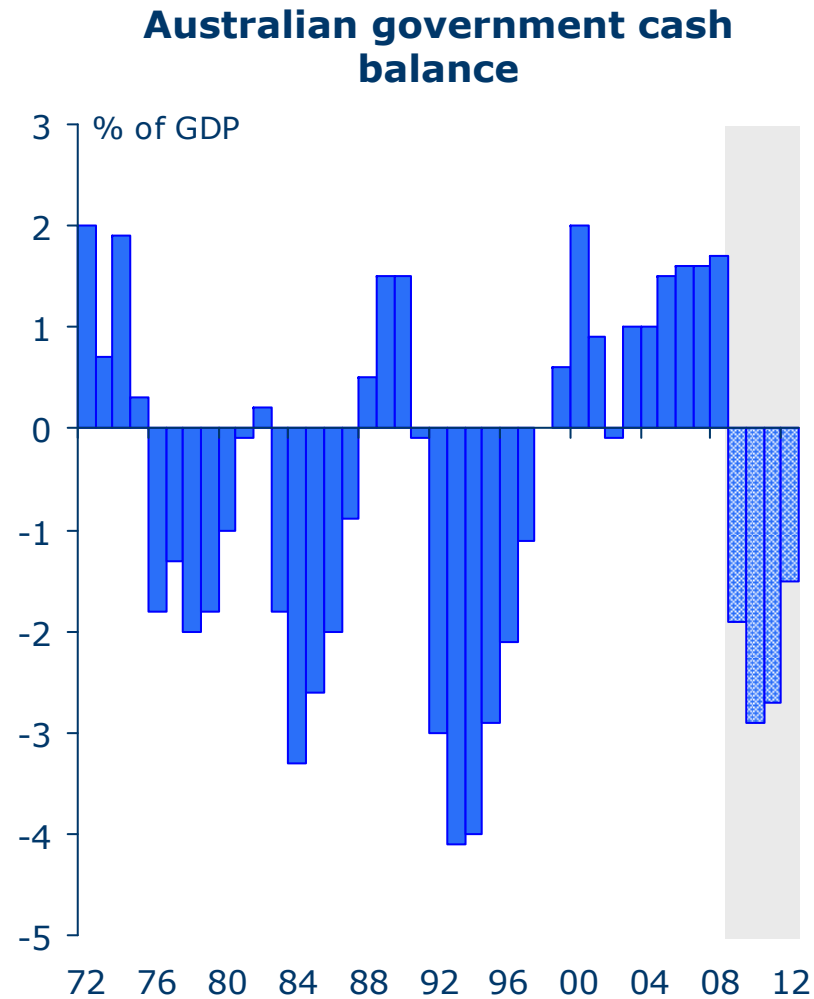
## Impact of Australian Government fiscal stimulus packages



Source: Australian Government, *Updated Economic and Fiscal Outlook Statement* (February 2009) p. 11.



# The budget deficits and resulting government net debt are by no means unprecedented <sup>36</sup>

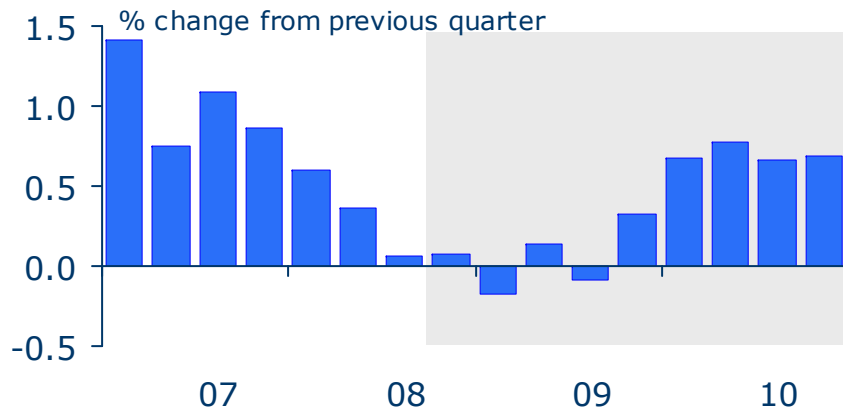


Sources: *Mid-Year Economic & Fiscal Outlook* (November 2008); *Updated Economic & Fiscal Outlook* (February 2009); ANZ.

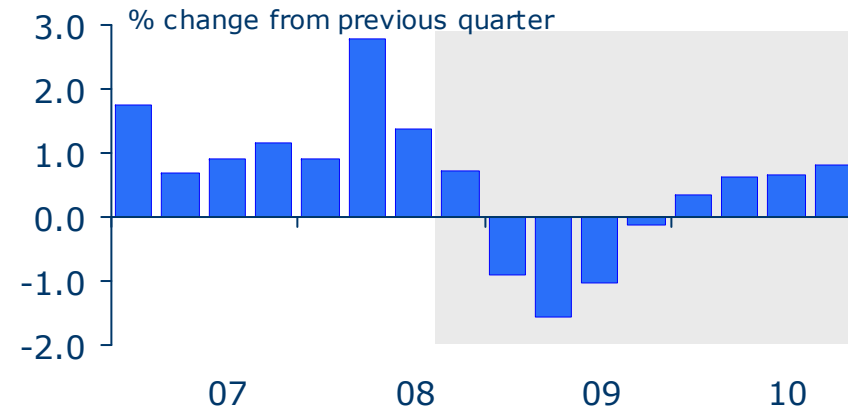


# Australia might avoid consecutive quarters of negative real GDP growth, but it will have a recession by other definitions <sup>37</sup>

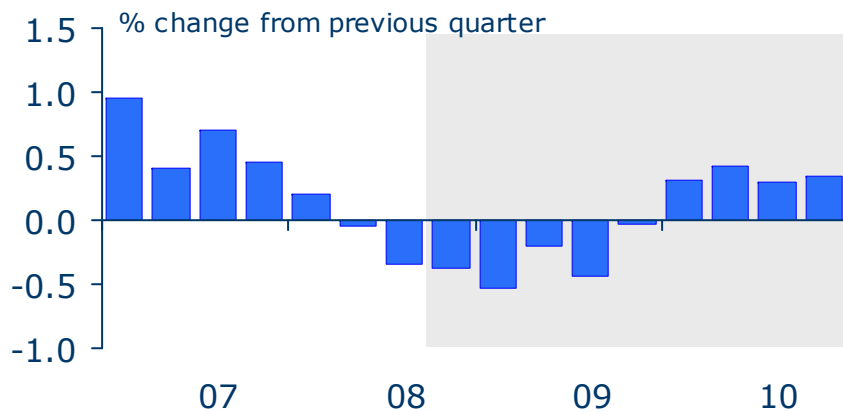
**Real gross domestic product (GDP)**



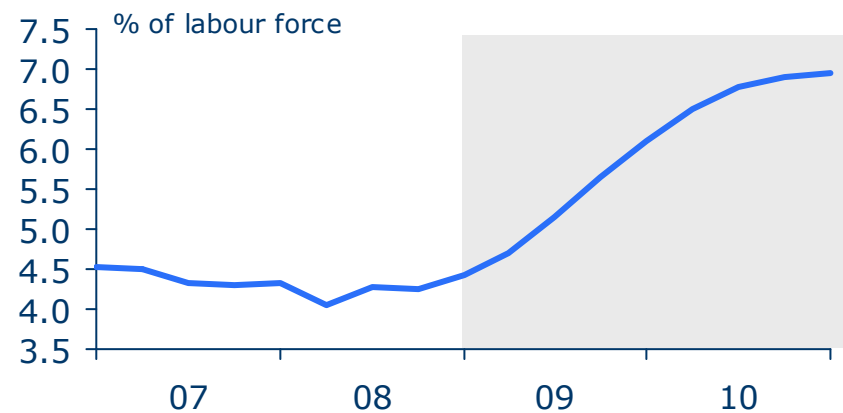
**Real gross domestic income (GDI)**



**Real per capita GDP**



**Unemployment rate**

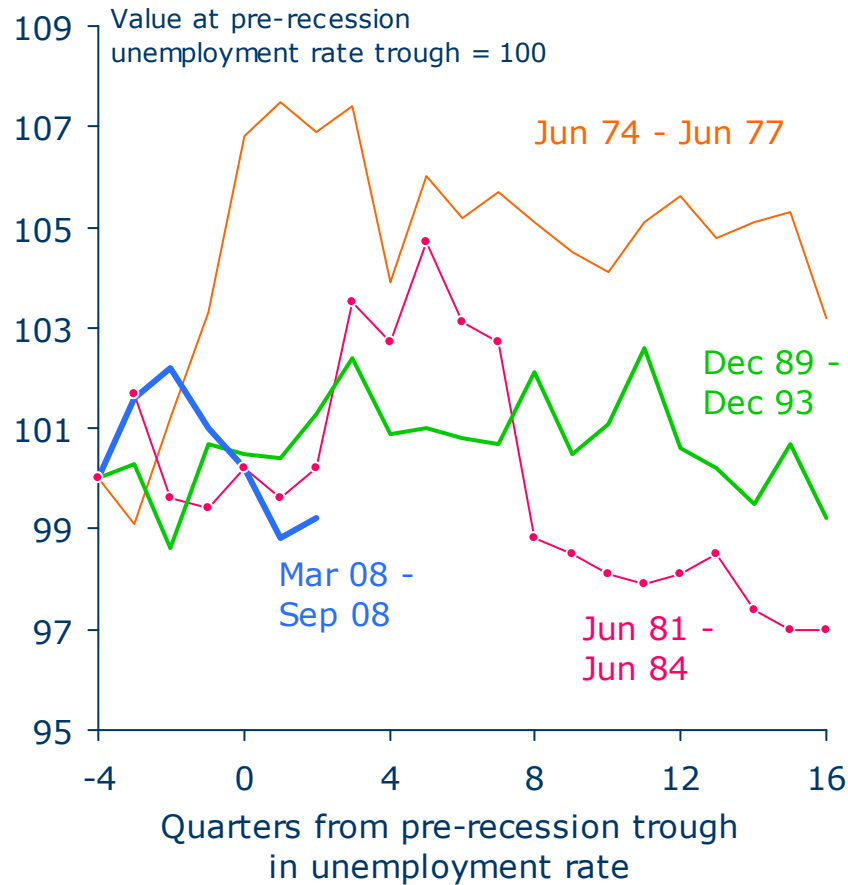


Note: Real gross domestic income is real GDP adjusted for changes in the terms of trade (export relative to import prices). Shaded areas denote ANZ estimates or forecasts. Sources: ABS; ANZ.

