

Economic Issues for the Cotton Industry

**Presentation to the
Australian Cotton Shippers Association
2003 Conference**

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ANZ Bank**

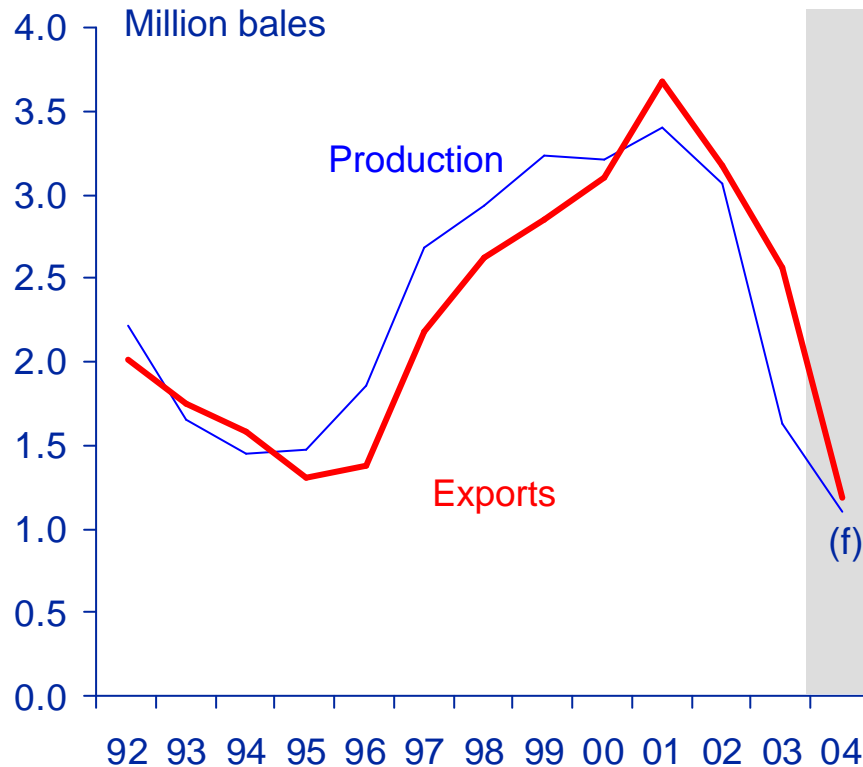
**Royal Pines Resort
Gold Coast
4 September 2003**

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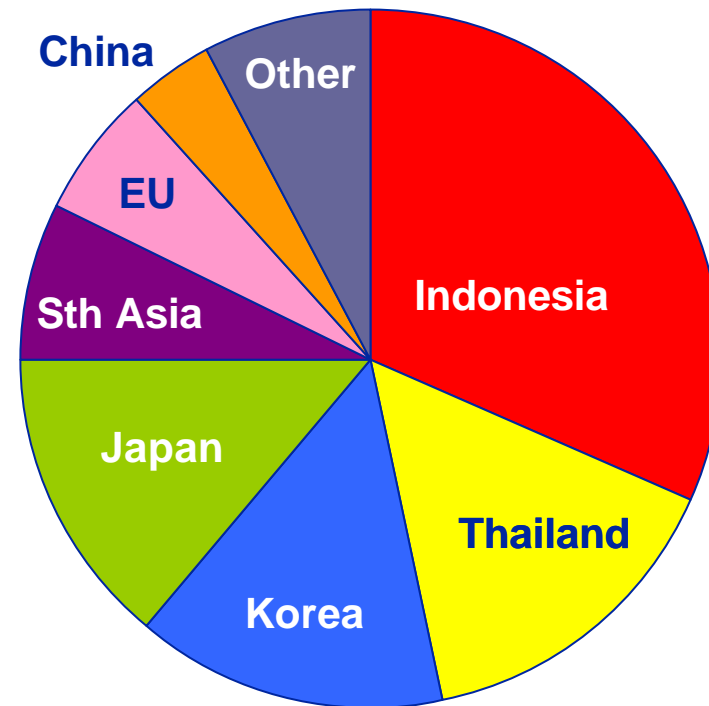
Internet: <http://www.anz.com/go/economics>

Australian cotton producers are vitally interested in export markets

Australian cotton production and exports



Australian cotton export markets, 2002



Sources: Cotton Australia; ABARE; DFAT.

The long-awaited upturn in the global economy is now getting under way

Evidence

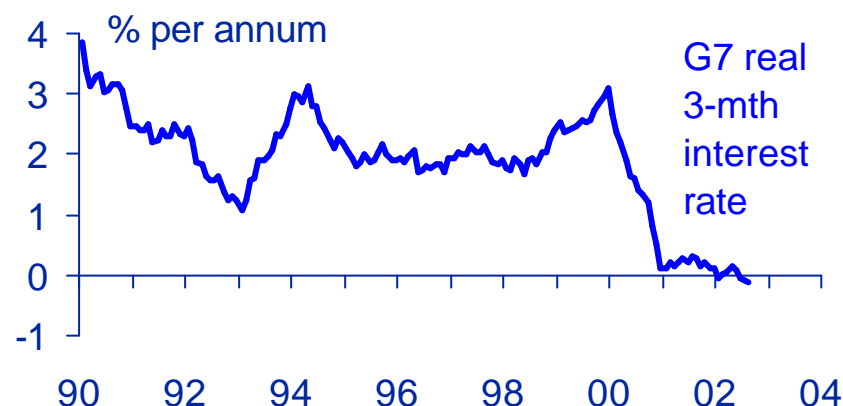
- As 'headwinds' fade, massive policy stimulus is starting to work
- Most US economic data are now pointing to a strong rebound
 - the labour market is the only major exception
- Japan's economy has been tracking stronger than expected
- Most other Asian economies are reporting weak June quarter numbers (largely due to SARS)
 - (limited) data since then generally points to a rebound in activity
- June quarter numbers for Europe have also been very weak
 - but there are clear signs that 'animal spirits' are improving

Implications

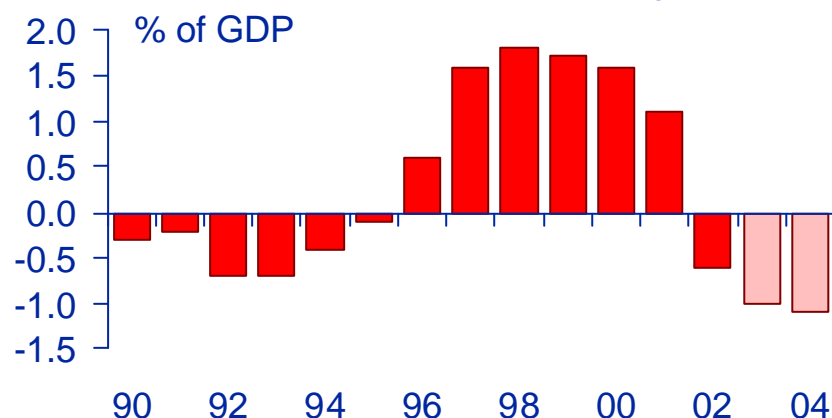
- Deflation risks are receding
 - in some economies (particularly China) inflation may surprise on the upside
- The next movements in global interest rates will be upwards
 - albeit not until well into 2004
 - Europe may see one final rate cut
- Market expectations may have run somewhat ahead of reality
 - so that volatility in financial markets will continue
- The fall in the US\$ has been halted (for the moment)
 - but will resume as global recovery becomes more synchronized
- 'Geo-political risks' could easily flare up again

Policy stimulus is 'kicking in' as growth-retarding 'headwinds' fade away

OECD monetary policy



OECD fiscal policy

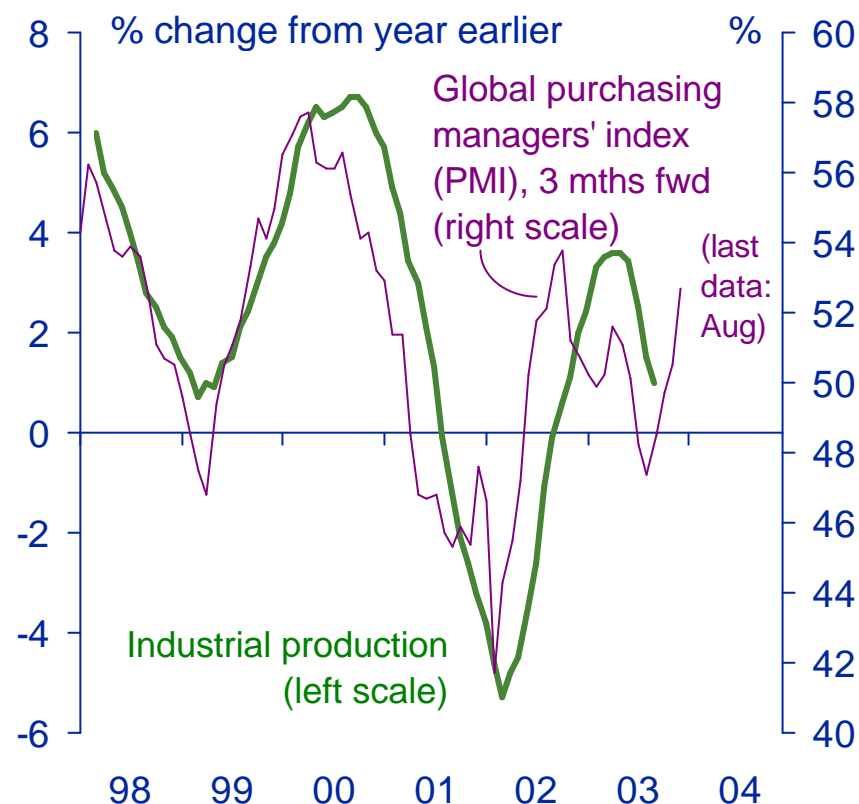
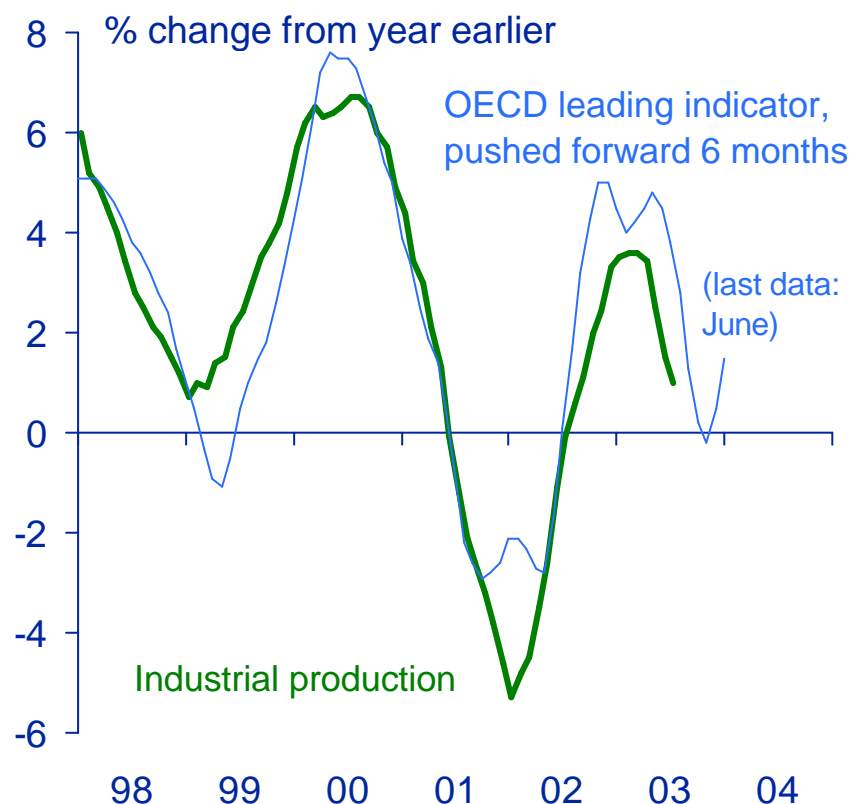


Note: 'Fiscal policy' measure is the cyclically-adjusted primary budget balance (ie excluding net interest payments). Sources: Datastream; OECD; Economics@ANZ.

