

# Economic outlook for 2005

Presentation to the annual  
West Coast Eagles / ANZ  
'Footy and Economics Breakfast'

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**ANZ Bank**

**Burswood Resort**  
**Perth**  
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[www.anz.com/go/economics](http://www.anz.com/go/economics)

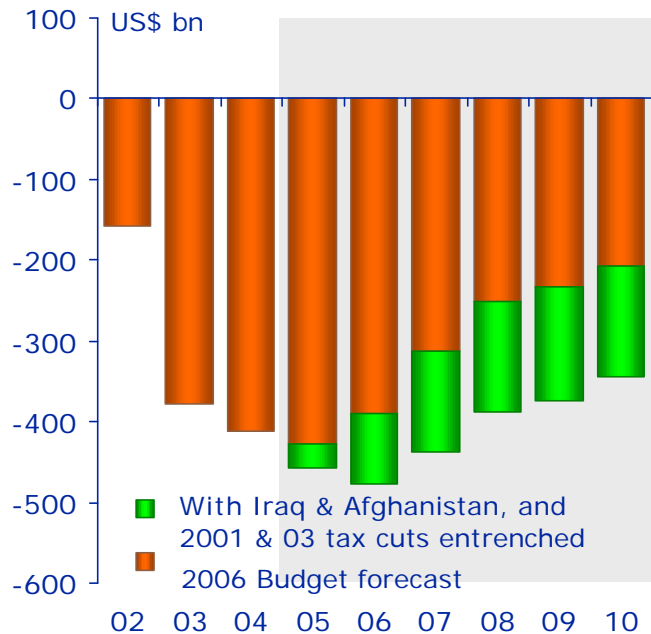
*economics@*

## Key assumptions about the world economy

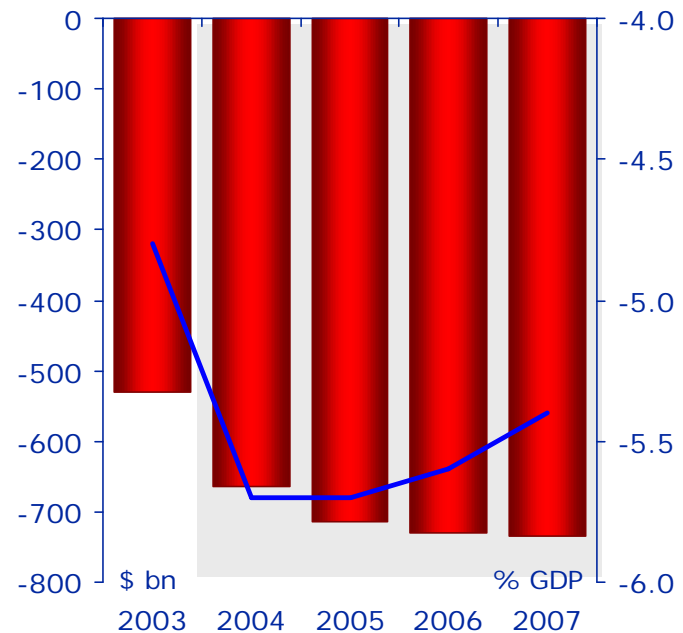
- Oil prices will average US\$45/barrel in 2005 and \$40 in 2006
  - apart from coal and iron ore, other commodity prices have likely peaked, but won't fall a lot
- World economic growth will slow from 5% in 2004 to around 4% pa in 2005 and 2006
  - 2005 forecast reflects slower growth in the US and (to a lesser extent) China, as well as Japan and Europe
  - 2006 forecast assumes further slowing in the US, but a pick-up in China and a more modest acceleration in Europe
- The Federal Reserve will continue to raise short-term interest rates 'at a measured pace', reaching 4% by early 2006
- The US\$ will remain under downward pressure for at least the first half of 2005, reaching \$1.40 against the euro by mid-year
  - after which the wider US-Europe interest differential may be sufficient to prevent further US\$ depreciation against the €
- Asian central banks will continue to resist significant revaluations of their currencies
  - though that doesn't rule out a change in China's exchange rate regime to a tightly managed float against a currency basket

## US 'twin deficits' likely to weigh more heavily on financial markets over next few years

### US budget balance



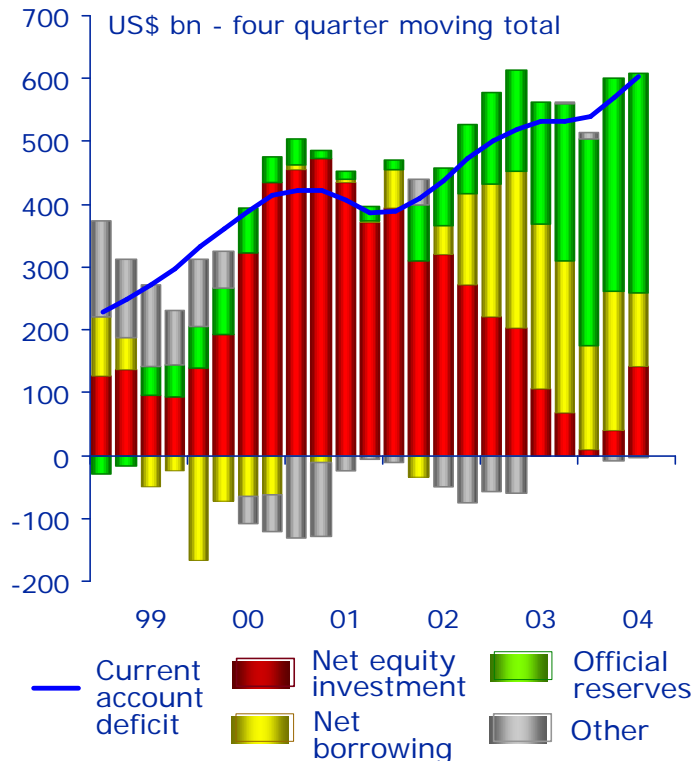
### US current account balance



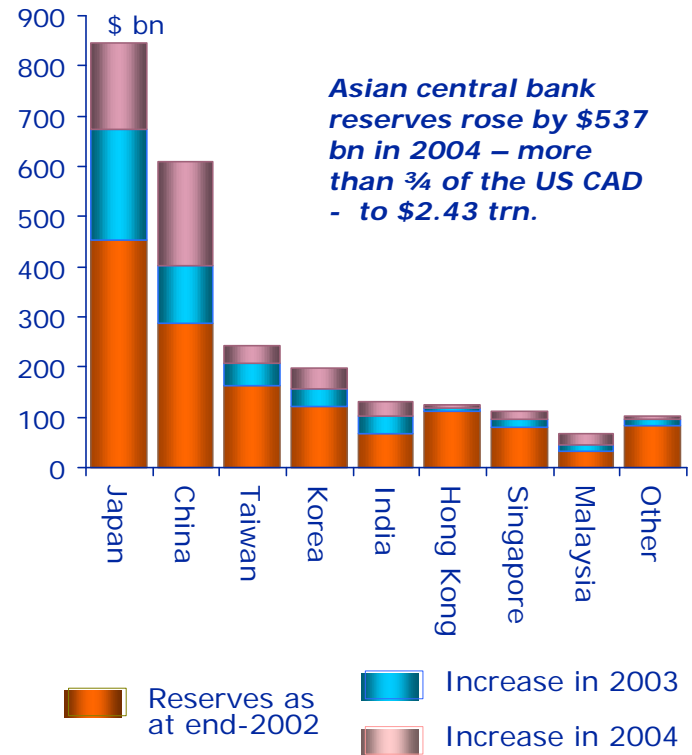
Sources: Office of Management & Budget, *President's Budget for 2006*; Congressional Budget Office; Bureau of Economic Analysis; Economics@ANZ.

# Foreign central banks are now financing around half of the US current account deficit

## US current account deficit and its financing



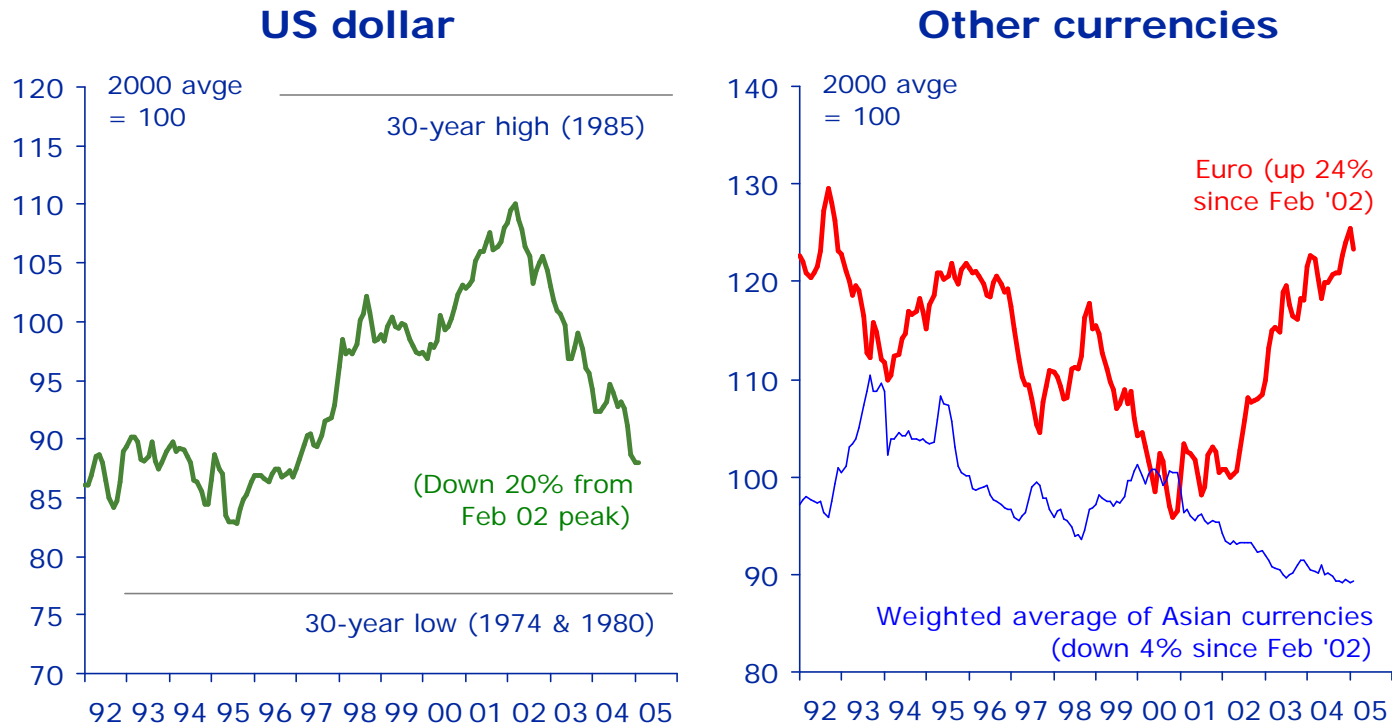
## Asian FX reserves



Note: 'equity investment' includes corporate bonds.  
Sources: US Bureau of Economic Analysis; Department of the Treasury; central bank websites; Datastream.