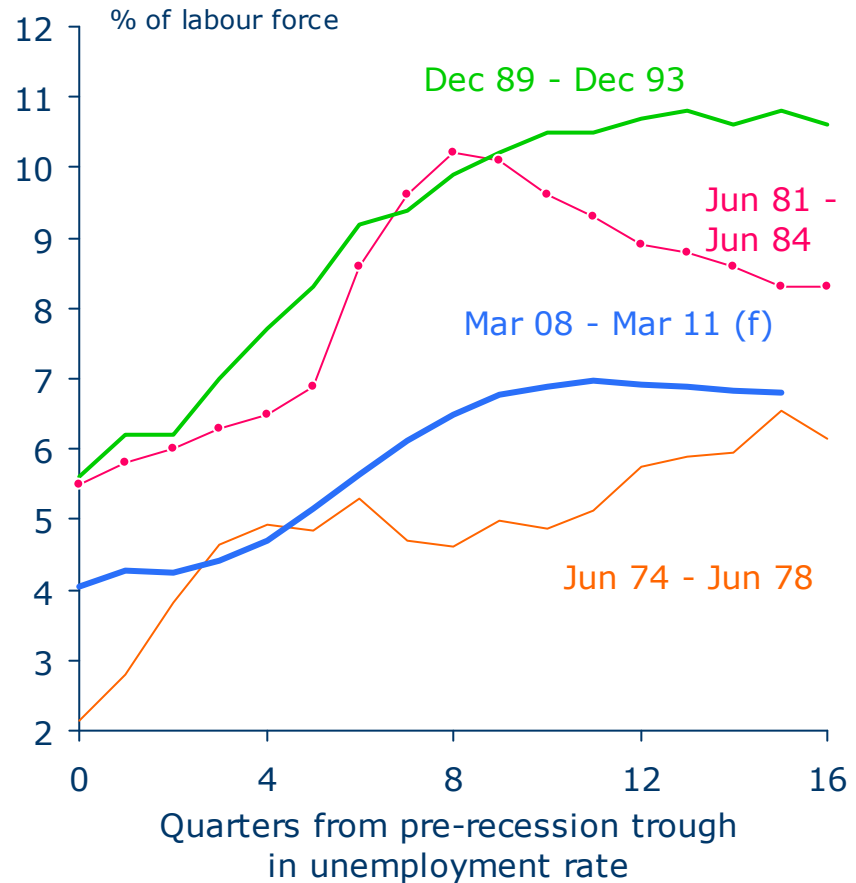


# Employees haven't priced themselves out of jobs in the way that they did prior to each of the last three recessions

**Real unit labour costs before and during recessions**



**Unemployment rate during recessions**

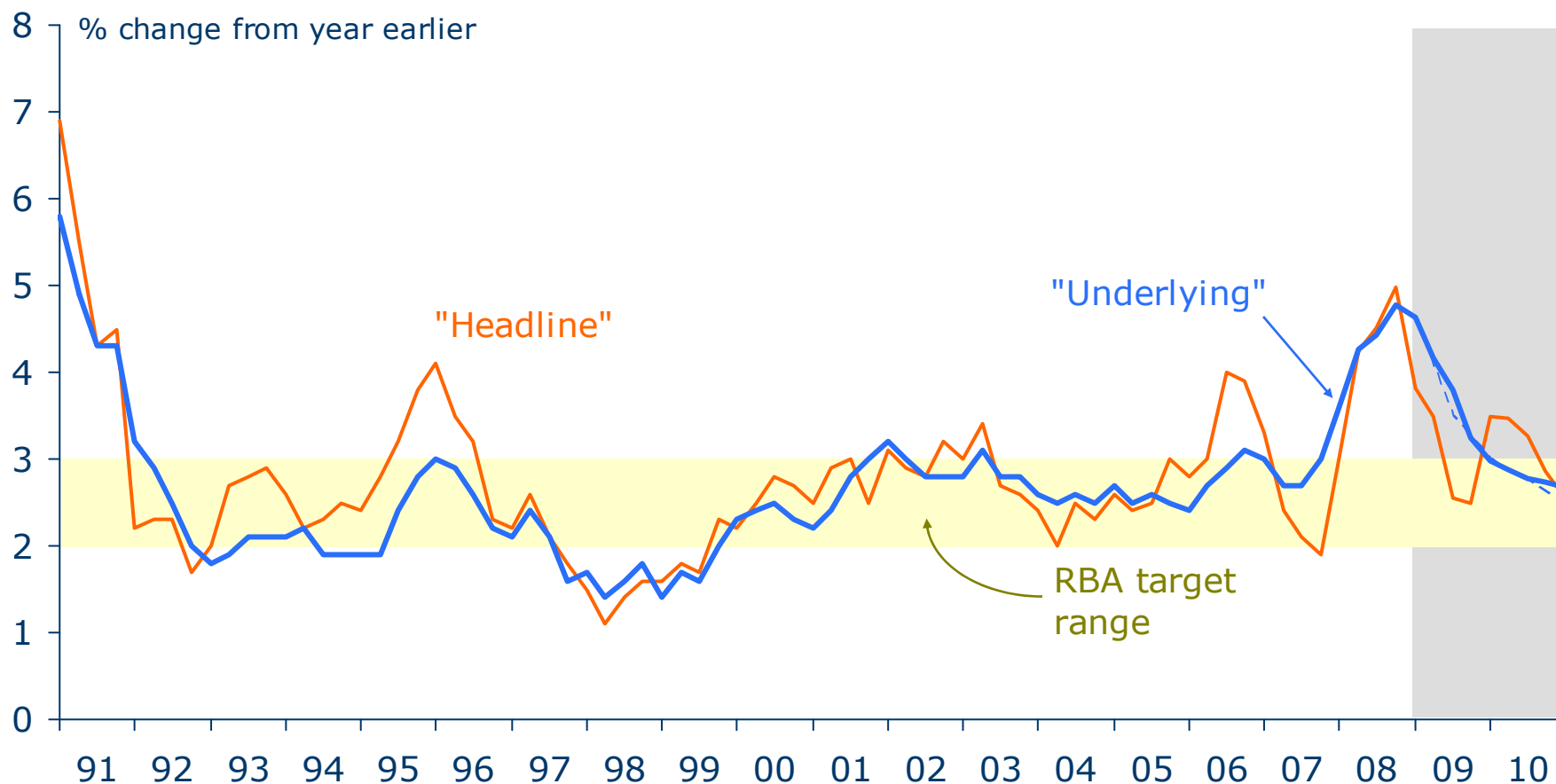


Note: real unit labour costs are employee compensation plus other 'on-costs' per unit of output produced, deflated by an index of output prices. Sources: ABS; ANZ.



Inflation is now likely to fall away quite quickly, although the fall in the A\$ makes deflation less of a risk than elsewhere

