ANZ Australian Economics Weekly

Settling down?

04 April 2008

Inside:

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Our Vision:

For Economics@ANZ to be the most respected, sought-after and commercially valued source of economics research and information on Australia, New Zealand, the Pacific and Asia.

Economic wrap

- The Reserve Bank left interest rates on hold at 7.25% at its April meeting.
- The official cash rate now looks to have peaked in the current tightening cycle. The RBA is growing more confident that domestic demand is moderating, as evidenced by softer credit and retail sales data this week, and this should eventually start to put downward pressure on inflation.

Market matters

- Financial markets were more settled this week.
- The market thinks the next move in Australian interest rates will be down.
- The A$ put in a lacklustre week.
- But local equities were stronger, thanks to Wall St.

Economy in focus: Global financial market conditions improve but Australian borrowing costs to remain elevated

Our spotlight on key issues and developments in the Australian economy.

- Global financial markets have been under considerable stress over the past nine months in the wake of the US sub-prime crisis and associated credit squeeze.
- While it is impossible to forecast an end to these financial stresses, it appears that the actions of the Federal Reserve in shoring up confidence in the US banking system may signal a settling of financial conditions if not some improvement.
- A sustained improvement will, however, require a confidence within the financial markets community that the worst of the financial crisis is behind us. Also important will be a restoration of confidence in the underlying stability of the financial system and the economy.
- Until we see investors return to global debt markets, Australian borrowers will continue to face high floating and term interest rates.

New publications from Economics@ANZ

Available at www.anz.com/go/economics

- *ANZ International Economics Monthly, April 2008*

Dr. Alex Joiner
Economist, Australia

Economic wrap

Credit – it's business 'and' personal…

RBA left interest rates on hold at April board meeting.

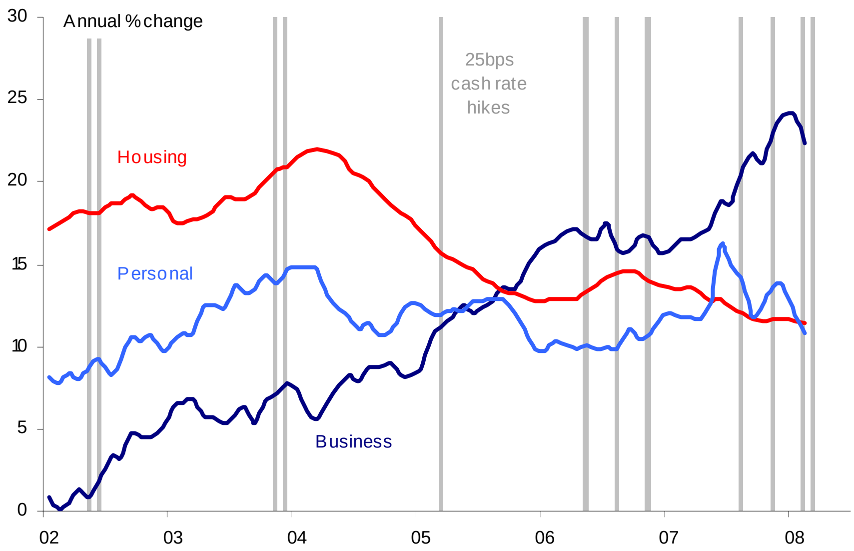
The RBA's board meeting on Tuesday came and went without much fuss with official interest rates remaining on hold at 7.25%, as was widely expected. Further clues about Australian monetary policy were provided by RBA Governor Glenn Stevens in his semi-annual appearance before the Parliamentary Committee on Economics, Finance and Public Administration. The Governor's overall comments were consistent with our view that the official cash rate has peaked in the current cycle and that domestic demand is moderating. We received more evidence of this in today's weak retail sales figures for February. Nominal monthly retail sales declined by 0.1% in February, following a similar fall in January.

Private sector credit was the other major statistical release this week, with figures scoured over to find further evidence of a slowing economy. Total private sector credit increased by 0.7% in February, the slowest monthly growth rate since October 2002. However, annual growth in private sector credit remains solid at 15.5%. There was a twist in this month's figures with housing credit growth remaining surprisingly solid and business credit growth coming in significantly softer than expected. Personal credit growth contracted for the second consecutive month, the first such occurrence since late 1993.