# The US dollar has further to fall – while Asian currencies must rise eventually

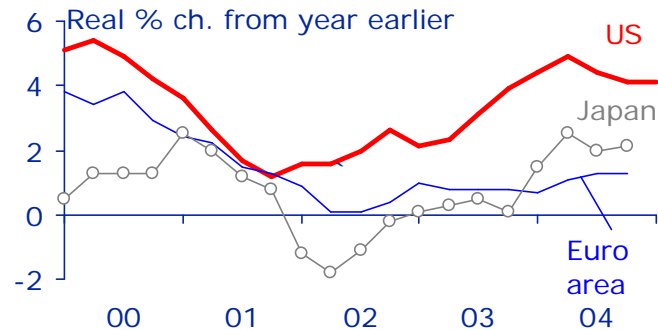
## Real effective exchange rates



Sources: JP Morgan; Economics@ANZ. Asian currencies are JPY, CNY, KRW, TWD, HKD, THB, MYR, SGD, IDR, PHP and INR, weighted by 2002 GDP at market exchange rates.

# A sharply weaker US\$ would probably dampen world economic growth

## Final domestic demand



## US 10-year bond yields

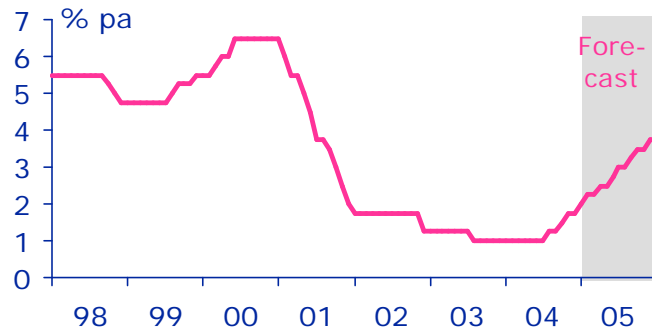


Sources: US Bureau of Economic Analysis; Japan Economic & Social Research Institute; Eurostat; Datastream.

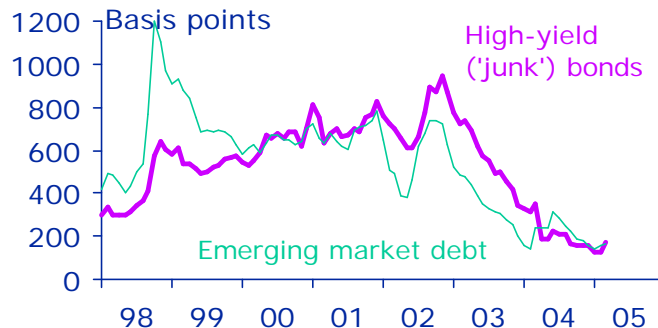
- In theory, exchange rate changes 'redistribute' economic growth among countries (and types of demand)
- However this assumes that governments and central banks adopt complementary policies
- In practice, the ECB (which is mandated to target inflation, not growth) won't cut rates to offset € strength, while the BoJ can't cut rates to offset ¥ strength (since its cash rate is already zero)
- Meanwhile the Fed is raising US rates, and a sharp fall in the US\$ would put upward pressure on long rates, and hence on mortgage rates

# The Federal Reserve will continue to raise US interest rates on a regular basis

## US fed funds rate



## Yield spreads over Treasuries



Sources: US Federal Reserve; Lehman Brothers; Datastream.

- Minutes of the 14 Dec FOMC meeting make it clear that the Fed will continue raising rates until
  - ‘the real funds rate target [is at] the level it most likely would need to reach to keep inflation stable and output at its potential’
  - which most US economists would put at around 2% real (ie, 4%)
  
- The FOMC minutes and subsequent speeches by four FOMC members suggest they may also be worried about ‘potentially excessive risk-taking in financial markets’
  - very low credit risk spreads
  - speculative demand for property
  - upturn in IPO/M&A activity

## **Alan Greenspan, usually a master of obfuscation, couldn't have spelled it out more clearly**

**“Rising interest rates have been advertised for so long and in so many places that anyone who hasn't appropriately hedged his (*sic*) position by now obviously is desirous of losing money”**

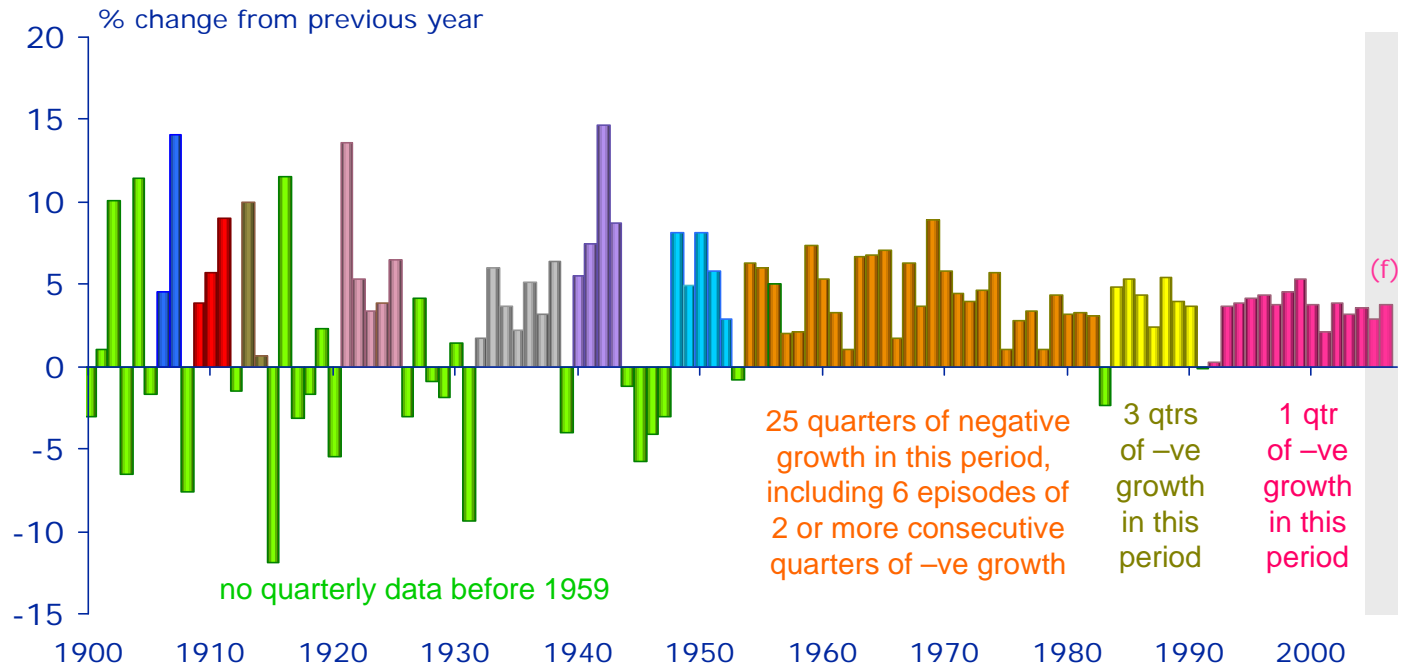
**- unscripted remarks at the European Banking Conference, Frankfurt, Germany, 19 November 2004**

*Source: Neil Henderson, The Washington Post, 20 November 2004, p. E1.*



# Australia is enjoying its longest run of uninterrupted economic growth since Federation

## Australian real GDP growth, 1901 - 2006

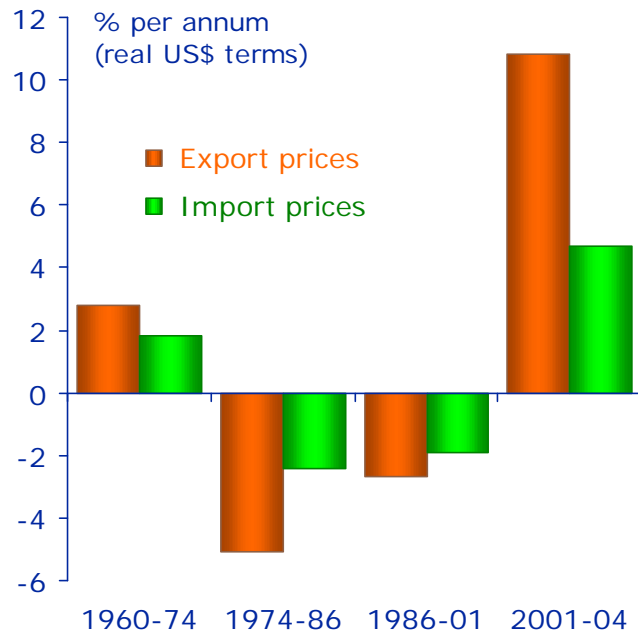


Note: data are for financial years ended 30 June.

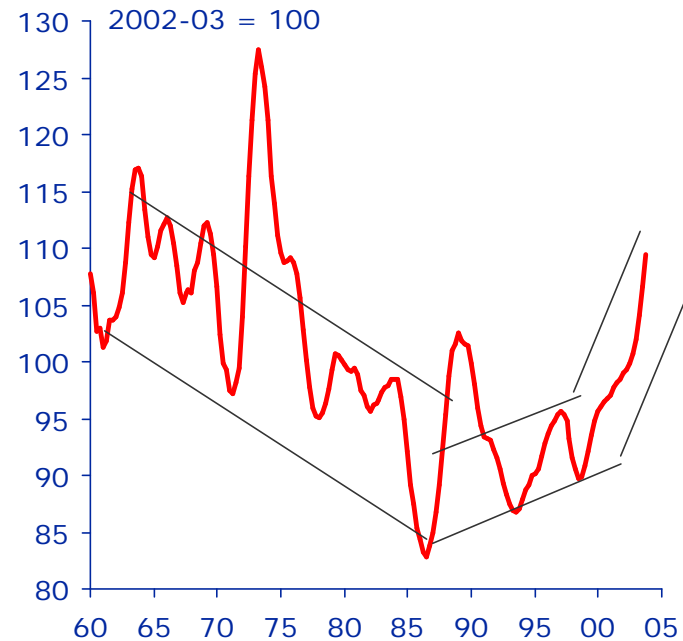
Sources: Angus Maddison, *Monitoring the World Economy* 1820-1992; Reserve Bank; ABS; Economics@ANZ.