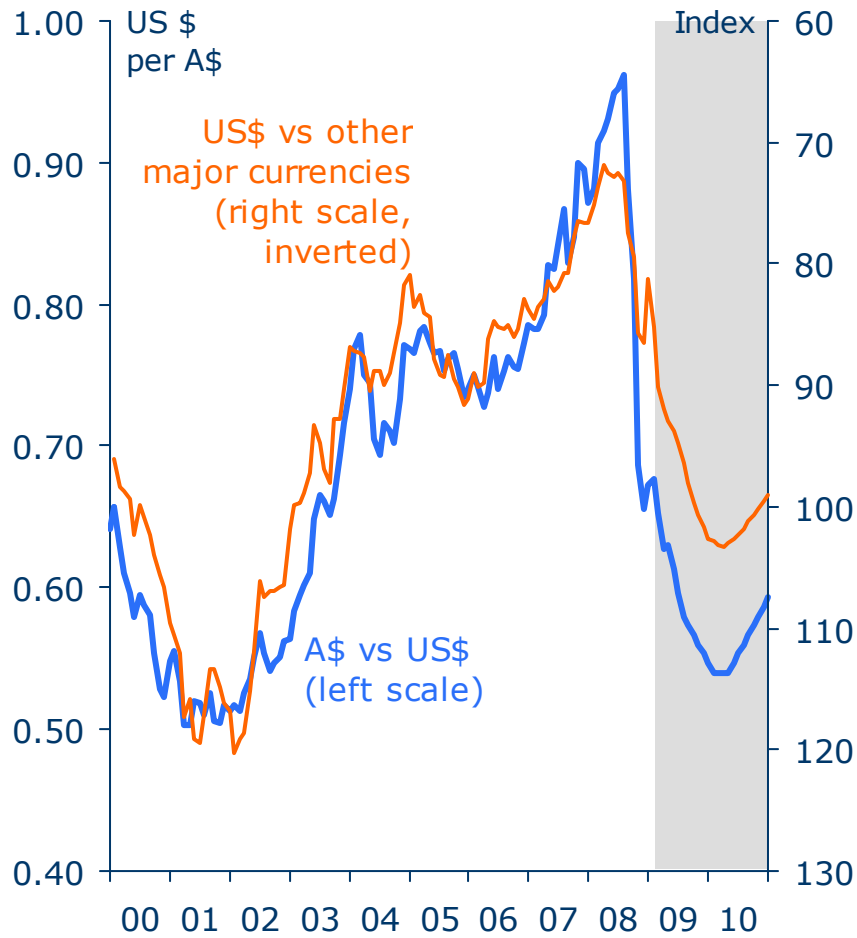
## Consumer prices



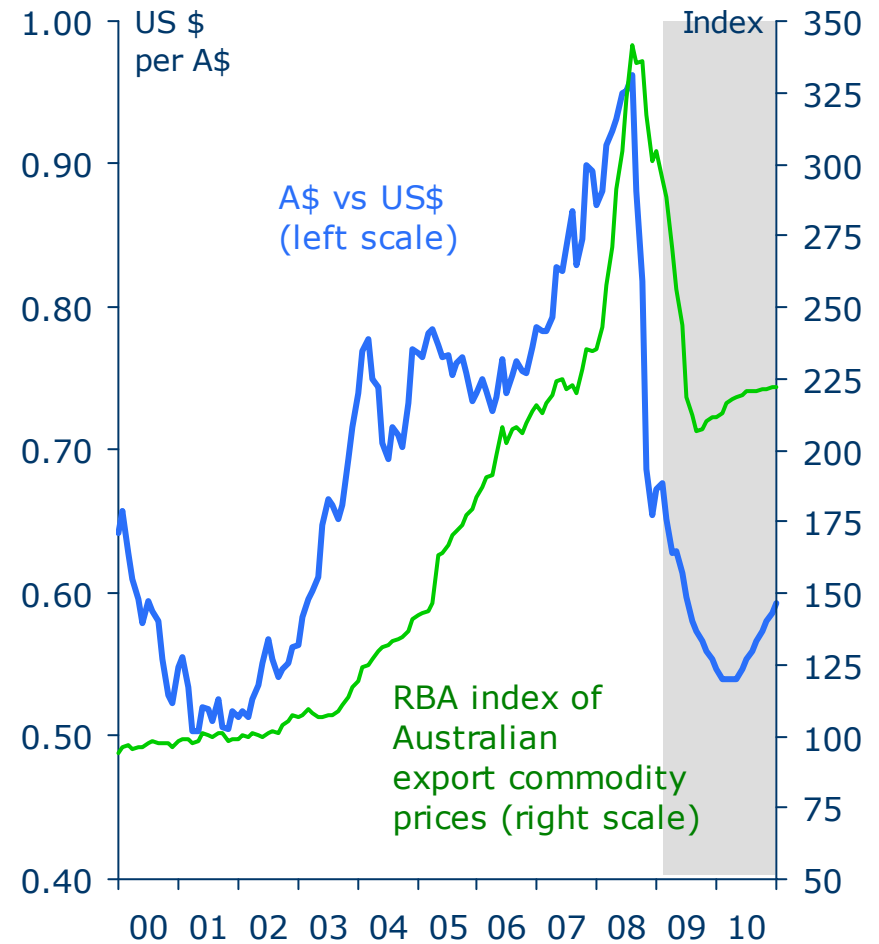
Note: excludes impact of introduction of GST and major health policy changes and proposed commencement of emissions trading scheme in mid-2010. Sources: ABS; RBA Statement on Monetary Policy (November 2008); ANZ Economics & Markets Research.

# The A\$ will fall further against a resilient US\$ - though this will help cushion the economy and resist deflation 40

### A\$ vs US\$



### A\$ & commodity prices



Sources: Datastream; US Federal Reserve; RBA; ANZ.

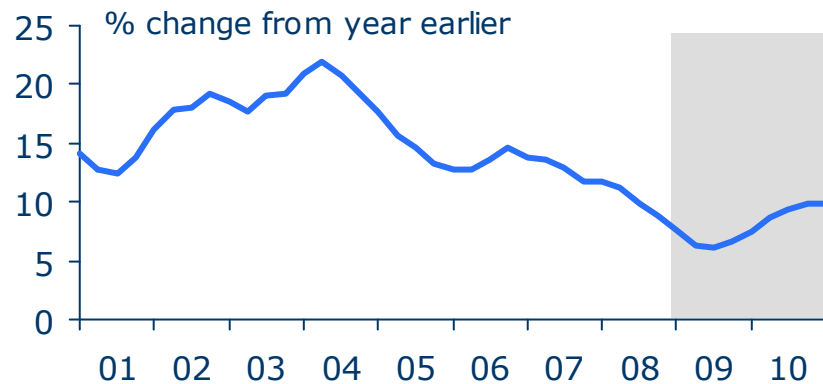




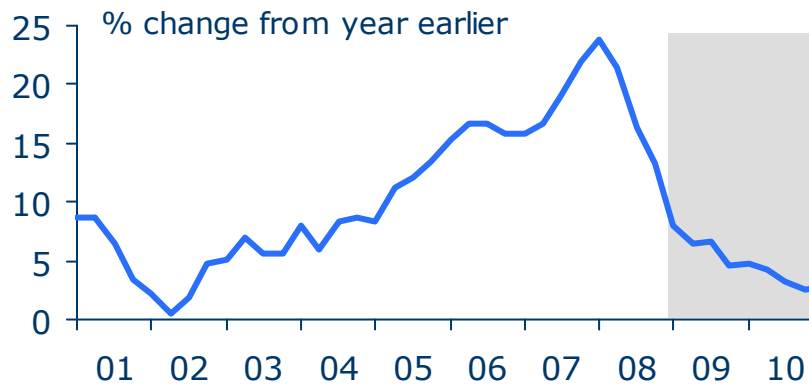
# Credit growth is expected to slow over the next two years reflecting both demand and supply influences

## Credit growth

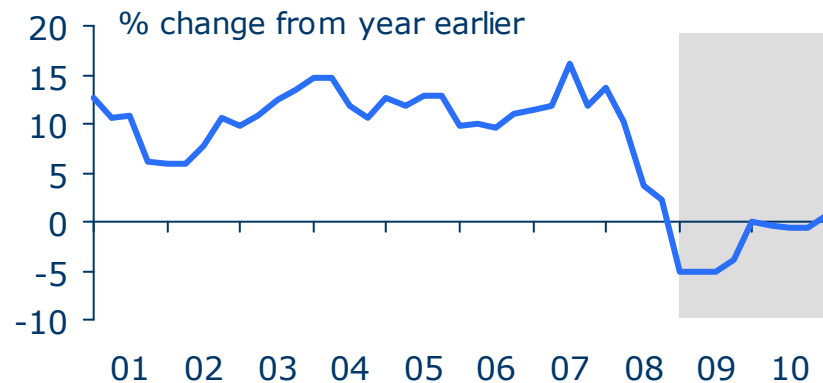
### Housing



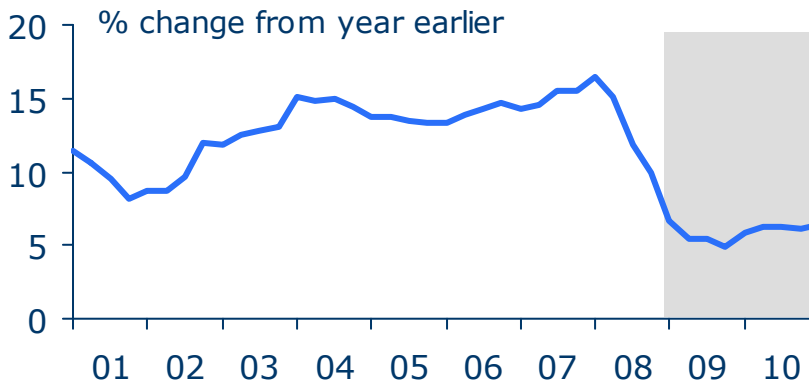
### Business



### Other personal



### Total

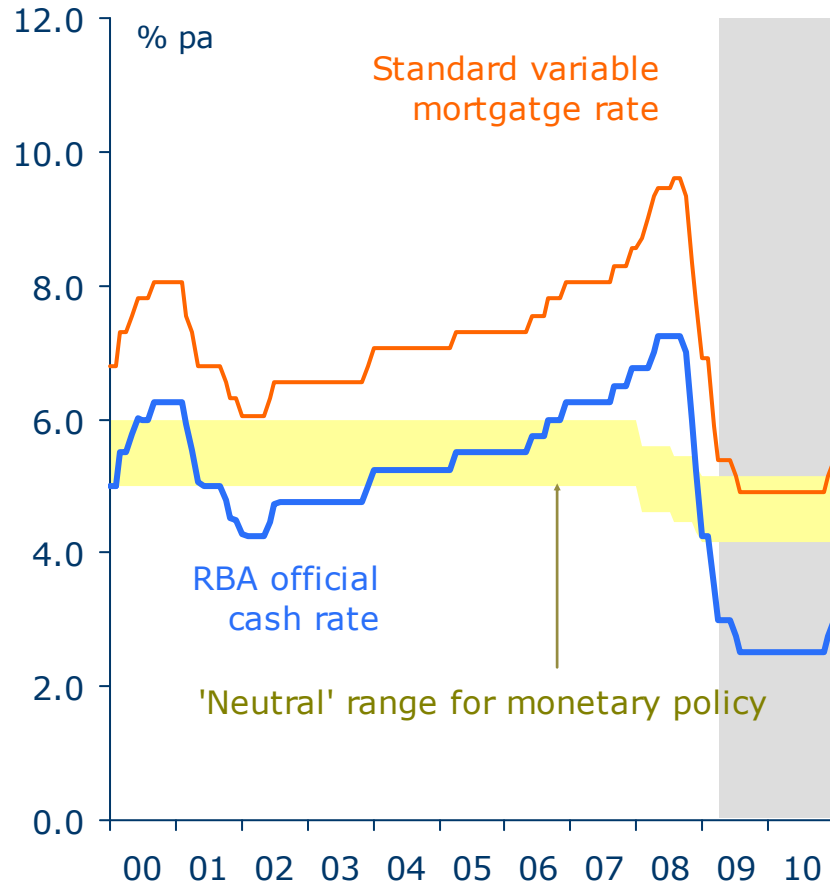


Sources: RBA; ANZ.

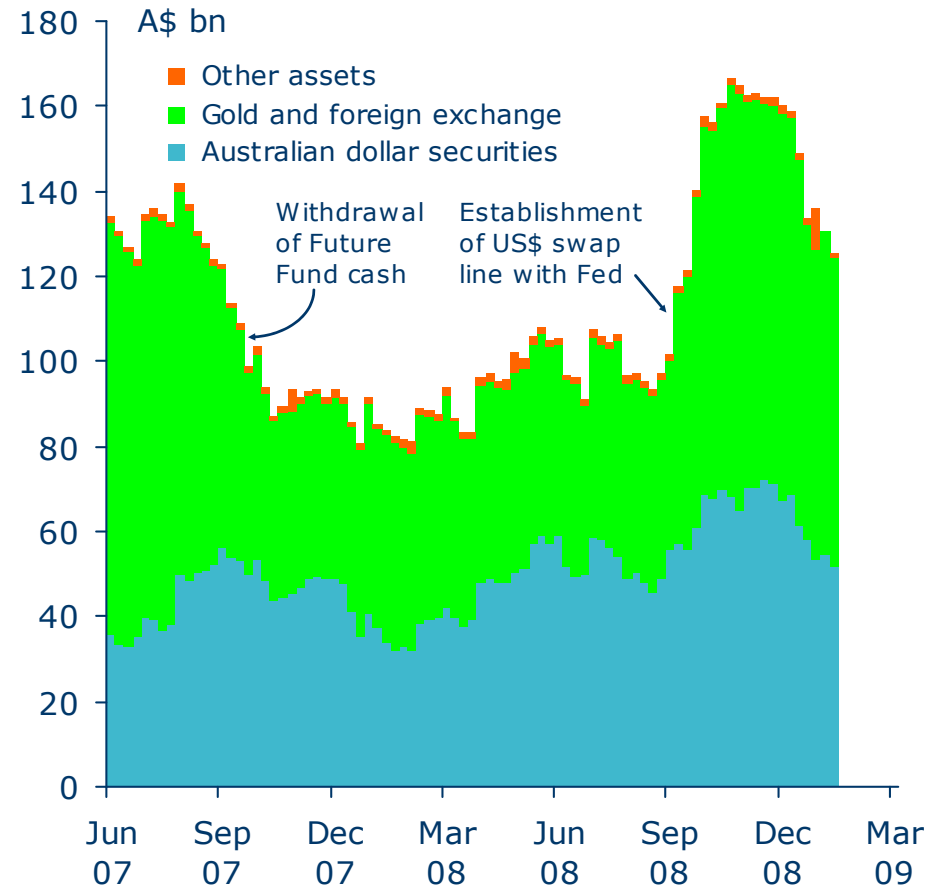


Although the RBA hasn't needed to be as 'creative' as the Fed, <sup>42</sup> it has taken the cash rate to a 45-year low

**Reserve Bank cash rate**



**Assets on the Reserve Bank's balance sheet**



Sources: RBA: ANZ.

