Open partnerships
Open possibilities

Australia's macroeconomic prospects

Presentation to ABARE Outlook 2008

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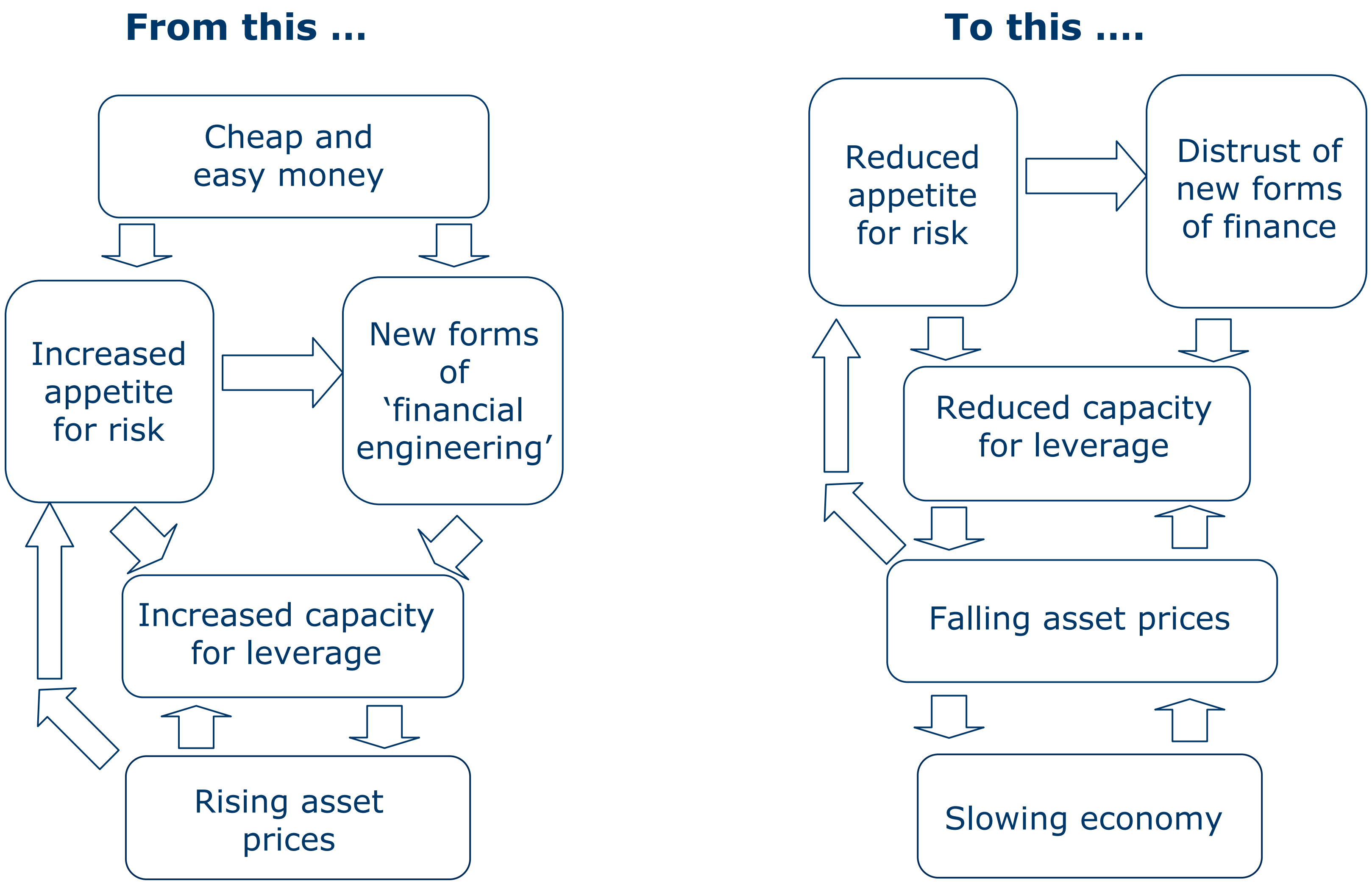
Australia's economy is at the intersection of two very powerful global forces

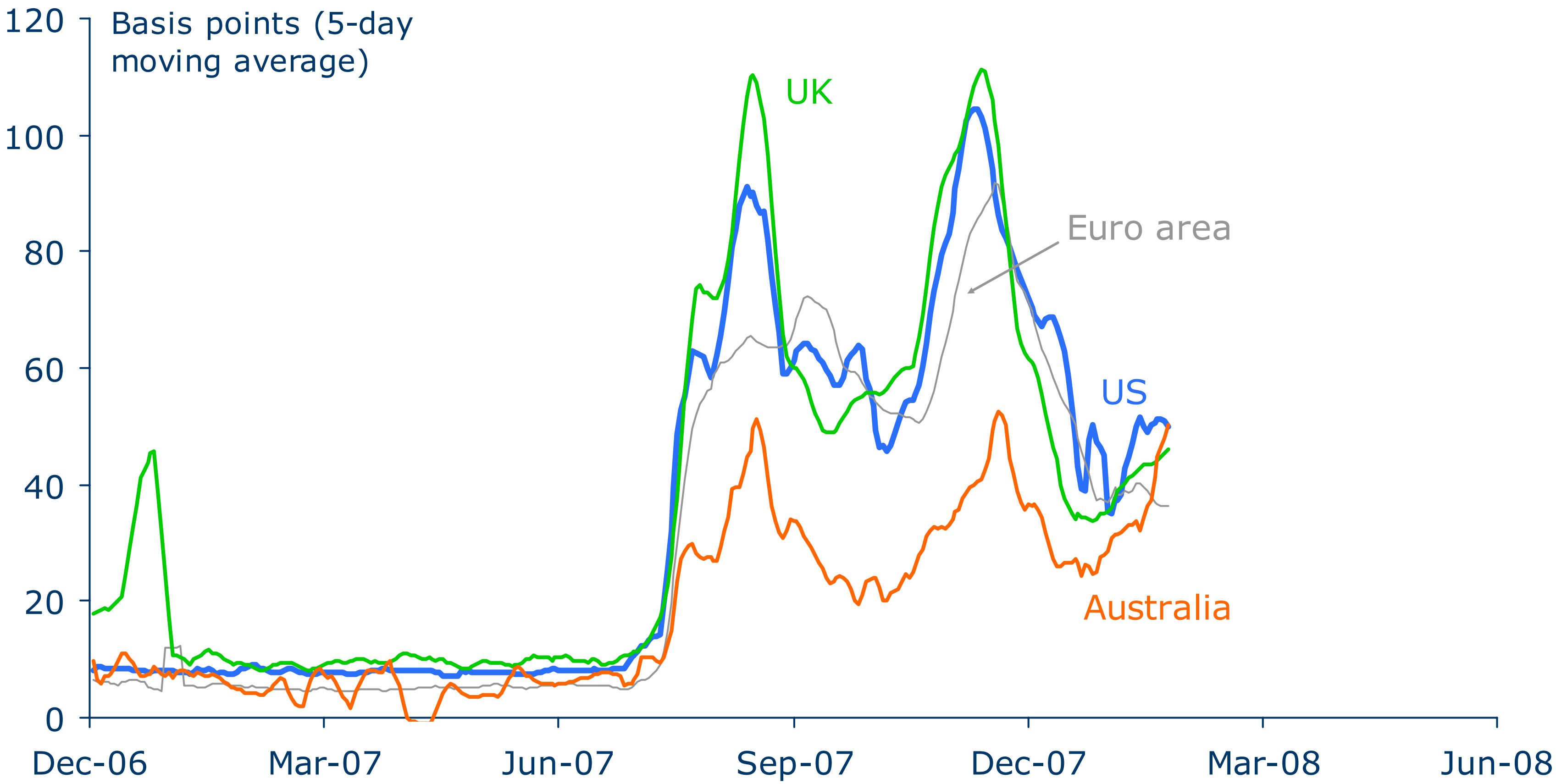
- The crisis in global credit markets
  - resulting from the bursting of the credit market 'bubble' which built up during the middle years of this decade
  - triggered by, but no longer confined to, the US sub-prime mortgage market
  - resulting in substantial declines in the value of a wide range of securities and derivatives
  - threatening to lead to a global 'credit crunch'
  - and possibly to a recession in the US and other large industrialized economies
- The on-going rapid growth and industrialization of China and other emerging economies
  - putting continued upward pressure on a wide range of commodity prices
  - as well as heightening concerns about climate change
- Australia is exposed to both of these forces
  - financing the world's fourth largest current account deficit predominantly through borrowing means Australia is exposed to the risk of a global 'credit crunch'
  - but the commodities boom is also adding directly and indirectly to inflationary pressures within Australia, and putting upward pressure on the A$
- Australia's short- to medium-term macroeconomic prospects will largely depend on the relative strength of these two forces

The current global financial crisis stems from the bursting of a 'credit market bubble'



Australian banks have been subject to the same short-term funding pressures as US and European banks …

Spreads between short-term (90-day) inter-bank borrowing rates and expected official cash rates

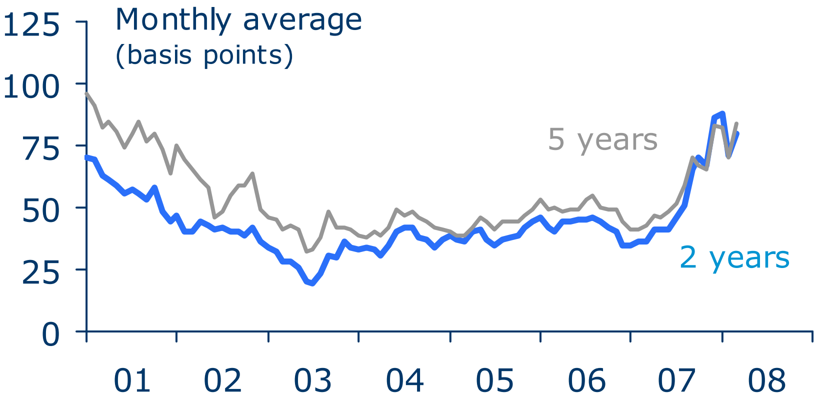


Note: 'expected official cash rates' proxied by overnight index swaps (OIS).
Sources: Thomson Financial; Bloomberg.