- Economic policy settings have for some time been much more stimulative than during the early 1990s global downturn
- Over the past 18 months this stimulus has been blunted by a series of 'headwinds'
 - including geo-political tensions, falling share prices, high oil prices and SARS
 - additionally it has taken some time to purge excesses and imbalances built up during the 1990s boom
- Although they haven't gone away completely (and could flare up again), these headwinds have now eased enough to allow policy stimulus to come through

Leading indicators for the global economy have turned around over the past two-three months

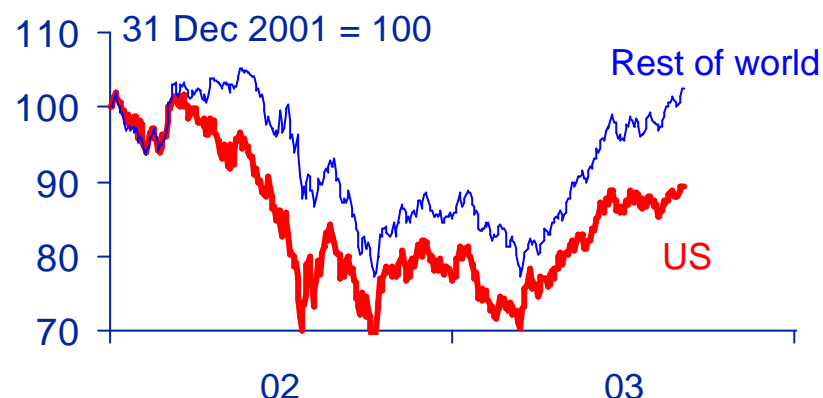
Leading indicators of global industrial production



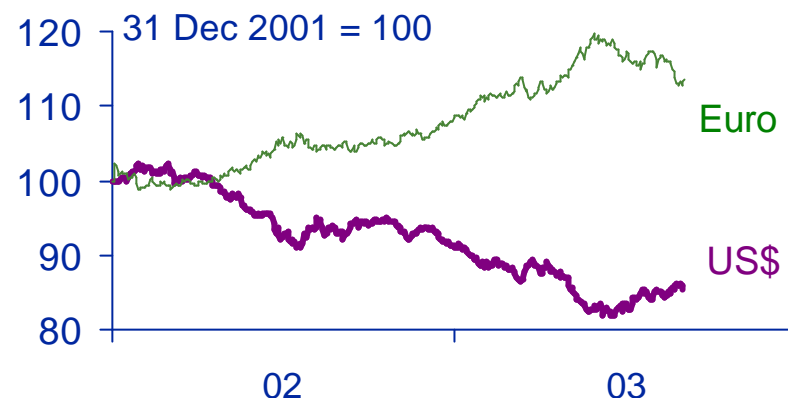
Note: Global IP series constructed by Economics@ANZ from data for 42 countries. Global PMI is a weighted average of PMIs for the US, Euro area, UK, Canada, Australia and (from January 1999), Hong Kong and Singapore. *Sources:* Datastream, OECD, ISM, CIPS, Reuters, NTC, AiGroup, Economics@ANZ.

Financial and commodity markets have also detected the shift in the global economic cycle

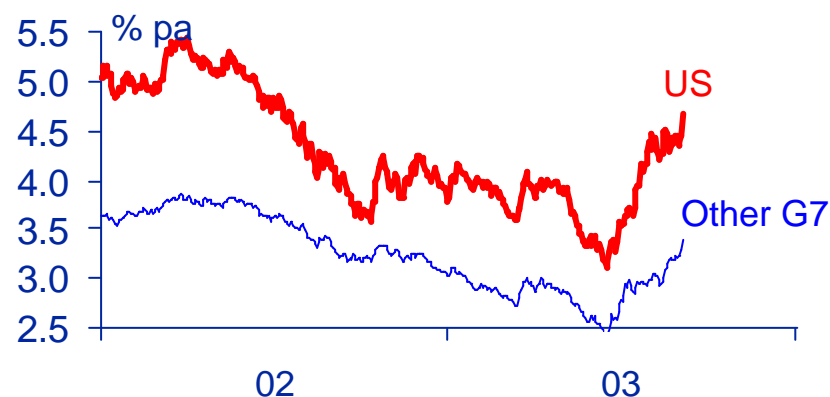
Share markets



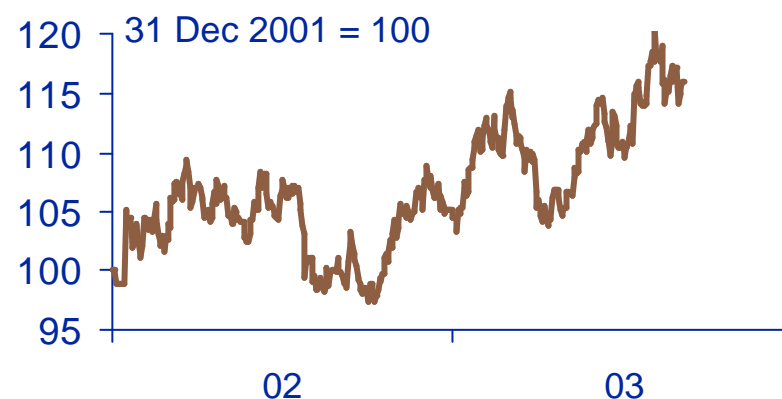
Currency trade weighted indices



10-year bond yields



Base metal prices



Sources: Reuters; Datastream; Metallgesellschaft.

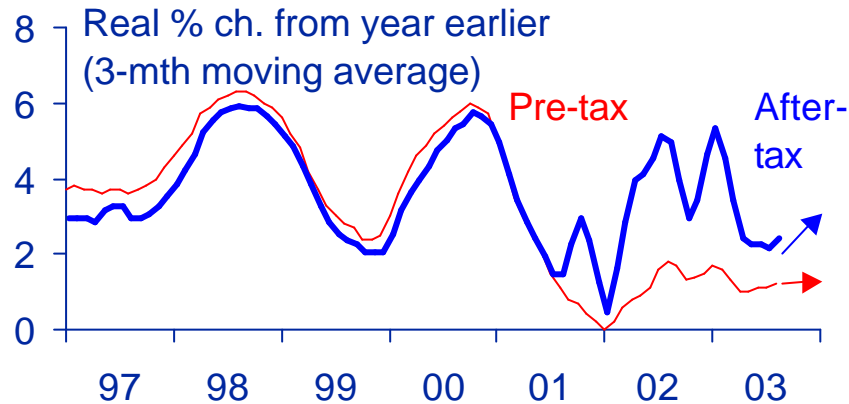
Outlook for world economic growth

	% change in real GDP				
	1996-2000	2001	2002	2003 (f)	2004 (f)
United States	4.0	0.3	2.4	2½	3½
Western Europe	2.7	1.6	1.1	¾	2
Japan	1.4	0.4	0.2	1¾	1¾
<i>Industrial economies*</i>	3.1	0.9	1.6	1¾	2½
China	8.3	7.3	8.0	8	7½
Other East Asia	3.3	2.0	4.6	3½	4¾
South Asia	5.4	5.0	4.4	6¼	6
Latin America	2.9	0.5	-0.5	1¾	3½
<i>Developing economies*</i>	4.6	3.8	4.5	5¼	5½
<i>World*</i>	3.7	2.1	2.8	3¼	4

* Includes countries not shown separately. Sources: National statistical agencies; IMF; Economics@ANZ.

Policy stimulus has allowed US households to start rebuild savings while continuing to spend

