

Economic outlook for 2007

Presentation to the annual
ANZ – West Coast Eagles
'Footy & Economics Breakfast'

Saul Eslake
Chief Economist
ANZ Bank

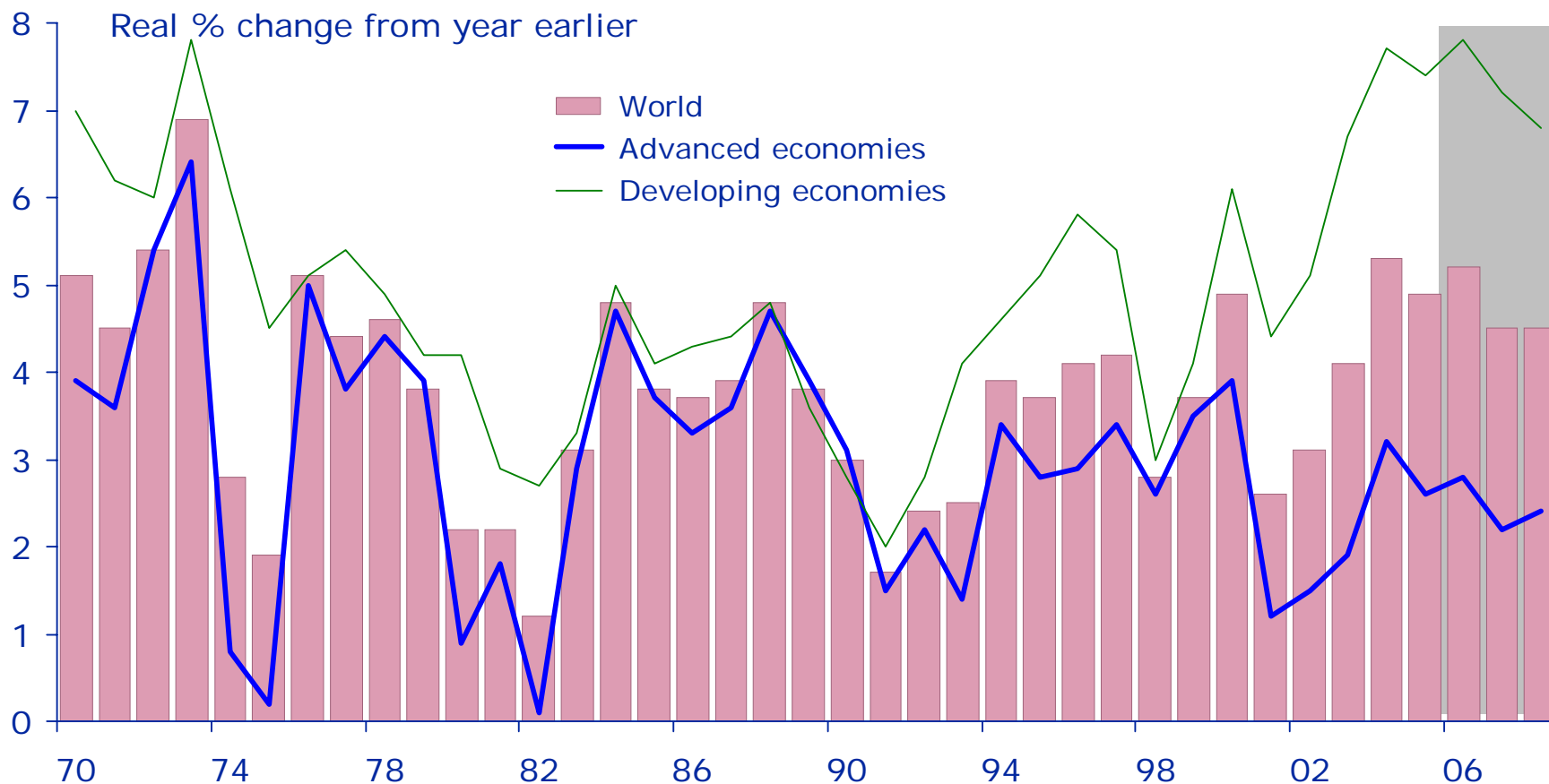
Burswood Resort
Perth
16th February 2007

www.anz.com/go/economics

*economics@***ANZ**

World economy in what is likely to be its longest period of above-trend growth in over 30 years

