ANZ Australian Economics Weekly

RBA attempts to restore confidence

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Our Vision:

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

Economic Update

- The RBA has attempted to restore some confidence in the Australian economic outlook, talking up Australia's economic fundamentals and intervening in the foreign exchange market to avert a free-fall in the A$. We continue to expect the RBA will deliver a 50bps rate cut next week.
- The unprecedented decline in the $A over the past few months suggests a degree of stress emerging in our balance of payments. As global capital markets freeze, so does the capital flow required to fund our current account deficit. As global markets normalise these stresses should abate and allow for a modest rise in the $A over the months ahead.
- The Government has released its modelling of the impact of the planned Emissions Trading Scheme. The economic impact is small, with real GDP per capita projected to fall by an average of 0.1 to 0.2% p.a. from 2010-50.

Market wrap

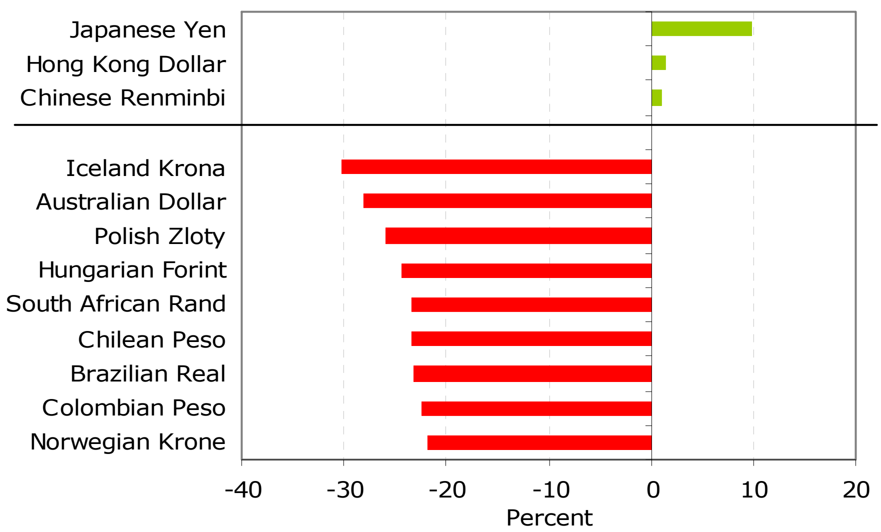
- Rates markets move away from expecting a 75bps November rate cut, the AUD puts in a solid rebound and local equities recover early losses.

Coming up

- ANZ Job ads and ABS House prices (Q3) (Mon 3rd Nov 11:30 AEDT)
- RBA rate decision (Tues 4th Nov 14:30 AEDT)
- Building approvals (Sep) and Trade balance (Sep) (Wed 5th Nov 11:30 AEDT)
- Labour force (Oct) (Thurs 6th Nov 11:30 AEDT)

Chart of the week

Top 3 and Worst 8 performing currencies in the last 3 months (total return versus the US dollar)



Source: ANZ and Bloomberg

Economic Update

Coming up

- **ANZ job advertisements (Oct)** Have been falling since May. Will the downward trend continue?
- **House prices (Q3)** (Mon 3rd Nov 11:30 AEDT) Small fall expected.
- **RBA rate decision** (Tues 4th Nov 14:30 AEDT) We, and most of the market, are looking for a 50bps cut. The tone of recent RBA communications suggests the risks are for a smaller cut than a repeat of last month's aggressive move.
- **Building approvals** (Sep) Rate cuts likely to cause some stabilisation.
- **Trade balance** (Sep) (Wed 5th Nov 11:30 AEDT) Is expected to deteriorate following an oil-related surge in imports in September.
- **Labour force** (Oct) (Thurs 6th Nov 11:30 AEDT) Employment is expected to record its first fall since May and the unemployment rate is set to rise.