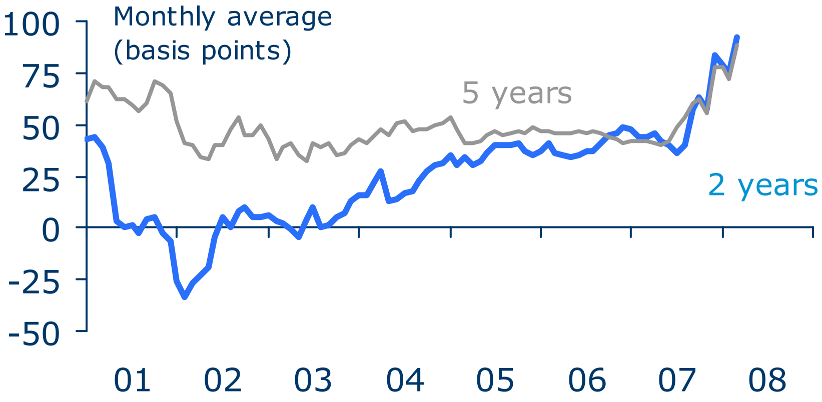
… and Australian longer-term debt markets have likewise seen similar increases in spreads as US debt markets

Swap spreads

United States

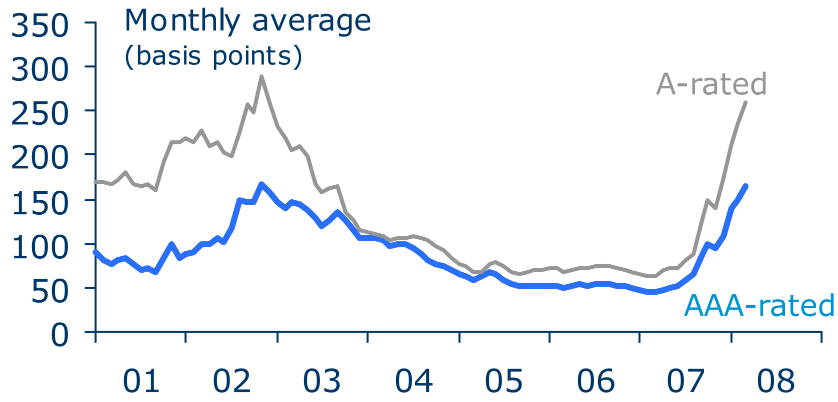


Australia

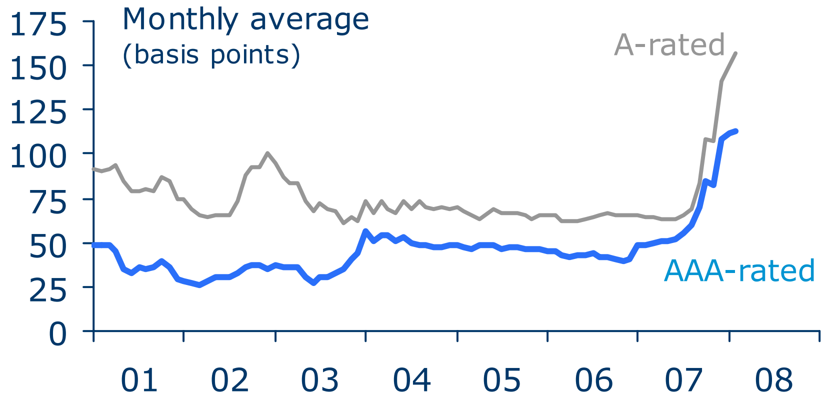


Corporate bond yield spreads

United States



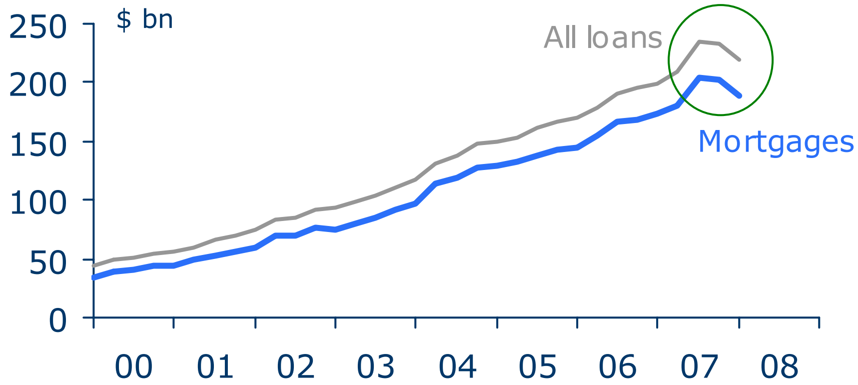
Australia



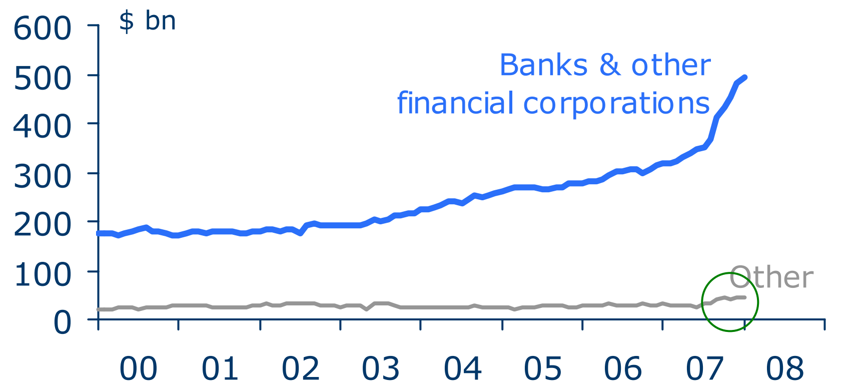
Note: spreads are to government bond yields of comparable maturities.
Sources: Thomson Financial; Bloomberg; Reserve Bank of Australia.

In Australia, as in the US, the debt securities markets have almost completely closed to non-bank borrowers

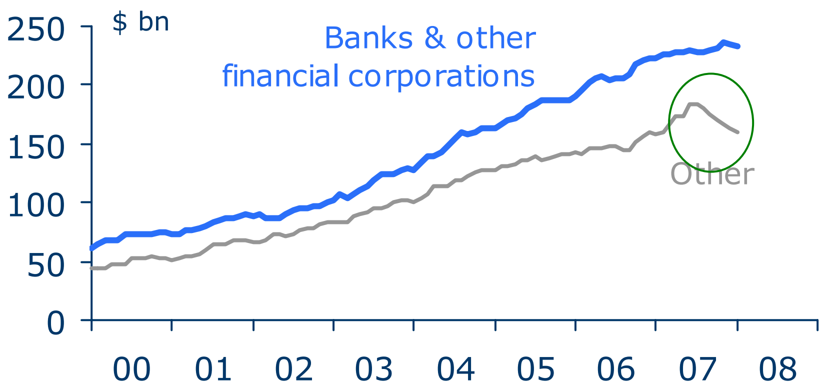
Securitizers' loan assets



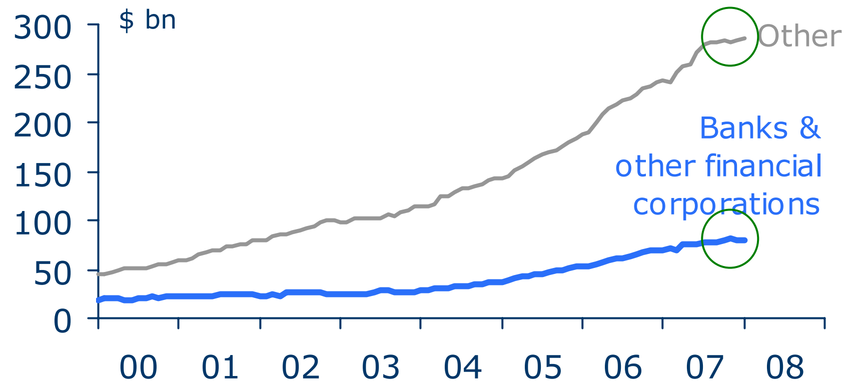
Short-term debt securities issued in Australia



Australian non-government debt securities issued offshore



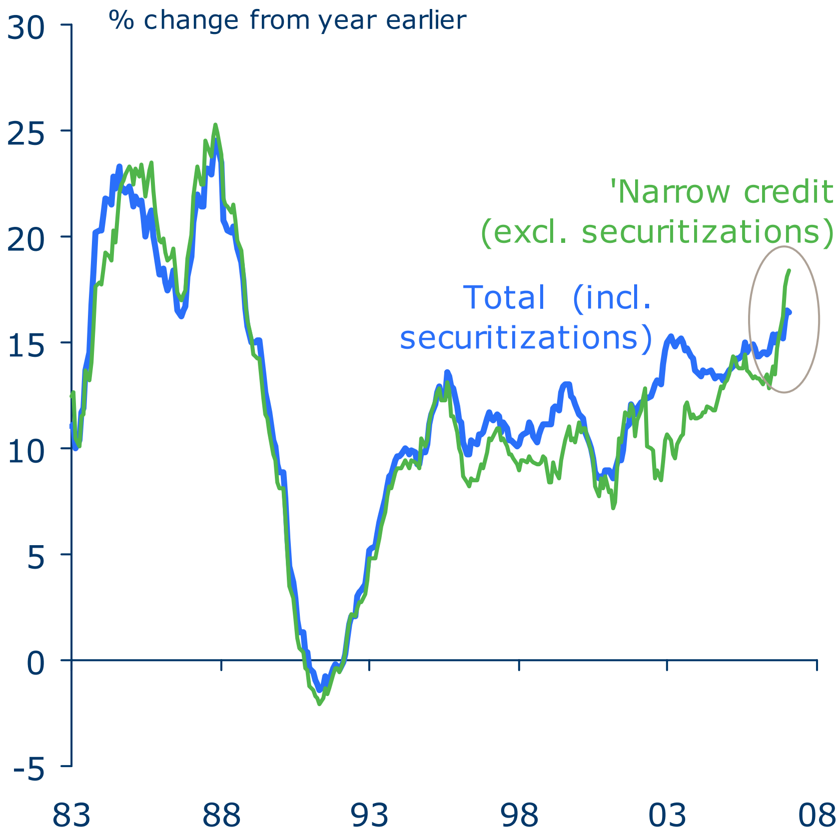
Long-term debt securities issued in Australia