# The world economy is giving Australia's exporters a pay rise and our consumers a price cut

## Long-term price changes for Australian exports and imports



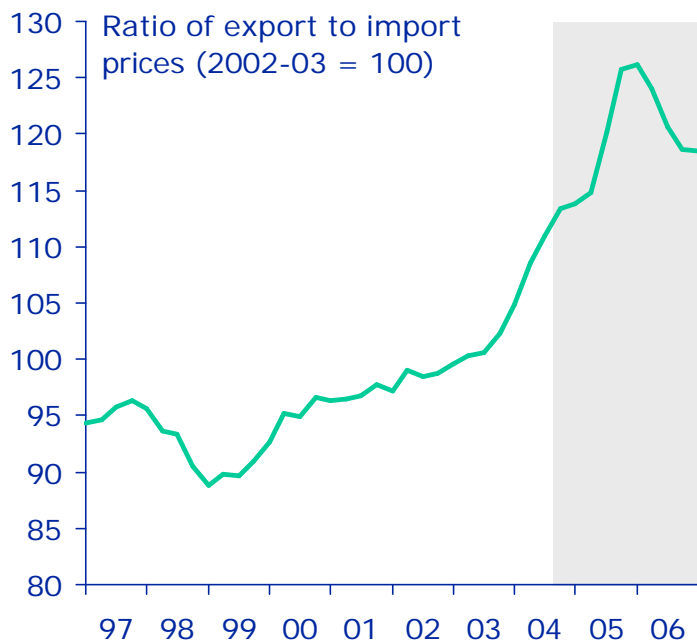
## Ratio of export to import prices ('terms of trade')



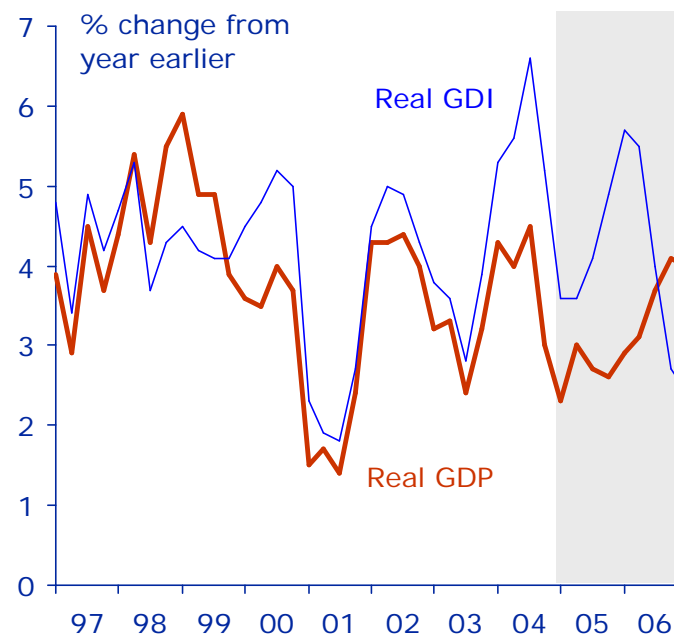
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ.

# The huge swing in Australia's terms of trade means that income is now outpacing output

## Australia's terms of trade



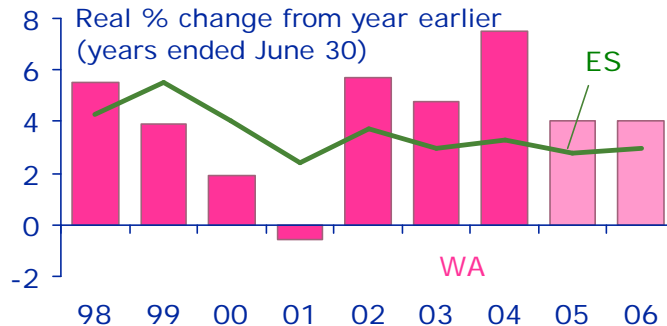
## GDP and gross domestic income (GDI)



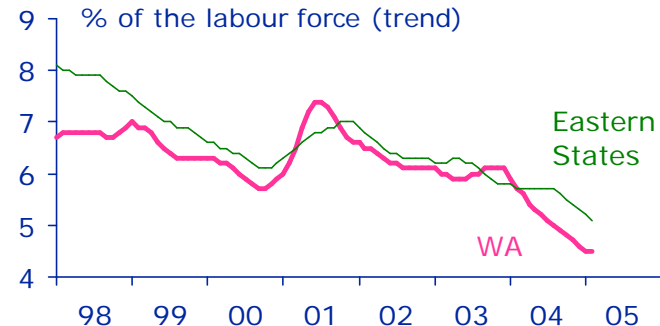
Note: Real gross domestic income (GDI) is real gross national expenditure (GNE) plus exports deflated by the import price deflator minus real imports, ie, GDP adjusted for changes in the terms of trade. Sources: ABS; Economics@ANZ forecasts.

# This is a very favourable environment for the Western Australian economy

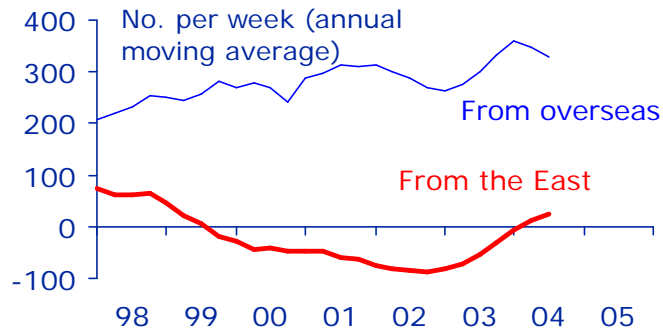
## Gross State product



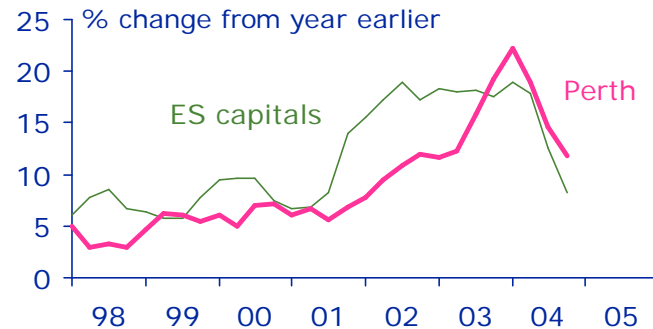
## Unemployment



## Immigration to WA



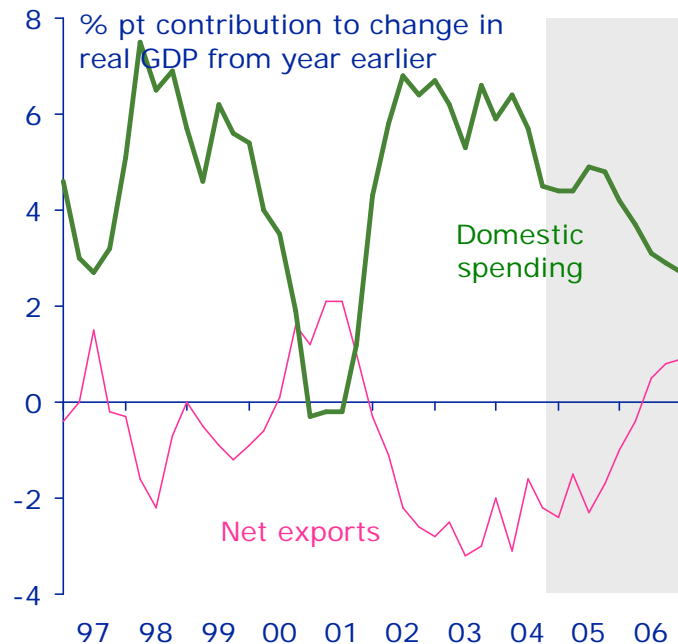
## Established house prices



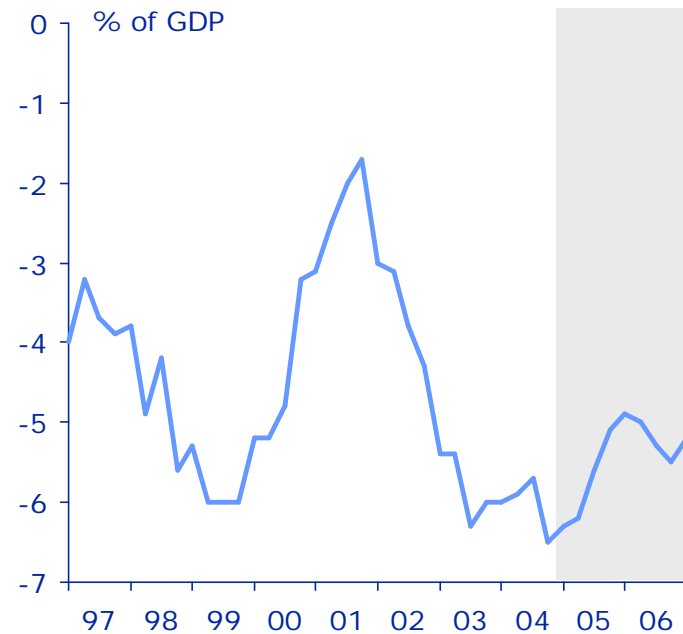
Sources: ABS; Economics@ANZ.