Private sector credit growth softened in February, with housing credit growth remaining solid…

Housing credit grew by 0.9% in February, to be 11.4% higher over the year. Robust housing finance approvals data would suggest that there remains at least some steam left in housing credit growth going forward, despite higher interest rates. This is primarily due to the strength of the underlying drivers of the residential housing market. Ongoing strong demand for housing, in an environment of limited additional supply, will characterise the residential market for some time to come. This is also reflected in the release of additional detail for housing credit data, indicating that credit growth to owner occupiers remained solid in the month at 1.0% (to be up 12.1% in the year). Whereas, investors have been much more responsive to interest rate hikes, with credit growth to this segment slowing to only 0.6% in the month (up 10.0% in the year).

Private sector credit growth this monetary policy cycle



Sources: Economics@ANZ, RBA

…but business credit growth was weaker than expected…

Surprisingly, business credit growth was significantly softer this month to be up only 0.5% (but still up a strong 22.3% over the year), well below the 1.8% average monthly growth rate since January 2007. This may have been due to re-intermediation of credit flows slowing in the month, despite direct financial market funding remaining difficult and expensive. Increases in business lending rates, which have been much more exposed to financial institution funding cost increases than mortgage rates, may also have deterred businesses from adding to their debt levels, combined with increasing concerns of a slowing domestic economy. If this slowing in business credit growth persists it is unlikely that the future capital expenditure plans of businesses (as reported to the ABS) will be realised. As a consequence the slowing of business investment may act as a drag on economic growth going forward.

...and personal credit growth was also soft...

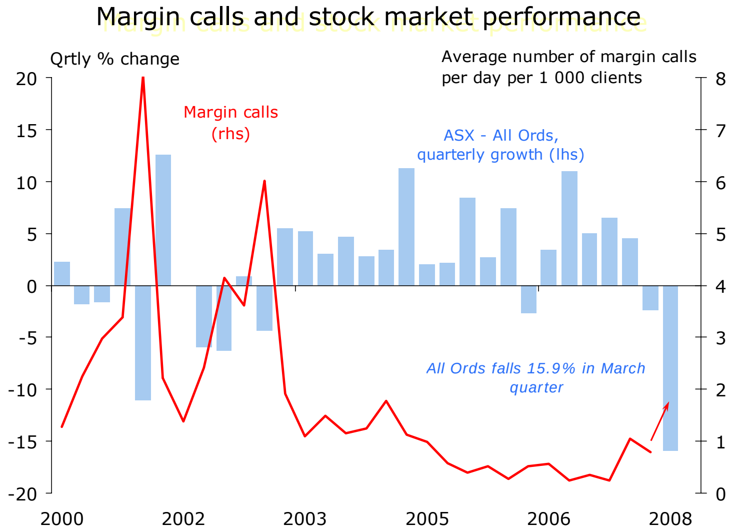
Personal credit fell 0.1% in February, taking annual growth to 10.8%. After being distorted by superannuation changes last year, a softening trend has emerged in personal credit growth as higher interest rates prompt a winding back of discretionary spending on big-ticket items. Today's soft retail trade figures, which showed the second consecutive contraction of monthly sales values, may point to a further softening of personal credit growth as consumer scale back purchase across the board. Further, VFACTs data, also released this week, points to the emergence of a softer trend for car sales going forward.

...due, in part, to an increase in margin calls.

Softer personal credit growth in recent months has also been prompted, at least in part, by an increased rate of margin calls as stock market prices have fallen. This is because when a margin loan is called it must be "topped up" (or the shares sold at a loss) which in effect slows the stock of overall personal credit growth. This is analogous to what the increased rate of repayments on home loans has done to "artificially" slow housing credit growth in recent months after equity was removed from home loans to put into superannuation.

Further significant falls in equities prices in March suggests that a further jump in the rate of margin calls will weigh significantly on personal credit growth in the month. The share market fell sharply throughout the quarter, falling 15.9%.

Falls in the stock market point to rising numbers of margin calls



Sources: Economics@ANZ, RBA, ASX

According to RBA data the number of margin accounts reached 200,000 in December from 87,000 in December 2000. The value of this lending has risen more than 5-fold to represent around one-fifth of total personal lending. Despite this increase, investors, in aggregate, have been relatively cautious with gearing levels averaging just over 40%. This should limit any significant rise in the rate of margin calls as seen in 2001 and 2003 when gearing levels exceeded 50%.