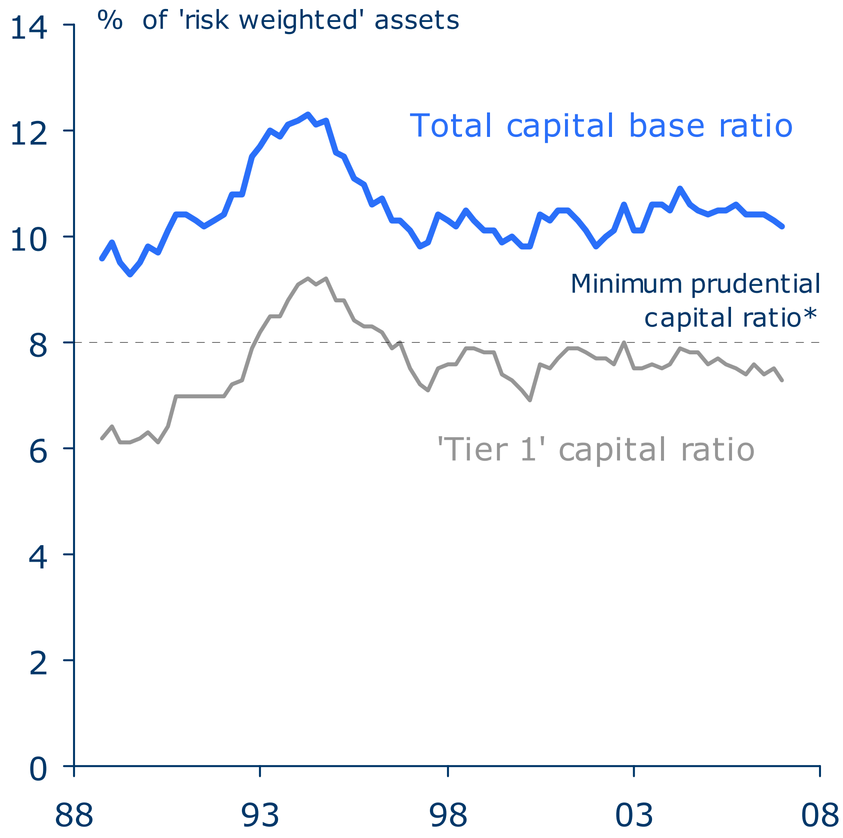
Note: excludes government debt securities. *Source:* Reserve Bank of Australia

With debt securities markets largely closed, credit demand is returning to the banking system – straining banks' capital

Australian financial intermediaries' business lending



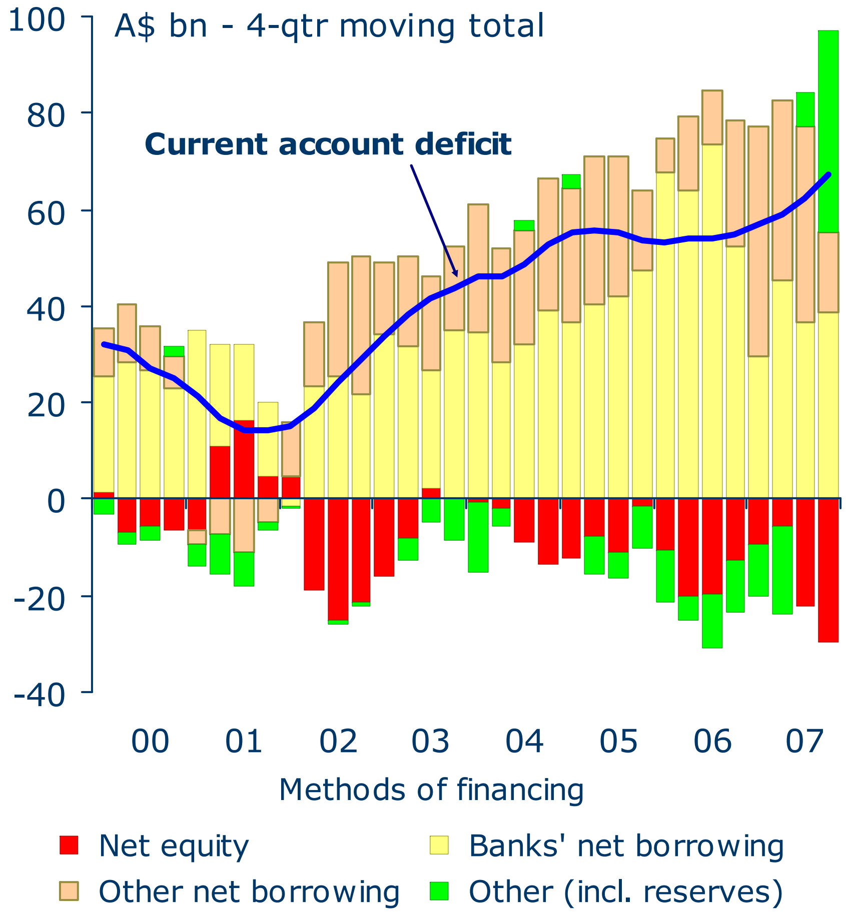
Australian banks' capital adequacy ratios



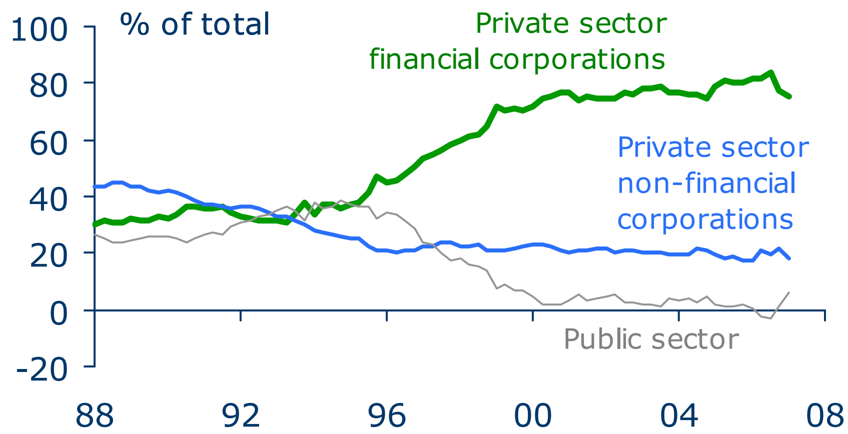
* Under APRA regulations, banks must maintain total base capital in excess of 8% of their risk-weighted assets, half of which must be in the form of 'Tier 1' capital (paid-up capital, disclosed reserves and retained earnings).
Sources: Reserve Bank of Australia; Australian Prudential Regulation Authority.

Reliance on banks' overseas borrowings to finance the deficit leaves Australia exposed to abrupt shifts in global markets

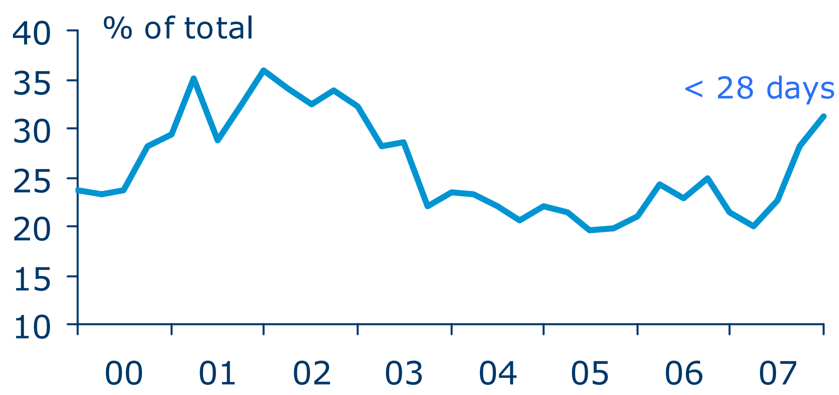
Financing Australia's current account deficit



Net foreign debt, by borrower



Maturity structure of net foreign debt

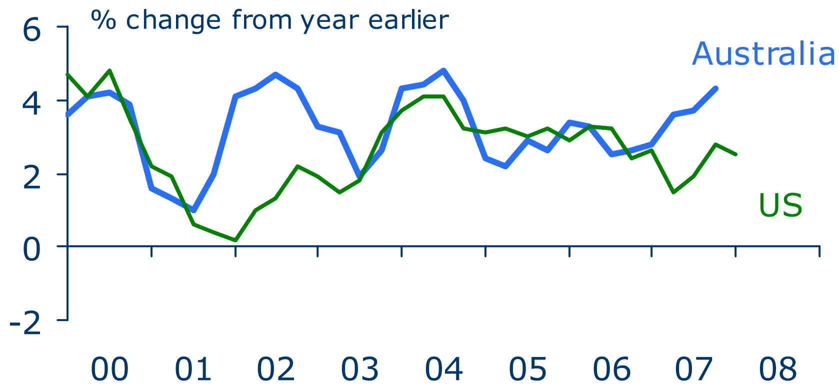


Sources: Australian Bureau of Statistics; ANZ.

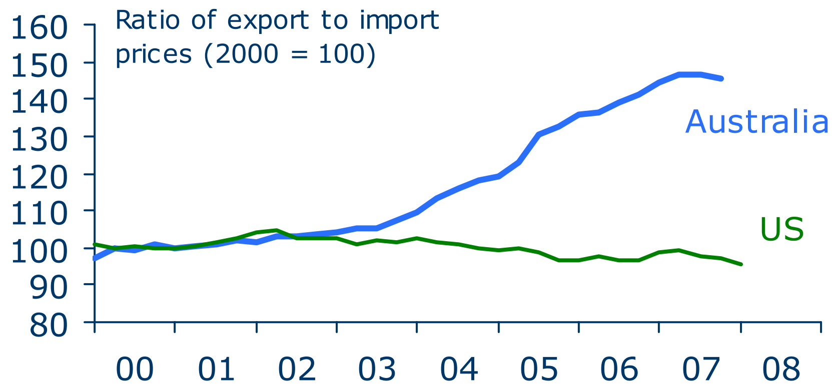
Australian and US economic cycles have not been closely correlated this decade, and are diverging further now