## While overall growth has been strong, the pattern of growth has become unbalanced

### Domestic vs net external sources of growth



### Balance of payments on current account

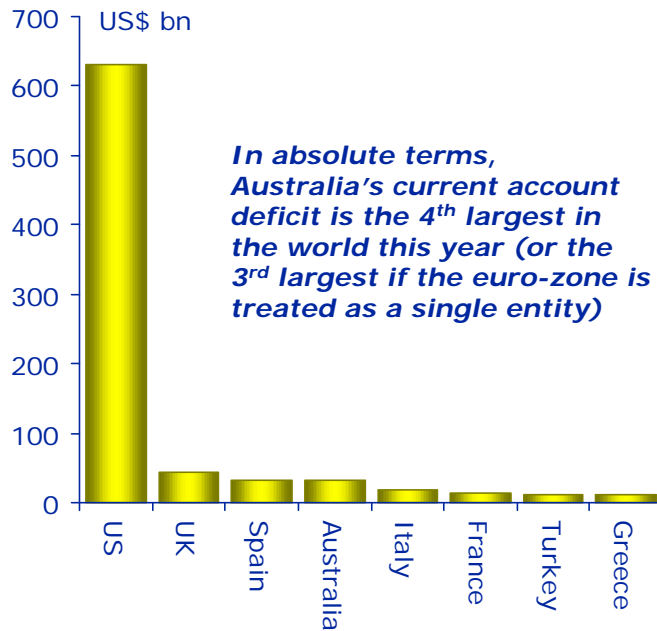


Source: Australian Bureau of Statistics;  
Economics@ANZ (forecasts in shaded areas).

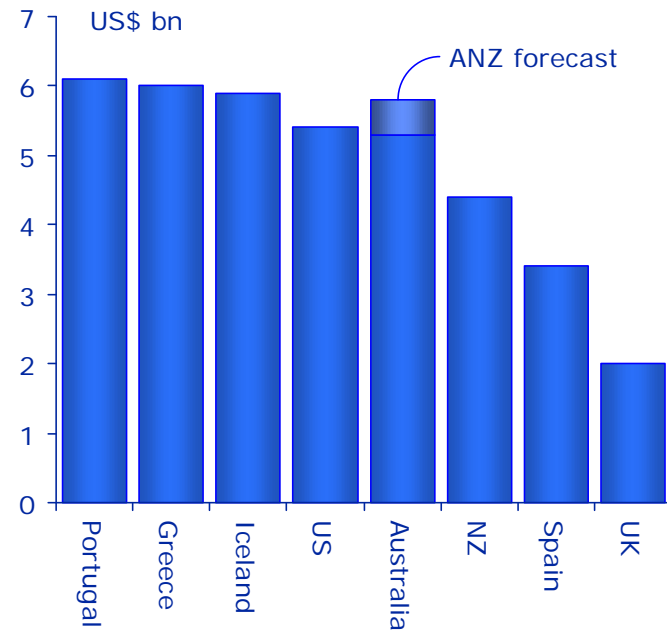
# Australia's current account deficit is one of the largest in the world

## Current account balances, 2004

In US\$ billions



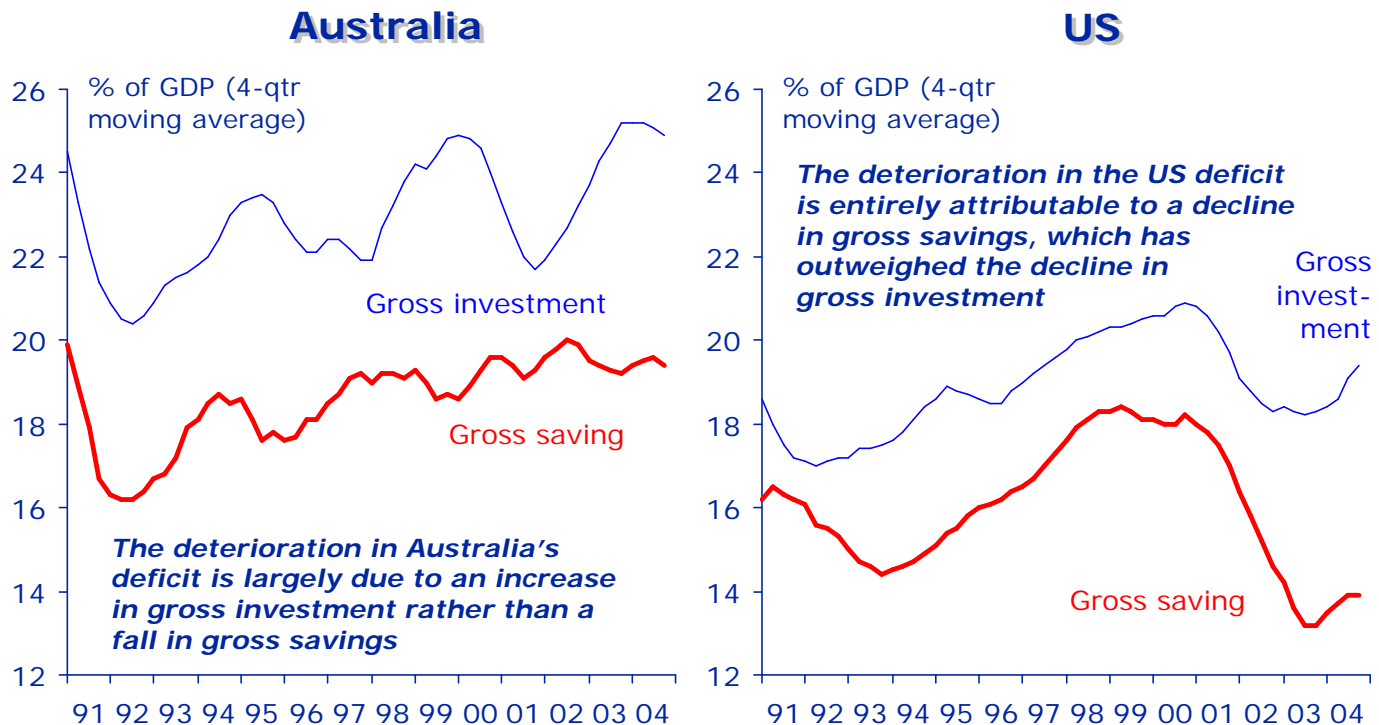
As a % of GDP



Source: IMF World Economic Outlook September 2004 data base; % of GDP chart refers to OECD countries only.

# Financial markets perceive a 'quality' difference between the Australian and US deficits

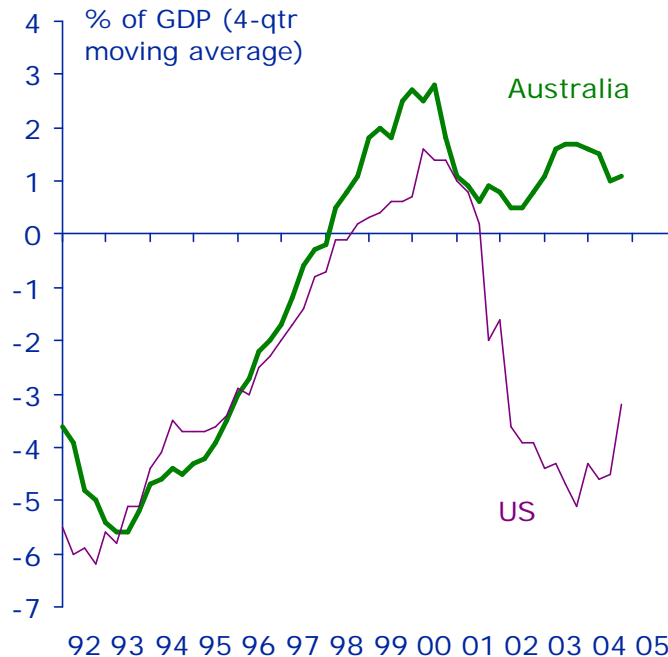
## Saving and investment as a share of GDP



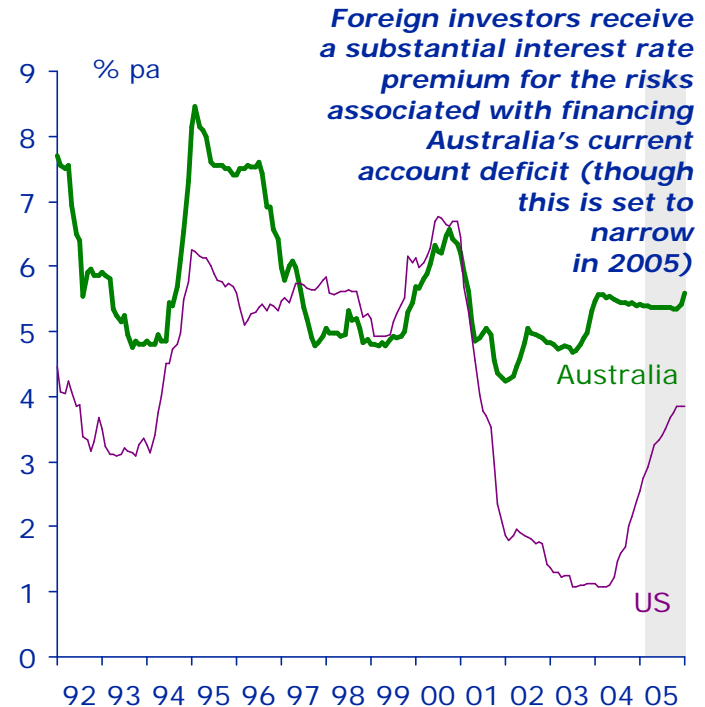
Note: The current account deficit is equal to the difference between gross saving and investment. Sources: ABS; US Bureau of Economic Analysis; Economics@ANZ.

# Australia's deficit isn't paralleled by a budget deficit, and foreign lenders get paid for the risk

## Government borrowing



## 90-day interest rates

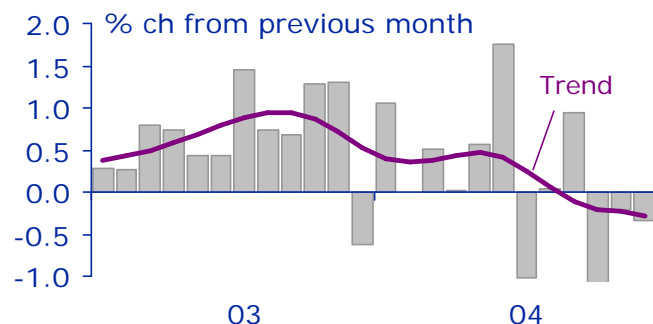


Source: ABS; US Bureau of Economic Analysis; Datastream; Economics@ANZ.