Key points to note from this week's economic data releases are:

- VFACTS **new motor vehicle sales** increased by 1.5% in original terms, but was 3.3% lower over the year. In seasonally-adjusted terms, we estimate that sales fell by 5.1% in the month and 2.2% over the year.
- Total **private sector credit** rose by 0.7% in February. Annual growth in private sector credit remains solid at 15.5%. Housing credit expanded by 0.9% in February, leaving annual growth at 11.4%. Business credit growth was up only 0.5% in the month, up 22.3% over the year. Personal credit fell by 0.1% in the month, taking annual growth to 10.8% over the year.

- Monthly nominal **retail sales** declined marginally by 0.1% in February but remain 5.8% higher over the year. The weak result was below market expectations of a 0.3% rise and follows a downwardly revised 0.1% decline in January (originally reported as a flat result).

Data preview

Dr. Alex Joiner
Economist, Australia

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Economist, Australia

7th April: Building Approvals (Feb)

ANZ forecast: -2.9% MoM, -5.5% YoY, Last: 1.9% MoM, 5.1% YoY

The continued tightening of monetary policy in early 2008 is anticipated to further depress residential building activity. The expectation that the RBA will now keep rates at a peak of 7.25% for a protracted period of time is expected to keep any new supply of housing subdued throughout this year. The contraction in approvals over this period will exacerbate the tightness in the housing market. Underlying demand for new housing is currently running at around 180K new dwellings per annum, well ahead of the current rate of completions at 150K. ***(AJ)***

6th April: International Trade in Goods & Services (Feb)

Trade balance: ANZ forecast: -$2.8bn, Last: -$2.7bn

We anticipate that the trade deficit will again be relatively wide this month as disruptions to resources exports, especially coal due to extreme weather conditions. These disruptions are expected to keep coal supply from Queensland constrained for much of the first half of 2008. However, the news is not all bad. Large increases in bulk commodity prices in the pipeline should ensure that the outlook for the trade deficit in the second half of 2008 is much brighter than in the first half. Some solace can be taken in the ABS preliminary data for imports which foreshadow a relatively small increase of 0.3% in the month on a balance of payments basis. ***(AJ)***

10th April: Labour force (Mar)

Employment: ANZ forecast: +10,000, Last: +36,700

Unemployment rate: ANZ forecast: 4.1%, Last: 4.0%

Participation rate: ANZ forecast: 65.2%, Last: 65.2%

Recent labour market outcomes have been on the strong side, with annual growth in employment picking up to 2.9% over the year to February and the unemployment rate achieving a fresh 33-year low of 4.1%. However, leading indicators suggest that the labour market is approaching a turning point. In particular, the ANZ job advertisements series and the ABS job vacancies series have both eased in recent months. We thus expect employment to increase by a more modest 10,000 in March. Assuming a participation rate of 65.2%, this will see the unemployment rate tick up to 4.1%. ***(RP)***

Market matters

Katie Dean
Senior Economist, Markets

Settling down

Confidence started returning to US markets this week

Financial markets have continued to settle this week. The Fed's new policy initiatives appear to be having the desired effect by easing short-term liquidity pressures. The second of the New York Federal Reserve's auctions under its new Term Securities Lending Facility was held overnight with a total of 'just' US$25bn auctioned, down from last week's auction of US$75bn. While bid-to-cover ratios were slightly higher this week, the smaller amount on auction gives some comfort that the financial sector's need for cash is becoming a little less desperate.

Confidence also received a big boost from the news that UBS and Lehman Brothers had been able to raise a combined US$19bn in new capital. This has provided markets with an important signal, ie. that investors are coming back to market. This good news has seen credit markets tighten notably and has allowed markets to weather further writedowns by European and US banks this week (cummulative losses now top US$230 bn) as well as Fed Chairman Bernanke's admission that the US economy is probably in in recession.

The improvement in confidence saw US Government bonds to sell-off this week. A modest reversal in safe-haven flows has seen the 10-year government bond yield rise to a 1-month high of 3.60% while the 2-year government bond yield has touched nearly a six-week high of 1.92%. However with the crucial US payrolls data out tonight – a third consecutive monthly decline is expected - it's not clear that these levels will be sustained.