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RBA attempts to restore confidence

"While nobody can predict accurately all that lies ahead, it is important not to become too pessimistic because, fundamentally, household finances and the economy more generally remain in good shape"

RBA Deputy Governor Ric Battellino, 30th Oct 2008

This week the RBA Deputy Governor, like Governor Stevens last week, attempted to restore some confidence in the Australian economic outlook. While highlighting that Australia's economic outlook is very uncertain, the Deputy Governor stated that Australia's housing market is not as dire as in the US, partly because Australian borrowers have a much greater capacity to repay debt relative to many US borrowers. That said, Battellino stopped short of ruling out some fall in Australian house prices from here.

The RBA Deputy Governor suggested high inflation could limit further rate cuts

Significantly, the RBA Deputy Governor stated that the main problem that has build up in Australia is inflation. Because of that, "*Managing the economy this time will be more difficult than in 2001 because we are starting with a bigger inflation overhang… there is still a big task ahead to bring inflation down and this could limit room for manoeuvre on monetary policy*."

But we still expect a 50bps cut on Melbourne Cup Day

We believe that the Deputy Governor's speech was directed to OIS markets, which had been pricing in for aggressive RBA rate cuts (up to 75bps in November). We do not think this statement precludes the RBA from cutting rates when it meets on Melbourne Cup day. We continue to believe that the deteriorating global environment, not the inflation outlook, will be the more important determinant of monetary policy in Australia in the short-term. As such, we still expect the RBA to cut its official cash rate by 50bps this Tuesday.

RBA Intervenes to shore up currency

The RBA intervened earlier this week to avert a free-fall in the A$

Improving risk appetite in global markets and RBA intervention has seen the Australian dollar bounce strongly this week following the near free fall seen last week when the currency looked like falling through $US0.60. The currency hit a low early morning Tuesday right on US$0.60c as global equity markets, in particular Asian equity markets, plumbed new lows. RBA intervention late last week and earlier this week was aimed more at restoring orderly market conditions rather than propping the currency up. Ultimately it was the rebound in equity and commodity markets that pulled the currency higher. On late Thursday the currency had rebounded to a high of over US$0.68c.

As can be seen from Chart of the Week (p1), the Australian dollar has been one of the worst performing currencies over the last three months; only to be out done by the Icelandic Krona. In our view, a range of short-term financial stresses have caused the currency to overshoot on the downside in recent weeks and once (if) market conditions settle down, we should see the Australian dollar rally and then stabilise at a new higher level. That said, the medium-term outlook is for a weaker currency well into 2009. Weakening global growth, soft commodity prices and declining local interest rates are all consistent with the Australian dollar hitting a cyclical low point of something like US60c in late 2009.

A short-term balance of payments crisis?

A sudden slowing of capital inflow into the Australian market has weighed on the A$

The unprecedented decline in the exchange value of the Australian dollar suggests a degree of stress emerging in our external balance of payments. Specifically, it appears that the seizure of global debt markets throughout the month of October has resulted in a sudden slowing of capital inflow into Australian dollars via international debt markets. The bulk of debt capital inflow into Australia is via the issuance of term debt and the raising of short-term money by Australian banks in the international capital markets. With those markets effectively closed; that issuance has stopped.

In other words, a short sharp balance of payments crisis

In effect we have seen a large and sudden contraction in the capital account surplus (capital inflow) in the face of a still large current account deficit. In the past six months the current account deficit is clearly improving (largely through an improving trade position) but it has not improved quickly enough to offset the negative impact on the currency from the disruptions to capital flows in the past month. A very short sharp balance of payments crisis appears to have overwhelmed the currency in October.

Global credit markets are improving

Other factors have been at work; the use of the Australian dollar markets by speculators to hedge positions in illiquid markets (such as emerging market equities). This essentially involves getting short the Australian dollar to hedge long 'growth' positions. The shrivelling of global market risk appetite, falling commodity prices and shifting growth expectations for the emerging economies have all played a role as well.

If Australian banks can resume issuing into global markets, the A$ could bounce back

This week saw some further encouraging signs on global credit markets. Money market spreads (OIS/LIBOR) are slowly improving, the US Federal Reserve's commercial paper (CP) facility appears to have been a success with a surge in CP issuance ad of course equity markets have bounced strongly from the early week lows. If these improvements translate into Australian banks issuing into the global markets over the weeks ahead we would expect that to translate into a rebound in the Australian dollar as the capital inflow resumes. Our target is for the Australian dollar to rise back into the low to mid 70 against the US dollar.