Australian and US economic indicators

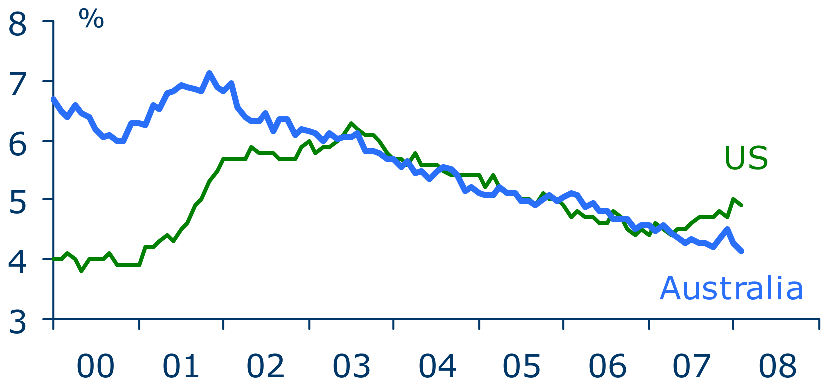
Real GDP growth



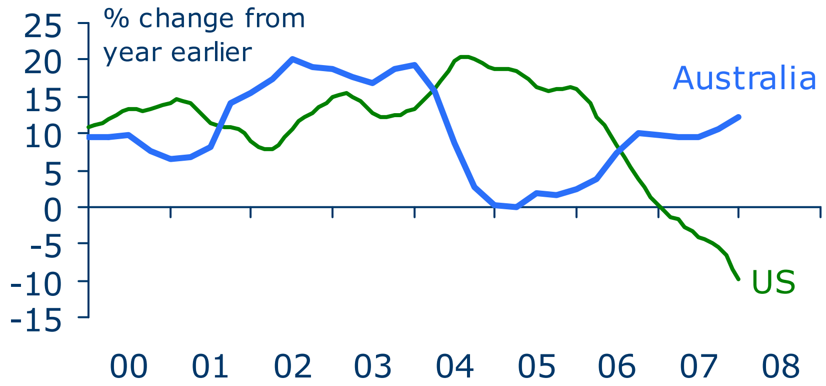
Terms of trade



Unemployment



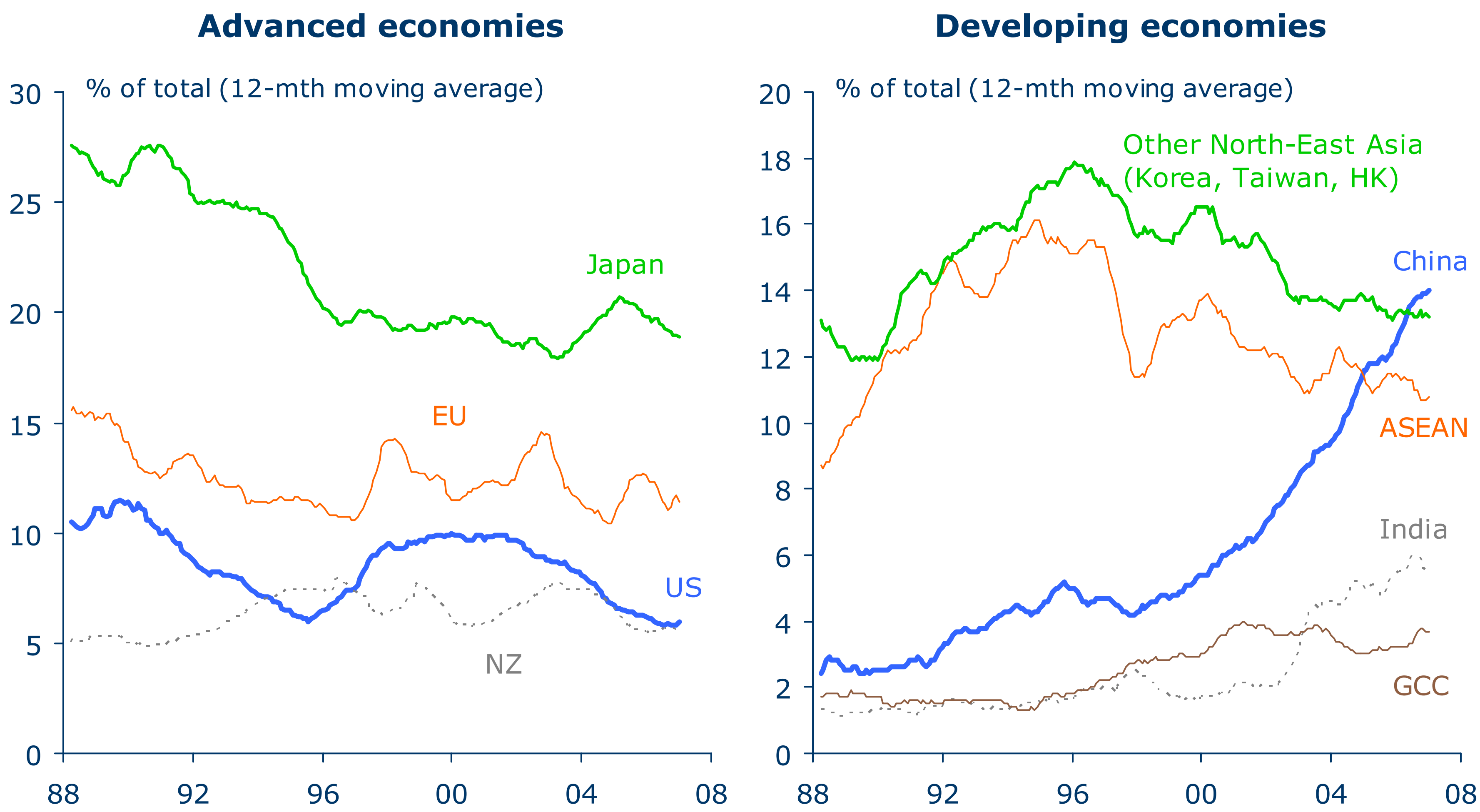
House prices



Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; US Bureau of Labor Statistics; S&P.

Australia is much less directly dependent on the US and other OECD export markets than it used to be

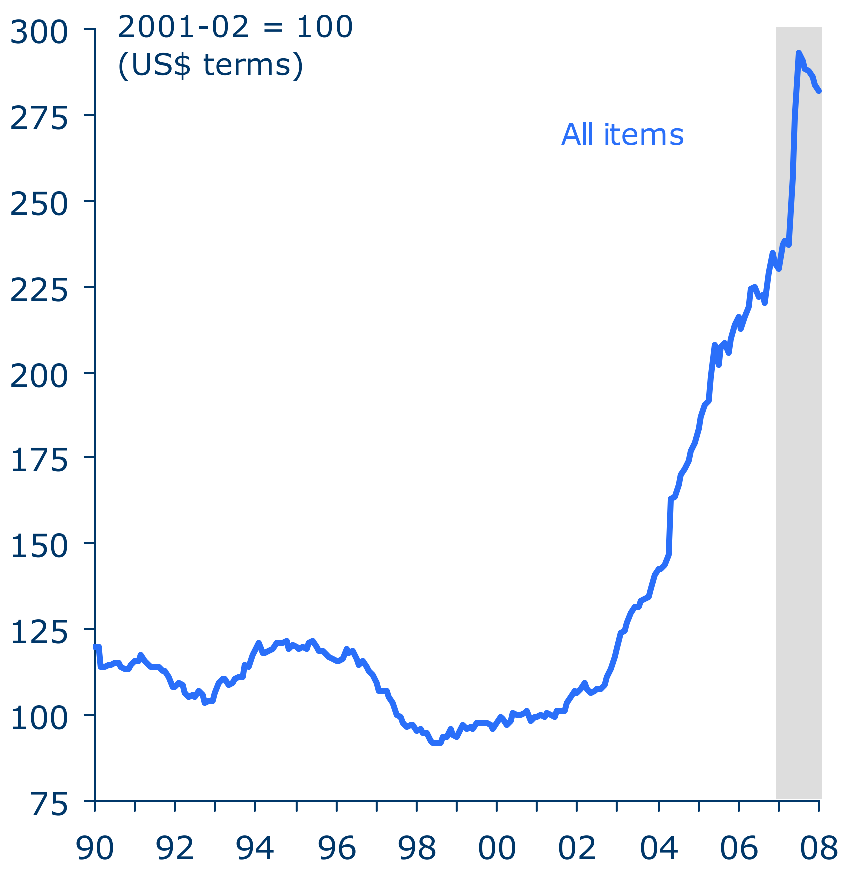
Australia's major export markets



Sources: Australian Bureau of Statistics.

Expected rises in coal and iron ore export prices will deliver a further leg upwards in the commodity price cycle in 2008-09

Australian export commodity prices

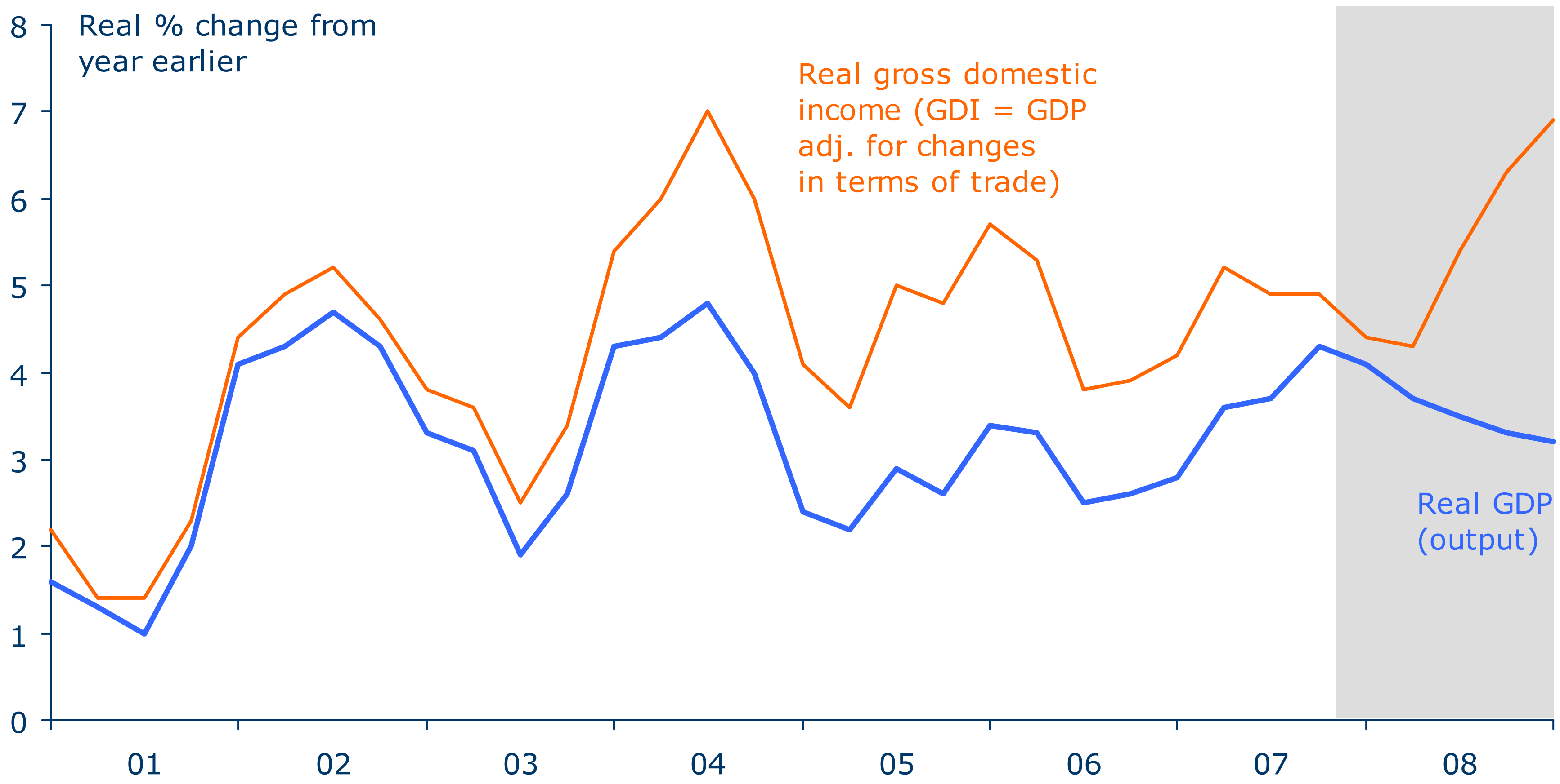


Australia's "terms of trade"

Note: "terms of trade" is the ratio of average export to average import prices.
Sources: Reserve Bank of Australia; ABS; ANZ.