The market now thinks the RBA will cut rates by year-end

In Australia the RBA, as expected, kept rates on hold and signalled a relatively neutral bias for monetary policy going forward. With a sombre global backdrop and today's retail sales data confirming that domestic demand is slowing, the market has increased its bet that, not only will the next move in rates be down, but that cuts will occur as early as November this year. We continue to judge this pricing as premature. RBA Governor Stevens' testimony to parliament today confirmed that while official interest rates are near the top of the cycle, any prospective easing in inflation back to the RBA's comfort zone will be gradual. With inflation likely to top 4% in March, our feeling is that it will take a mighty shock to domestic incomes and spending in Australia to convince the RBA to cut rates by year-end.

But high inflation suggests that view is premature.

Having inititially rallied on the RBA's decision, local bonds have subsequently sold off in line with the US market. The upshot is that our 3s10s curve, at -6.5pts, is little changed since last Friday. Given the policy view we've outlined above, we continue to expect Australia's 3s10s curve to range-trade for some time.

Labour market the short-term key for the A$

The A$ has been lacklustre against a stronger US$ this week with this cross reamaining capped below US$0.92c. The recovery in global investor confidence has by-passed the local currency, which appears to have been dragged down by news of a weaker local economy and mixed commodity prices. Not even an (unconfirmed) rumour that coking coal contract prices were set to be agreed at +200% for the year ahead was enough to spark an A$ revival. That said, the A$ has made up some ground against the ¥ and the NZ$ this week on an apparent deterioriation in the prospects of the Japanese and New Zealand economies.

Local employment data will provide direction for the A$ next week

Fundamentally, prospects for the A$ remain strong. Australian export prices are well-supported and interest rate differentials are not going to ease any time soon. A further improvement in confidence in US markets, to the extent it improves risk appetite, should also be a positive for the A$. However, for now, markets appear focused on the fact that the Australian economy is in the midst of a turning point. Next week's labour force data is therefore shaping up as crucial. Another strong outcome should set up the A$ for another charge towards US$0.94c. A fall in employment however would be devestating for the

A$, leaving it vulnerable to a fall towards US$0.88c. Get set for an action-packed week!

What a relief

Our shares move higher, thanks to Wall St

The cautious optimism that returned to Wall St has spread to the Australian share market this week. The RBA's decision to keep rates on hold also provided a reprieve for investors. At the time of writing, the ASX 200 was up 5% for the week, the best performance in ten weeks. In a pleasant change, all sectors were up this week. As should be expected, the finance sector was the top performer, bouncing back solidly after a month of torrid losses.

That said, to say the worst is now behind us would be premature. With the local economy slowing, interest rates set to remain high, and global investors still on tenterhooks, local equities will continue to face considerable headwinds in the coming months.

Economy in focus:

Warren Hogan
Head of Markets Research

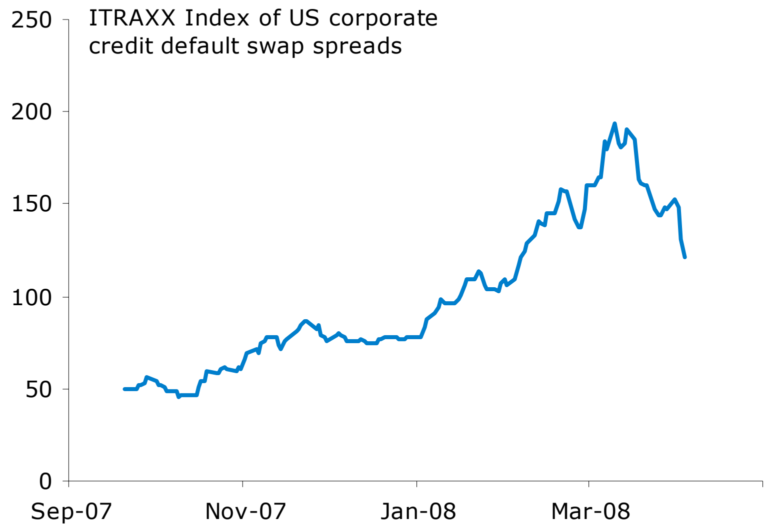
Global financial market conditions improve but Australian borrowing costs to remain elevated.

Financial conditions may be settling, if not actually improving

Global financial markets have been under considerable stress over the past nine months in the wake of the US sub-prime crisis and associated credit squeeze. In Australia, the impact has been to drive out credit spreads (increasing private sector borrowing costs), reduce equity values and tighten liquidity conditions in the primary debt markets and associated derivatives markets. While it is impossible to forecast an end to these financial stresses, it appears that the actions of the Federal Reserve in shoring up confidence in the US banking system may signal a settling of financial conditions if not some improvement.