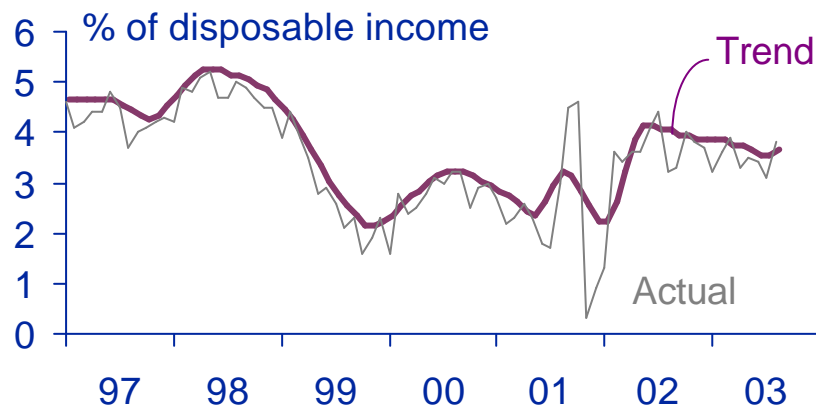
Personal income



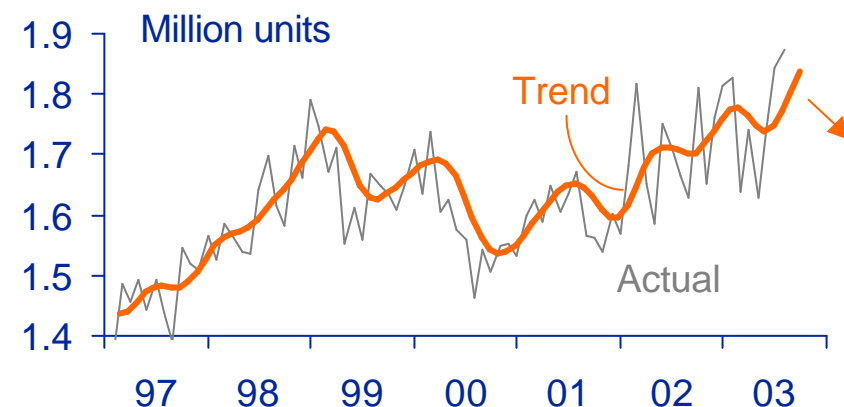
Personal consumption spending



Personal saving rate



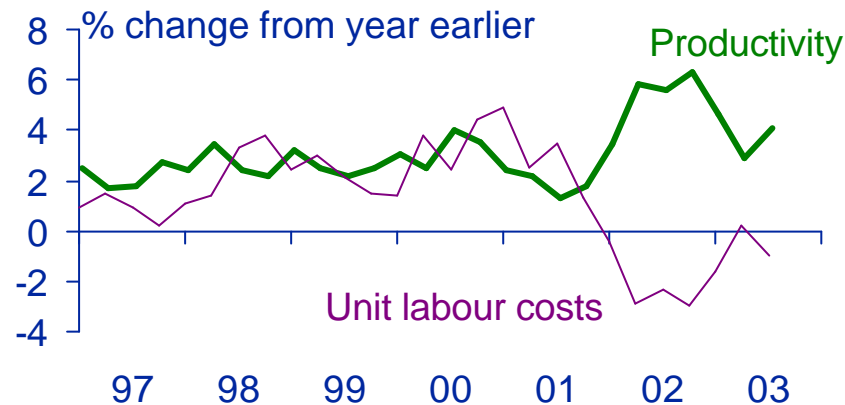
Housing starts



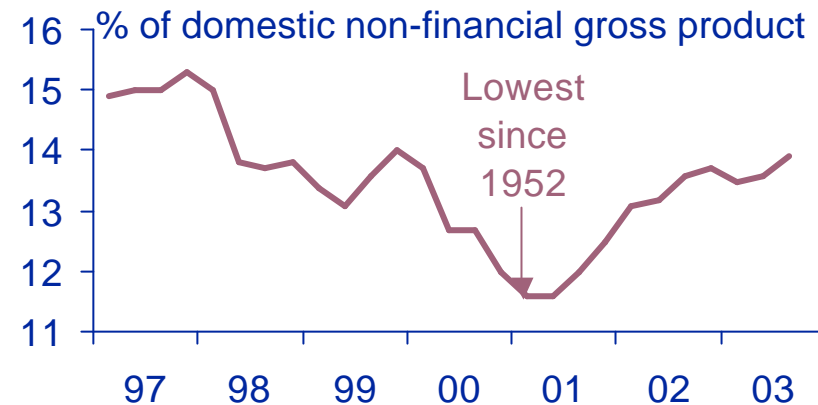
Note: 'Trend' estimates calculated using ABS formulae. Sources: Commerce Department; Economics@ANZ.

Meanwhile US corporate profitability has been largely restored and investment is now recovering

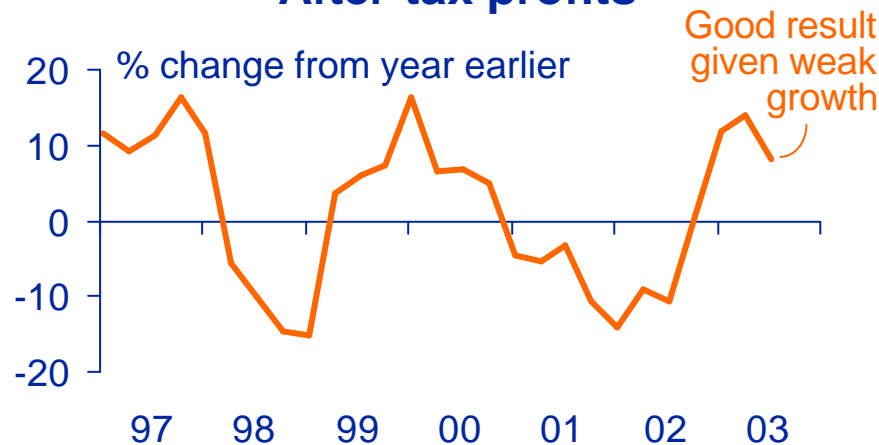
Productivity and labour costs



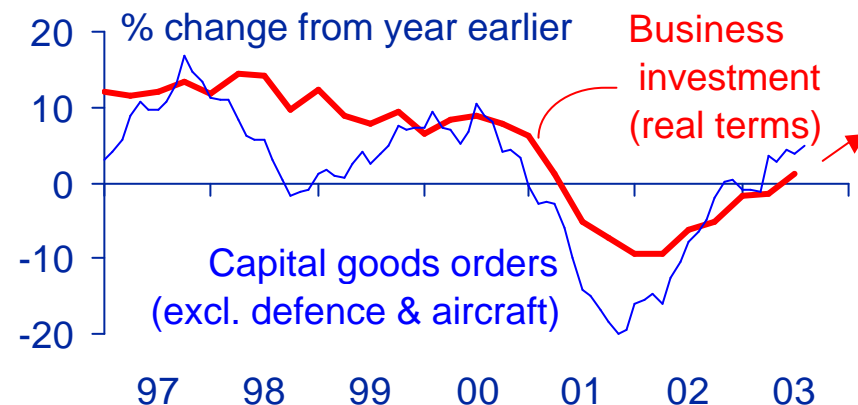
Net cash flow margin



After-tax profits



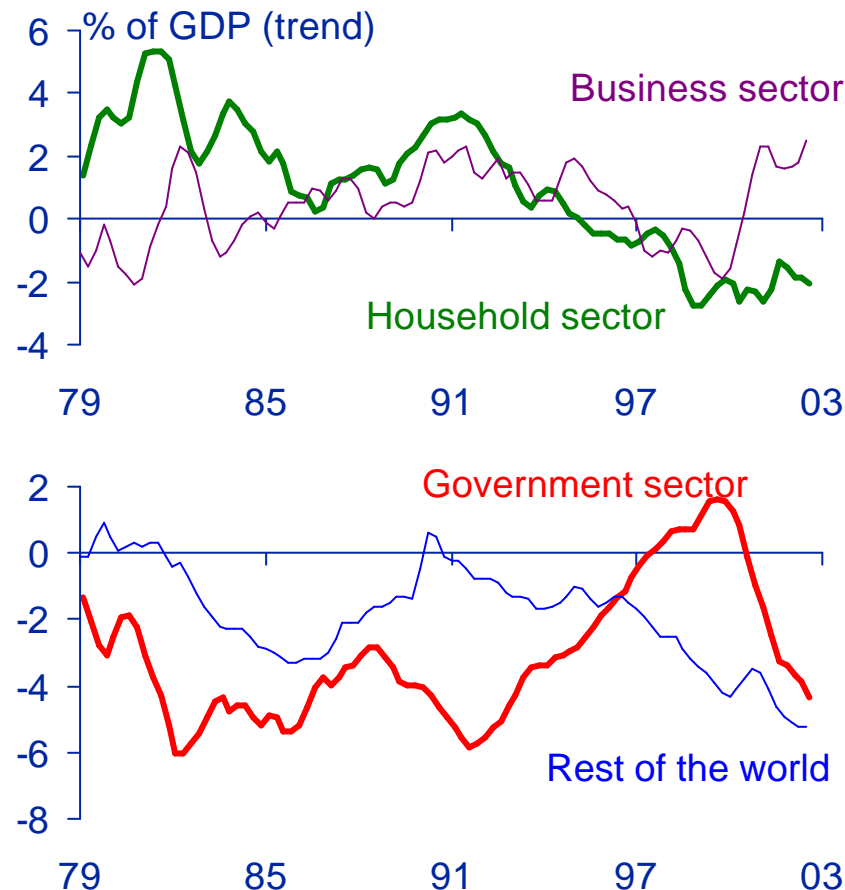
Business investment



Sources: US Bureau of Economic Analysis; Commerce Department; Bureau of Labor Statistics.

While a near-term US recovery seems assured, it's not yet clear how sustainable it will be

US financial balances



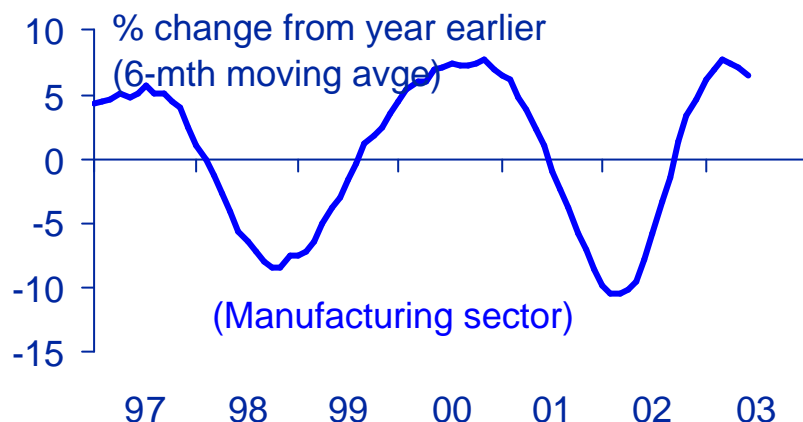
'Financial balance' = saving minus investment.

Sources: Commerce Department; Economics@ANZ.