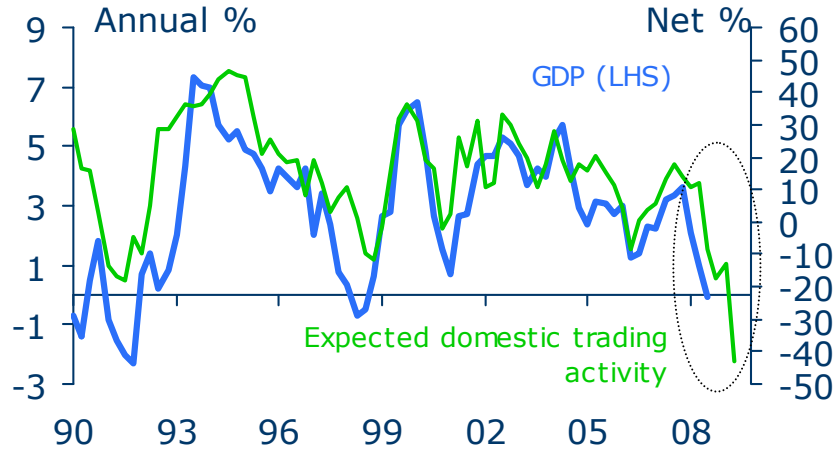


## Outlook for the New Zealand economy

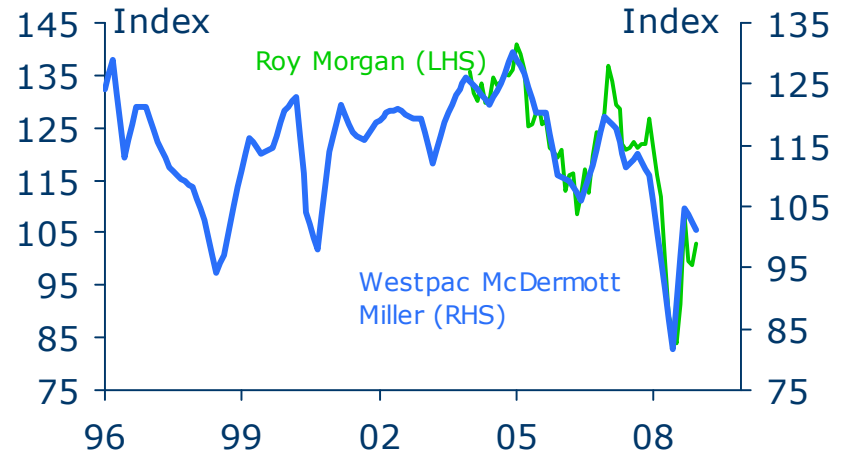
- **The economic picture is deteriorating. Business confidence surveys are either at, or near, historical lows. It is likely that the recession will extend to five, possibly six, quarters. The impact of the recent financial market turbulence is now clearly being felt domestically not only through the cost and availability of credit (the initial impact), but also now as real economies slow and result in falling export demand and lower commodity prices.**
- **We need to appreciate two dynamics when looking at the outlook for the NZ economy. While undergoing a cyclical downturn, this is also in combination with a structural adjustment, namely returning the external balance (current account deficit) to a more sustainable position. We expect a very deep and more pronounced recession this year, which is notable in that it immediately follows from a recession in 2008.**
- **Domestically, a sharp turn in the labour market also now represents the next leg of vulnerability. Anecdotes and recent business surveys suggest the unemployment rate is set to rise sharply past 7 percent. We likewise see growing risks around the hinterland, as the flow on effects from falling commodity prices and global environment are felt.**
- **NZ's sovereign credit rating is under pressure. S&P have signalled that the 2009 *Budget* will be a key benchmark in assessing NZ's rating, which is currently on a negative outlook. Our modelling suggests it will be very difficult for the Government to show a credible fiscal plan given economic headwinds. This is also constraining how far fiscal policy can act as an economic stabiliser.**
- **Monetary policy has more work to do but we are also becoming more attuned to how far rates can fall. We are expecting another 75bp cut from the RBNZ in March, and a terminal OCR of 2.5 percent. Movements below that may be somewhat constrained by the structural aspects to the economic downturn.**
- **We expect the currency to be the key release valve through which the cyclical downturn and structural adjustment are navigated.**
- **We are pencilling in a solid recovery from mid 2010, but this is somewhat premised off a deeper downturn in 2009, with a natural base effect, in combination with cyclical support factors, coming to the fore.**

# The NZ economy is deteriorating

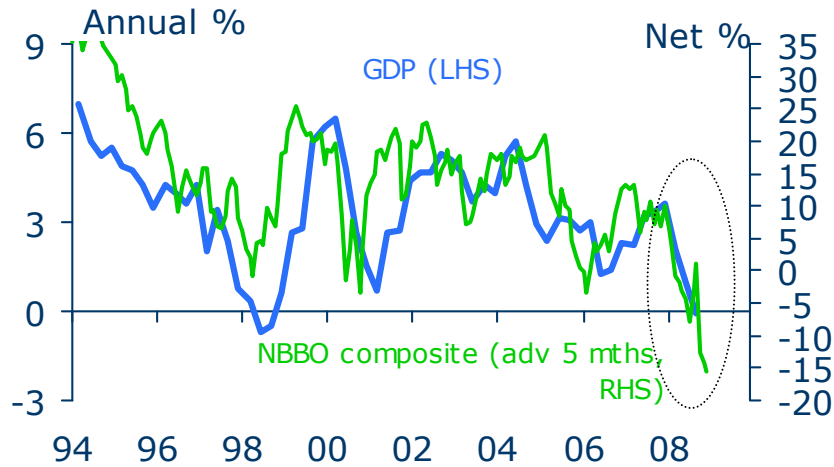
**Business confidence at multi-decade lows**



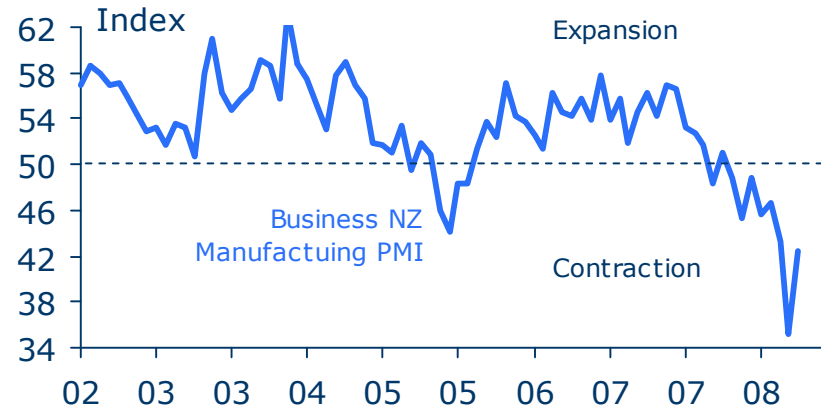
**Consumers subdued despite lower petrol, tax and mortgage rates**



**Further contractions in GDP likely**



**Slowdown reaching all pockets of the economy**



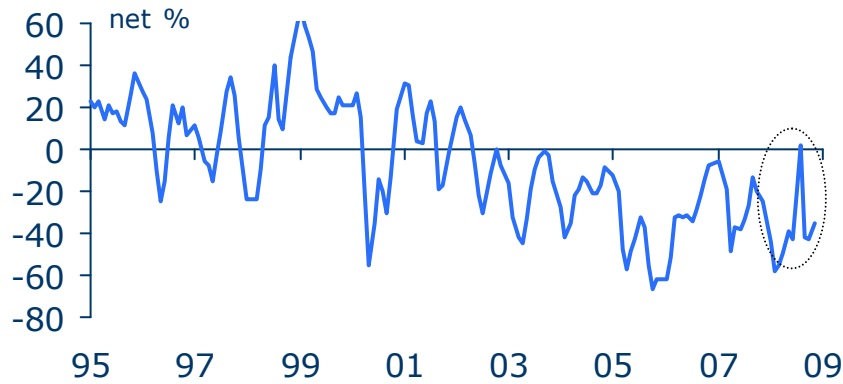
Sources: Statistics NZ, NZIER, Westpac, Roy Morgan, Business NZ, ANZ National



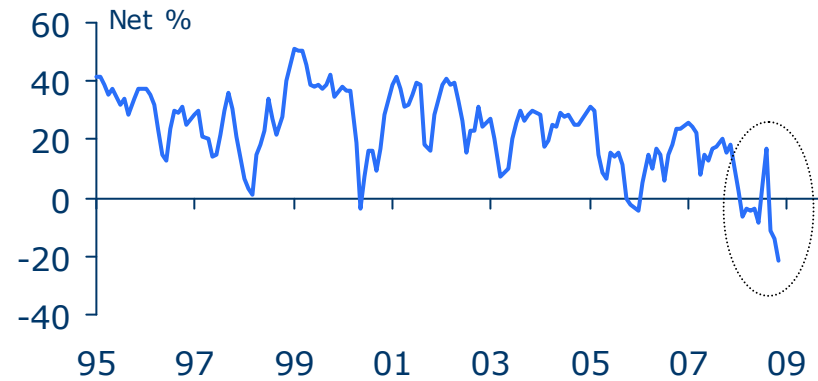
# Business confidence remains weak, especially employment