The US equity market has rallied approximately 7.5% from last month's lows, credit spreads have contracted and the US dollar appears to have stabilized. While this is a welcome development, we doubt that the financial strains in the global markets will pass soon. Importantly, while the panic surrounding the collapse of Bear Stearns may have been arrested by Fed action, international money and debt markets remain dislocated and the pricing of credit reflects on-going tightness in the system (see chart below).

US credit spreads



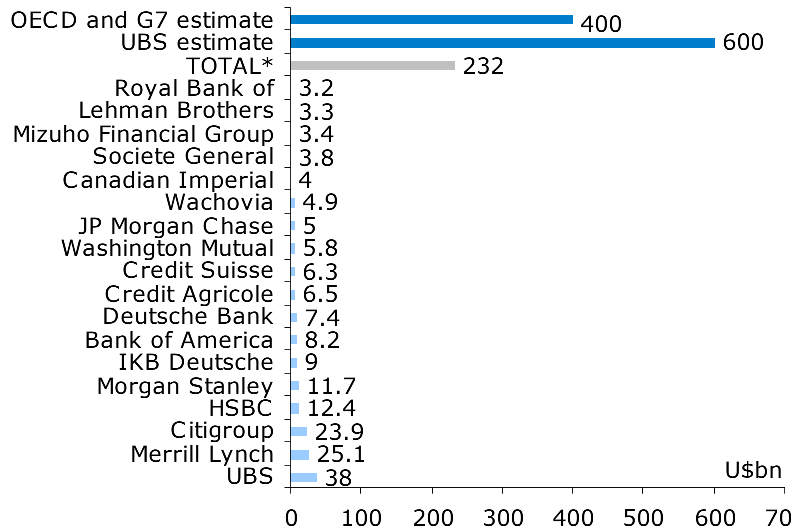
Bank write-downs add up to US$232bn to date

They may eventually reach as high as US$600bn

A sustained improvement will, however, require a confidence within the financial markets community that the worst of the financial crisis is behind us. This process is evolving slowly via bank write-downs. The table below outlines the extent of write-down thus far. Estimates suggest total losses could be as high as US$600bn (the OECD estimate is approximately US$400bn). With only US$232bn on the table at this stage, this form of analysis suggests financial markets may remain 'stressed' for some time (see chart of losses below).

A primary driver of lower liquidity in financial markets and rising volatility has been a surge in the precautionary demand for money on the part of private investors such as superannuation funds. Until that precautionary demand eases, we do not expect the current difficult financial environment to change in a material way. Investors will only begin deploying precautionary liquidity into risky assets when prices reflect fundamentals or are even 'cheap' to underlying fundamentals. At this stage, the price of securities in the key 'stressed' mortgage basked markets does not appear to be lower enough to bring a substantial increase in demand for these securities.

Bank write-downs and credit losses



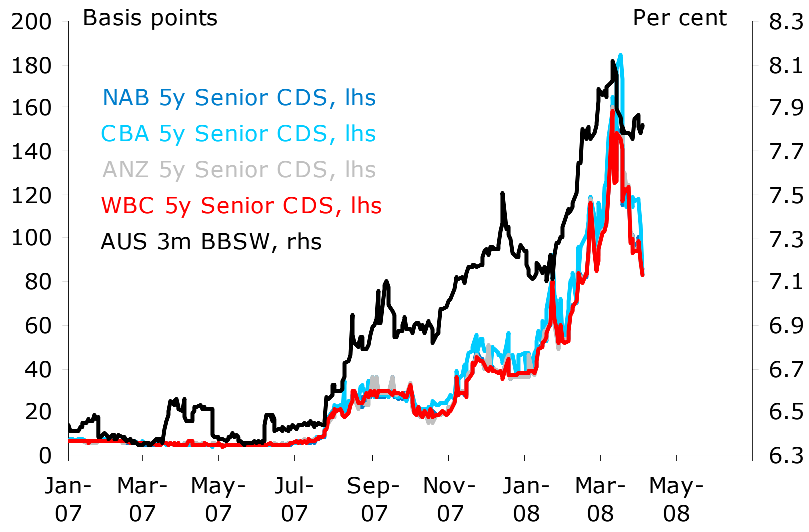
Also important will be a restoration of confidence in the underlying stability of the financial system and the economy. While central bank (particularly Federal Reserve) actions may help restore confidence in the liquidity of the banking system, these actions will not avert the pending macroeconomic adjustment. This adjustment is well underway in the US with consumer spending declining and unemployment rising. There are early signs of a slowdown in other economies, including Australia. Indeed, recent declines retail sales and personal credit over the first few months of 2008 suggests households are undertaking an orderly de-leveraging of balance sheets in response to the more difficult financial conditions that have emerged in 2008.