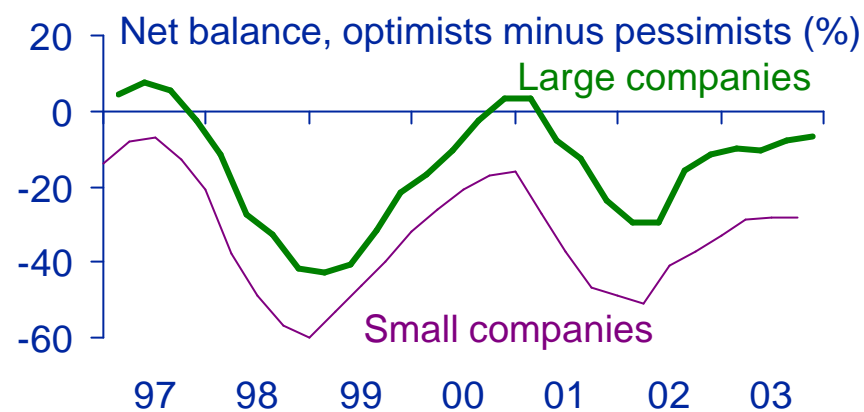
- Almost all of the 'adjustment' to the end of the 1990s bubble has taken place in the business sector
- Household finances remain very 'unbalanced' relative to historical norms, while another major imbalance has opened up (again) in the government sector
- These imbalances have helped keep the US economy afloat over the past three years – but they cannot be sustained indefinitely
- US households are vulnerable to any sharp rise in interest rates or persistent weakness in jobs growth
- The US as a whole is vulnerable to any major shifts in global capital flows

Partial restructuring in some areas of Japan's economy is promoting a recovery in investment

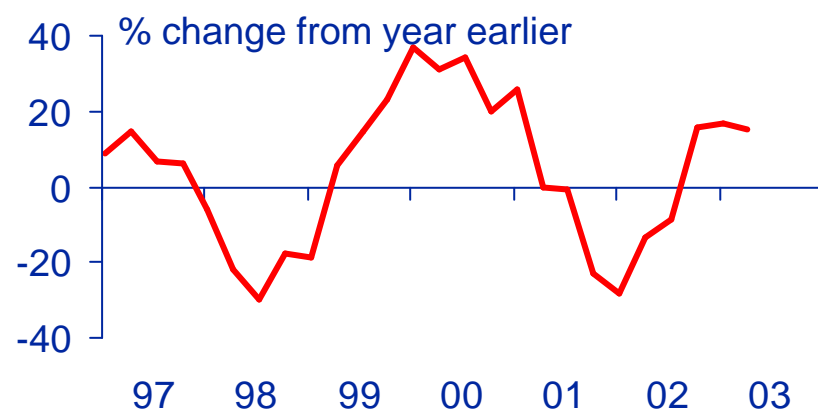
Labour productivity



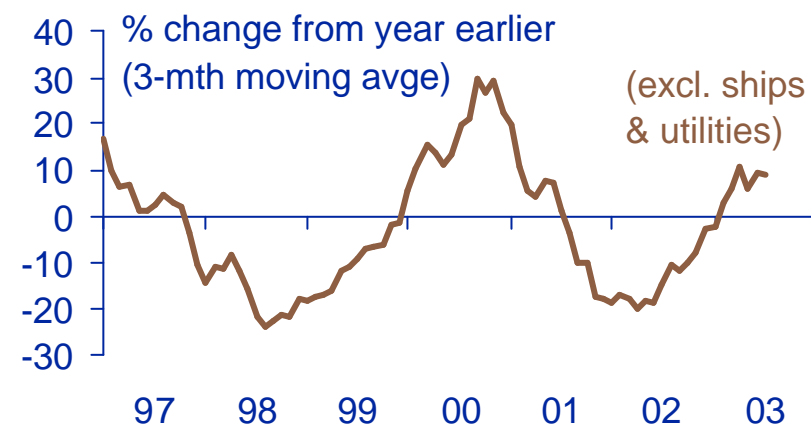
Business confidence



Operating profits



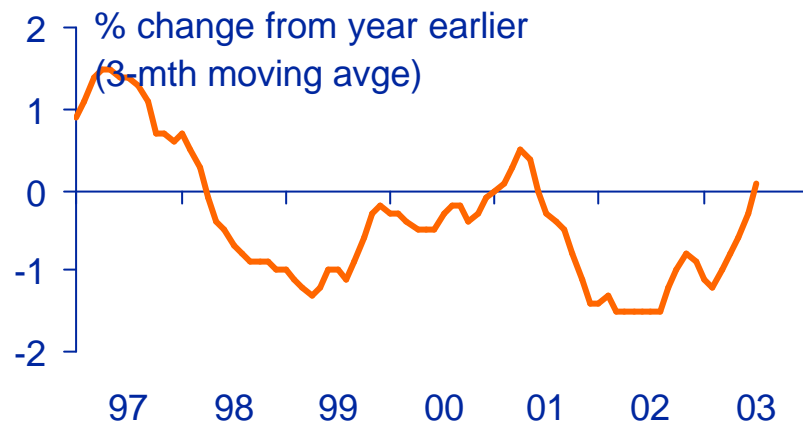
Machinery orders



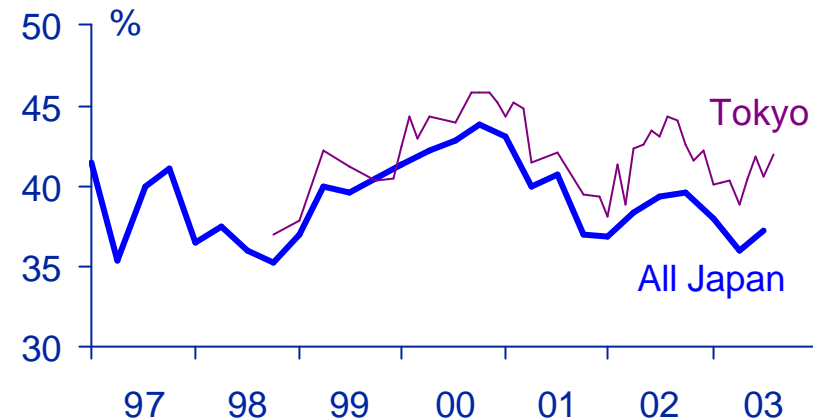
Sources: Economic & Social Research Institute; Bank of Japan.

Employment conditions in Japan have stopped deteriorating, giving consumers more confidence

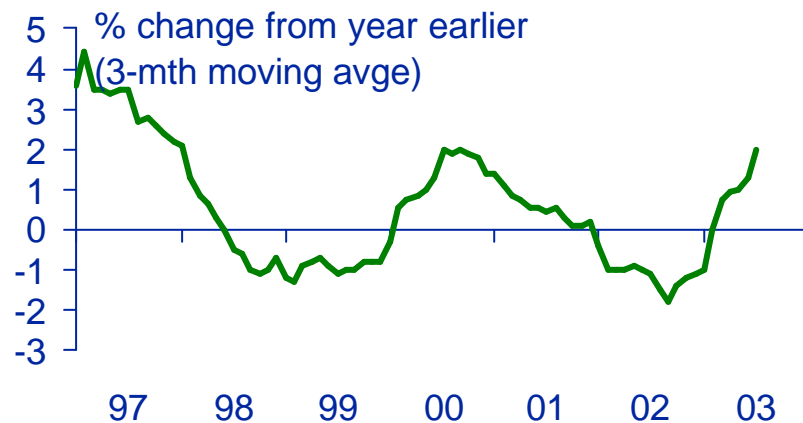
Employment



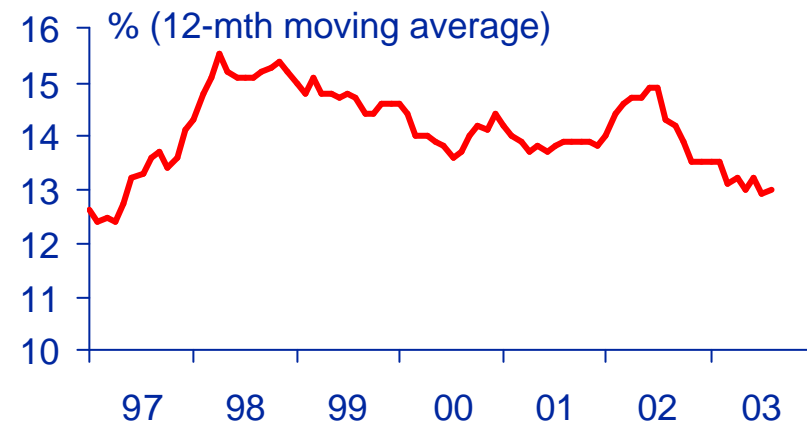
Consumer confidence



Average monthly earnings



Household saving ratio



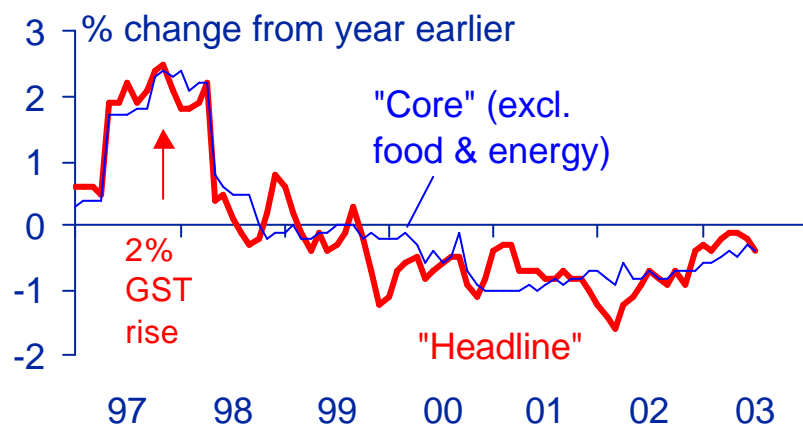
Sources: Health, Labour & Welfare Ministry; Economic and Social Research Institute (ESRI).

Deflationary pressures appear to be easing, which *may* pave the way to more sustainable growth

Wholesale prices



Consumer prices

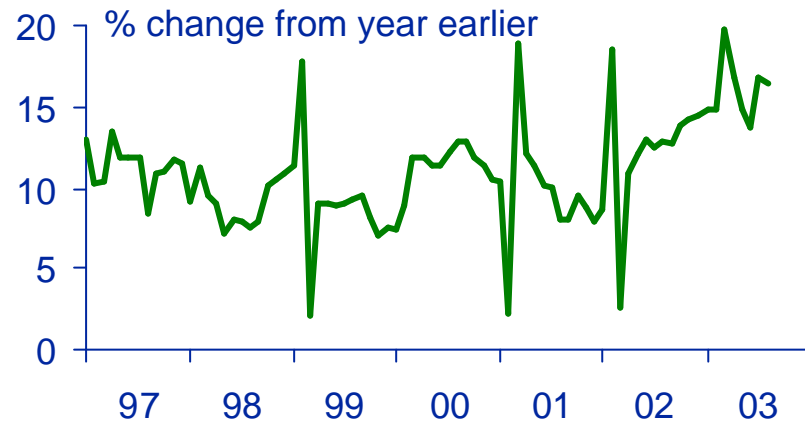


Sources: Bank of Japan; Home Ministry; OECD.