## National Bank *Business Outlook* survey

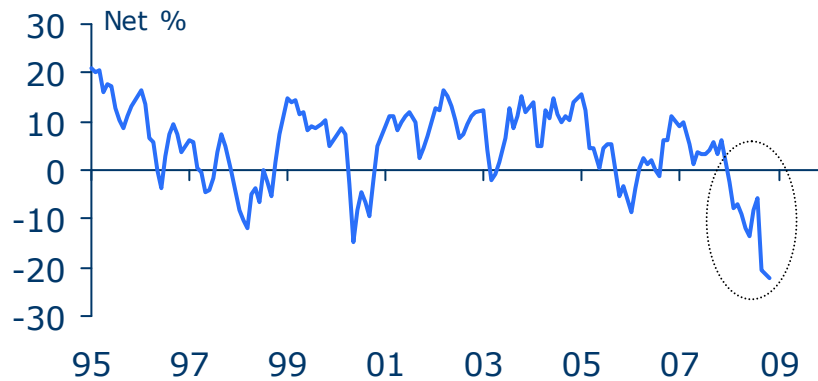
**Headline confidence**



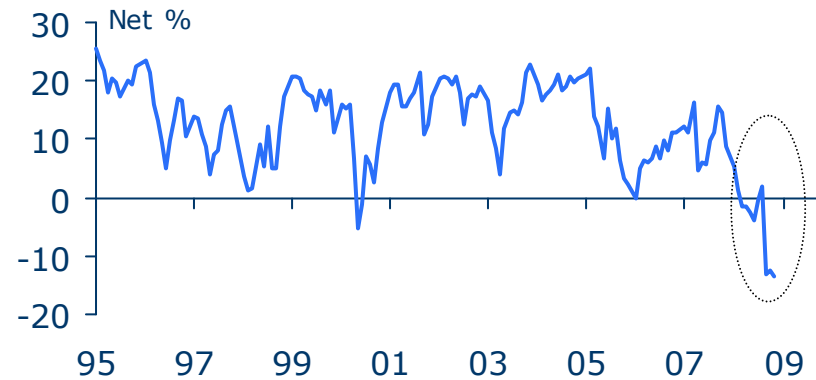
**Own activity**



**Employment**



**Investment**

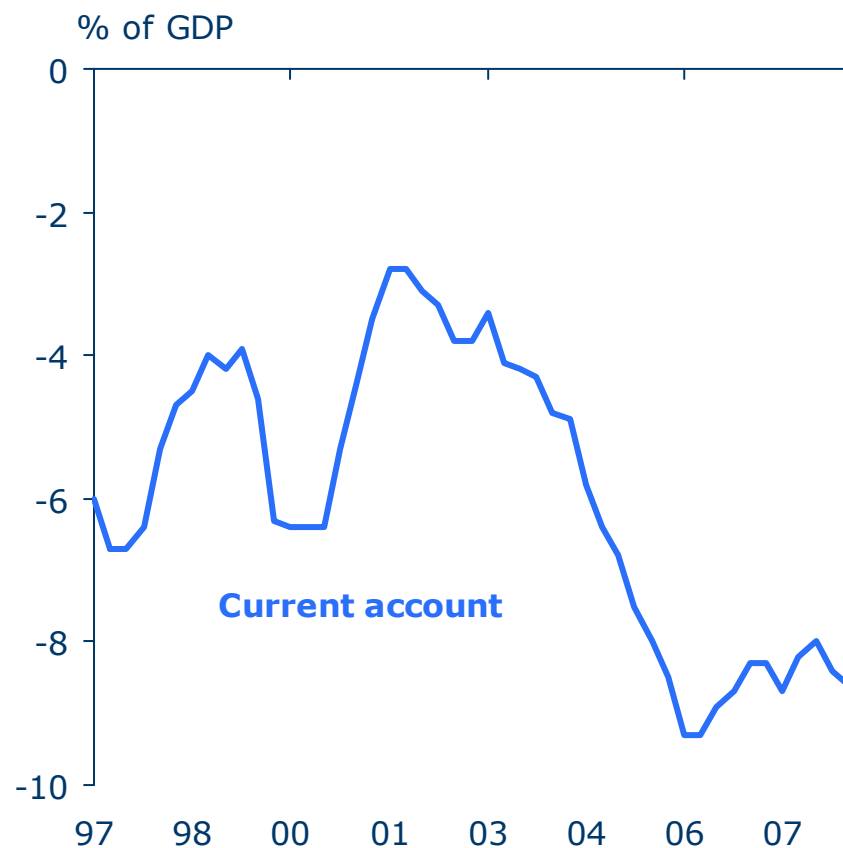


Sources: ANZ National

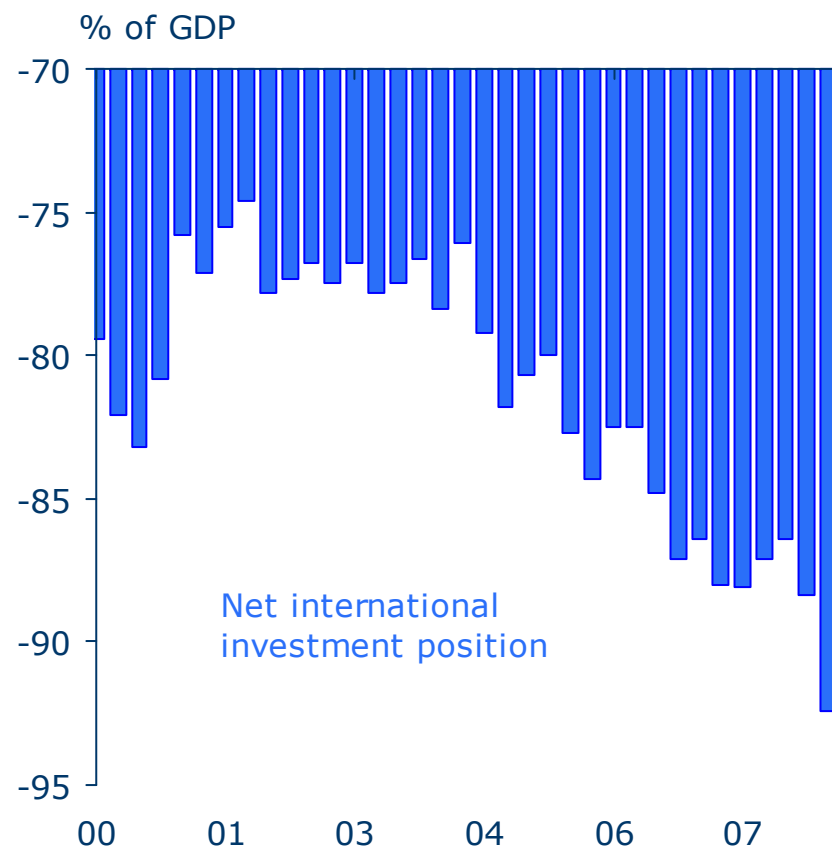


## There are two dynamics at play: a cyclical downturn and a structural adjustment

### NZ's external position is poor and set to deteriorate further

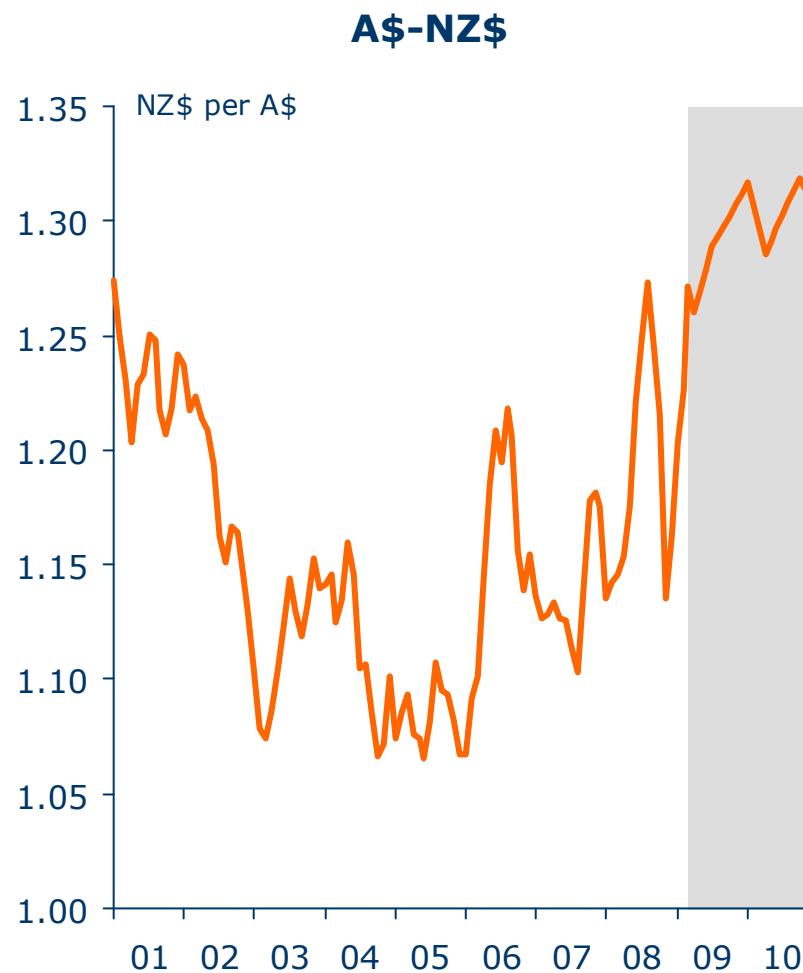
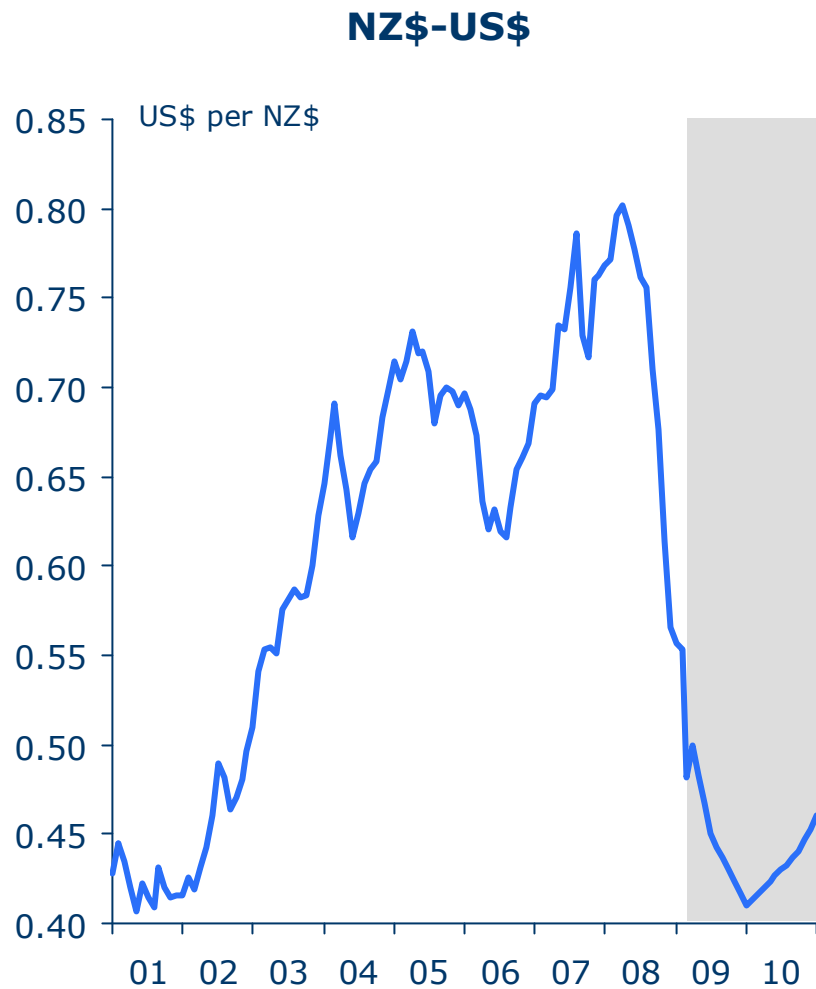