This will boost Australia's income by another 2% in 2008-09, on top of 11% from terms of trade gains already so far this decade

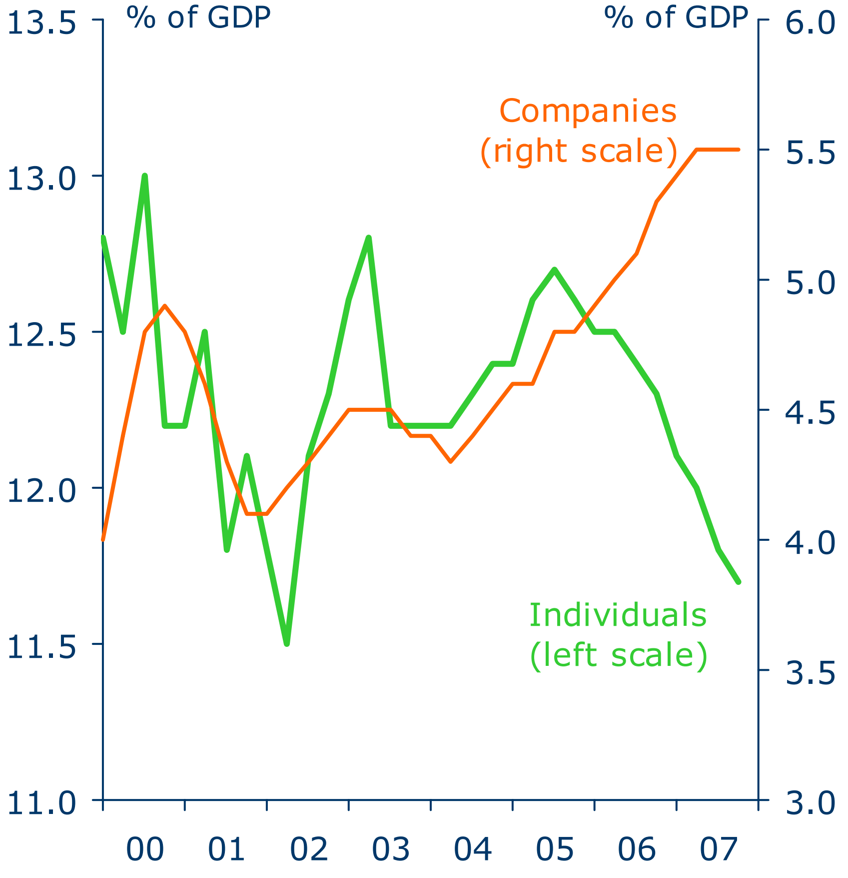
Australia's real gross domestic income and output



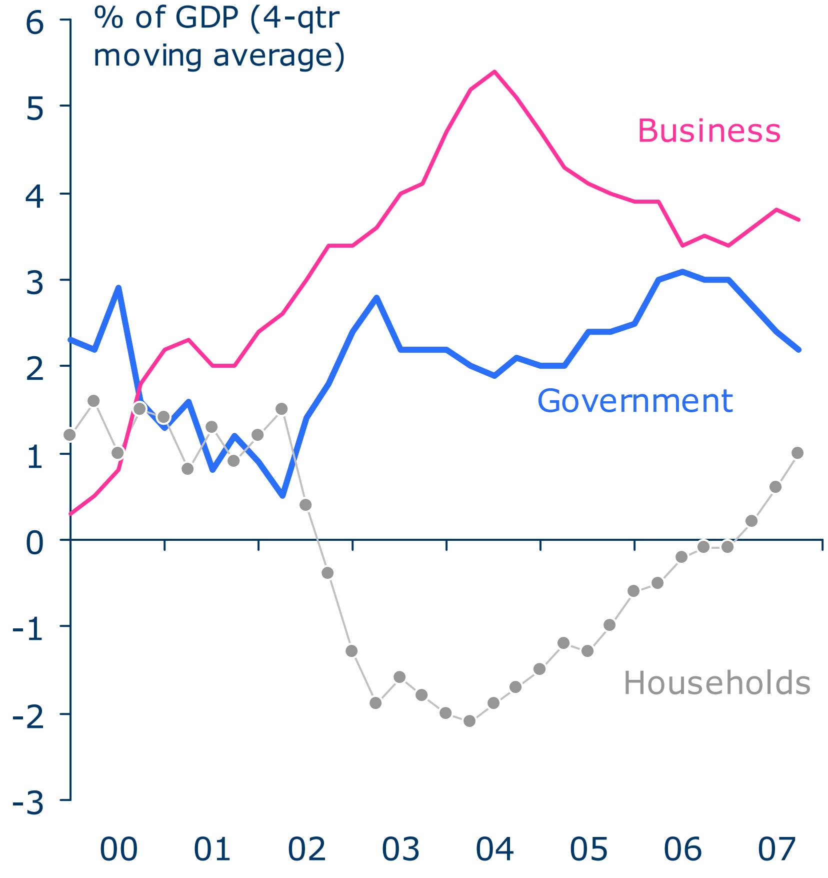
Sources: Australian Bureau of Statistics; ANZ.

Income will continue to be re-cycled from the business sector to households through the Budget, boosting total spending

Australian income tax collections



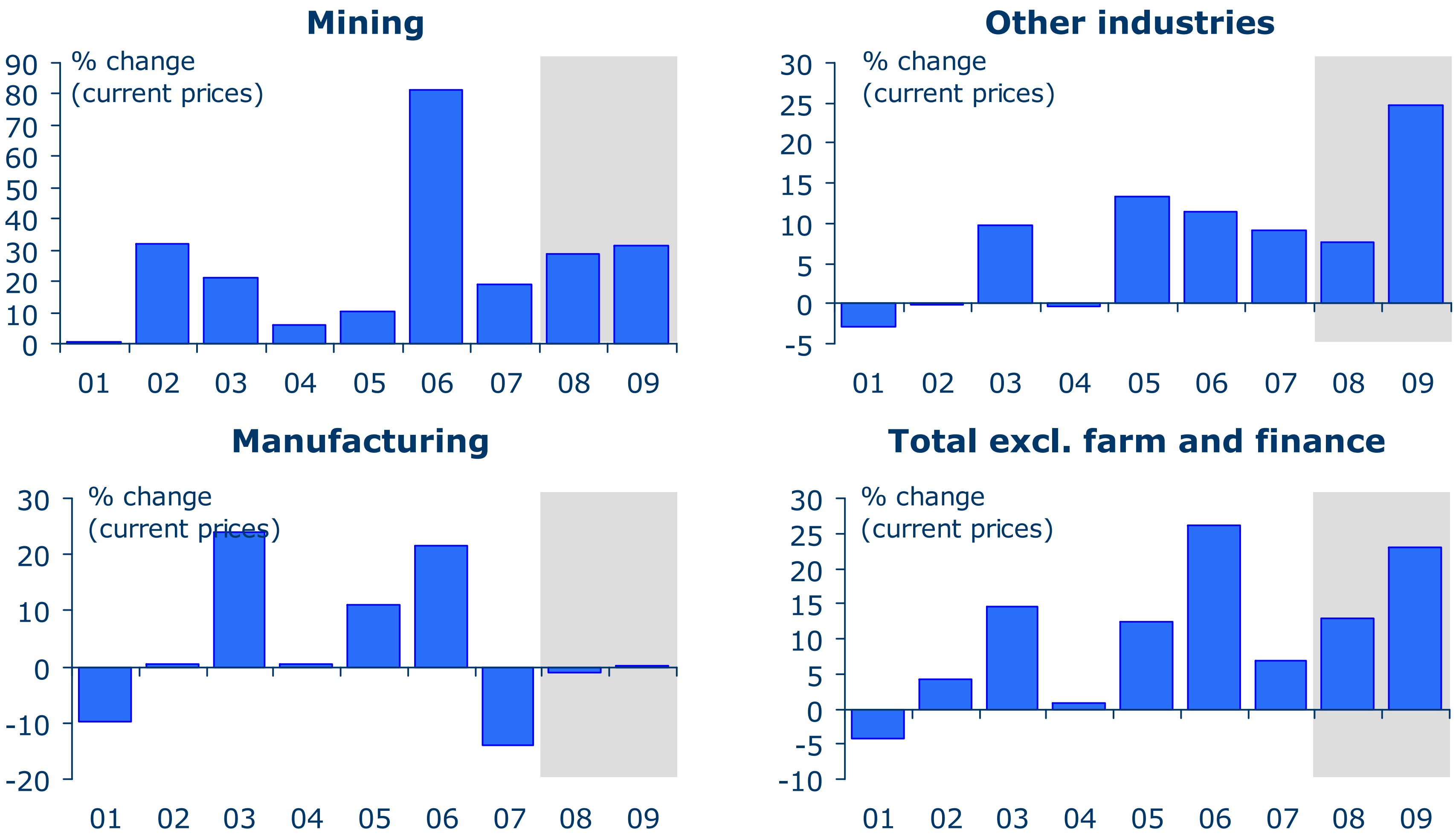
Net saving by sectors of the Australian economy



Sources: Australian Bureau of Statistics; ANZ.

Business investment is expected to keep rising strongly, despite global uncertainties and deteriorating financial conditions