The first cut on the real economic impact

Next week's data set will show if the global financial shock has started to affect the local real economy

Next week we will receive the first set of data for the real domestic economy following the shock to global financial markets over September and October. This week's US data, which showed a sharp fall in consumer and business spending caused the economy to contract by 0.3% in the September quarter, confirms the damage that is being done to global economic prospects. At this stage we expect Australian economic growth will remain (slightly) positive in the September and the December quarters. Although we note that this is mainly due to fiscal support; the boost to retail sales from income tax cuts in July and the likely boost to consumer spending from the $8bn rebate for pensioners and low income families in December.

Retail sales are likely to post a fall in September

In the intervening months however we expect the data will show that underlying activity in Australia is weakening quickly. Conditions in the consumer sector in particular have deteriorated sharply. Personal credit growth is at its weakest rate since the last recession, consumer confidence is soft and household wealth has fallen sharply, with the RBA estimating the value of financial wealth alone has fallen by 11% since the end of June this year. To make matters even worse for households, Australian petrol prices rose in September, as the weaker currency offset the impact of weaker US$ oil prices. We thus expect to see a notable weakening in the ABS measure of retail sales in the coming months, starting off with a 0.8% contraction for the month of September. This data is due on Monday.

This week we'll also receive a timely update on the state of the labour market. , The sharp fall in ANZ newspaper job ads, which are down 25% over the year to September, paints a sobering outlook for employment growth. Moreover, the NAB Quarterly Business Survey showed that skill shortages are no longer considered the most significant constraint on output according to the NAB Quarterly Business Survey. The ANZ Job Ads survey for October, which will give an even clearer update on employer's reaction to the extraordinary developments of recent weeks, will be released on Monday.

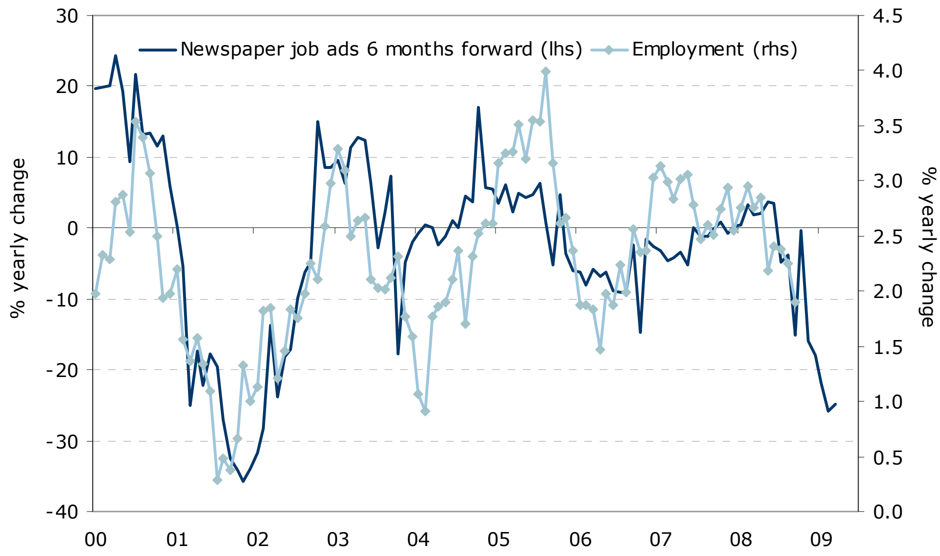
Indicators of labour demand have turned sharply

Thursday's labour market data will show the extent to which weaker demand for labour is causing actual employment growth to slow. To date, the slowdown in employment growth has been moderate, from a peak of 2.4% YoY in June to 1.9% YoY in September. We expect this process to have accelerated in October, however, amidst financial market turmoil and a greater number of reported job losses. We are thus forecasting next week's data to show that employment fell by 14.1K in October, the first monthly fall since May 2008. This would see the unemployment rate increase 4.5% in the month, the highest level since 2007.