### Net IIP not only needs to stabilise, but has to improve



Sources: Statistics NZ, ANZ National

# A lower NZ\$ is a key prerequisite for the economy to rebalance

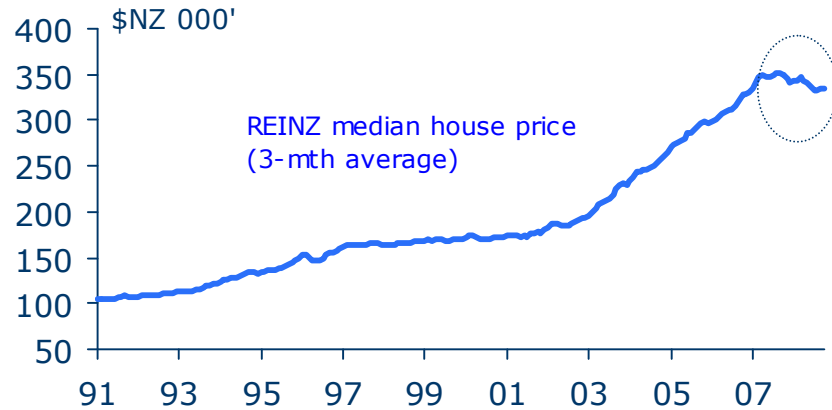


Sources: Bloomberg, ANZ National

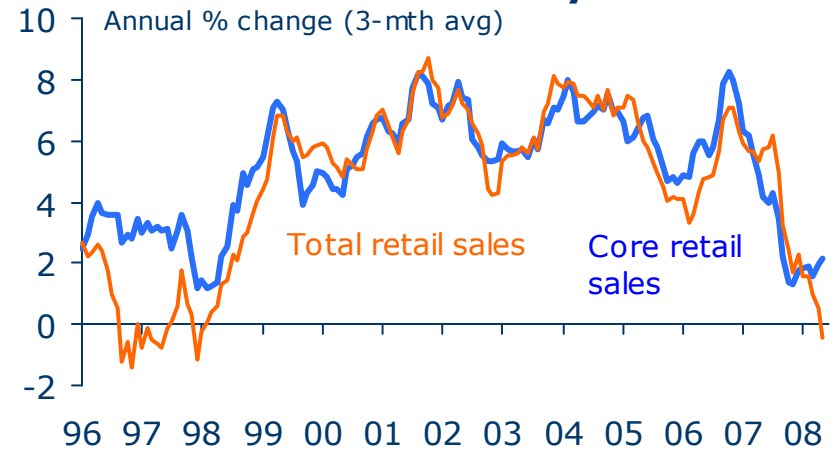


# The rebalancing also centres on households

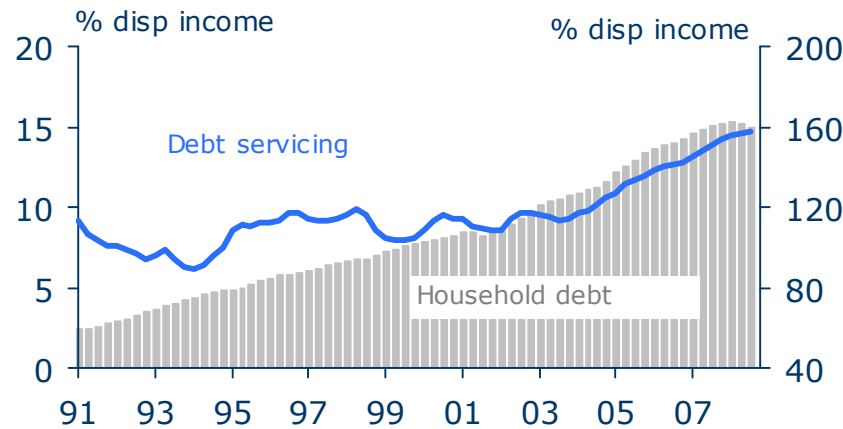
### House prices retreating



### Consumers' wallets have been hidden away



### Debt servicing burden is still high



### Household credit growth subdued



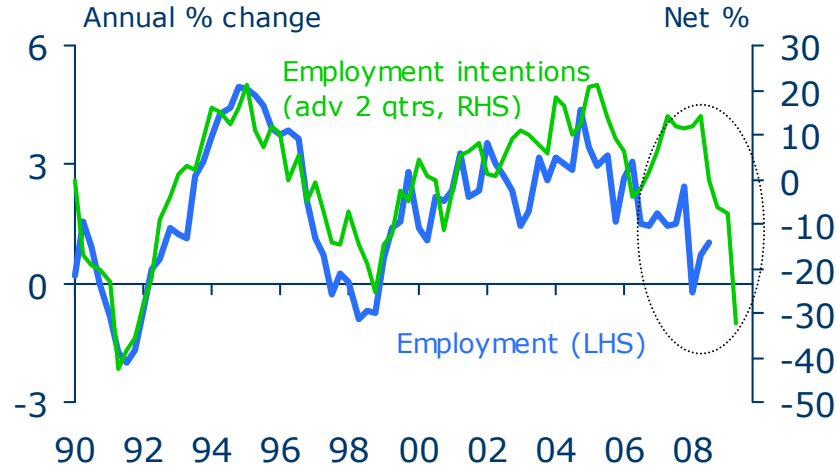
Sources: RBNZ, REINZ, Statistics NZ, ANZ National



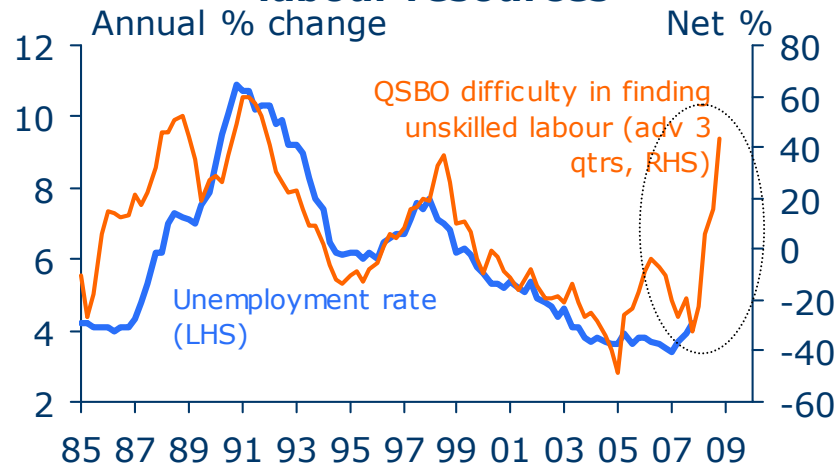


# The labour market represents the next leg of vulnerability

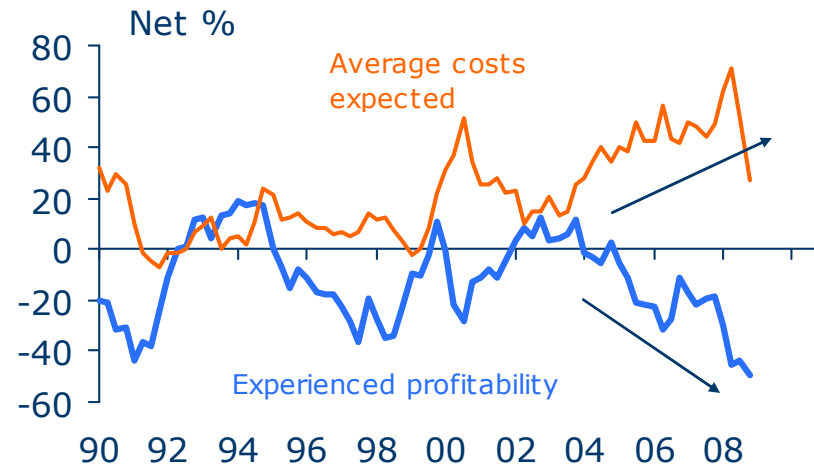
## The labour market is turning sharply...