Global economic growth

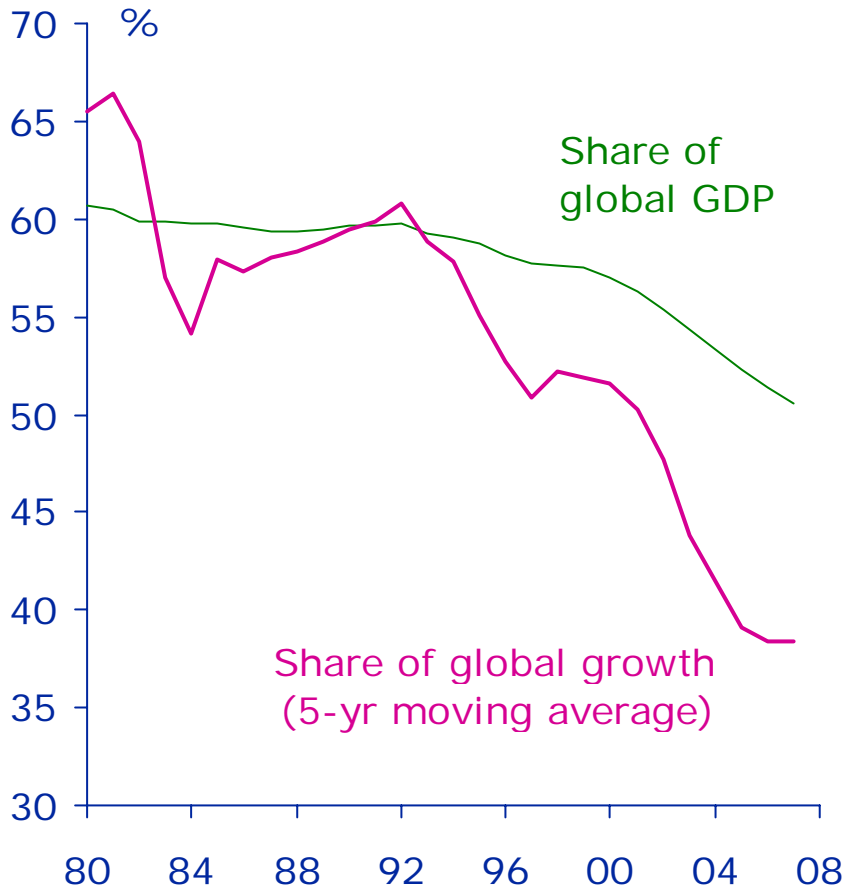


Note: GDP is measured in US\$ at purchasing power parities.

Source: IMF; Economics@ANZ.

Above-trend global growth is largely being driven by developing countries

Advanced economies



Developing economies

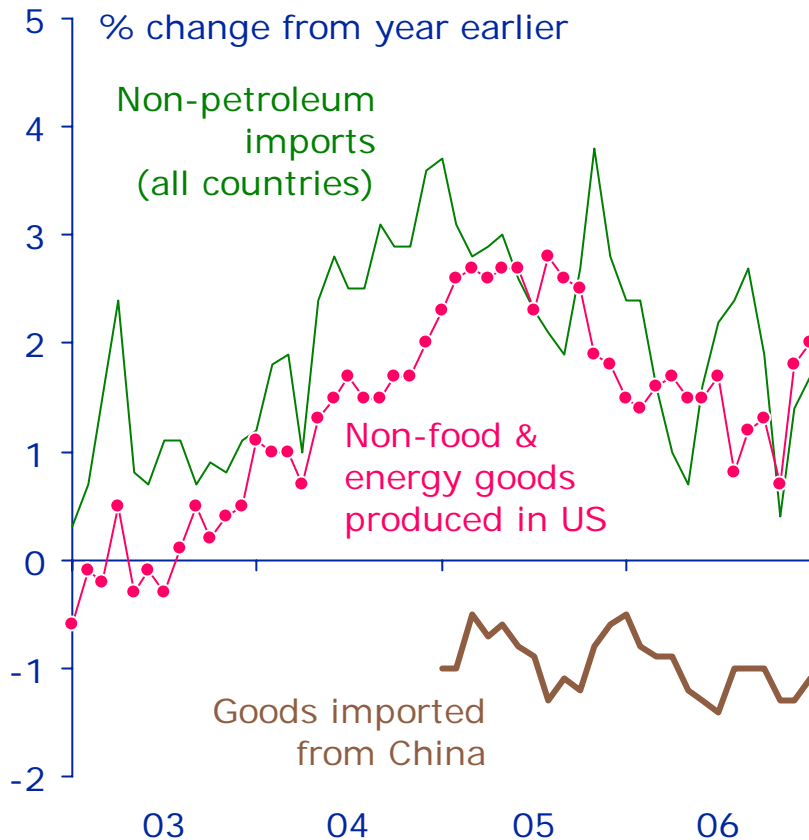


'Advanced' economies comprise the US, Western Europe, Japan, Canada, Australia, New Zealand, Korea, Taiwan, Hong Kong, Singapore and Israel.