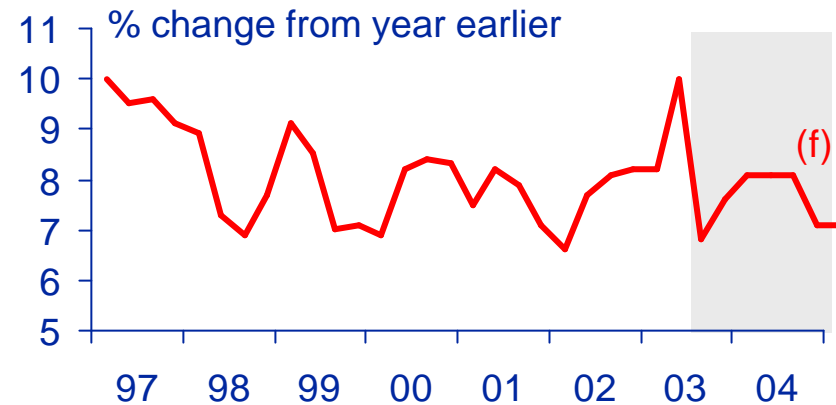
- Protracted deflation has been both a symptom of the scale of Japan's economic problems and an obstacle to recovery
- Deflationary pressures have eased noticeably this year
 - something which didn't happen (at the consumer level) during the last short-lived upturn in 2000
- Since its change of leadership in 2001 the Bank of Japan has been more vigorous in trying to end deflation by 'unorthodox' means
- A return to positive inflation would assist corporate and financial restructuring, and give monetary policy more 'traction'

China's economy is regaining momentum after the temporary jolt caused by the SARS outbreak

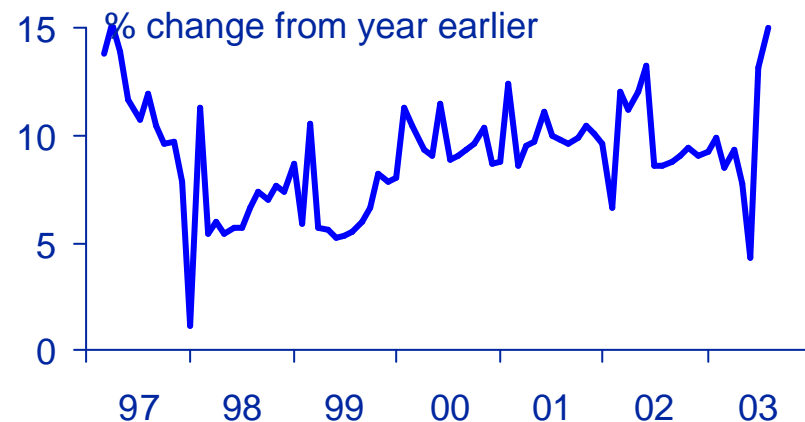
Industrial production



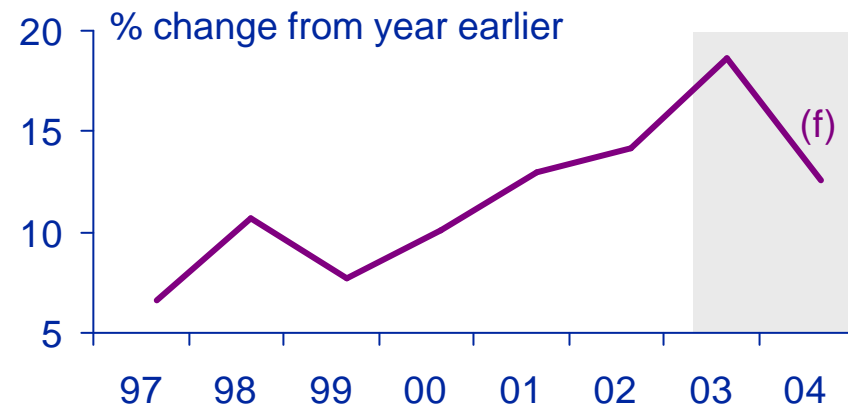
Real GDP growth



Retail sales



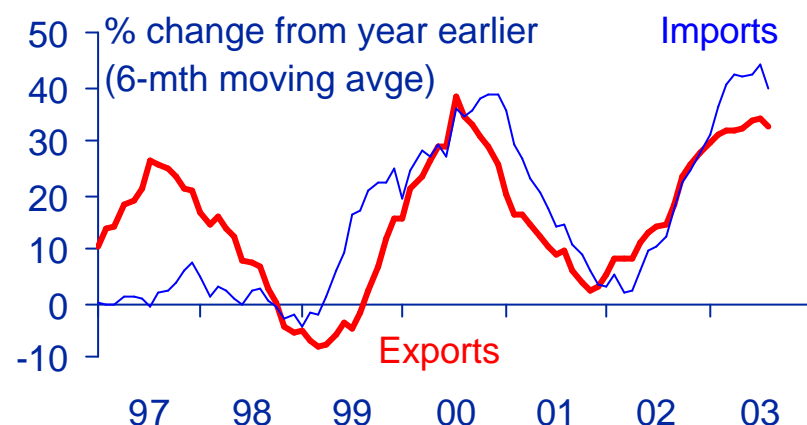
Fixed capital investment



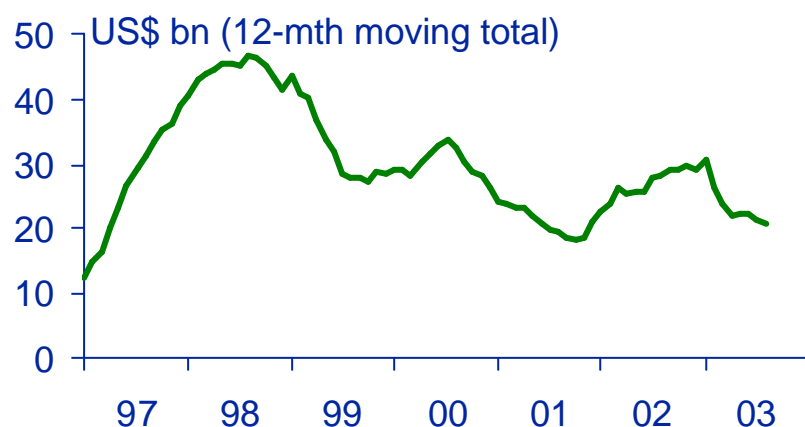
Sources: National Statistics Bureau.

China's exports are growing rapidly – but its imports are growing even faster

Merchandise trade



Trade balance

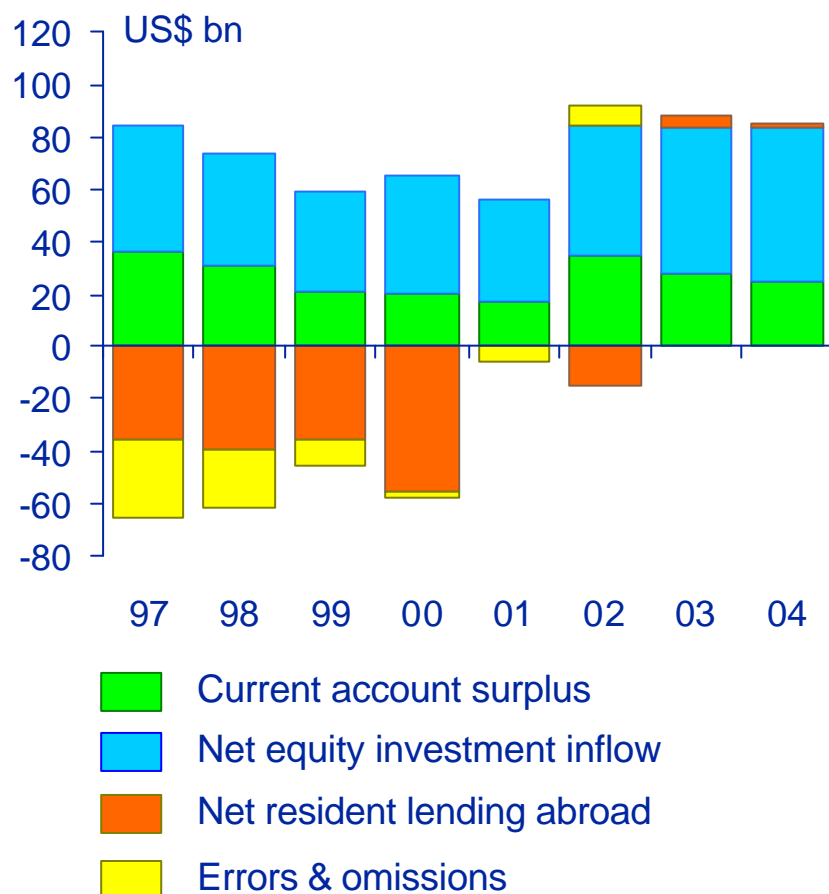


Source: National Statistics Bureau.

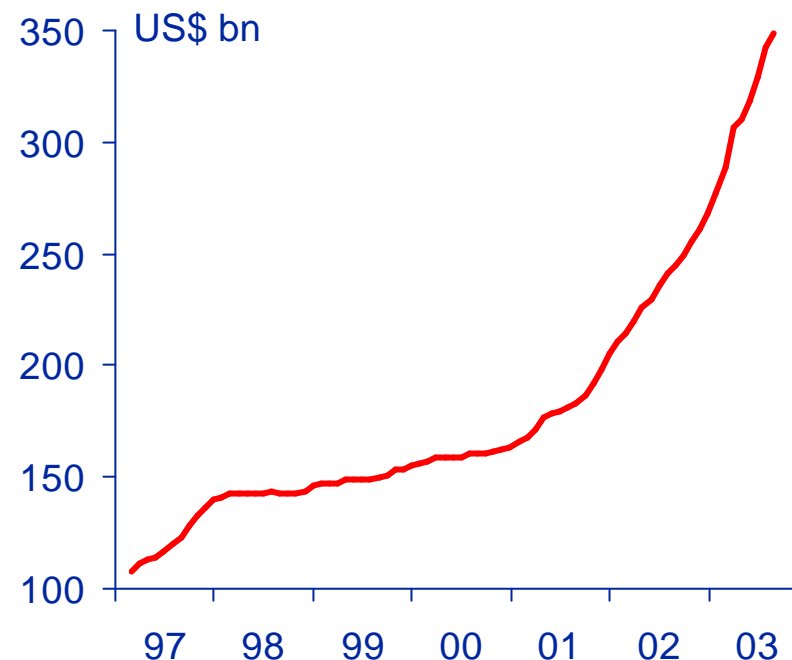
- Chinese exports have risen at an average annual rate of 17% over the past five years – but imports have risen at an average annual rate of 24%
- Contrary to widespread opinion China's trade surplus is shrinking
 - China's bilateral surplus with the US (and Australia) is widening
 - but it runs (growing) deficits with most other countries
- A large part of China's export growth is being driven by 'outsourcing' from other countries
 - 'foreign-invested enterprises' now account for over 60% of the growth in China's exports

China's determination not to revalue the renminbi is causing problems for its monetary policy