Suggesting annual employment growth could weaken to just 1% in the coming months

Further out, the ANZ Job Advertisements Series for September pointed to further weakness in employment growth in coming months, taking the YoY rate to around 1% in early 2009 (see Figure 1). The labour market is forecast to deteriorate further from there, with employment growth expected to turn negative in YoY terms in H2 2009.

Figure 1: ANZ newspaper job ads and employment growth

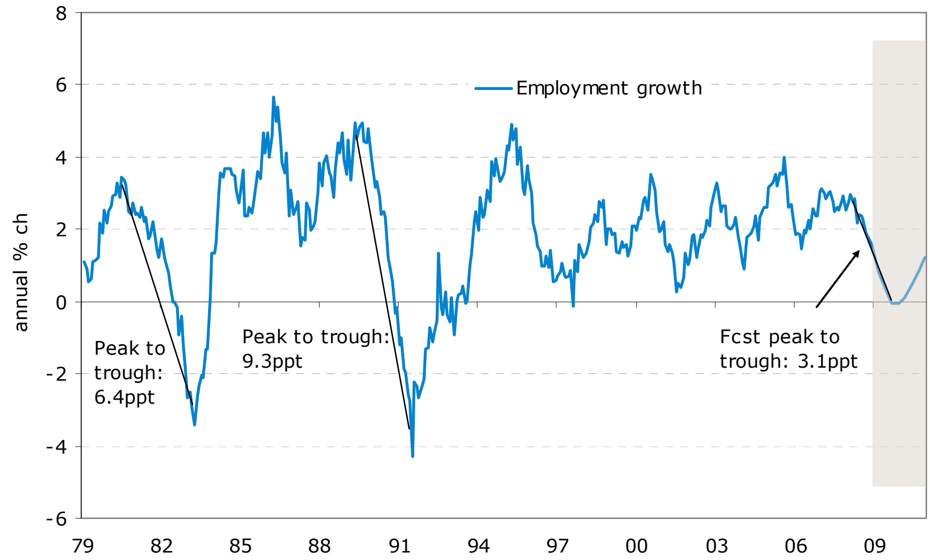


Source: ANZ and ABS

Past downturns show the labour market can deteriorate quickly if the economic outlook worsens

The performance of the domestic labour market remains key to Australia's prospects for riding out the global recession. At this stage, we expect a fairly modest downturn relative to history, mainly because at this stage we are not forecasting Australia to fall into recession. Figure 2 however shows how quickly, and how deeply, the labour market can deteriorate if the economy starts to contract.

Figure 2: Australian employment growth



Source: ANZ and ABS

Treasury expects a small cost for CO_2–e emissions trading

Julie Toth
Senior Economist

The Australian Government will introduce CO_2-e emissions trading in 2010

The Australian Government is committed to introducing a CO_2-e emission trading scheme in 2010, in order to help reduce Australia's greenhouse gas emissions and help mitigate expected climate changes. This week Treasury released its long-awaited estimates of the likely economic costs and benefits of the scheme, for the period from 2010 (the expected starting date) to 2050. The modelling works by estimating a 'base case' for the economy and then applying four different scenarios to it that assume different emissions reduction targets for Australia (and different levels of international co-operation), to determine what the economic effects of each scenario might be.

Treasury estimates emissions trading will cost 0.1% of GDP per capita, on average, from 2010 to 2050

Both the timing (from 2010) and the focus (long-term) of the modelling mean that our current short-term economic conditions and cycles are not strictly relevant to the results — while they might change the starting point for the base case, they will not change the effect each scenario might have on our future growth. The base case growth assumptions are positive but relatively conservative, with an annual average of 1.4% growth in GDP per capita for the entire period, 2010 to 2050.