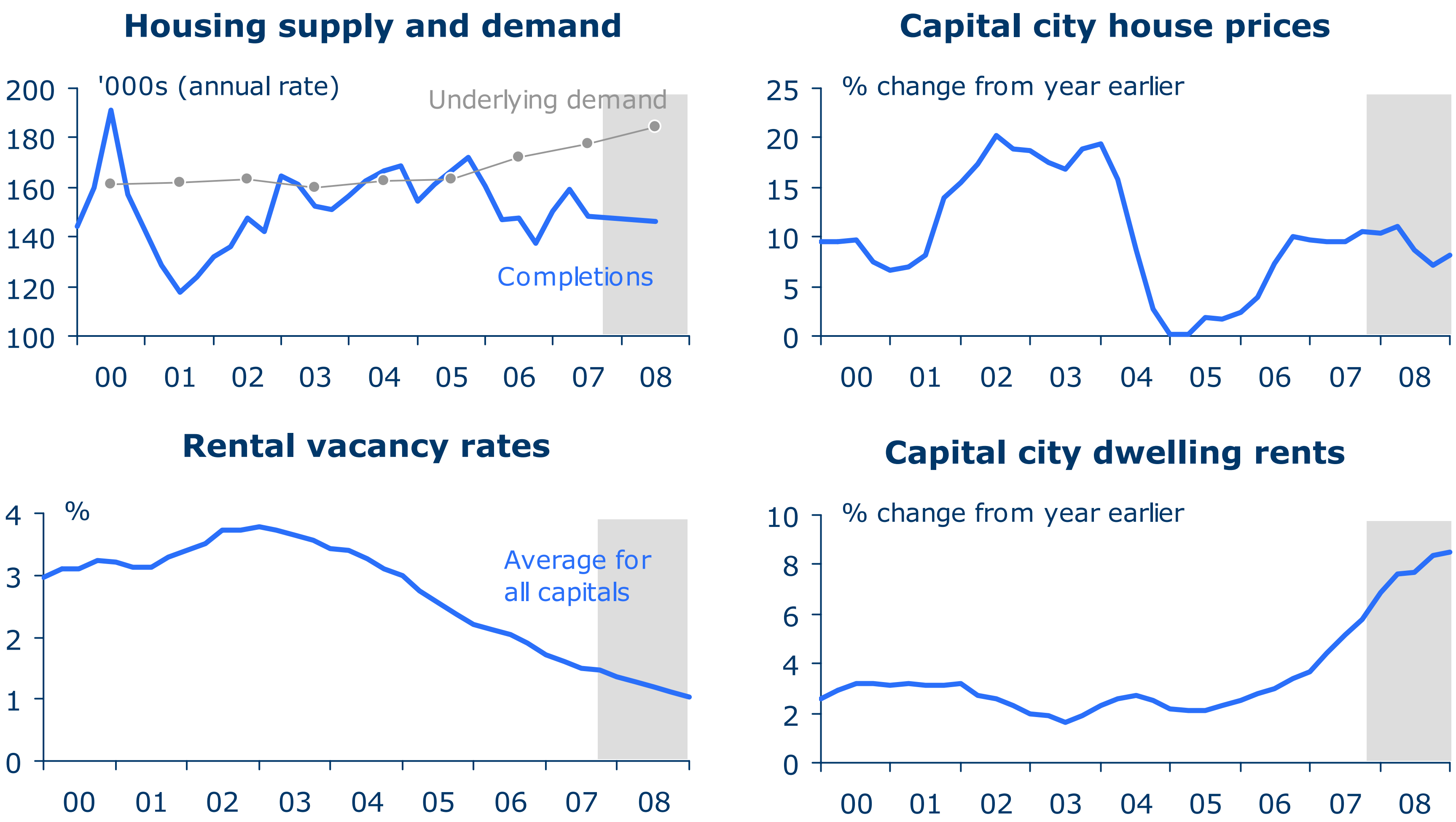
Actual and projected capital expenditure



Note: Data are for financial years ended 30 June. Projections for 2007-08 and 2008-09 are based on expected levels of capital expenditure reported to the ABS in its January-February 2008 survey, adjusted for the extent to which expectations in this survey have been realized over the five years to 2006-07. *Sources:* ABS; ANZ.

The Australian housing market is likely to remain characterized by excess demand – a stark contrast to the US housing market

Australian housing market fundamentals

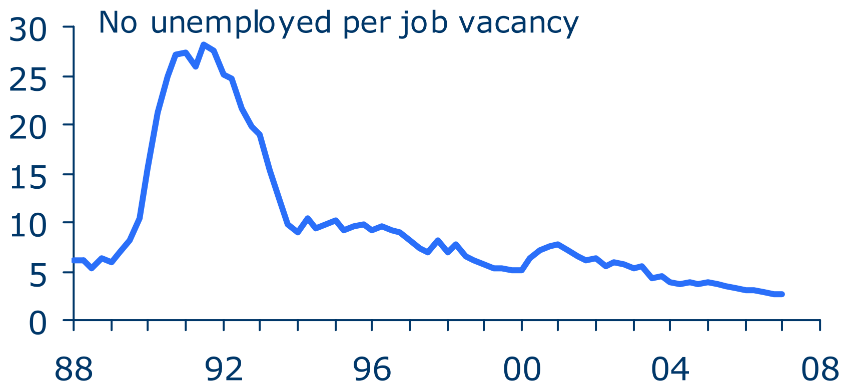


Sources: Australian Bureau of Statistics; Real Estate Institute of Australia; ANZ.

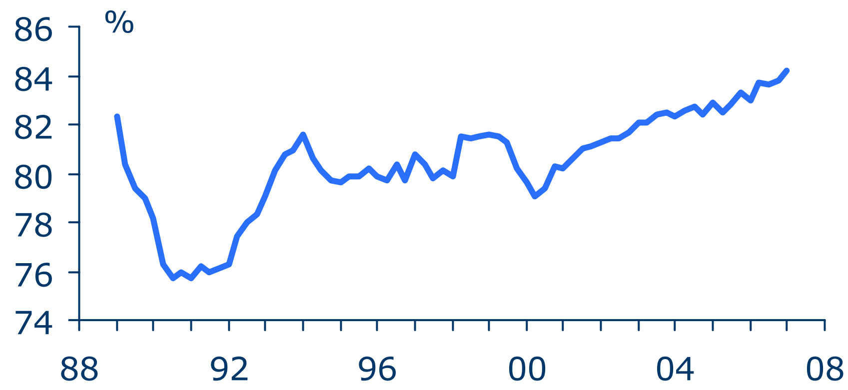
After more than 16 years of continuous economic growth, Australia's economy has run into serious capacity constraints

Indicators of 'spare capacity' in the Australian economy

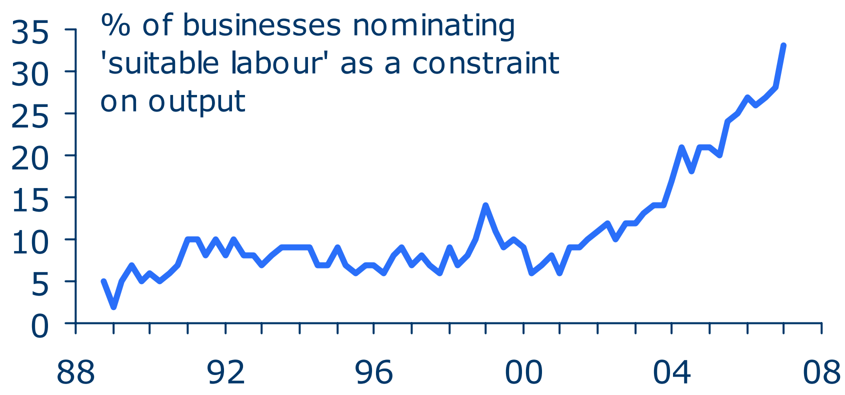
Unemployed persons per job vacancy



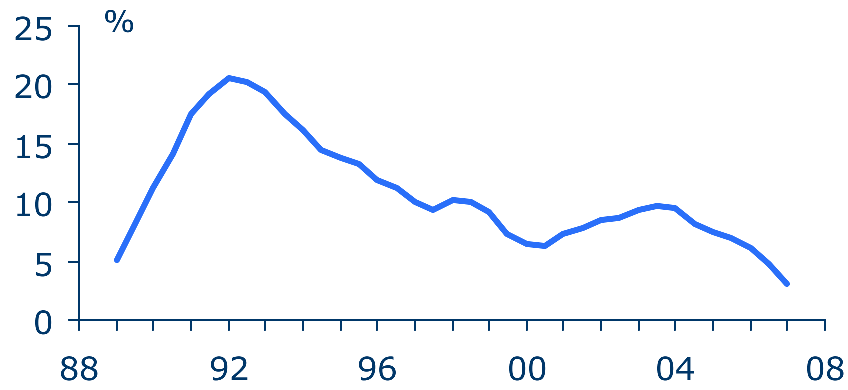
Capacity utilization rate



Businesses reporting labour shortages



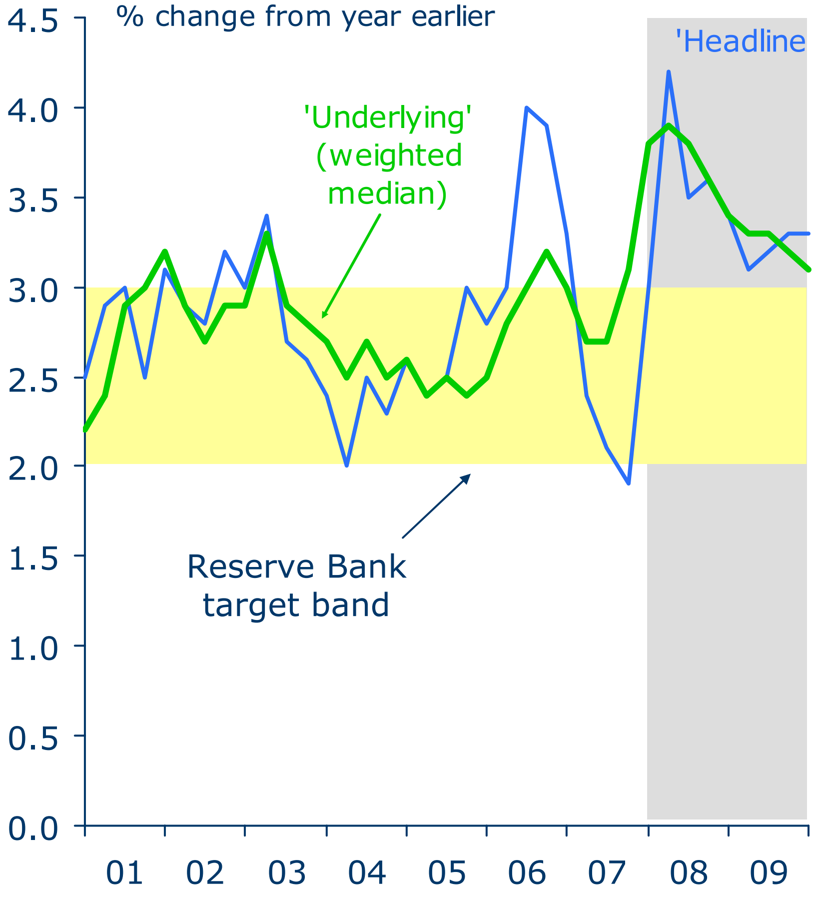
Office vacancy rates



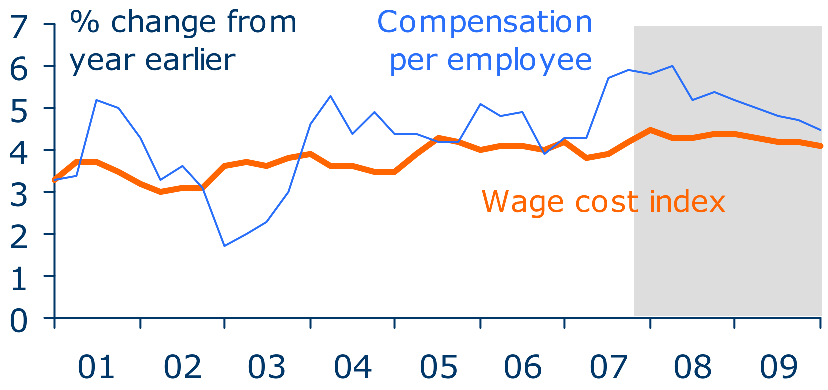
Sources: Australian Bureau of Statistics; nabCapital; Property Council of Australia.