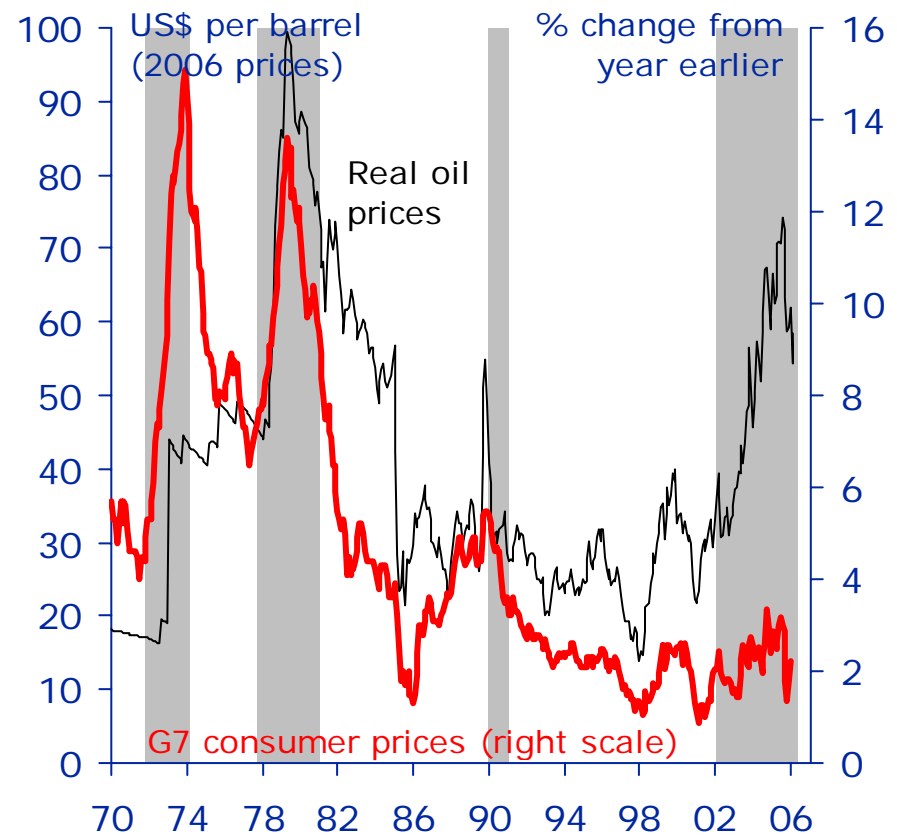
Sources: IMF, *World Economic Outlook*; Economics@ANZ.

Developing economies have provided a source of discipline on advanced economy prices and costs