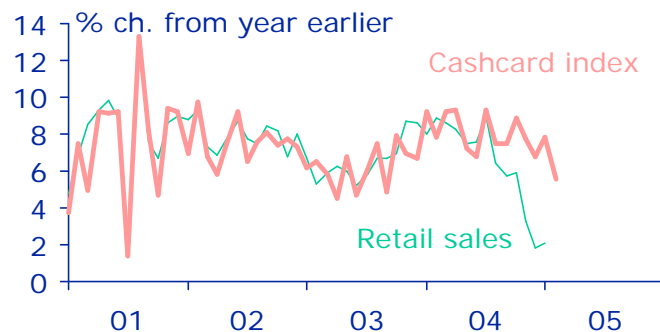


# Australian retail sales data suggests consumer spending is slowing – but is that really true?

## Retail sales



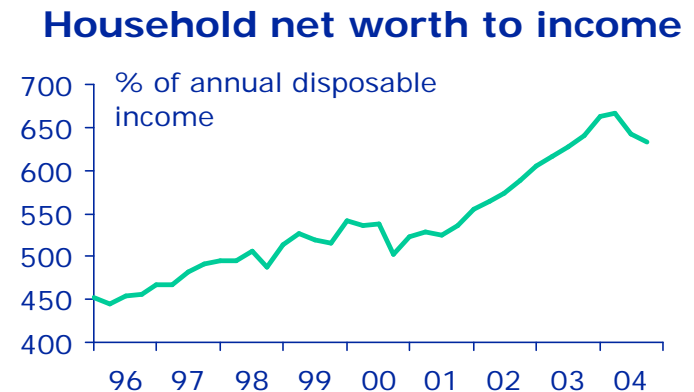
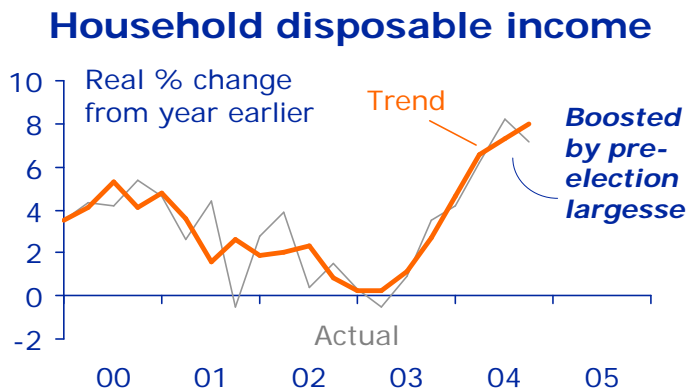
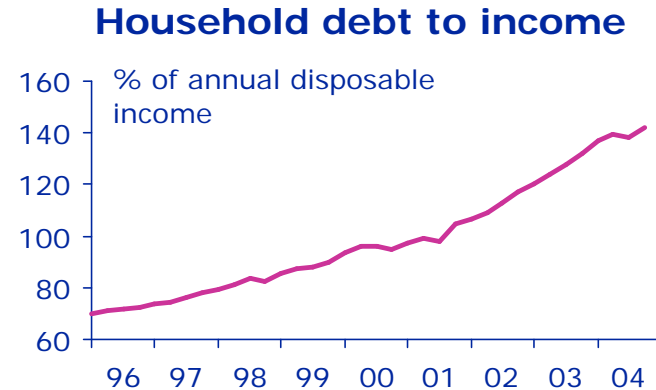
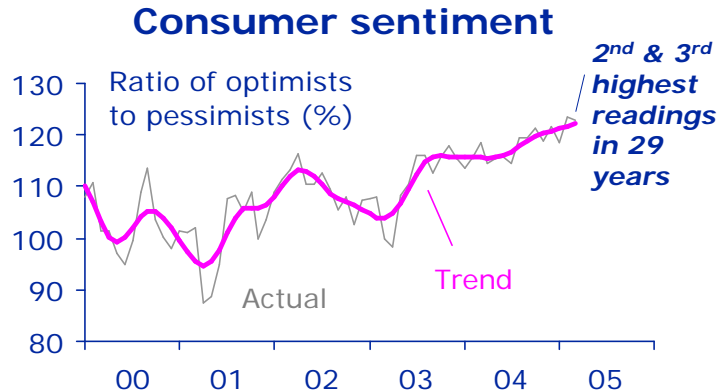
## Retail sales and cashcard index



Sources: ABS; First Data International Australia.

- Retail sales were surprisingly weak towards the end of last year
  - the underlying trend is now negative for the first time since Dec 1999 – Jan 2000
- The ABS retail sales numbers look a bit suspect
  - in the past three months they have been much softer than the Cashcard index of EFTPOS spending, which is usually a good leading indicator of retail sales
- Note that (unlike the US) retail sales data don't include spending on cars or petrol
  - car sales have been exceptionally strong and petrol prices have been high
- Households may well be saving some of their tax cuts, but soft retail sales seem at odds with household 'fundamentals'

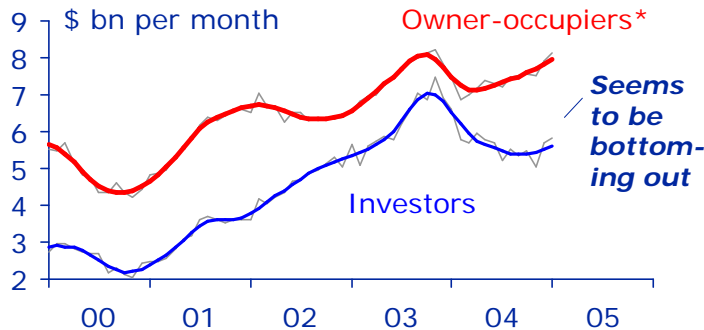
# Most 'fundamentals' for household spending remain fairly strong



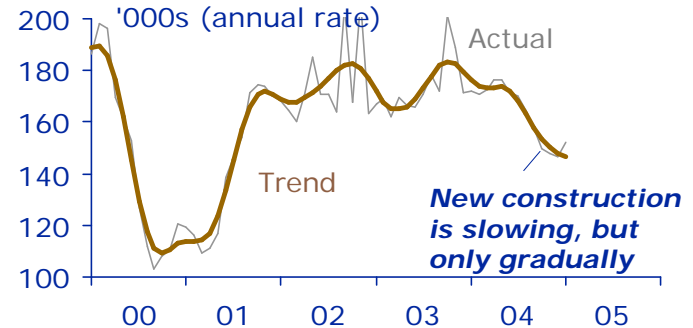
Sources: Westpac/Melbourne Institute; ABS; Economics@ ANZ.

# The housing sector has slowed – but the slowdown may now be bottoming out

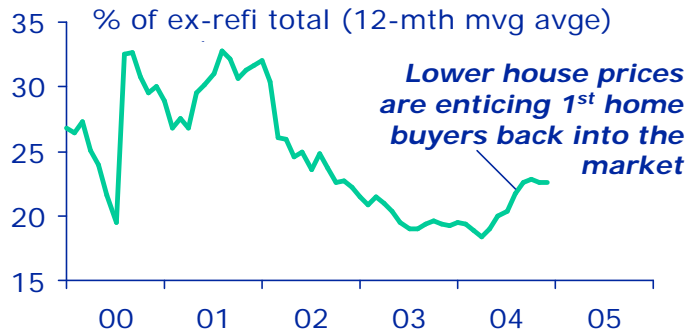
### Housing finance commitments



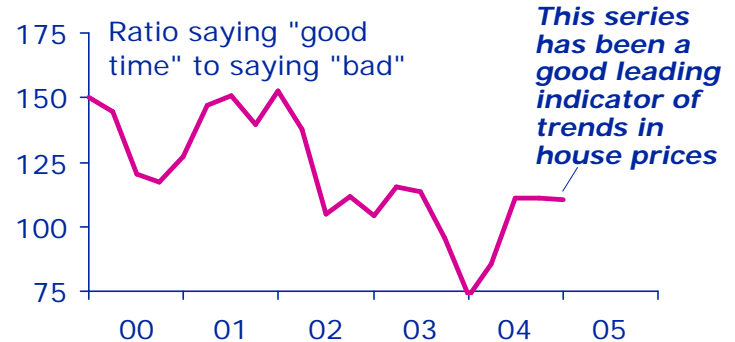
### Residential building approvals



### 1<sup>st</sup> home buyer finance



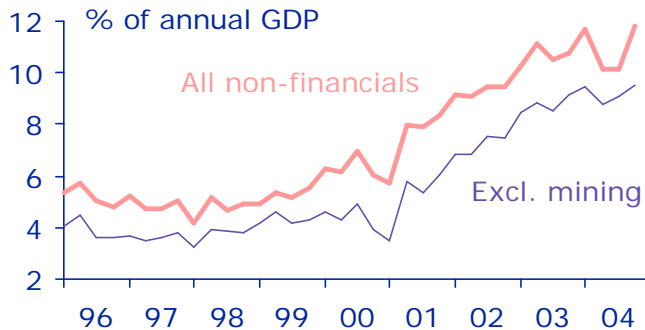
### Home-buying sentiment



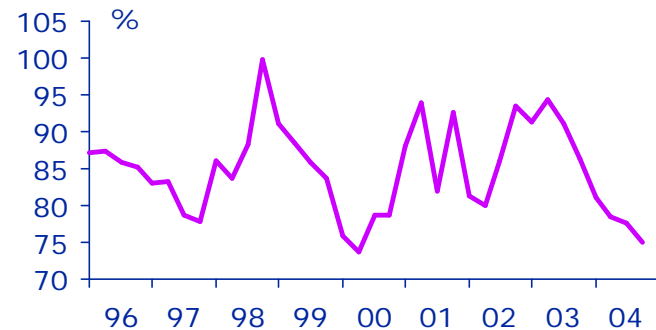
Sources: ABS; Westpac/Melbourne Institute; Economics@ANZ.