Rising inflation (reflecting demand growth in excess of supply potential as well as global factors) is a serious policy concern

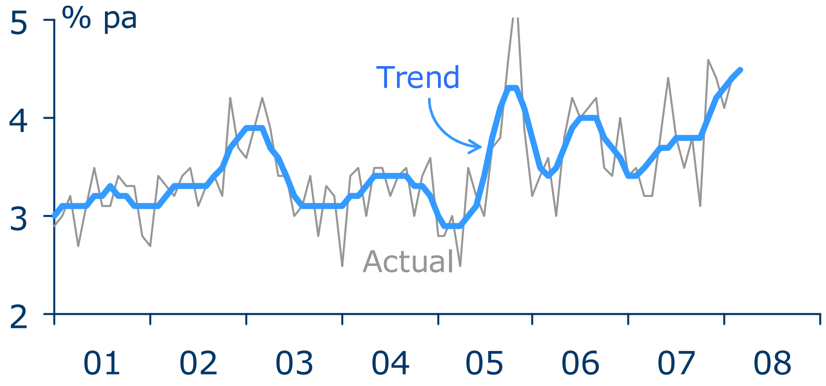
Consumer prices



Measures of labour costs



Household inflation expectations



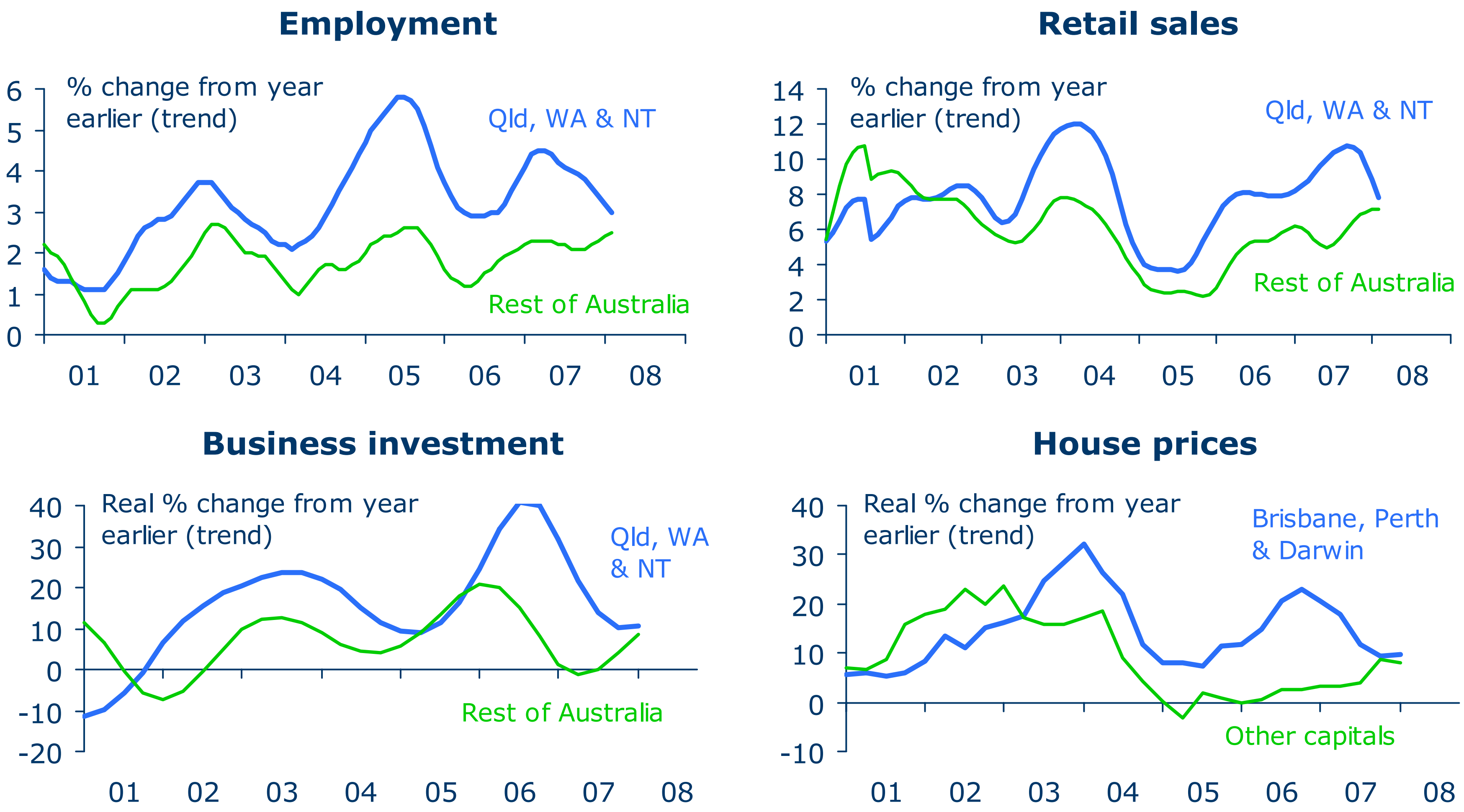
Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Westpac-Melbourne Institute; ANZ.

In a fully employed economy if some sectors are to grow rapidly then others <u>have</u> to shrink

- After more than 16 years of continuous growth Australia's economy is running out of 'spare capacity'
- As a result, increases in aggregate demand in excess of the growth rate of the economy's 'supply potential' will inevitably lead to higher inflation, a larger current account deficit, or both
- If, in this situation, some sectors (eg mining) are to grow rapidly in order to meet global demand, other sectors <u>have</u> to grow more slowly (or shrink) if these consequences are to be avoided
- Similarly if some regions (eg WA and Qld) are being pushed towards faster growth then other regions <u>must</u> of necessity grow at a slower rate
- In practice, the 'room' required by faster growth in particular sectors or regions is being created by a combination of
  - rising interest rates
  - a stronger exchange rate
  - and rising costs
- <u>Inevitably</u>, these will disproportionately impact households with a mortgage, and sectors such as manufacturing and tourism
- Over the medium-to-longer term the only way to avoid this situation is through policies which expand the economy's 'supply' potential

Resources boom benefits north and west more than the south-east, but the gap between the two is now narrowing a bit

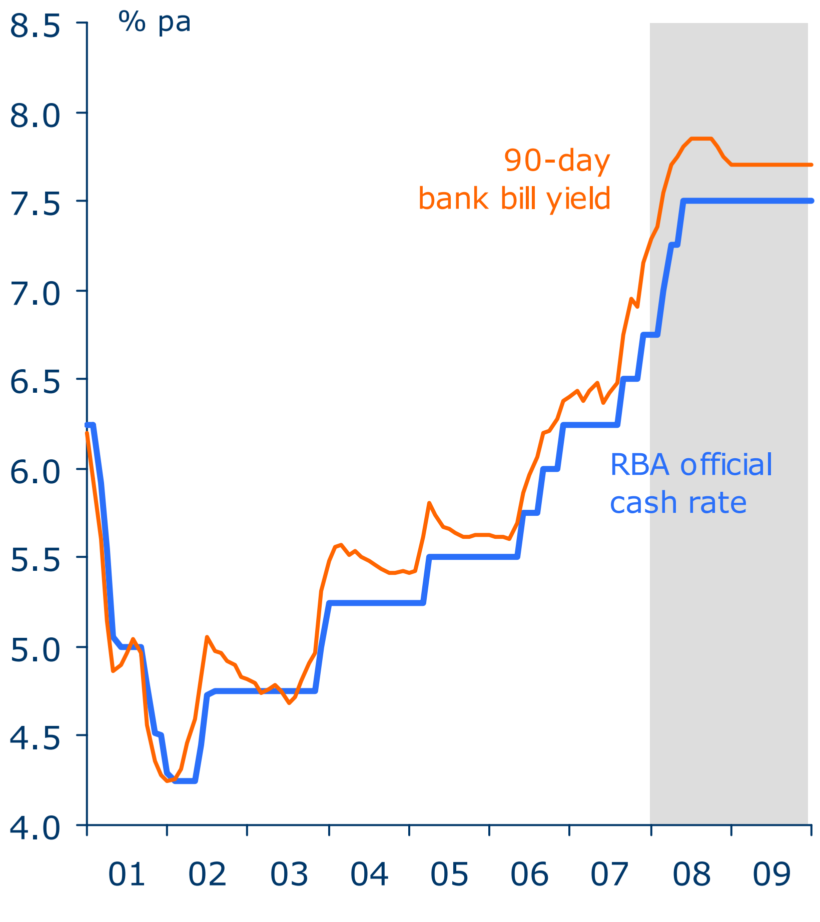
Resource-rich vs other States and Territories



Sources: Australian Bureau of Statistics; ANZ.

Reserve Bank will hike rates at least twice more to 'slow demand' and bring inflation back within the target range

Short-term interest rates



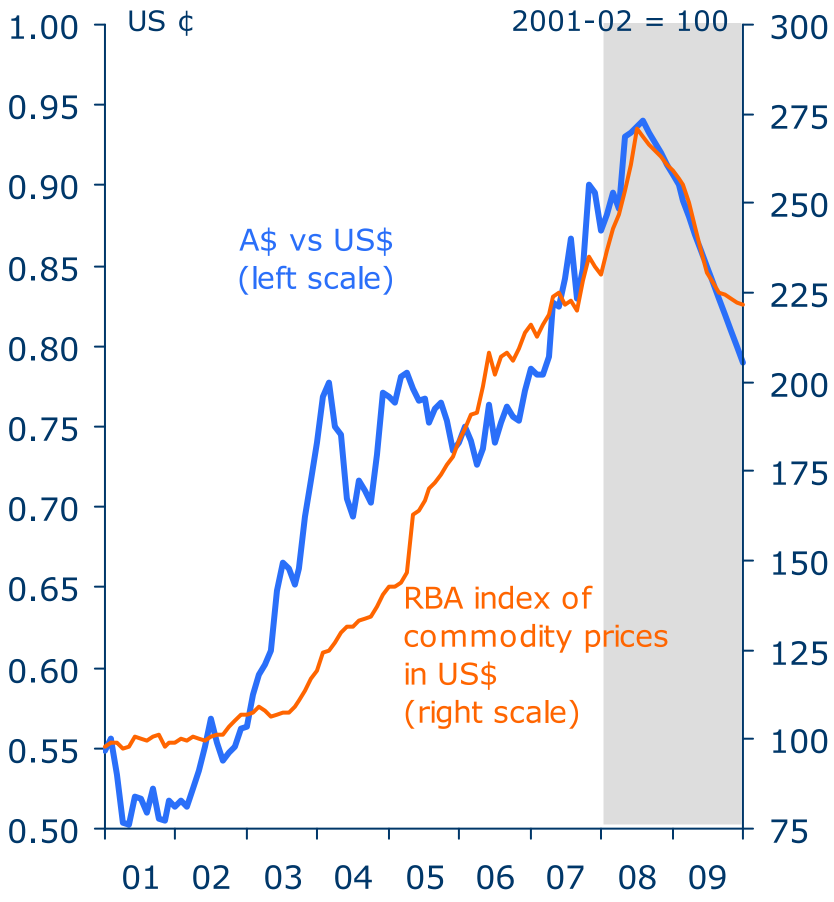
Sources: Thomson Financial; ANZ.