Since the Government released its Green Paper that set out its preferred policy position in June, many private companies and organisations have commissioned their own research into the likely costs and effects of emissions trading. These studies have generally estimated (and probably over-estimated[1]) large costs for the companies directly involved in emissions trading. So what do the experts at Treasury expect emissions trading to cost the economy? They say the ETS will:

Emissions trading will need to start at a price of at least $23/t in 2010

- Reduce real GDP per capita by an average of 0.1 to 0.2% p.a. from 2010 to 2050, depending on the emissions reduction target for 2020 (-5% to -25%)
- Reduce real GNP per capita by an average of 0.1% p.a. from 2010 to 2050
- Require a starting trading price in 2010 of between $23/t of CO_2-e (for a 5% reduction by 2020) and $52/t f CO_2-e (for a 25% reduction by 2020)
- Require international agreement in order to keep costs at a minimum. Delays to international co-ordinated action will mean higher mitigation costs for all. International market-based trading mechanisms will reduce mitigation costs

[1] There is a well-documented tendency for business to over-estimate the cost of new regulation prior to its introduction. For environmental regulation, see for example H. Hodges, "Falling Prices: Cost of Complying With Environmental Regulations Almost Always Less Than Advertised", *Economic Policy Institute Briefing Paper,* Washington, Nov 1997.

- Be more effective and less costly with earlier action (by locking in low-emissions technologies earlier), even without international action and trading

High emissions industries will grow slower, or even shrink

- Have higher adjustment costs for Australia than other developed economies, because we have a higher share of emissions-intensive industries in our mix
- Require structural shifts in Australia's economy, with slower (or negative) growth in high-emissions sectors and higher growth in low-emissions sectors, plus long-term shifts in electricity generation away from coal to other sources
- Lead to slower (but still positive) growth rates in emissions-intensive trade-exposed sectors such as coal, non-metallic minerals, livestock, iron and steel
- Lead to contraction in aluminium, petroleum processing and possibly coal production (depending on the success of carbon sequestration technologies)
- Lead to stronger growth in low-emissions technologies and in sectors that can generate CO_2-e credits such as carbon sequestration methods and forestry
- Lead to a one-off rise in average consumer prices (CPI) of 1-1.5% in 2010, mainly due to higher electricity and gas prices
- Cost each household an extra $4-$5 for electricity and $2 for gas per week

Low emissions sectors and technologies will grow faster

- Have more impact on low income households who spend more on utilities
- Eventually lead to higher petrol, meat and other food prices when fuel tax concessions are eventually lifted and agriculture is brought into the scheme.

The next steps for introducing emissions trading will see the Government release a White Paper setting out its policies and draft legislation by the end of this year.

Key data summary

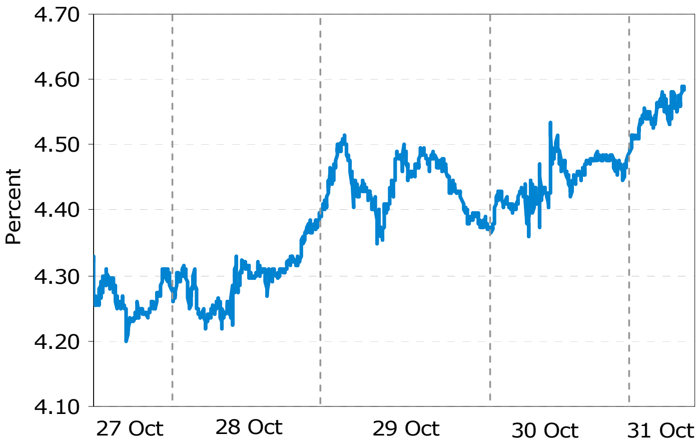
Please see ANZ's separate publication '*ANZ Data and Event Calendar*' for the schedule and previews of upcoming key local and global data events. Please email emr@anz.com if you would like to subscribe to this publication.