Wholesale prices of goods in the United States



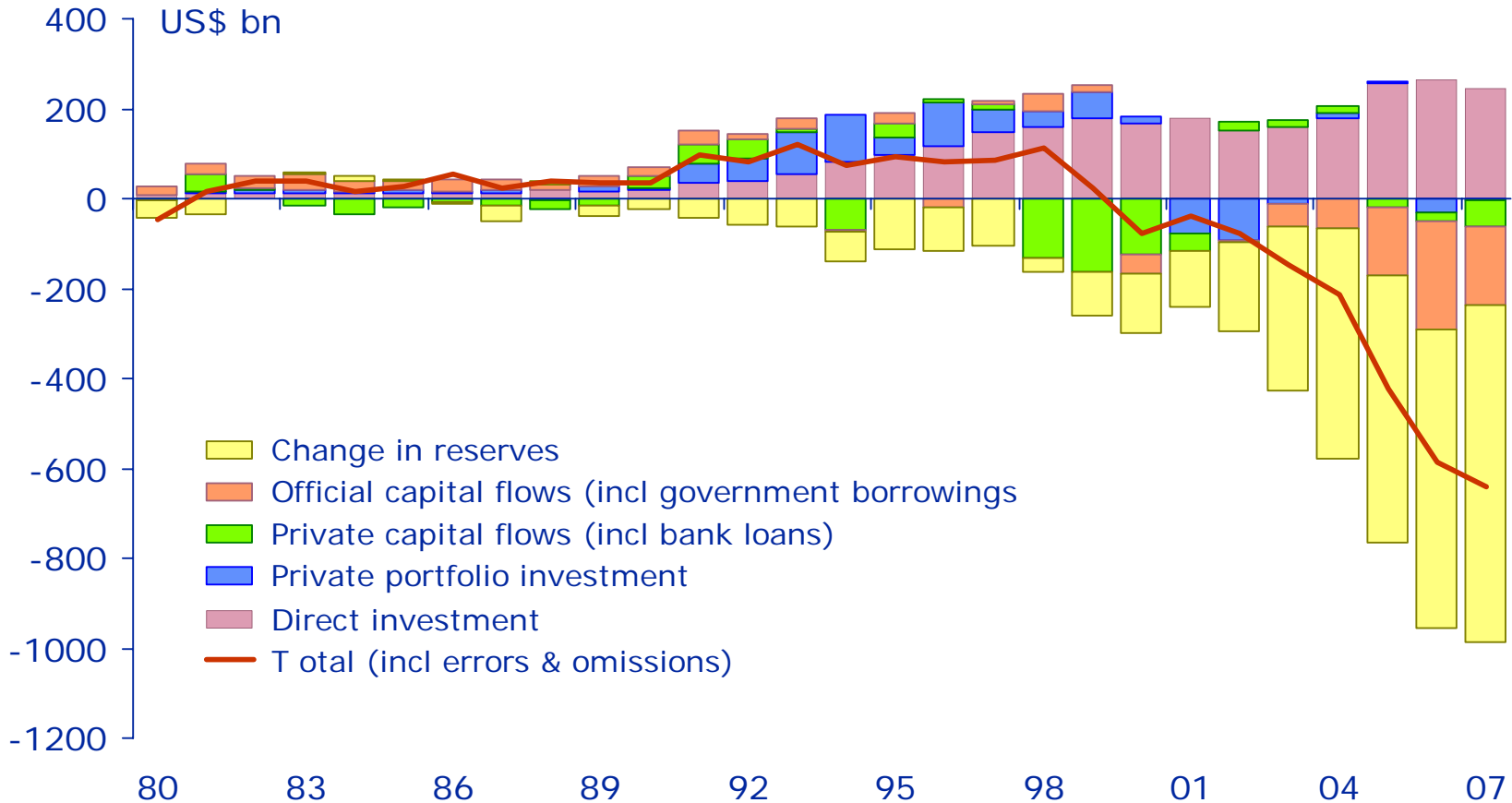
Oil prices and inflation



Sources: US Bureau of Economic Analysis; US Bureau of Labor Statistics; OECD; Datastream; Economics@ANZ.

Developing countries have exported massive amounts of capital to the industrialized world