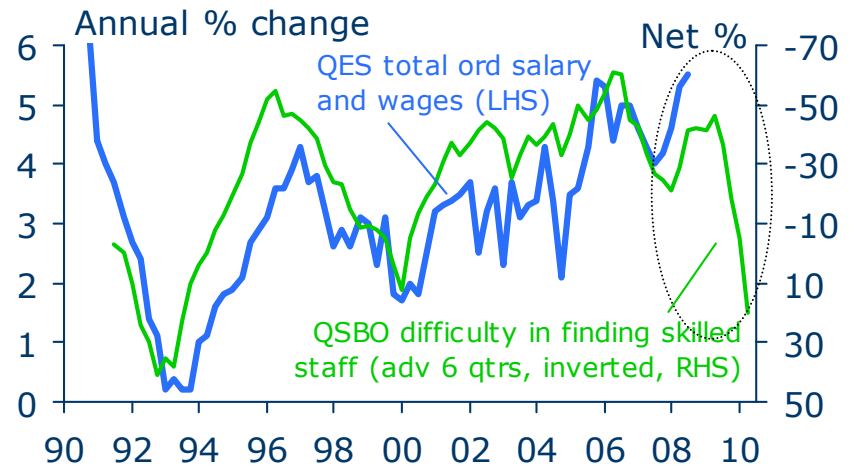
## Resulting in rapid freeing up in labour resources



## ...as firms focus on costs



## Wage growth is likely to have peaked

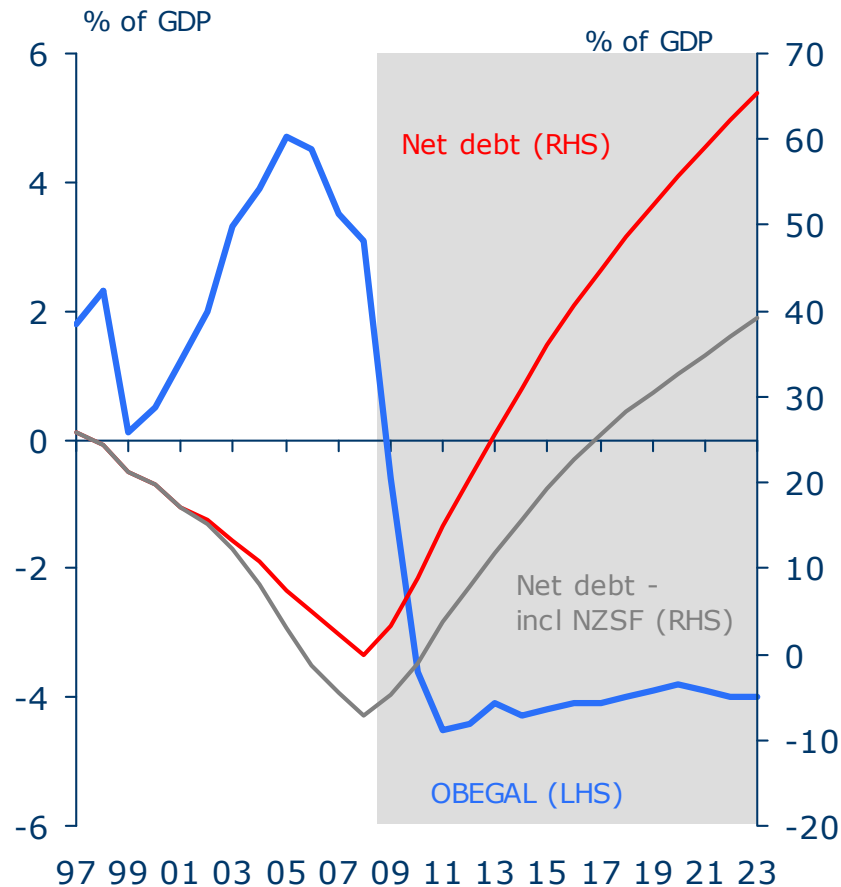


Sources: Statistics NZ, NZIER, ANZ National



## Risk of a credit rating downgrade is non-trivial

### A deteriorating fiscal position



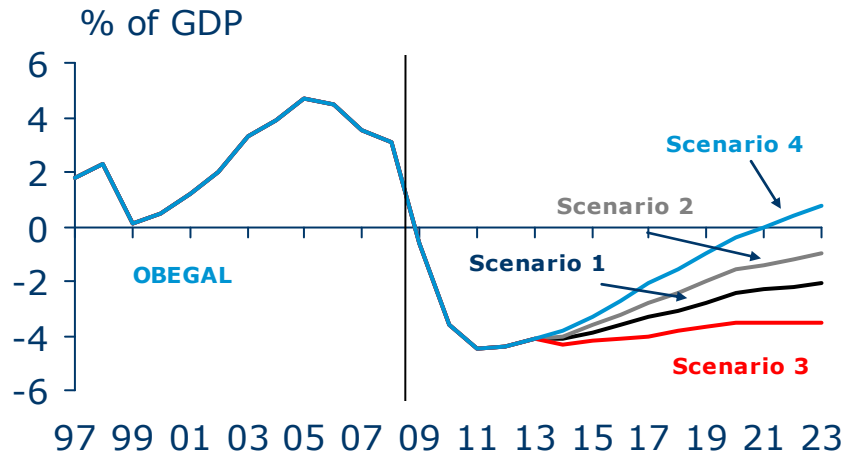
*Note:* 'OBEGAL' is operating balance before gains and losses and excluding NZ Super Fund revenue.

*Sources:* Statistics NZ, NZ Treasury, ANZ National

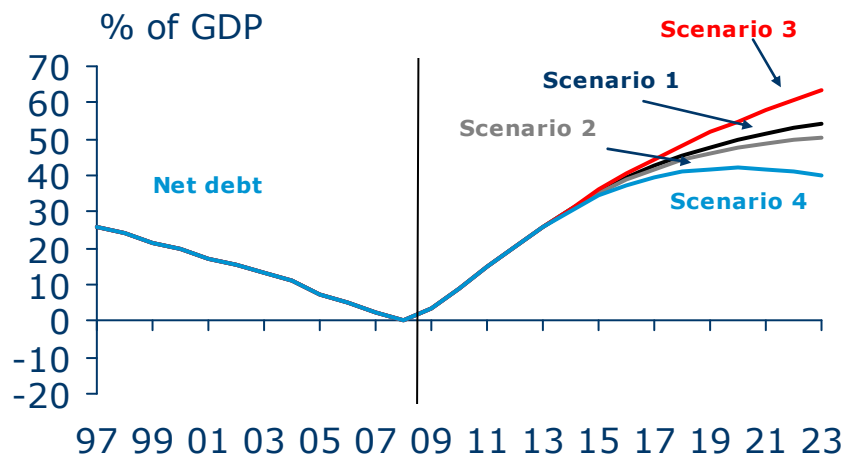
- A weaker economy is now the “central” scenario in so far as the Government’s fiscal forecasts are concerned. Under this scenario, sustained operating deficits are expected for a considerable period. Net debt rises sharply.
- Fiscal policy is acting in a counter-cyclical manner. Recently announced initiatives include personal tax cuts of \$1b in April, a \$480m support package (spread over four years) for small and medium sized businesses, and the bringing forward of both short and longer-term infrastructure spending (with details likely to be announced shortly).
- Looking at the opening stock of debt (zero) suggests NZ is well placed to continue to provide counter-cyclical support. However, this is now somewhat constrained by disconcerting medium-term fiscal projections and a desire to avoid a credit rating downgrade.
- S&P has placed NZ’s AA+ rating on negative outlook, and has noted a one in three chance of a ratings cut. With a poor external position, S&P need to gain comfort from the fiscal projections presented in the 2009 *Budget* (likely in May).
- Our modeling work (refer over page) suggests it will be difficult for the Government to present a credible medium-term fiscal strategy that allows the fiscal position to improve.

# It will be difficult to present a credible medium-term fiscal outlook to arrest a downgrade

## OBEGAL scenarios



## Net debt scenarios



Note: 'OBEGAL' is operating balance before gains and losses and excluding NZ Super Fund revenue.

Sources: Statistics NZ, NZ Treasury, ANZ National

**Scenario one: go for growth.** Labour productivity growth improves from the base scenario of 1.5 percent to 2.0 percent per year, taking average GDP growth to 2.8 percent from 2013 to 2025.

**Scenario two: commit to a lower operating provision – early.** This scenario assumes the government acts early and makes a cut to the projection year's operating provision (\$1.0 billion from \$1.7 billion), but still assumes growth in spending in line with CPI. Real per capita spending remains constant, but at a lower starting point. The reduction is beyond the short-term horizon where there is obvious pressure to maintain and provide counter-cyclical fiscal policy support, but still close enough so benefits have time to cumulate from 2014 to 2023..

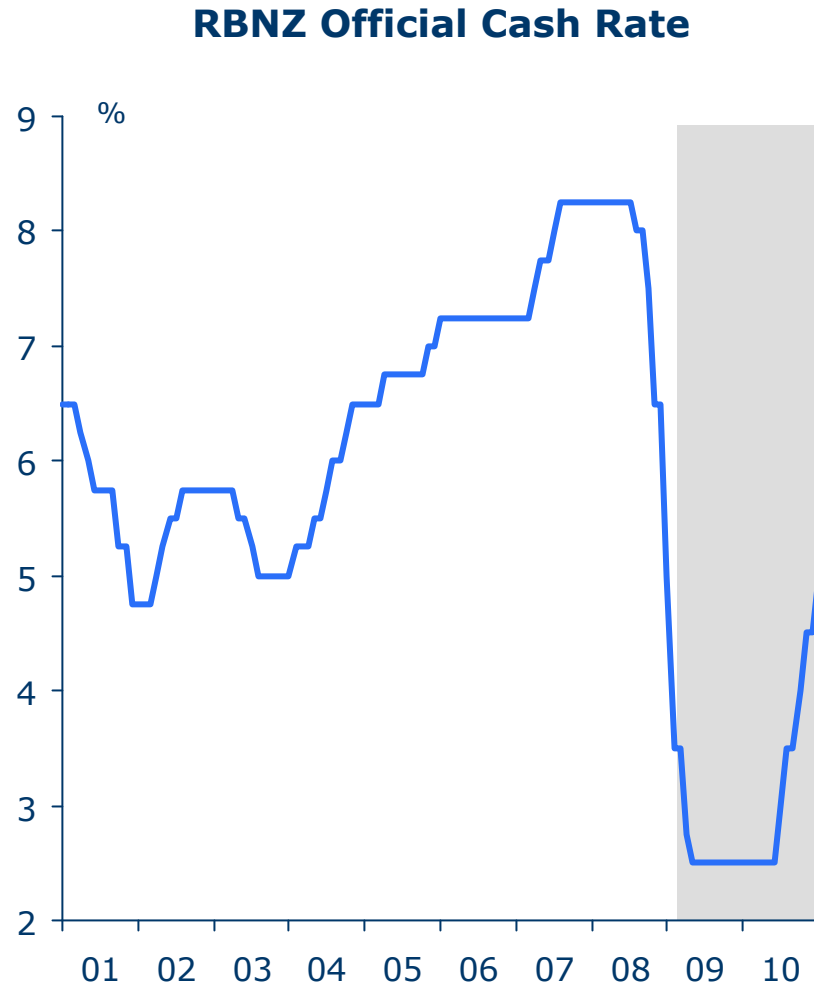
**Scenario three: claw our way back slowly.** Rather than having the operating provisions grow in line with inflation from 2014 to 2023, they remain constant from the base of \$1.7 billion. This is implicitly a scenario of falling real per capita spending.