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

- The quarterly NAB survey showed that **business confidence** stayed weak at -7pts in Q3. Profitability deteriorated sharply from 2pts to -8pts and forward orders fell from -1pts to -6pts.
- The **DEWR skilled vacancies** series fell 3.7% in October. The biggest falls were in NSW (-6.5%) and Victoria (-5.6%).
- In an address to ITSA, **RBA Deputy Governor Battellino** stated that "*there is still a big task ahead to bring inflation down and this could limit room for manoeuvre on monetary policy*".
- **Credit growth** was surprisingly robust at +0.7% in September. Housing and business credit growth were solid while personal credit growth declined in the month.
- **HIA New Home Sales** failed to react to the RBA's 1ppt interest rate cut and instead fell by 1.8% in September, the sixth fall in nine months.

Market Wrap

Chart 1: AUS 3-year yields, intraday



Source: ANZ and Bloomberg

Markets refuse to give up on a 50bp cut next week

- Local rates rose mid week as a better performance by US and Australian equities saw some safe haven flows unwound. RBA Assistant Governor Battellino's speech on Thursday saw markets move away from expectations of a 75bp easing in November towards a 50bp move and extended the sell-off in 3-year yields.
- At the time of writing, 3-year yields have risen 34bps to 4.60% from Friday's close. 10-year yields have risen 37bps to 5.30%. The 3s10s curve hit a high of +87.5bps over the week but has since flattened to around +70bps.
- The RBA rate decision will be the main game next week. We suspect the tone will disappoint current market expectations for three 50bp back to back rate cuts over the next three meetings which should see yields move higher from current levels. Retail sales, house price and labour force data due out next week will also be important.

Chart 2: AUD/USD, intraday

Source: ANZ and Bloomberg

AUD rebound on better risk metrics

- The AUD was under pressure early in the week on heightened risk aversion and on reports of strong selling by hedge funds. This saw the RBA intervene at above US$0.60 to provide liquidity to an extremely illiquid market.
- But the AUD rebounded later in the week as sentiment regarding emerging markets improved after China cut rates and after the Fed opened swap lines with various emerging market countries. A recovery in global equity markets, helping to ease safe haven flows, and a weaker US dollar were also major drivers for the AUD recovery.
- An expected 50bp rate cut from the RBA next week will only equalise rate differentials with the US following the Fed's 50bp cut this week, and on its own is unlikely to boost the AUD/USD significantly. Falling asset prices and emerging markets are likely to be larger determinants for the AUD over the coming months. Tactically, we still expect the AUD to move above 0.70 in the short term but clearly the bigger risk for the AUD is to downside over the coming months.

Chart 3: ASX 200, intraday data

Source: ANZ and Bloomberg

Aussie stocks recover from early declines

- The Australian equity market was sold down early in the week on fears the global economic slowdown could be deeper than expected thereby slowing corporate profits. But it surged mid-week following an impressive rebound in global stock markets and on better sentiment after rate cuts in the US and China.
- The best performing sectors over the week were materials and energy which rose 10.7% and 9.0% respectively. But the financial index fell 2.8% despite on consensus results from St George and Westpac this week.
- While softer commodities saw equities retreat from yesterday's highs on Friday's morning, it looks like the ASX200 will hold on to most of its mid-week gains to end the week broadly flat. At the time of writing the ASX200 was trading around 3952, versus last Friday's close around 3869.

Patricia Gacis

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.2	0.9	3.1
Household consumption	4.5	2.6	1.6	2.1
Dwelling investment	3.1	-0.1	-0.3	12.7
Business investment	13.0	8.1	-0.2	3.2
Public demand	2.9	5.7	2.9	2.1
Domestic final demand	5.3	3.8	1.4	2.9
Inventories (contribution to GDP)	0.6	-0.3	-0.2	0.3
Gross National Expenditure (GNE)	5.9	3.5	1.2	3.1
Exports	3.2	5.9	4.3	3.2
Imports	10.8	10.7	-0.4	6.2
Net Exports (contribution to GDP)	-1.8	-1.3	1.0	-0.9
Gross Domestic Product (GDP)	**4.2**	**2.3**	**1.8**	**1.9**
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.6	3.2	2.6
Underlying*	3.1	4.5	3.5	2.7
Wages	4.1	4.3	3.7	3.5
Labour market				
Employment (annual % change)	2.8	2.3	0.2	0.7
Unemployment rate (%)	4.4	4.3	5.4	6.3
External sector				
Current account balance: A$ bn	-67.2	-57.3	-68.1	-71.6
% of GDP	-6.2	-4.9	-5.6	-5.7