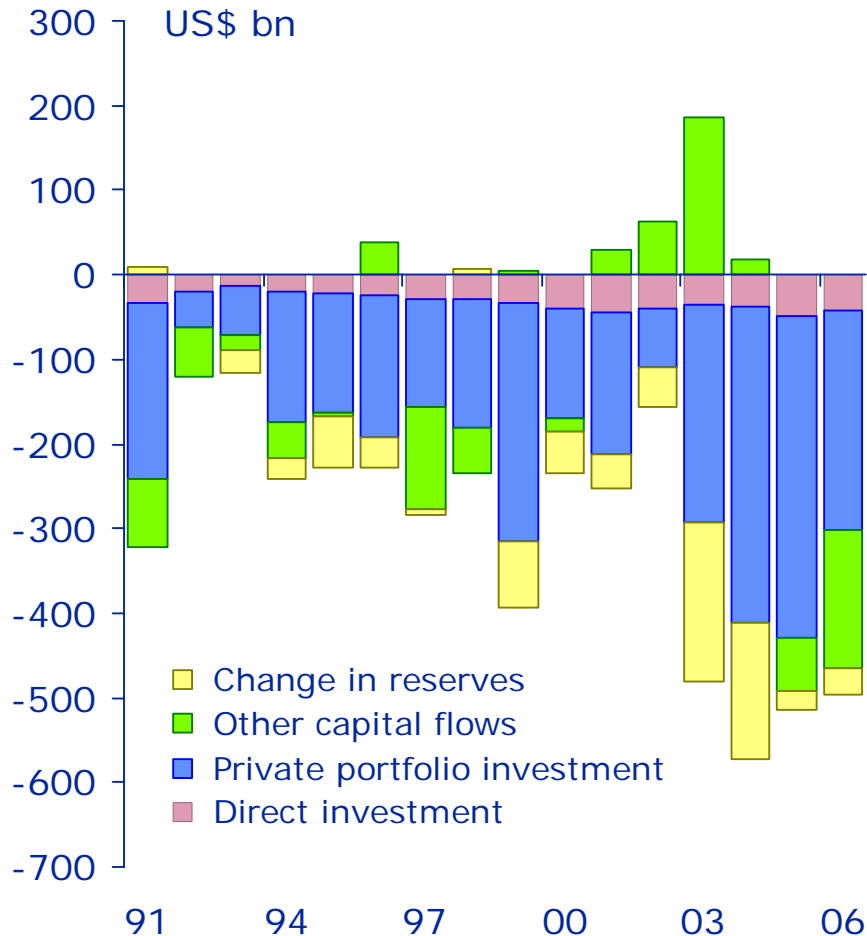
Capital flows to developing economies



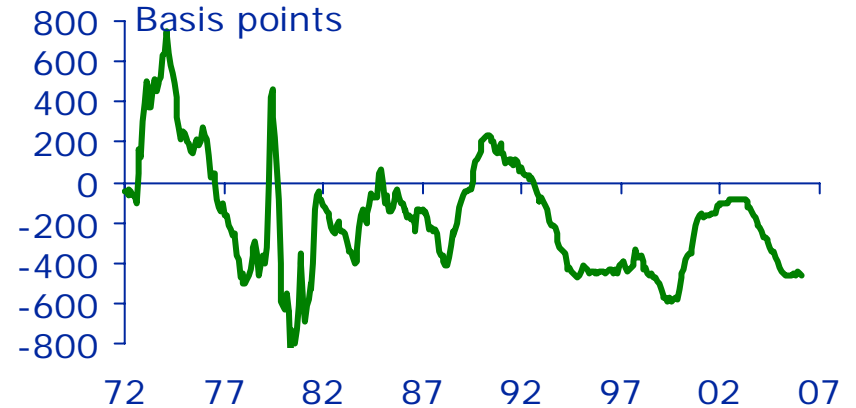
Note: 'Developing economies' in this chart includes Korea, Taiwan, Hong Kong, Singapore and Israel. All figures are net. Source: IMF; Economics@ANZ.