**Scenario four: the kitchen sink.** A combination of both scenarios one and two.

**The bottom line:** We doubt the 2009 *Budget* will provide S&P with comfort when it comes to assessing NZ's sovereign rating. While the starting position is strong, the projected deterioration is difficult to arrest.



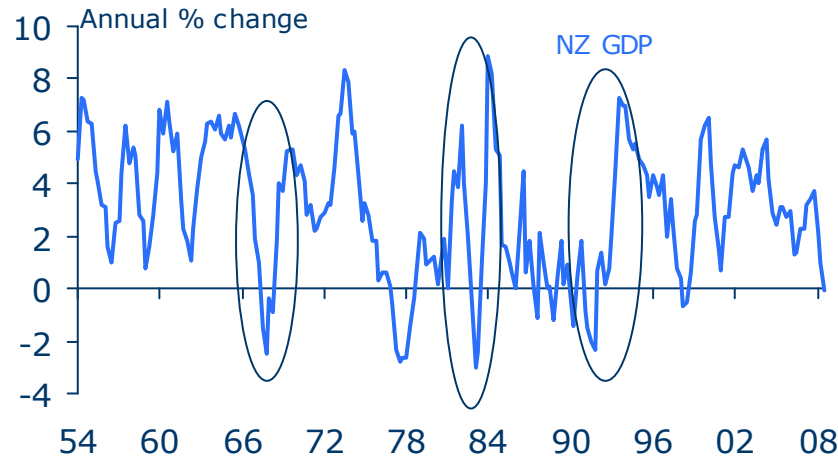
## Monetary policy has more work to do



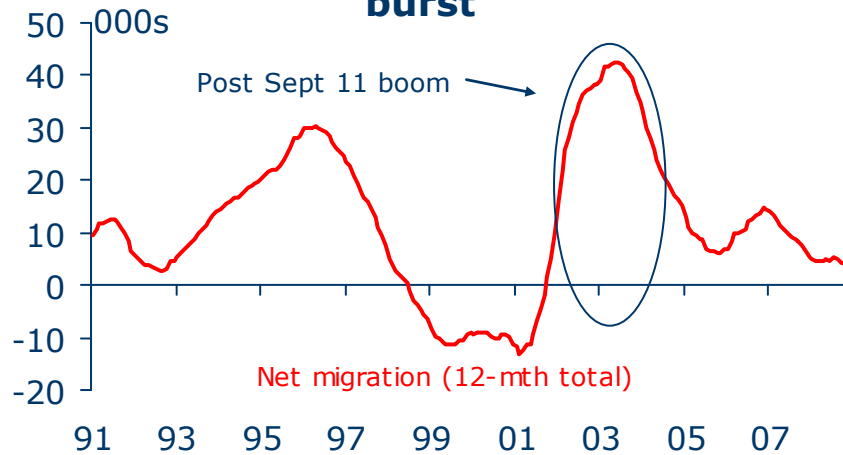
- The medium-term constraints on fiscal policy mean monetary policy has more work to do.
- We expect the OCR to be lowered by another 75bp in March, to be followed up with a 25bp cut in April, taking the OCR to a terminal rate of 2.50 percent.
- A rate below this cannot be ruled out and is easy to justify given the data-flow and economic circumstances. However, there is also the reality of the structural adjustment the economy is embarking on and the need for a further correction in the domestic economy in order to correct the external position.
- The currency is therefore expected to be the circuit breaker through which the cyclical downturn and structural adjustment are navigated.

# Recovery: 2010 story at the earliest

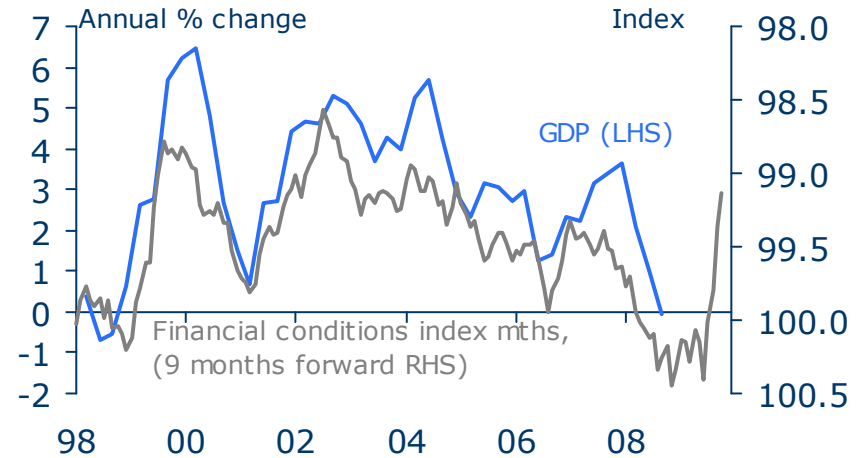
**History shows that a deeper trough often results in a sharper recovery**



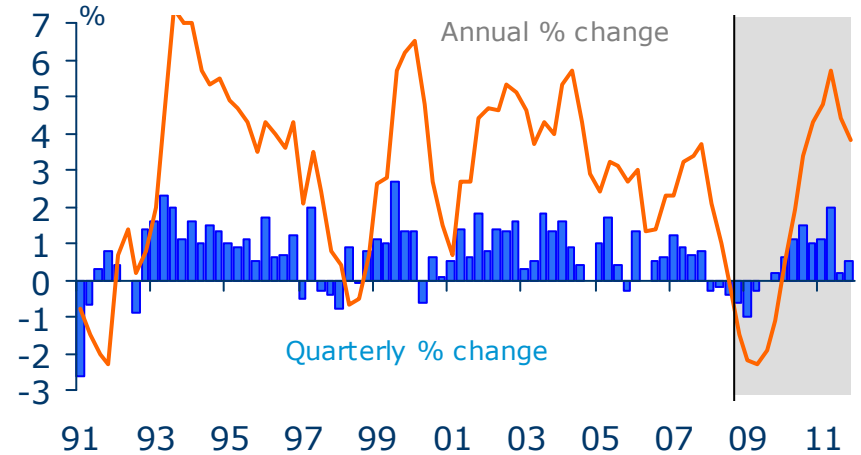
**Watch for a potential net migration burst**



**Financial conditions have improved markedly**



**NZ GDP forecast**

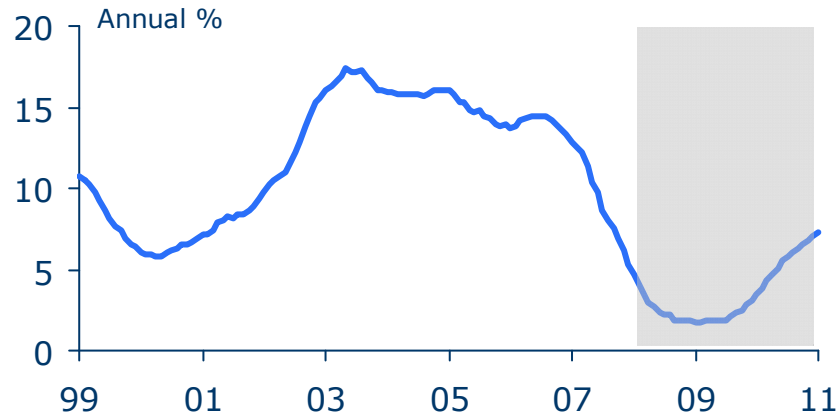


Sources: RBNZ, Statistics NZ, ANZ National

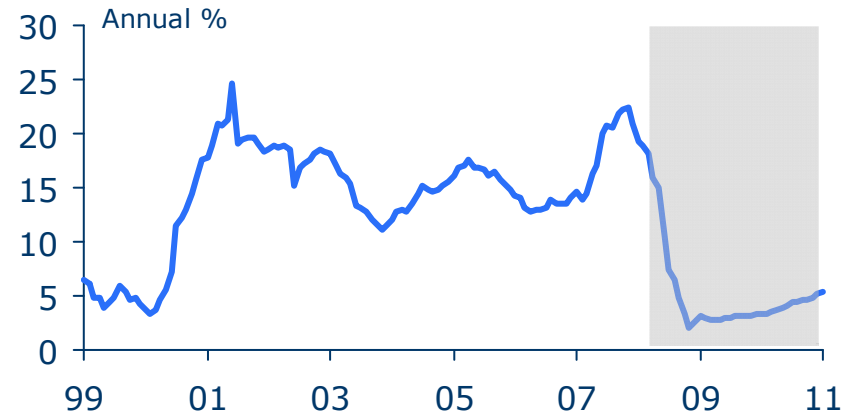


# Credit growth is weak and looks likely to remain so

**Housing credit**



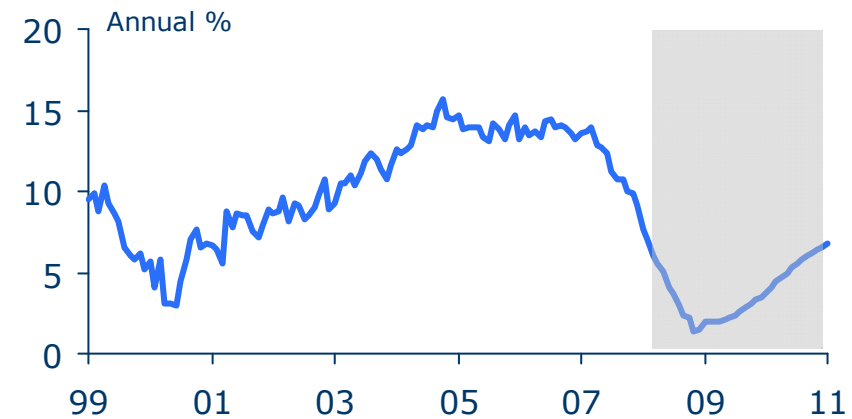
**Business credit - agriculture**



**Business credit - other**



**Total credit**



Sources: ANZ National; RBNZ



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