# Corporate sector\* finances are in a very strong position

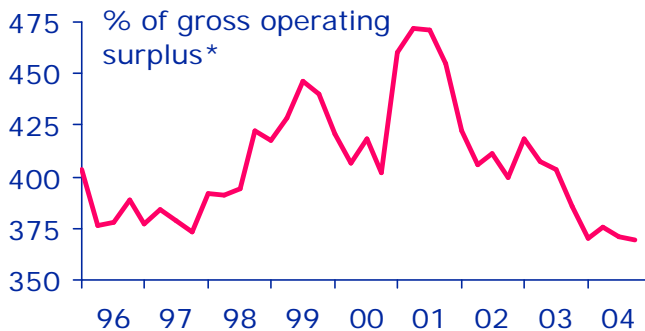
## Corporate profits



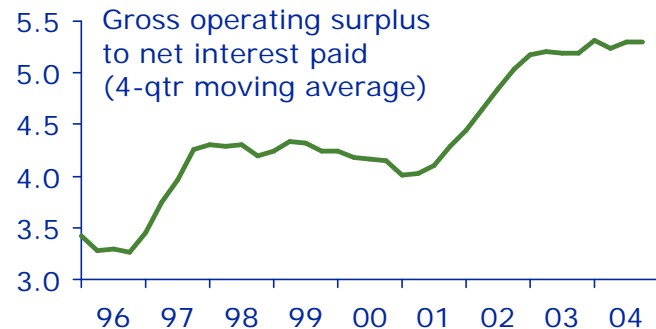
## Corporate debt-equity ratio



## Corporate debt to gross profits†



## Corporate interest cover



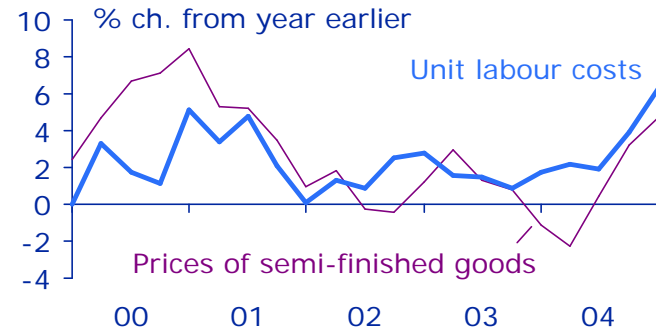
\* Non-financial corporate sector. † Gross profits (gross operating surplus) is (roughly) equivalent to EBITDA. Source: ABS.

## However currently very strong profit margins may come under some pressure this year

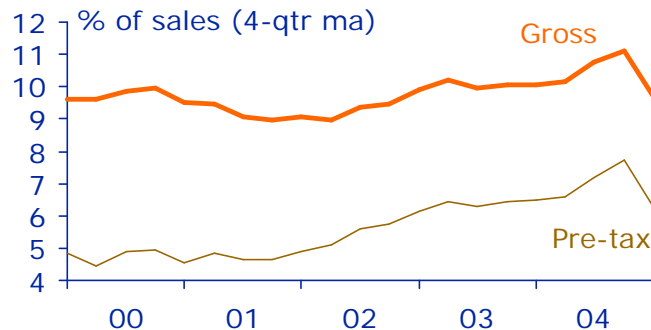
### Manufacturers' costs and prices



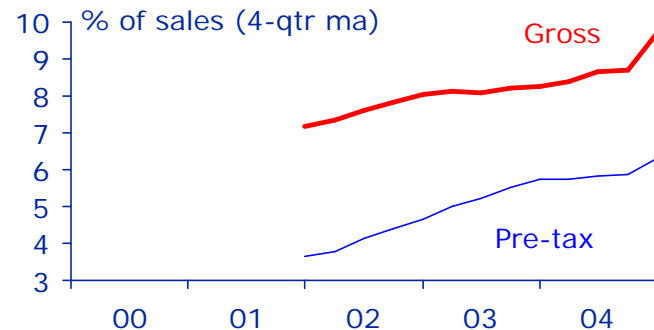
### Non-farm business costs



### Manufacturers' profit margins



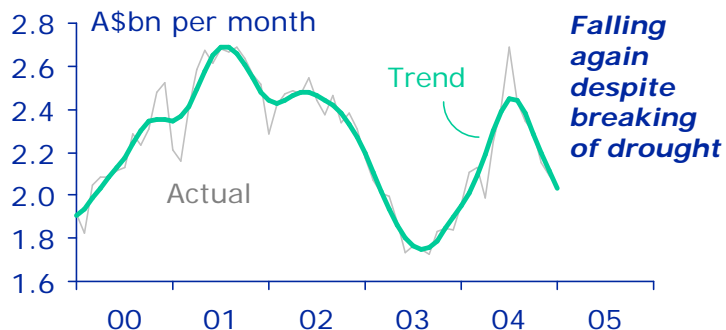
### Corporate profit margins\*



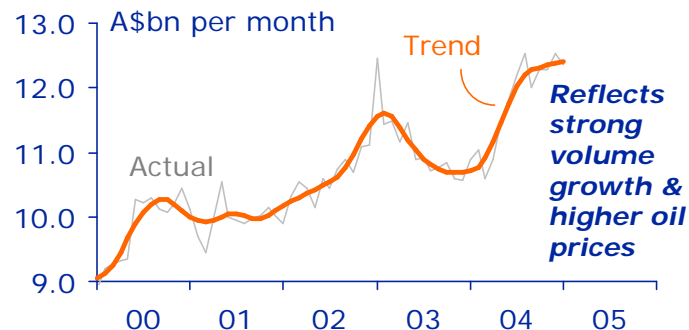
\* Excluding mining. Sources: ABS; Economics@ANZ.

# Persistently poor export performance and strong import growth keeping trade heavily in the red

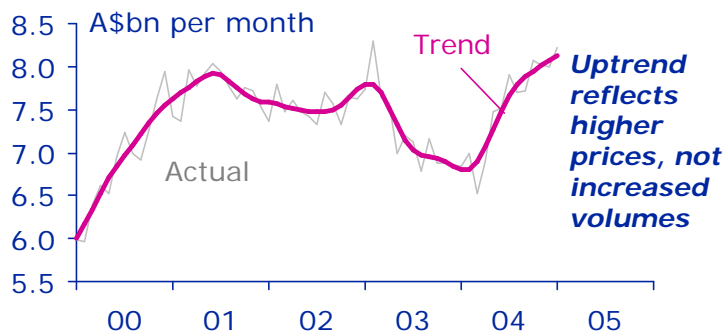
## Rural exports



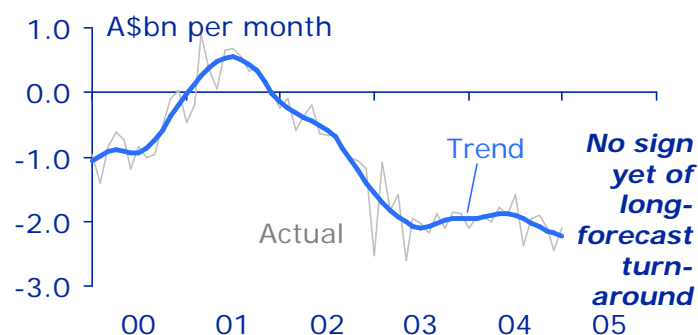
## Imports



## Non-rural exports\*



## Merchandise trade balance

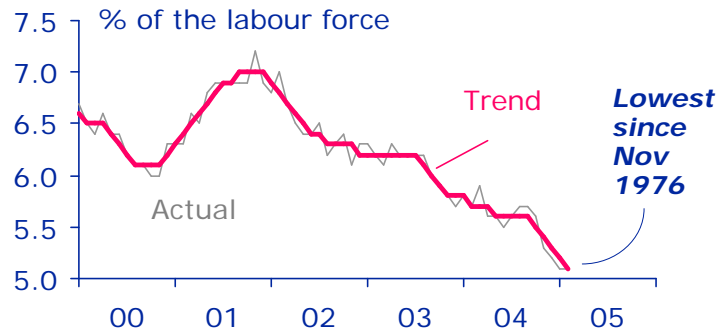


\*Excludes ANZAC frigates and RBA gold.

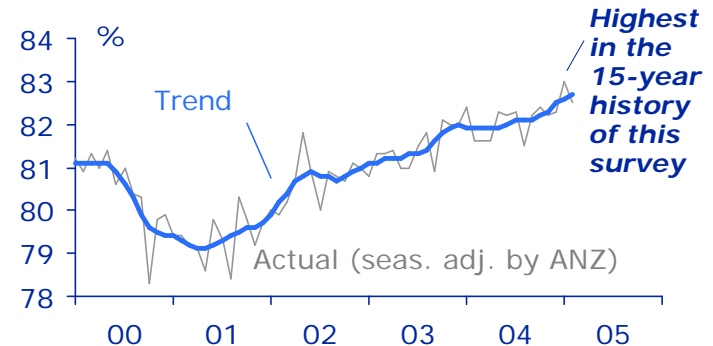
Sources: ABS; Economics@ANZ.

# The Australian economy is running into capacity constraints for the first time in 16 years

## Unemployment rate



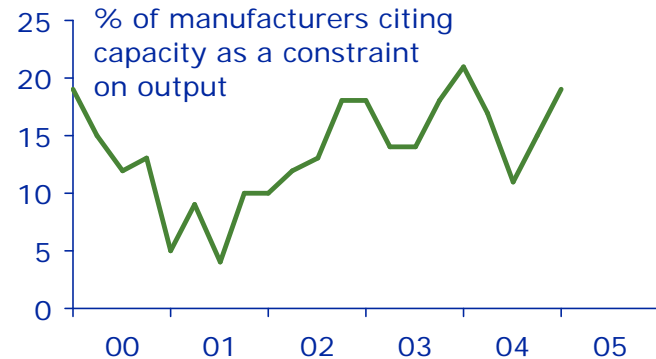
## Capacity utilization



## Labour shortages



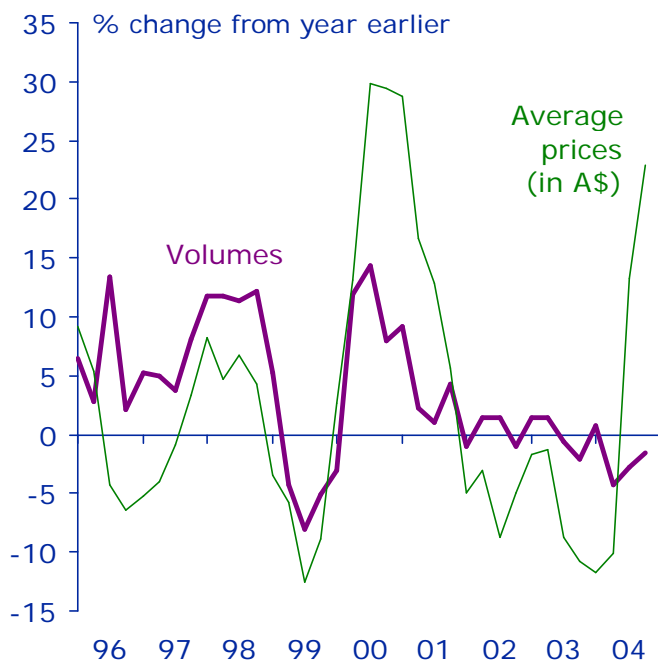
## Capacity as a growth constraint



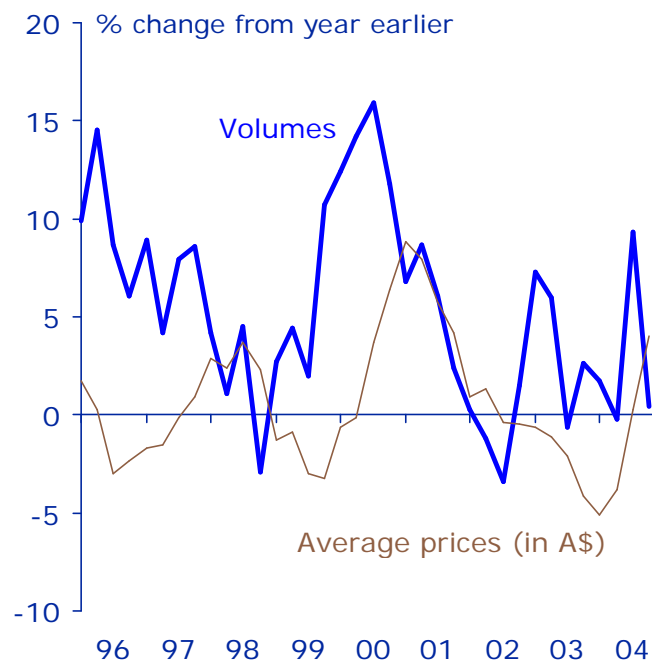
Sources: ABS; National Australia Bank; Westpac/ACCI; Economics@ANZ.