Japan is also exporting massive amounts of capital, keeping the yen weak

Capital flows from Japan



Japan-US 3-mth Libor spread



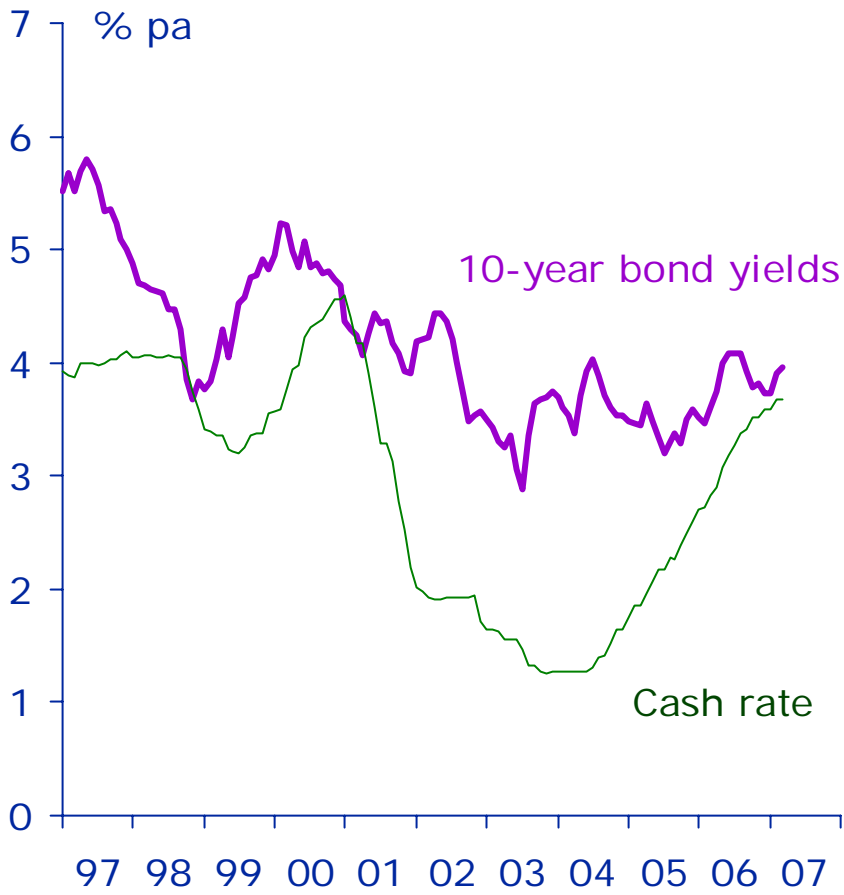
Real trade-weighted yen



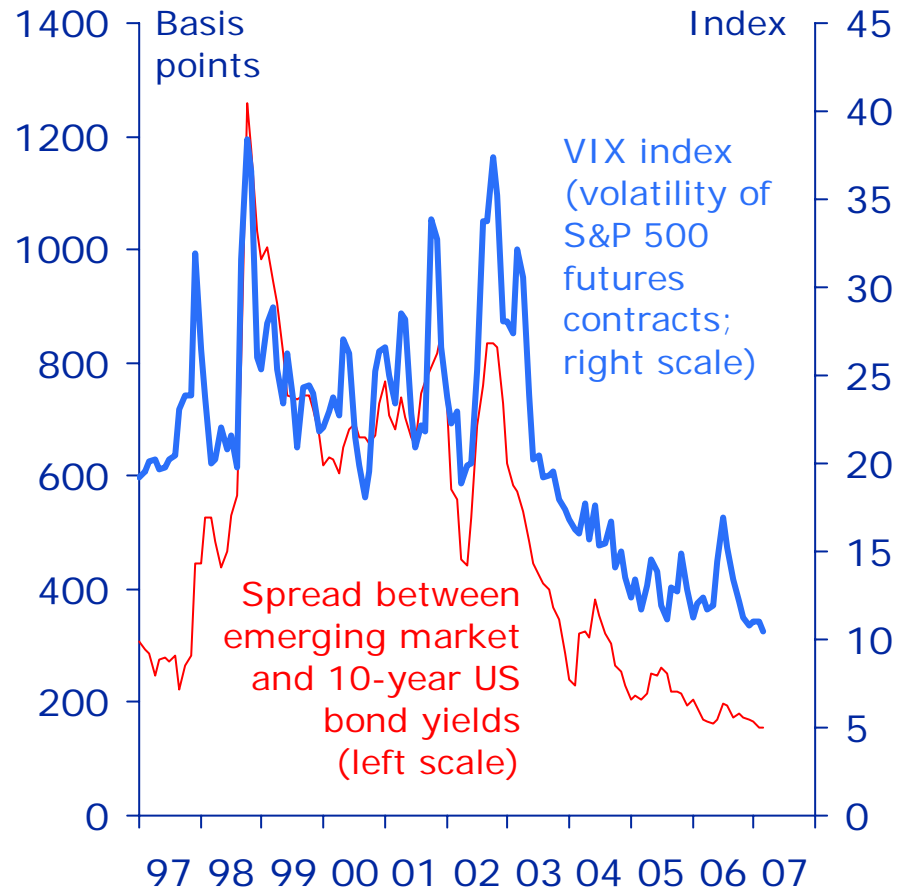
Sources: Bank of Japan; JP Morgan.

These capital flows are helping to keep long-term rates low and boosting investors' appetite for risk

G7 interest rates



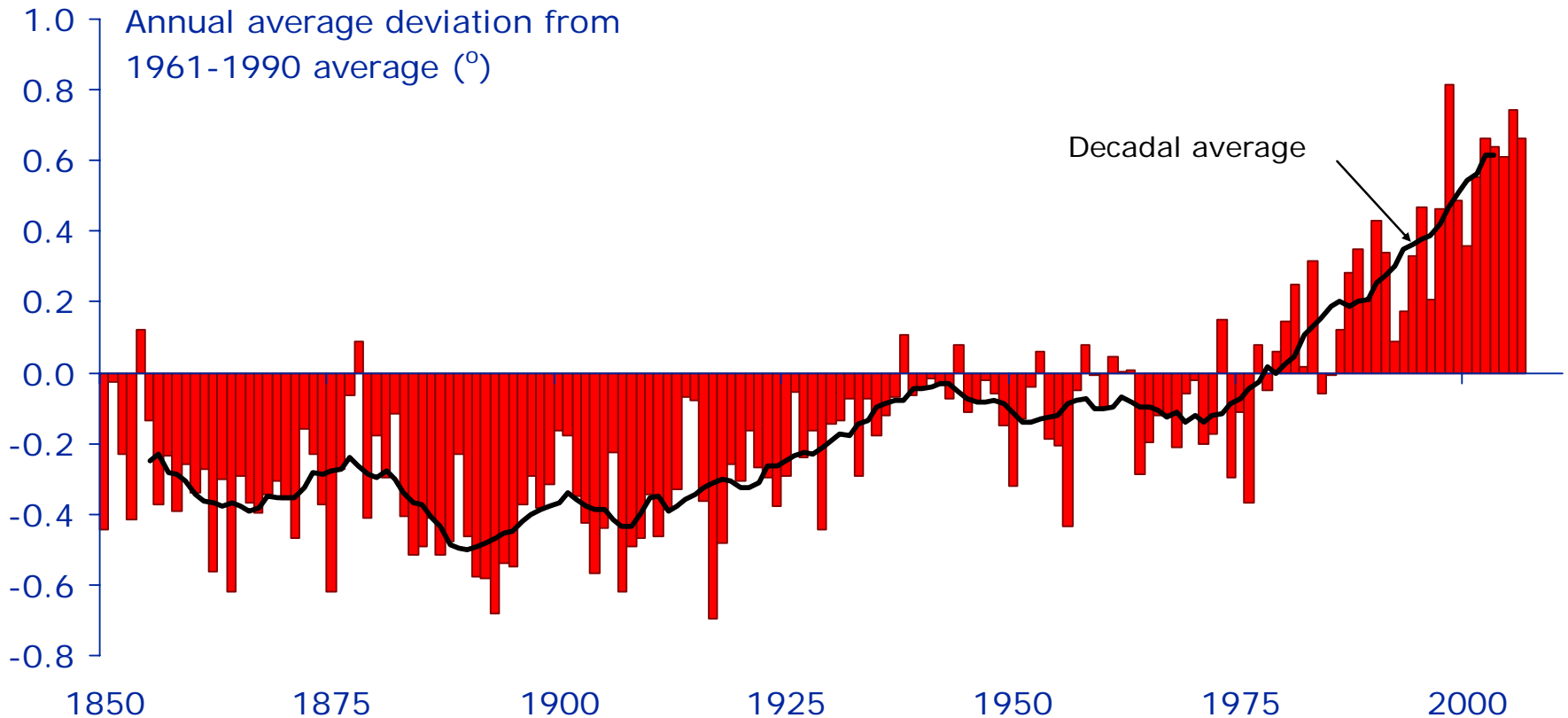
Indicators of investors' appetite for risk