China's balance of payments



FX reserves

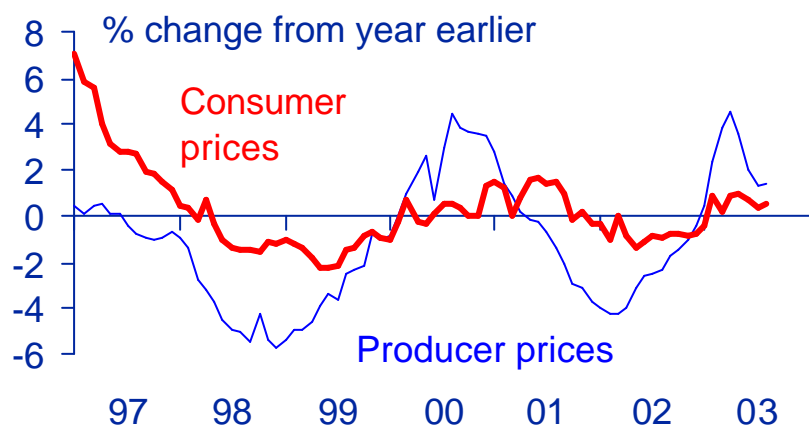
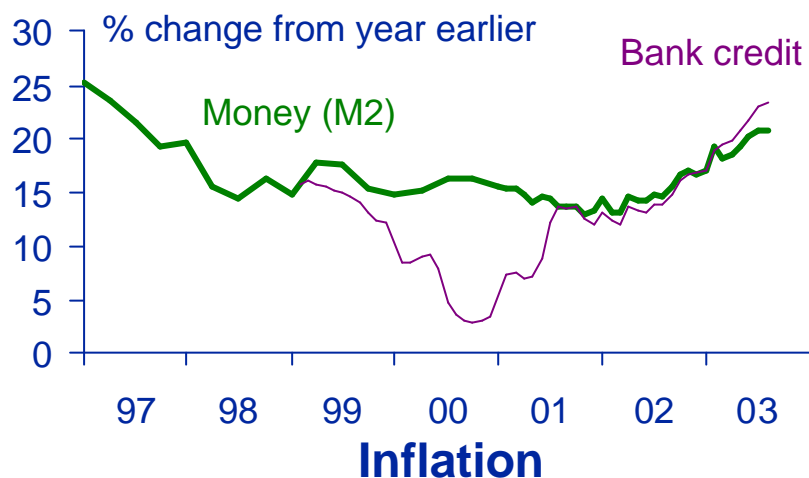


Maintaining the Rmb peg in the face of a dramatic swing in capital flows is forcing China into huge US\$ purchases and Rmb sales

Sources: Institute of International Finance; People's Bank of China

China faces a (currently small but) growing risk of credit-fuelled 'overheating' and inflation

Money and credit growth

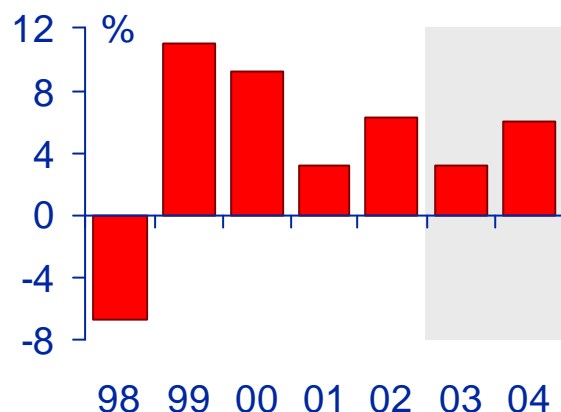


Source: National Statistics Bureau.

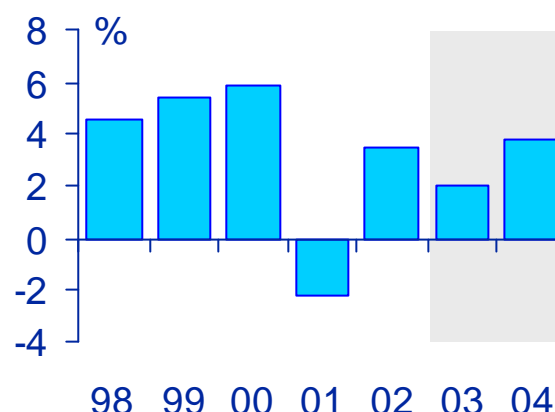
- The massive build-up in China's FX reserves has a counterpart in its domestic money supply
- Rapid monetary growth is in turn fuelling a boom in bank lending
 - lending for construction has risen by 33%, and to private enterprises by 57%, over the year to July
- This boom will ultimately worsen banks' bad loan problems
- The central bank and main bank regulator are trying to dampen down this boom by raising bank reserve requirements and issuing lending directives to banks
- Inflation has turned positive this year and is likely to rise further over the next 18 months

Other cotton-importing Asian economies should experience slightly stronger GDP growth in 2004

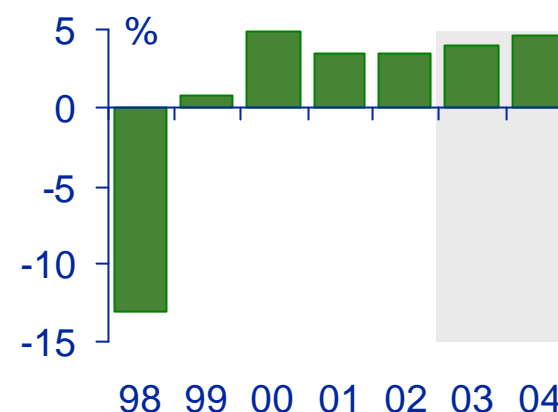
Korea



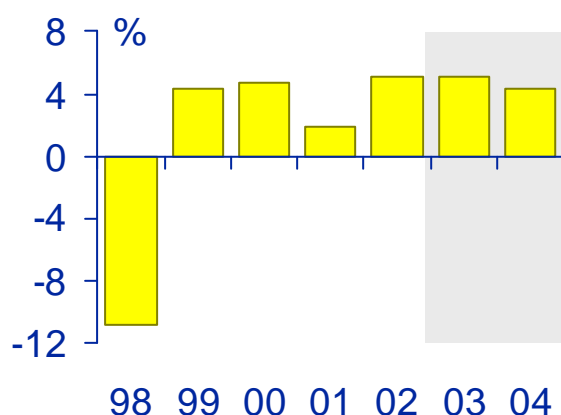
Taiwan



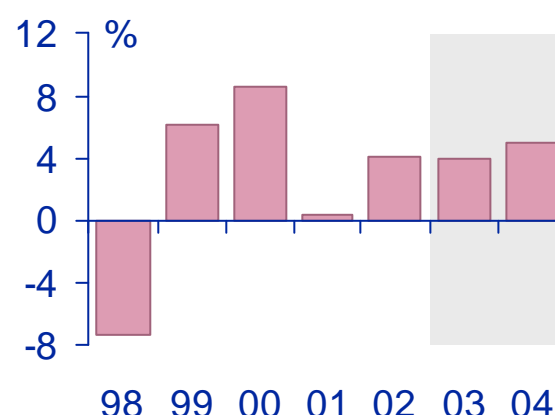
Indonesia



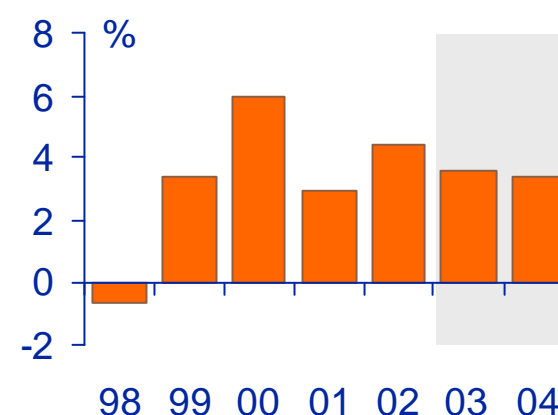
Thailand



Malaysia



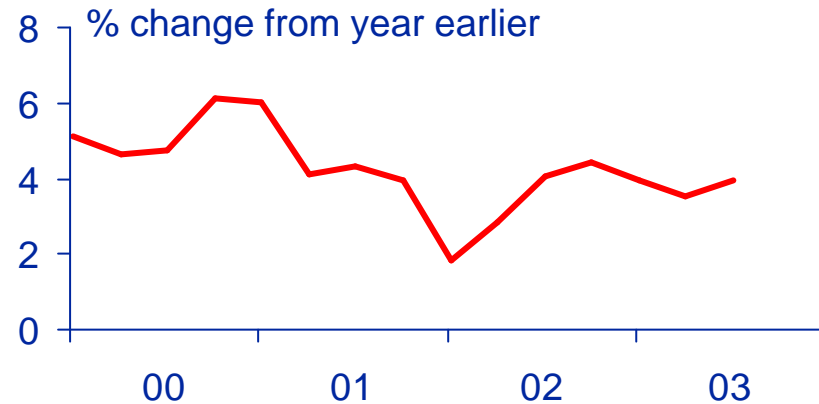
Philippines



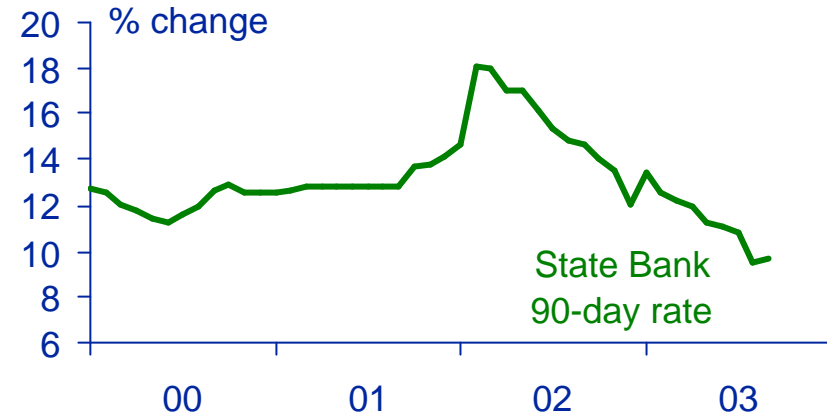
Sources: National statistical agencies; Economics@ANZ.

Indonesia's economic environment is gradually improving ...