## Capacity constraints have limited Australia's gains from strong world demand for minerals & energy

### Energy, minerals and metals exports



### Non-commodity exports

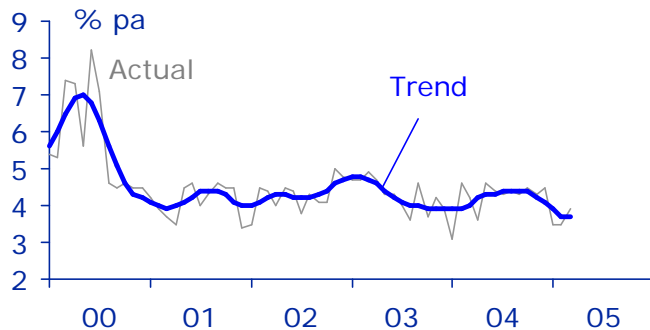


Note: Energy, minerals and metals exports excludes RBA gold sales; non-commodity exports excludes ANZAC frigates and Olympics-related transactions. Sources: ABS; Economics@ANZ.



# Some businesses and financial markets anticipate higher inflation, but households don't

## Inflation expectations (households)



## Expected change in selling prices (businesses)



## Inflation expectations (financial markets)



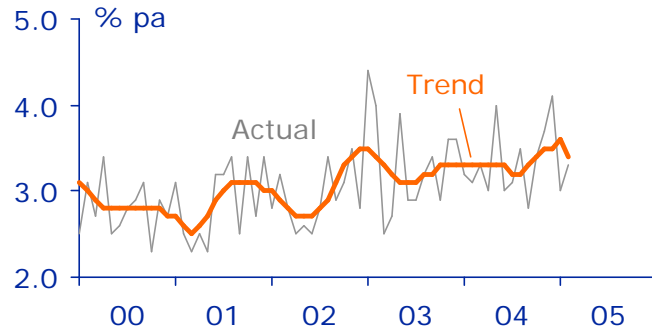
## Manufacturers' selling price expectations



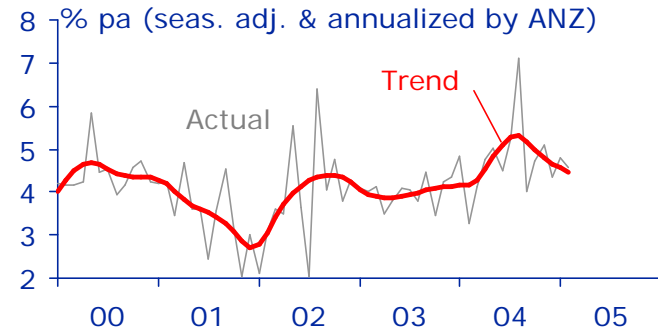
Sources: Melbourne Institute; National Australia Bank; Reuters; Westpac/ACCI;

# To date there's no sign of any pick-up in wage pressures, despite the tight labour market

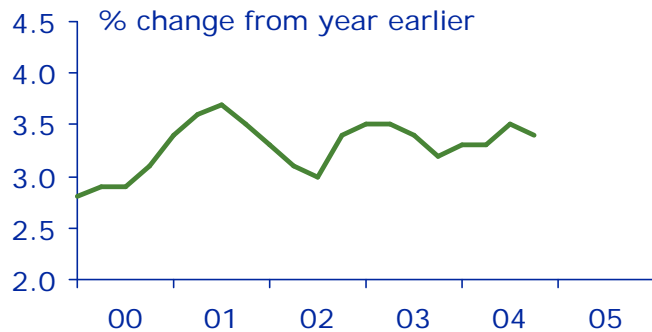
## Wage expectations (households)



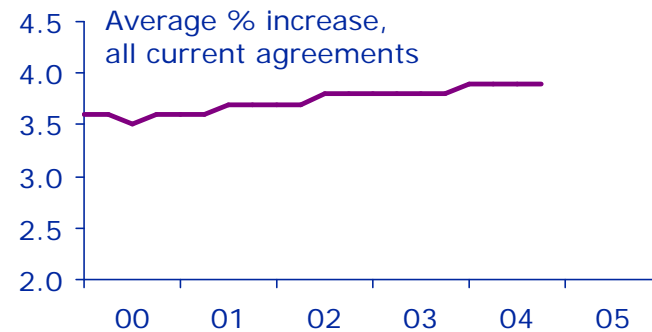
## Expected change in labour costs (businesses)



## Wage price index



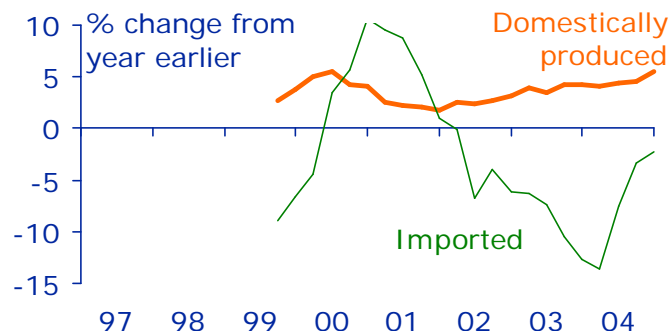
## Enterprise bargaining settlements



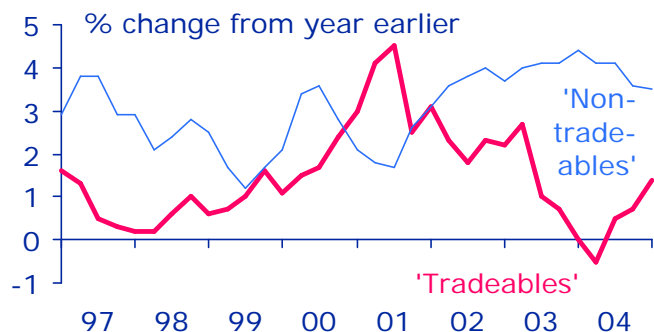
Sources: Melbourne Institute; National Australia Bank; ABS; Dept of Employment & Workplace Relations.

## Despite rising domestic cost pressures, we think a stronger A\$ will cap inflation in 2005

### Producer prices



### Consumer prices\*



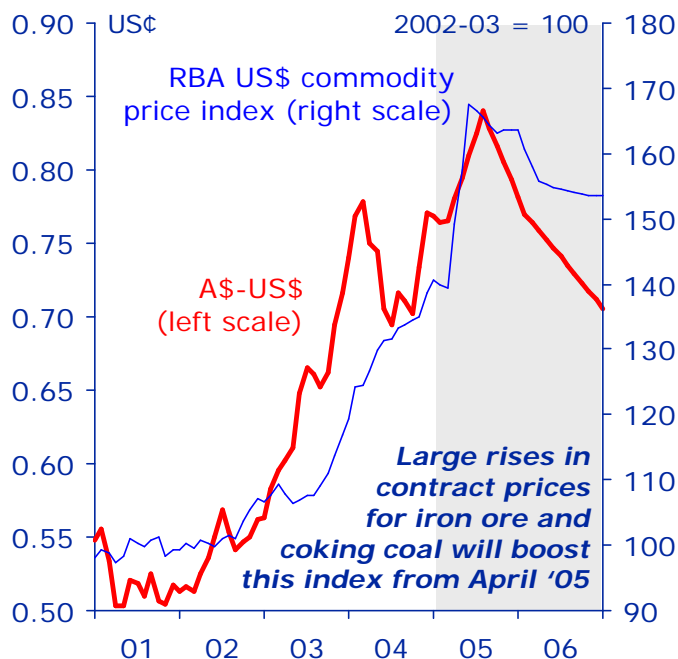
Excluding GST impact in 2000-01.  
Sources: ABS; Economics@ANZ.