Source: Thomson Financial Datastream.

Scientific consensus and growing public concern about global warming makes action more likely

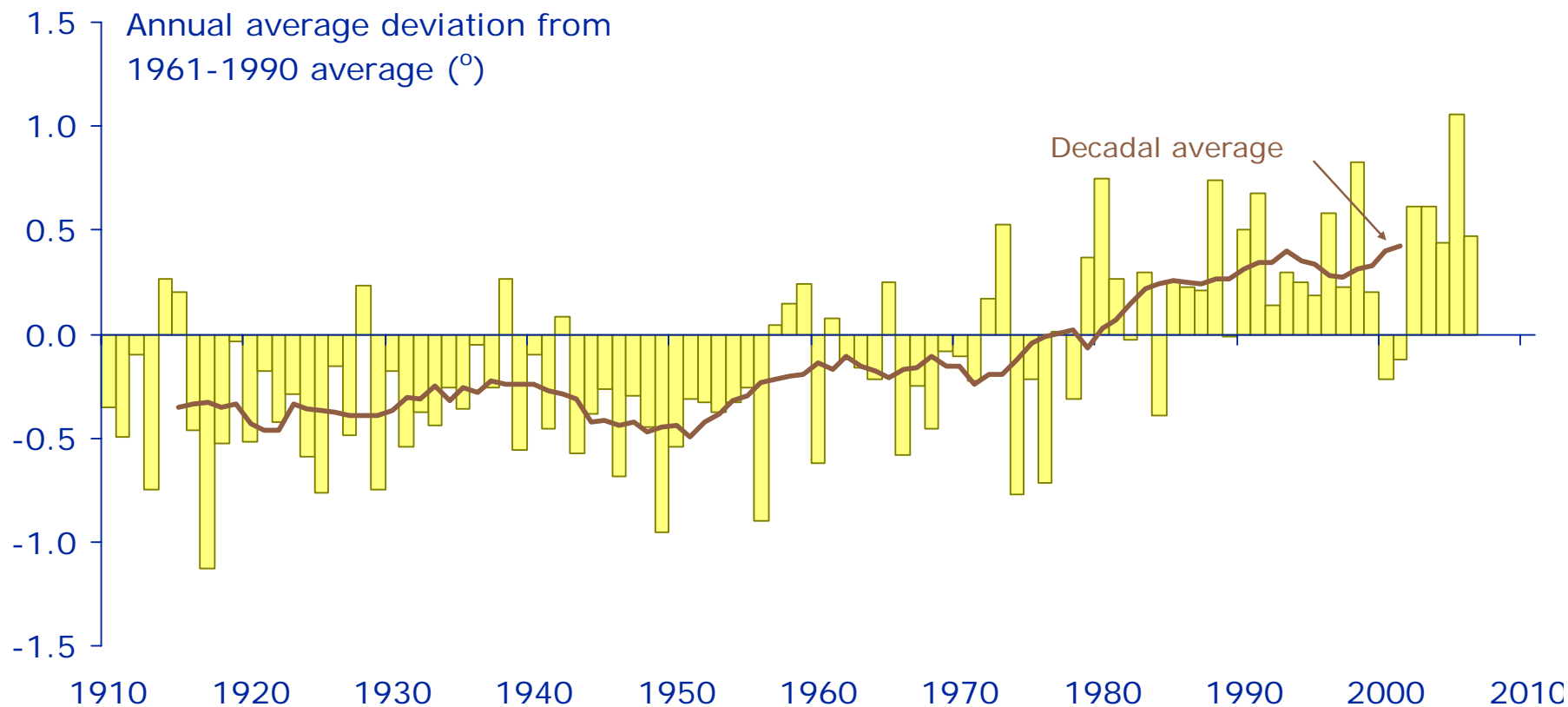
Global surface temperature anomalies



Source: Climatic Research Unit (CRU), School of Environmental Sciences, University of East Anglia (UK). Note that the CRU 'has an explicit policy of refusing to allow external examination of how they produce their global temperature series' (Carter et al, *World Economics* Vol. 7, No. 4, October-December 2006 p. 190).