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

Australian interest rates	Current	Dec 08f	Mar 09f	Jun 09f	Sep 09f	Dec 09f
RBA cash rate	6.00	5.25	5.00	4.50	4.50	4.50
90 day bill	5.81	5.60	5.35	4.80	4.80	4.80
3 year bond	4.49	4.30	4.15	3.85	3.90	4.25
10 year bond	5.23	4.90	4.85	4.60	4.60	4.95
3s10s yield curve	0.73	0.60	0.70	0.75	0.70	0.70
3 year swap	5.40	5.05	5.43	4.40	4.40	4.75
10 year swap	5.85	5.40	5.85	5.10	5.10	5.45
International interest rates						
RBNZ cash rate	6.50	6.00	5.50	5.00	4.75	4.75
NZ 90 day bill	7.15	6.53	5.83	5.33	5.15	5.05
US Fed funds note	1.00	0.75	0.75	0.75	0.75	0.75
US 2 year note	1.52	1.25	1.25	1.25	1.50	2.00
US 10 year note	3.93	3.55	3.55	3.45	3.60	3.85
Japan call rate	0.50	0.75	0.75	0.75	0.75	1.00
ECB refinance rate	3.75	3.50	3.25	3.00	3.00	3.00
UK repo rate	4.50	4.25	4.00	3.50	3.50	3.50

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

Foreign exchange rates	Current	Dec 08f	Mar 09f	Jun 09f	Sep 09f	Dec 09f
Australia and NZ exchange rates						
A$/US$	0.6713	0.73	0.72	0.68	0.64	0.60
NZ$/US$	0.5879	0.62	0.64	0.61	0.58	0.56
A$/¥	65.97	74.46	72.72	70.72	69.12	66.00
A$/€	0.5234	0.54	0.54	0.52	0.50	0.48
A$/£	0.4103	0.41	0.42	0.40	0.38	0.36
A$/NZ$	1.142	1.18	1.13	1.11	1.10	1.07
A$/CA$	0.8144	0.82	0.83	0.82	0.78	0.74
A$/CHF	0.7658	0.83	0.84	0.80	0.76	0.72
A$/CNY	4.587	5.07	5.04	4.73	4.42	4.11
A$ Trade weighted index	54.50	59.39	59.09	56.22	53.26	50.12
International cross rates						
US$/¥	98.3	102	101	104	108	110
€/US$	1.282	1.36	1.34	1.31	1.28	1.24
€/¥	126.0	139	135	136	138	136
£/US$	1.636	1.76	1.73	1.72	1.70	1.67
€/£	0.7841	0.77	0.77	0.76	0.75	0.74
US$/CA$	1.213	1.13	1.15	1.20	1.22	1.24
US$/CHF	1.141	1.14	1.16	1.18	1.18	1.20
US$ index	85.02	81.3	82.3	84.3	86.2	88.5
Asia exchange rates						
US$/CNY	6.838	6.95	7.00	6.95	6.90	6.85
US$/HKD	7.752	7.80	7.83	7.81	7.80	7.80
US$/IDR	11125	9600	9800	9700	9600	9400
US$/INR	49.68	48.00	49.00	48.00	47.00	46.00
US$/KRW	1281	1260	1300	1275	1250	1225
US$/MYR	3.563	3.49	3.57	3.58	3.53	3.48
US$/PHP	48.95	49.00	50.00	49.80	49.50	49.00
US$/SGD	1.479	1.46	1.53	1.54	1.52	1.50
US$/THB	35.02	35.50	36.00	35.75	35.25	34.75
US$/TWD	32.83	34.00	35.00	34.50	34.00	33.50
US$/VND	16825	16600	16600	16500	16300	16100
Pacific exchange rates						
PGK/US$	0.391	0.40	0.39	0.38	0.36	0.35
FJD/US$	0.560	0.60	0.59	0.57	0.56	0.55

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

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