- As a rough rule of thumb, every 10% (US 7½-8¢) rise (fall) in the A\$ subtract (adds) about ½ pc pt from (to) inflation over the following year
- By convention, the inflation projections in the RBA's quarterly Monetary Policy Statements assume that the exchange rate remains constant
  - so the latest projections would have assumed an A\$ of US77¢ (TWI 63½)
- By contrast we expect the A\$ will average over US80¢ (TWI 63) in 2005
  - if that turns out to be correct, then inflation will be in the lower part of the target band throughout 2005

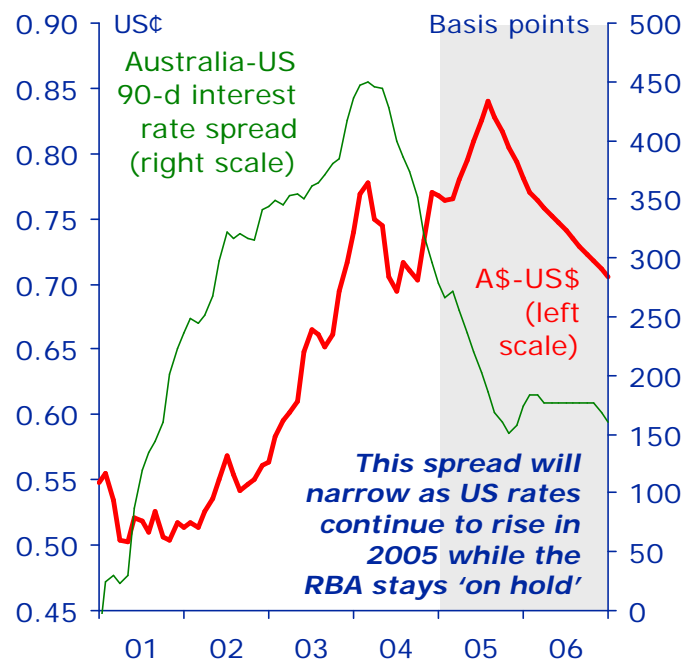
# Slower world growth and a narrowing interest rate spread will eventually see the A\$ fall

## Traditional 'fundamentals' and the A\$

### Commodity prices



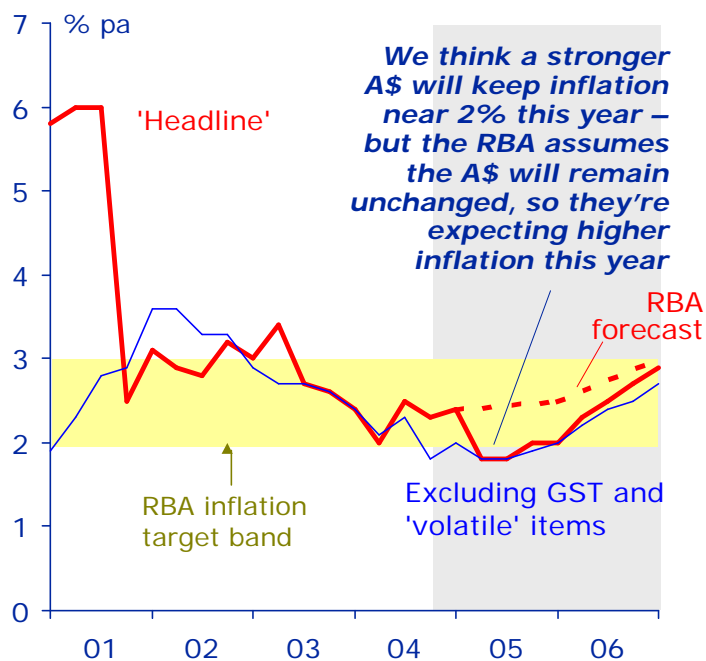
### Interest rate spreads



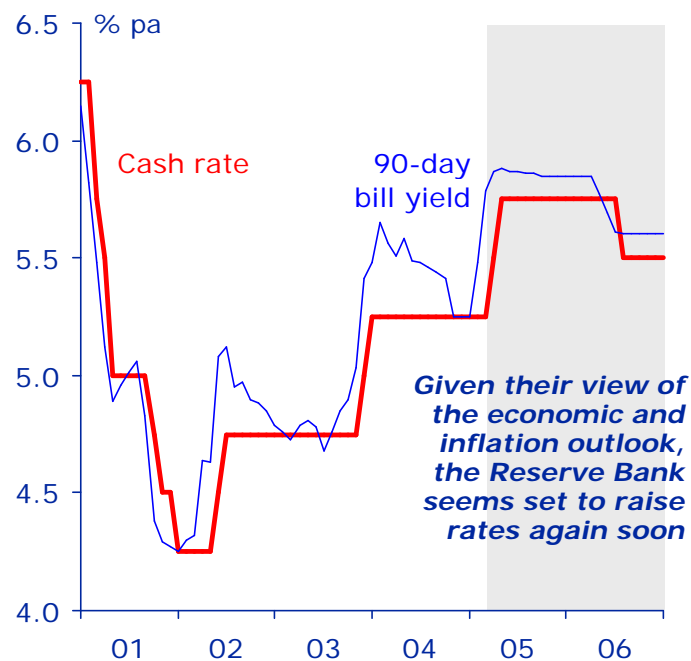
Sources: Datastream; Economics@ANZ.

## However the Reserve Bank has a more pessimistic view of inflation and thus is set to raise rates

### Inflation



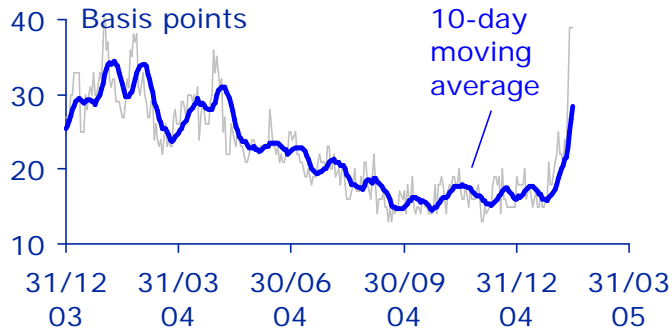
### Interest rates



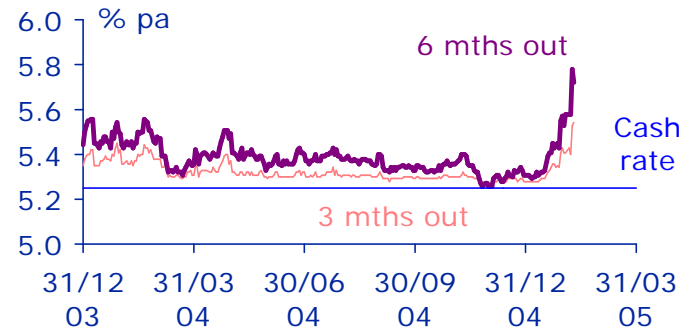
Sources: ABS; RBA; Economics@ANZ.

# Markets are now sure there'll be at least one rate rise, and possibly two, before year end

### Spread between 90-day bank bills and cash



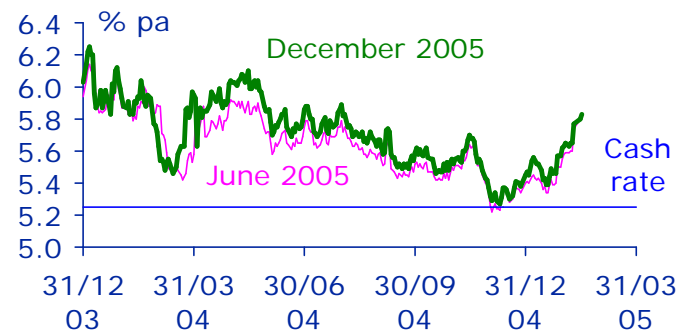
### Cash rate implied by overnight indexed swaps



### Probability of a 25bp rate increase implied by 30-day futures contracts



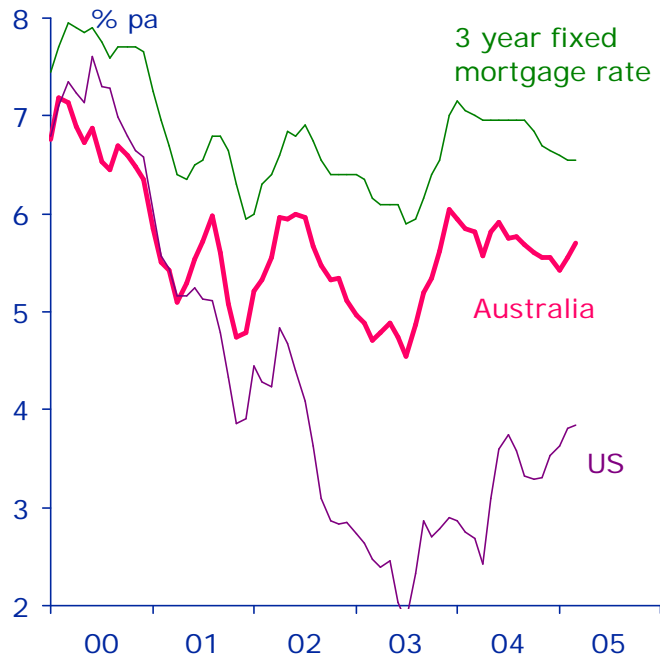
### 90-day bill yields implied by futures contracts



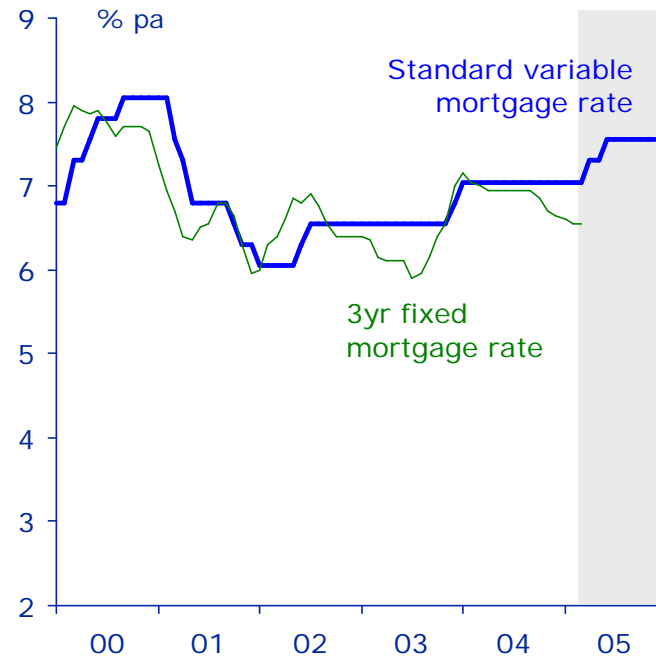
Note: charts show daily data from 31 Dec 2003 onwards.  
Sources: Datastream; Reuters; Economics@ANZ.

## Australian longer-term rates are being held down by US long rates – so there's still scope to 'fix'

### 3-year swap yields and fixed-rate mortgages



### Fixed and floating mortgage rates



Sources: RBA; Economics@ANZ.

## Summary

- Global growth has peaked and will slow this year, but not alarmingly – though the pattern of growth remains unbalanced
- The US\$ will remain under downward pressure, and US interest rates under upward pressure, for some time yet
  - but don't expect any major changes in Asian exchange rate policies
- After 14 years of continuous growth, Australia's economy is starting to run into capacity constraints
  - this normally happens towards the end of the business cycle
  - these are the circumstances in which inflationary pressures tend to build
  - the Reserve Bank wants to try to head these off by raising rates gently, earlier than in previous business cycles (and doesn't believe the A\$ will do this for them)
- The pattern of economic growth in Australia is starting to become unbalanced
  - ideally, we should aim for more exports and investment, and less private and government consumption (which would be good for WA)
- Interest rates are now likely to rise twice over the next few months
  - it's worth giving some thought to 'fixing'