The US economy has slowed in response and other economies are beginning to follow

For the Australian economy the prospect for an easing of global financial strains is important because the primary transmission mechanism of the recent global financial disturbance into the Australian economy has been via higher borrowing costs. While credit spreads have contracted from recent highs, borrowing costs for Australian borrowers, in particular Australian banks, remain elevated compared to a year ago (see chart below). Until we see investors return to global debt markets, Australian borrowers will continue to face high floating and term interest rates.

Australian interest rates will remain elevated

Australian bank 5yr CDS



Economic and financial market forecasts

Australian economic indicators		2007	2008f	2009f	2010f
Economic activity (annual % change)					
Private final demand		5.7	3.6	2.2	3.5
Household consumption		4.5	3.5	2.3	3.4
Dwelling investment		3.5	0.4	4.5	11.3
Business investment		11.2	4.9	0.8	0.6
Public demand		3.4	5.8	3.5	3.2
Domestic final demand		5.2	4.0	2.5	3.4
Inventories (contribution to GDP)		0.8	-0.1	0.0	0.0
Gross National Expenditure (GNE)		5.9	3.9	2.5	3.4
Exports		3.3	2.0	6.7	5.0
Imports		10.7	8.3	5.9	5.1
Net Exports (contribution to GDP)		-1.7	-1.6	-0.1	-0.3
Gross Domestic Product (GDP)		3.9	2.7	2.3	2.9
Prices and wages (annual % change)					
Inflation:	Headline CPI	2.3	3.4	2.8	2.9
	Underlying*	3.1	3.6	2.8	2.9
Wages		4.1	4.4	4.2	3.8
Labour market					
Employment (annual % change)		2.8	2.5	1.4	1.3
Unemployment rate (%)		4.4	4.1	4.5	4.8
External sector					
Current account balance:	A$ bn	-67.0	-67.2	-62.3	-76.3
	% of GDP	-6.2	-5.7	-5.0	-5.8

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

Australian interest rates	Current	Jun 08f	Sep 08f	Dec 08f	Mar 09f	Jun 09f
RBA cash rate	7.25	7.25	7.25	7.25	7.25	7.25
90 day bill	7.81	7.70	7.60	7.50	7.40	7.10
3 year bond	6.24	6.55	5.95	5.50	4.60	4.35
10 year bond	6.19	6.40	5.95	5.50	4.75	4.75
3s10s yield curve	-0.05	-0.15	0.00	0.00	0.15	0.40
3 year swap	7.32	7.65	6.80	6.20	5.45	4.82
10 year swap	7.19	7.60	6.90	6.30	5.70	5.30
International interest rates						
RBNZ cash rate	8.25	8.25	8.00	7.50	7.00	6.75
NZ 90 day bill	8.82	8.80	8.38	7.73	7.13	7.00
US Fed funds note	2.25	1.50	1.50	1.50	1.50	1.50
US 2 year note	1.90	1.50	1.75	2.00	2.25	2.75
US 10 year note	3.59	4.50	4.25	4.00	3.65	3.50
Japan call rate	0.5	0.50	0.50	0.50	0.50	0.75
ECB refinance rate	4.0	4.00	3.75	3.50	3.25	3.00
UK repo rate	5.25	5.00	4.75	4.50	4.50	4.50