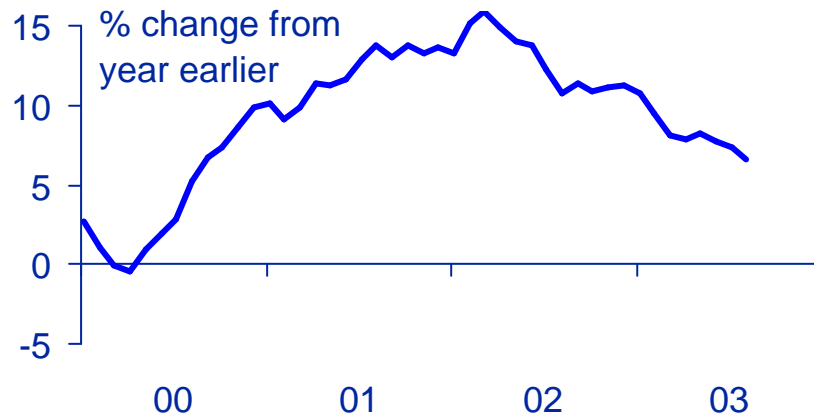
Real GDP growth



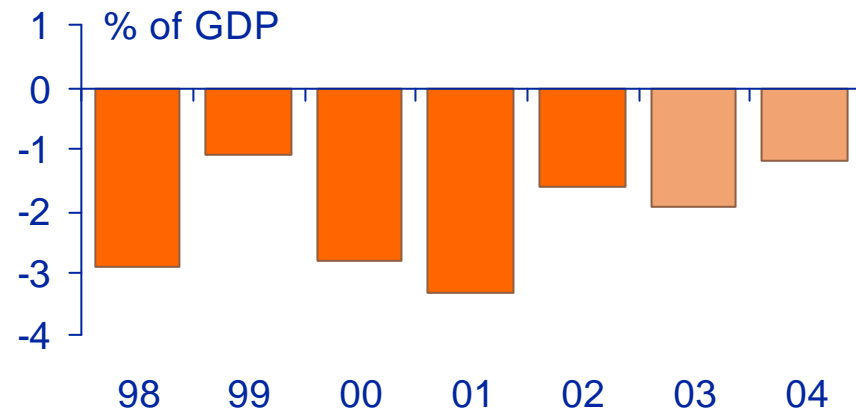
Interest rates



Inflation



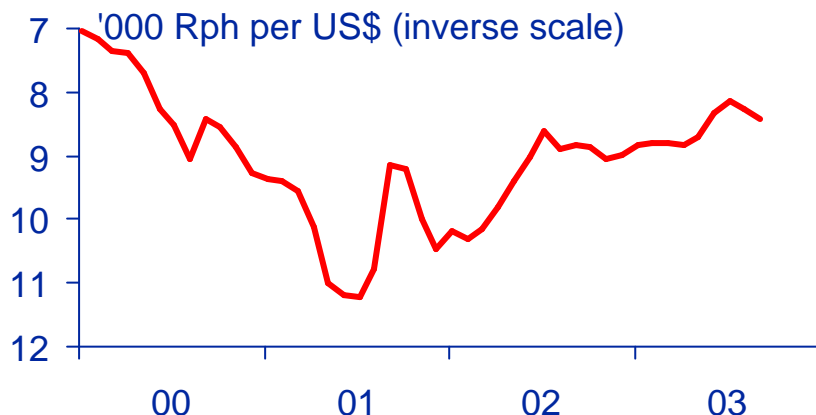
Budget balance



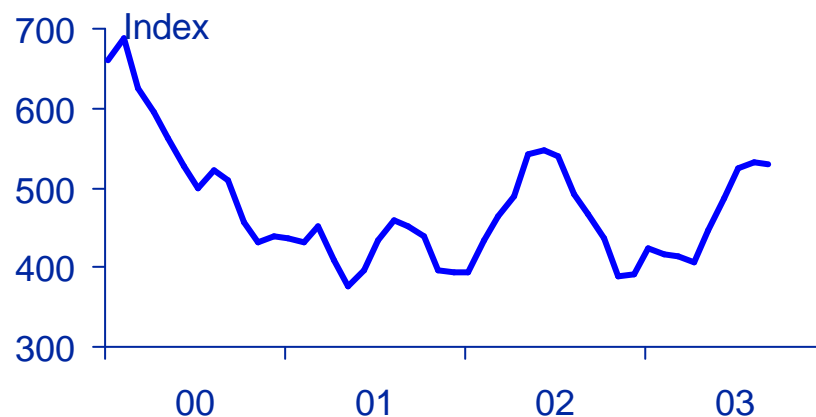
Sources: BPS Statistics Indonesia; Datastream.

... but security, regulatory and political risks continue to impede more rapid growth

Rupiah vs US\$



Jakarta stock exchange



Source: Datastream.

- Financial markets have been surprisingly unaffected by the Bali and Marriott bombings
- Concern over heightened security risks to some extent balanced by recognition of greater willingness on the part of Indonesian authorities to deal with it
- Progress in regulatory and legal system reform remains slow
- Political uncertainties will increase ahead of 2004 Parliamentary (April) and Presidential (July) elections
- So far Indonesia has not been able to sustain the 5-6% growth needed to reduce unemployment and poverty

Potentially important developments in trade policy over the next 6-18 months

- Termination on 1 January 2005 of the Agreement on Textiles and Clothing, and removal of all remaining textile and clothing quotas
 - some countries (including the US) have reserved the right to impose ‘safeguard measures’ to prevent/reverse ‘import surges’
 - these ‘safeguards’ can be directed at specific countries
 - removal of quotas will advantage China in particular
 - but to some extent at the expense of other textile exporters such as Bangladesh
- Critical milestones in the ‘Doha Round’ of multilateral trade talks
 - the only hope of eliminating global agricultural policy distortions, including US cotton subsidies of US\$4bn on a \$3bn crop produced by just 25,000 farmers
 - elimination of all such distortions would produce global welfare gains estimated at over US\$56bn, including over US\$3bn for Australia*
- Negotiations on a US-Australia Free Trade Agreement
 - limited implications for Australian cotton exporters

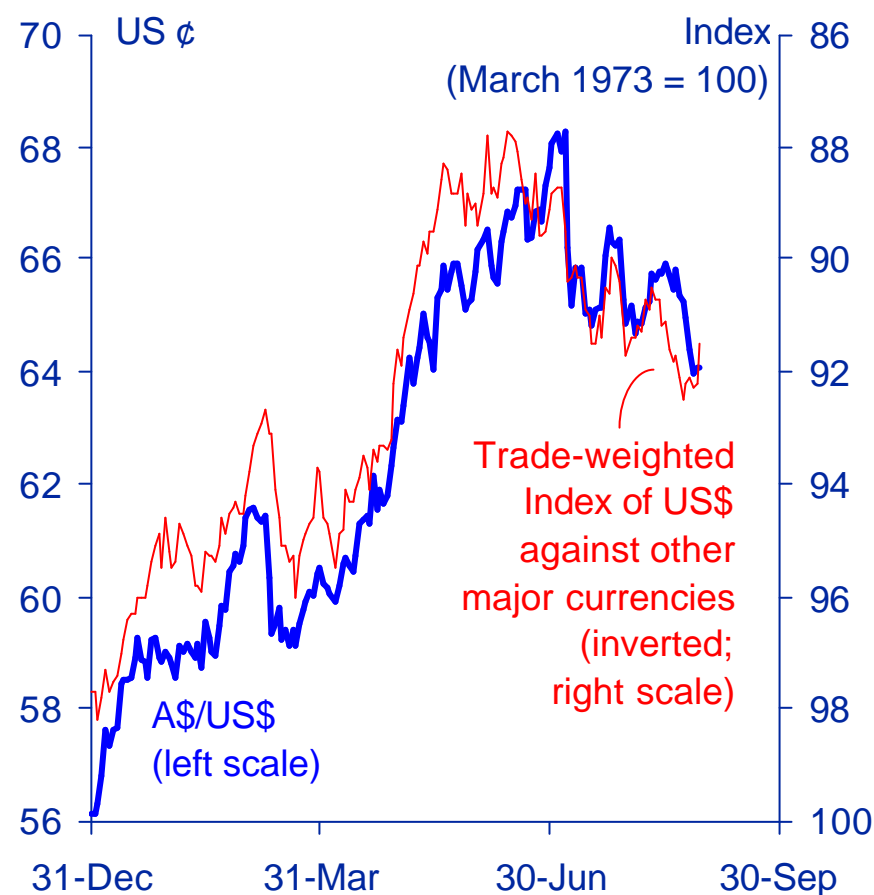
* Mary E. Burfisher (ed.), *The Road Ahead: Agricultural Policy Reform in the WTO*, USDA Agricultural Economic Report No. 797, January 2001.

Movements in the A\$-US\$ rate in recent years have largely mirrored movements in the US\$

Monthly since 1997



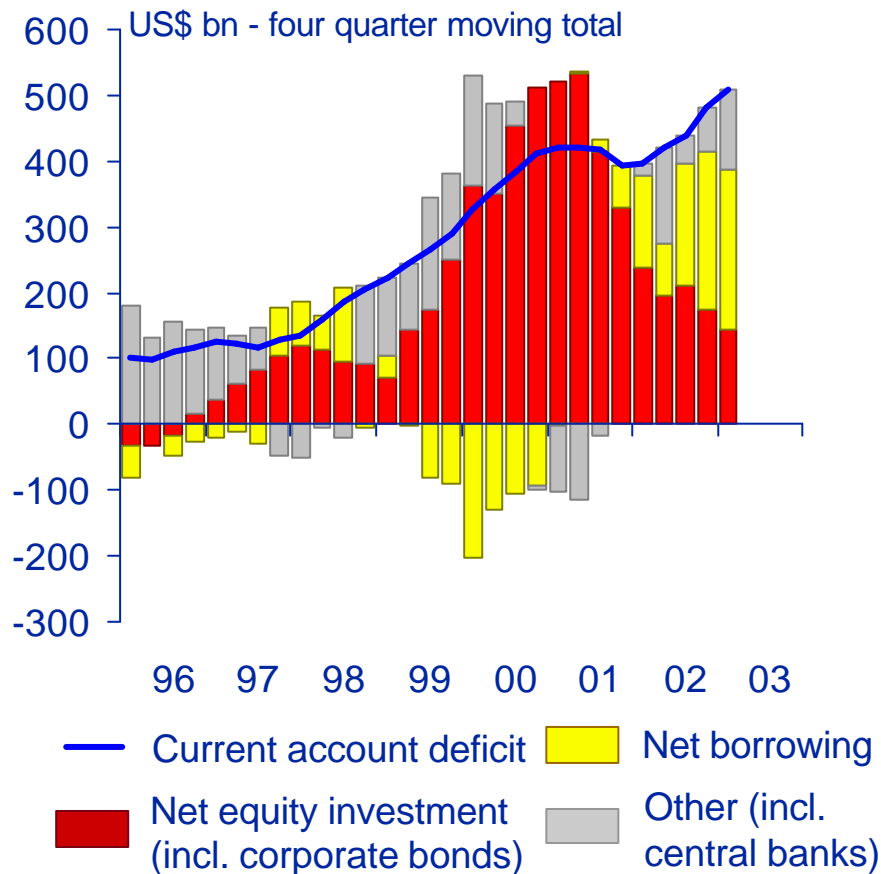
Daily during 2003



Sources: Datastream; US Federal Reserve; RBA.