- 10 interest rate increases since mid-2002 have had little lasting impact in restraining growth in domestic demand – largely because they've been offset by commodity-related income gains, repeated rounds of tax cuts etc.
- The RBA now says that 'a significant slowing in domestic demand … is likely to be necessary to reduce inflation over time' …
- … and that unless something else happens to produce such a slowdown (for example, sharply weaker global growth, tighter credit conditions, changes in fiscal policy etc.) ..
- … 'monetary policy is likely to need to be tighter in the period ahead' (ie, rates will rise some more)
- In other words – there <u>will</u> be a 'significant slowing in demand', what is not clear is how high rates will have to go in order to procure it

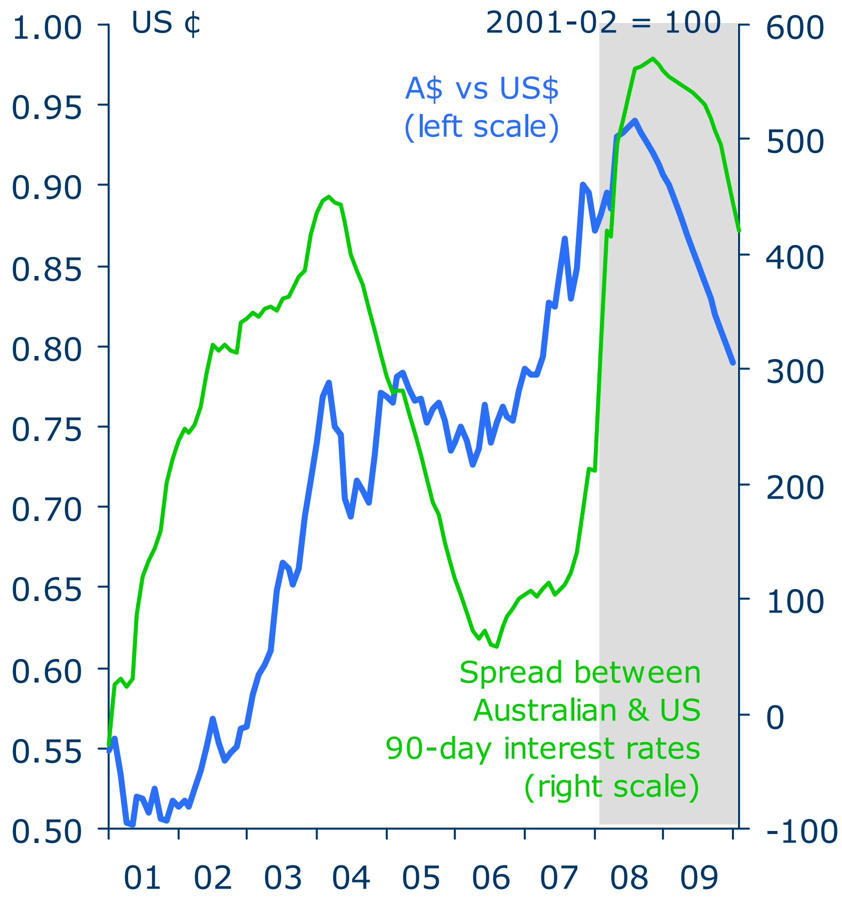
ANZ

Commodity prices and interest rate spreads likely to continue supporting the A$ into the second half of this year

A$ and commodity prices



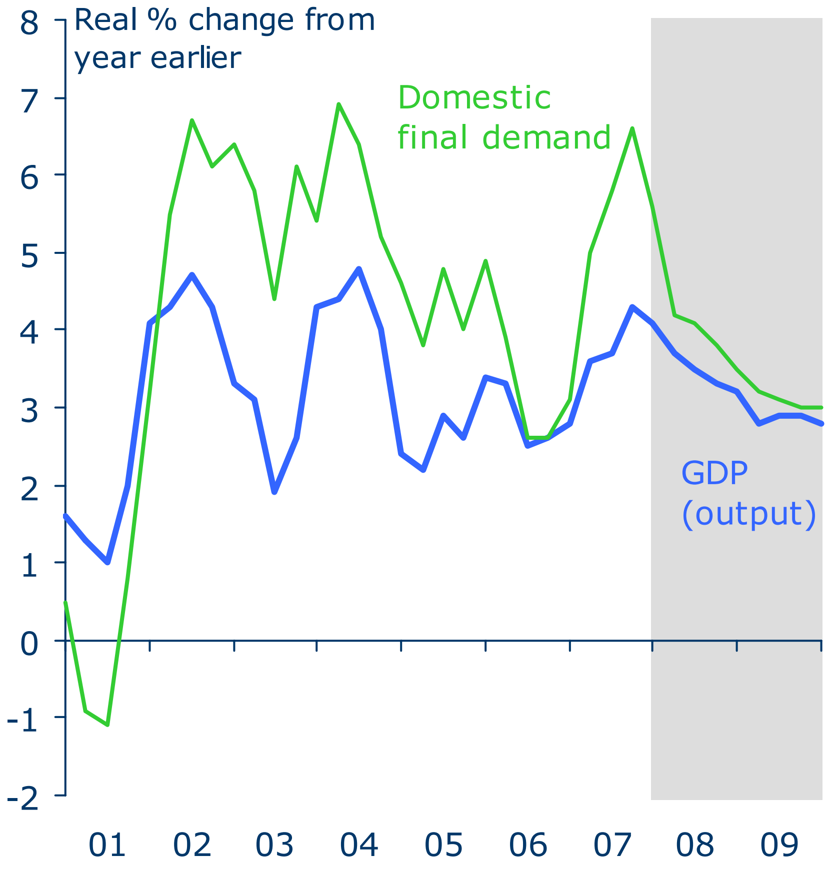
A$ and interest rate spreads



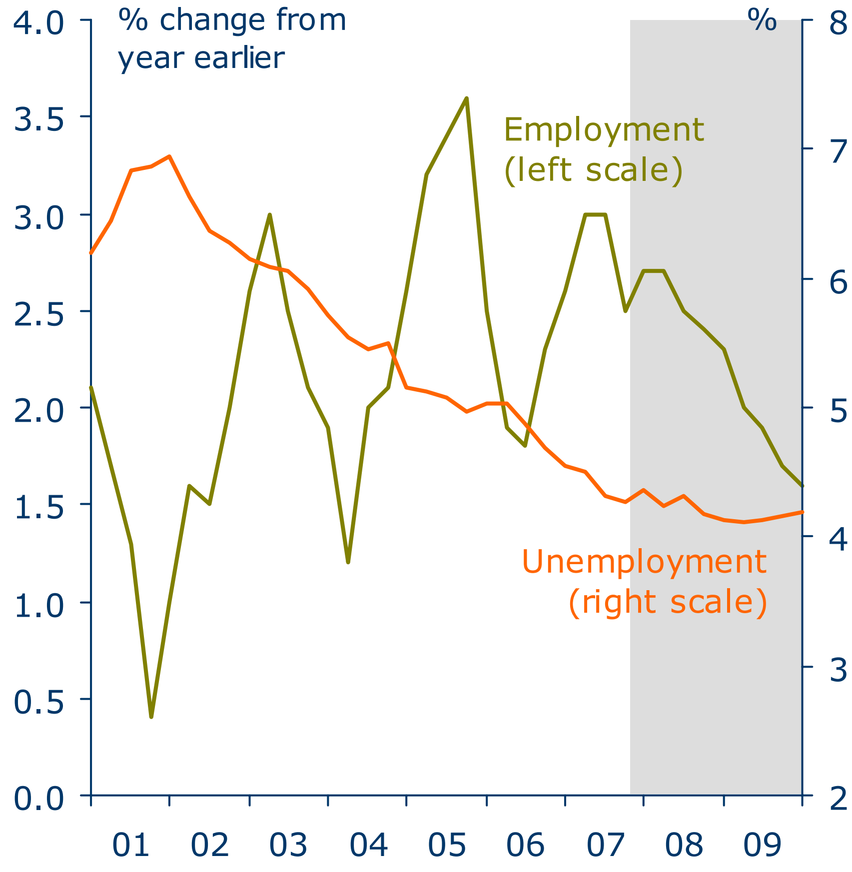
Sources: Thomson Financial; Reserve Bank of Australia; ANZ.

Higher interest rates will eventually squeeze domestic spending although it may take a while yet

Spending and output



Employment and unemployment



Sources: Australian Bureau of Statistics; ANZ.

Summary

- Australia's economic prospects in 2008-09 will be shaped by the relative strength of two powerful forces
  - the global 'credit crunch' triggered by (but no longer confined to) the US sub-prime mortgage market crisis, and its Australian echo
  - the ongoing rapid growth and industrialization of China and other developing economies, and their impact on the prices of Australia's export commodities
- Notwithstanding that the full effects of the 'credit crunch' are yet to be felt, globally or in Australia, the effects of rising commodity prices seem more likely to be predominate – at least for the next six months
- Unless the 'credit crunch' results in an abrupt slowing in the Australian economy, economic policy will of necessity continue to focus on the need to contain inflationary pressures
  - the Reserve Bank will lift the cash rate to at least 7½% - and perhaps higher
  - fiscal policy will desirably also make more of a contribution to restraining domestic demand growth than it has hitherto
- Domestic demand growth will slow from its 2007 pace, reflecting both tighter policy settings and the (as yet unknown) effects of the 'credit crunch'
  - this combination will <u>inevitably</u> have a disproportionate impact on indebted households, trade-exposed non-commodity business and the south-east States

Australian forecast summary

	Economic forecasts			
	2006	2007e	2008f	2009f
Real GDP growth (%)	2.8	4	3½	2¾
Unemployment rate (year-end, %)	4.6	4.4	4	4¼
'Underlying' inflation (year-end, %)	3.0	3.6	3½	3
Housing starts ('000)	153	150	145	155
Current account deficit ($bn)	55	64	51	50

	Financial market forecasts				
	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
RBA cash rate (% pa)	6.75	7.50	7.50	7.50	7.50
90-day bill yield (% pa)	7.25	7.85	7.75	7.70	7.70
10-year bond yield (% pa)	6.33	6.40	5.75	5.00	5.50
A$-US$	0.88	0.96	0.91	0.85	0.79
A$-¥	98	104	98	91	88
A$-€	0.60	0.65	0.65	0.63	0.62
Gold price (US$ / oz)	807	975	880	810	780
Oil price (US$ / barrel, WTI)	92	93	87	79	80