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

Foreign exchange rates	Current	Jun 08f	Sep 08f	Dec 08f	Mar 09f	Jun 09f
Australia and NZ exchange rates						
A$/US$	0.9123	0.94	0.92	0.90	0.87	0.84
NZ$/US$	0.7826	0.78	0.74	0.69	0.66	0.64
A$/¥	93.64	95.9	92.0	91.8	91.4	90.7
A$/€	0.5827	0.61	0.61	0.61	0.61	0.61
A$/£	0.4575	0.47	0.47	0.47	0.46	0.45
A$/NZ$	1.166	1.21	1.24	1.30	1.32	1.31
A$/CA$	0.9177	0.94	0.95	0.95	0.94	0.92
A$/CHF	0.9239	0.98	0.99	1.00	1.00	1.00
A$/CNY	6.402	6.37	6.13	6.03	5.90	5.77
A$ Trade weighted index	68.70	70.7	69.4	68.8	67.6	66.2
International cross rates						
US$/¥	102.6	102	100	102	105	108
€/US$	1.565	1.54	1.51	1.47	1.42	1.38
€/¥	160.7	157	151	150	149	149
£/US$	1.994	2.00	1.95	1.92	1.89	1.86
€/£	0.7849	0.77	0.77	0.77	0.75	0.74
US$/CA$	1.006	1.00	1.03	1.06	1.08	1.10
US$/CHF	1.013	1.04	1.08	1.11	1.15	1.19
US$ index	72.22	73.2	74.5	76.4	78.7	80.8
Asia exchange rates						
US$/CNY	7.016	6.78	6.66	6.70	6.78	6.86
US$/HKD	7.790	7.78	7.79	7.80	7.79	7.79
US$/IDR	9220	9100	9250	9350	9550	9400
US$/INR	40.03	39.0	39.2	39.3	39.3	39.4
US$/KRW	973.6	970	960	950	940	940
US$/MYR	3.1935	3.19	3.24	3.28	3.33	3.36
US$/PHP	41.725	39.8	40.8	41.5	42.0	42.5
US$/SGD	1.384	1.38	1.38	1.38	1.39	1.39
US$/THB	31.67	30.8	31.0	31.3	31.5	32.0
US$/TWD	30.42	32.80	33.00	33.00	33.30	33.45
US$/VND	16103	15500	15423	15345	15383	15422
Pacific exchange rates						
PGK/US$	0.368	0.40	0.38	0.36	0.35	0.35
FJD/US$	0.664	0.68	0.66	0.65	0.63	0.61

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*.

What to watch - 4 weeks from Monday 7 April 2008

Mon 7 April	Tues 8 April	Wed 9 April	Thur 10 April	Fri 11 April
9:30 AiG-HIA Performance of Construction (Mar) **11:30 ABS, International Trade in Goods & Services (Feb)** *Trade balance:* *ANZ forecast: -$2.8bn,* *Last: -$2.7bn* **11:30 ABS, Building Approvals (Feb)** *ANZ forecast: -2.9% MoM, -5.5% YoY, Last: 1.9% MoM, 5.1% YoY* **11:30 ANZ Job Advertisements (Mar)** 16:30 RBA, Official Reserve Assets (Mar)	9:30 NAB Business Survey (Mar)	10:30 Westpac Consumer Confidence (Apr)	10:30 Consumer Inflation Expectations (Apr) **11:30 ABS, Labour Force (Mar)** *Employment:* *ANZ forecast: +10,000, Last: +36,700* *Unemployment rate:* *ANZ forecast: 4.1%, Last: 4.0%* *Participation rate:* *ANZ forecast: 65.2%, Last: 65.2%*	
Mon 14 April	**Tues 15 April**	**Wed 16 April**	**Thur 17 April**	**Fri 18 April**
11:30 ABS, Housing Finance (Feb)	11:30 ABS, Lending Finance (Feb) **11:30 RBA, Monetary Policy Minutes**	10:30 Westpac Leading Index (Feb)	**11:30 RBA Bulletin (inc. RBA FX transactions)**	11:30 ABS, International Trade Price Indexes (Mar Qtr)
Mon 21 April	**Tues 22 April**	**Wed 23 April**	**Thur 24 April**	**Fri 25 April**
11:30 ABS New Motor Vehicle Sales (Mar) **11:30 ABS Producer Price Indexes (March quarter)**	AOFM Bond Issuance $300mn for April 2012	10:00 DEWR Skilled Vacancies (Apr) **11:30 ABS Consumer Price Index (March quarter)**		
Mon 28 April	**Tues 29 April**	**Wed 30 April**	**Thur 1 May**	**Fri 2 May**
		11:30 RBA Private Sector Credit (Mar)	9:30 AiG Performance of Manufacturing Index (Apr) **11:30 ABS, Building Approvals (Mar)** 16:30 RBA Commodity Price Index (Apr)	**11:30 ABS, Retail trade (Mar)**

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