Whether a country has a current account deficit or not matters less than how the deficit is financed

US current account deficit and its financing

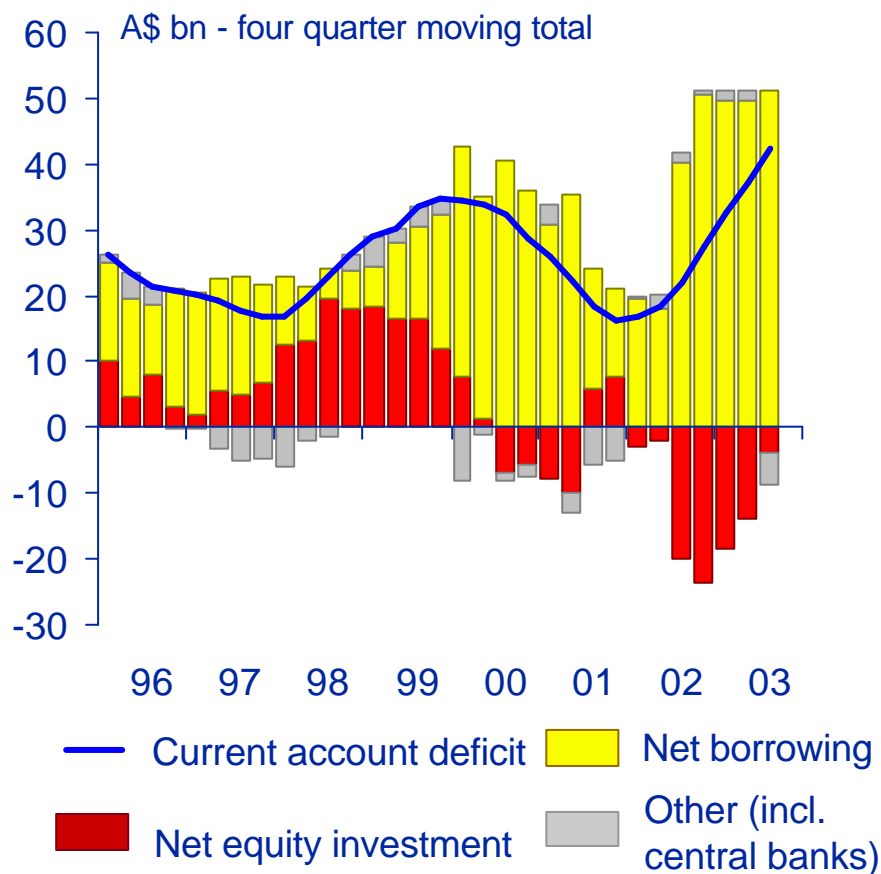


Sources: US Bureau of Economic Analysis.

- Until the collapse of its equities boom the US was able to finance its ever-growing current account deficit with equity inflows
- Since equity inflows are typically unhedged, they create net demand for US\$ which (for a time) more than offset the selling of US\$ due to the current account deficit
- From early 2002, the US current account deficit widened again – but the US became more reliant on debt financing, so the US\$ fell
- Equity inflows appear to have picked up again recently with improved hopes for the US economy – but this may not be sustainable

Australia is more reliant on borrowing to finance its deficit, and this affects the behaviour of the A\$

Australian current account deficit and its financing

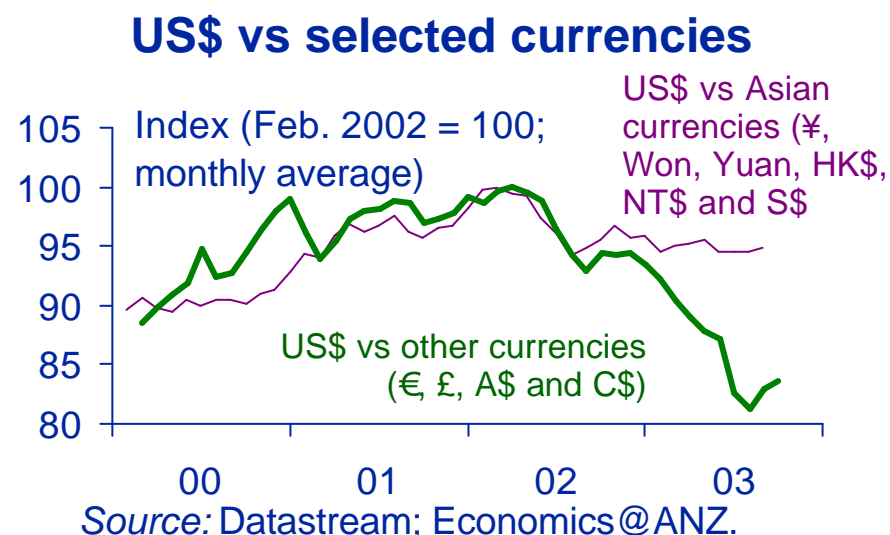
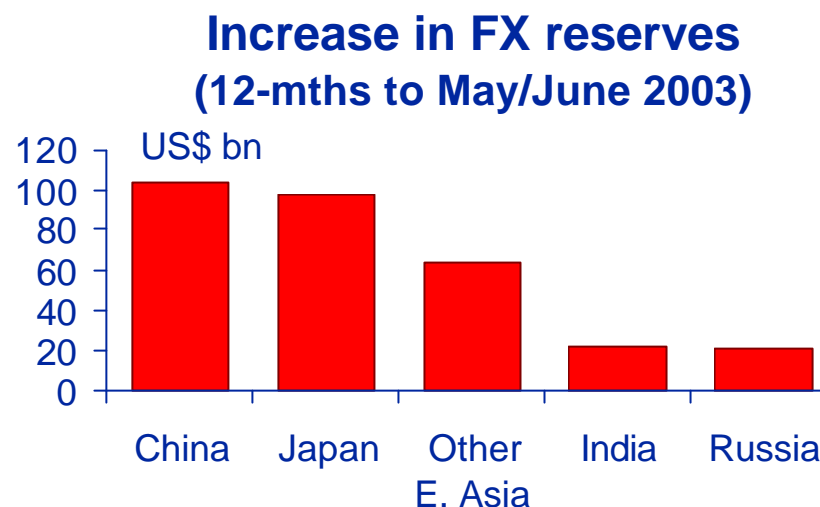


Sources: ABS

- Australia has become a net equity capital, so that we now rely almost entirely on borrowing to finance our current account deficit
- Most of this borrowing is done by the banks, who typically hedge it – so that the inflows don't create net demand for A\$
- Over the first half of this year, a turnaround in net equity flows combined with large unhedged A\$ bond purchases by Japanese retail investors) drove the A\$ up sharply
- Renewed enthusiasm for equities since late June appears to have drawn capital away from Australia again, resulting in a renewed decline in the US\$

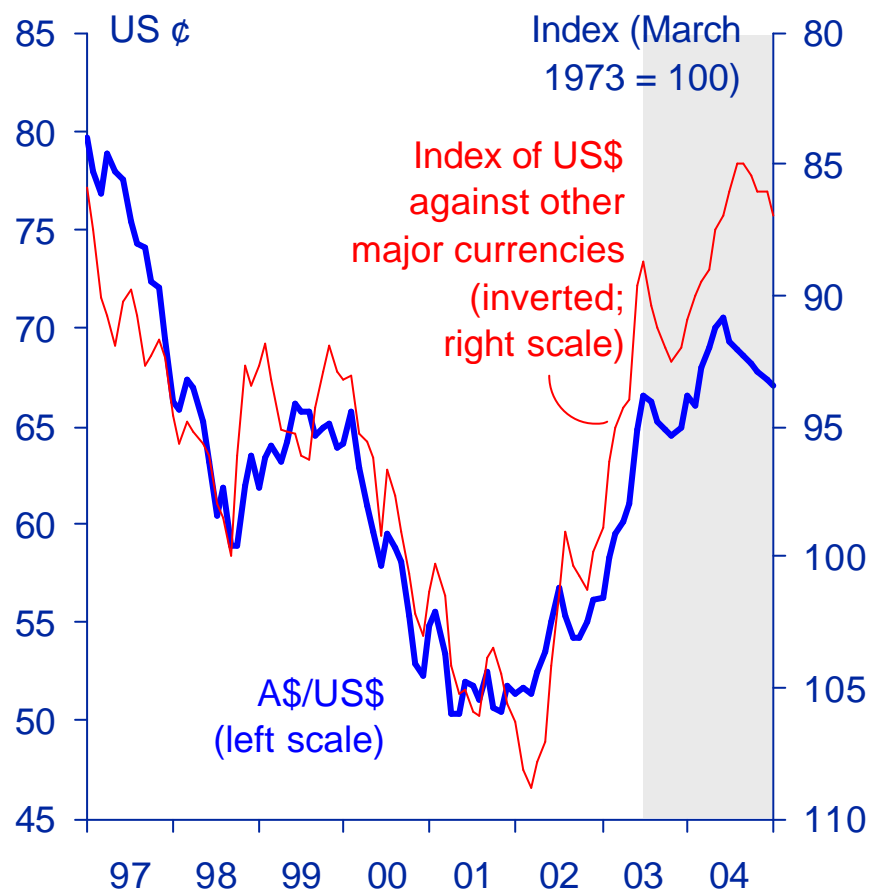
Asian central banks have financed half the US deficit in 2002-03 but can't keep it up indefinitely

- Asian central banks' reserves have risen by nearly US\$270bn since mid-2003, reflecting purchases of US\$ undertaken to stop their currencies rising against the US\$
- These purchases would have been sufficient to finance around half the US current account deficit
- They also deflected most of the adjustment to a declining US\$ on to 'freely floating' currencies such as the euro and the A\$
- As seen in China's case, such policies may have other adverse consequences and may not be sustainable indefinitely
- Changes in Asian currency policy could prompt a renewed US\$ fall



Some time next year the US\$ is likely to begin falling again, so the A\$ may have another spurt

A\$ vs US\$



Sources: Datastream; Economics@ANZ

- The US current account is likely to approach 6% of GDP next year – and it's unlikely that the US will be able to attract enough unhedged capital inflows to finance it: especially once growth begins to pick up outside the US
- The US\$ is thus likely to begin trending down again some time next year – initially against the 'freely floating' currencies
- The A\$ will trade in a US63-66¢ range near term but may have another spike upwards to around US70¢ during 2004
- While timing remains uncertain, a shift in Asian currency policies may take some of the pressure off the A\$ and other 'free floaters'

Summary and implications for the Australian cotton industry

- The world economy is in the process of picking up again
 - world cotton consumption growth in 2003-04 may be a little stronger than the 1% forecast by ICAC (though still below 2002-03's 4%)
- There are still significant imbalances within and among the world's major economies
 - it remains to be seen whether the recovery in the global economy will be sustainable beyond 2005
- Cotton-importing Asian economies should experience modestly stronger growth in 2004
 - but there is a gradually increasing risk of 'over-heating' in China which could be followed by a temporary downturn
- Trade policy developments in the next 6-18 months could potentially bring major benefits to Australian exporters
 - but powerful protectionist interests could stymie almost all progress
- The US\$ almost certainly has at least one more leg downwards
 - implying that a further upwards move in the A\$, perhaps to US70¢, is likely some time during 2004