Australian temperature data shows much the same picture regarding global warming

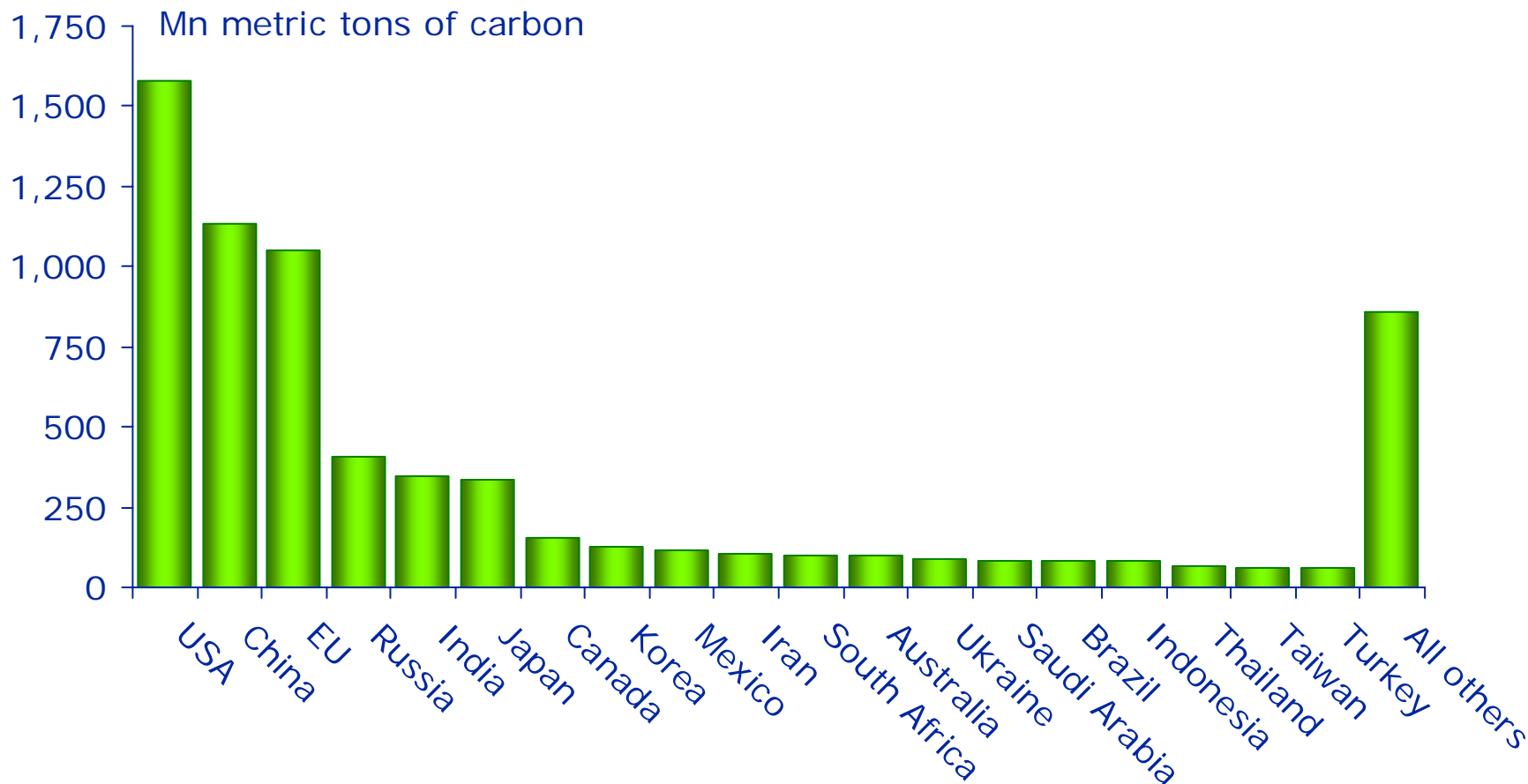
Australian surface temperature anomalies



Source: Australian Bureau of Meteorology.

Any serious effort at reducing GHG emissions has to involve non-Kyoto Protocol signatories ...

CO₂ emissions - 2003

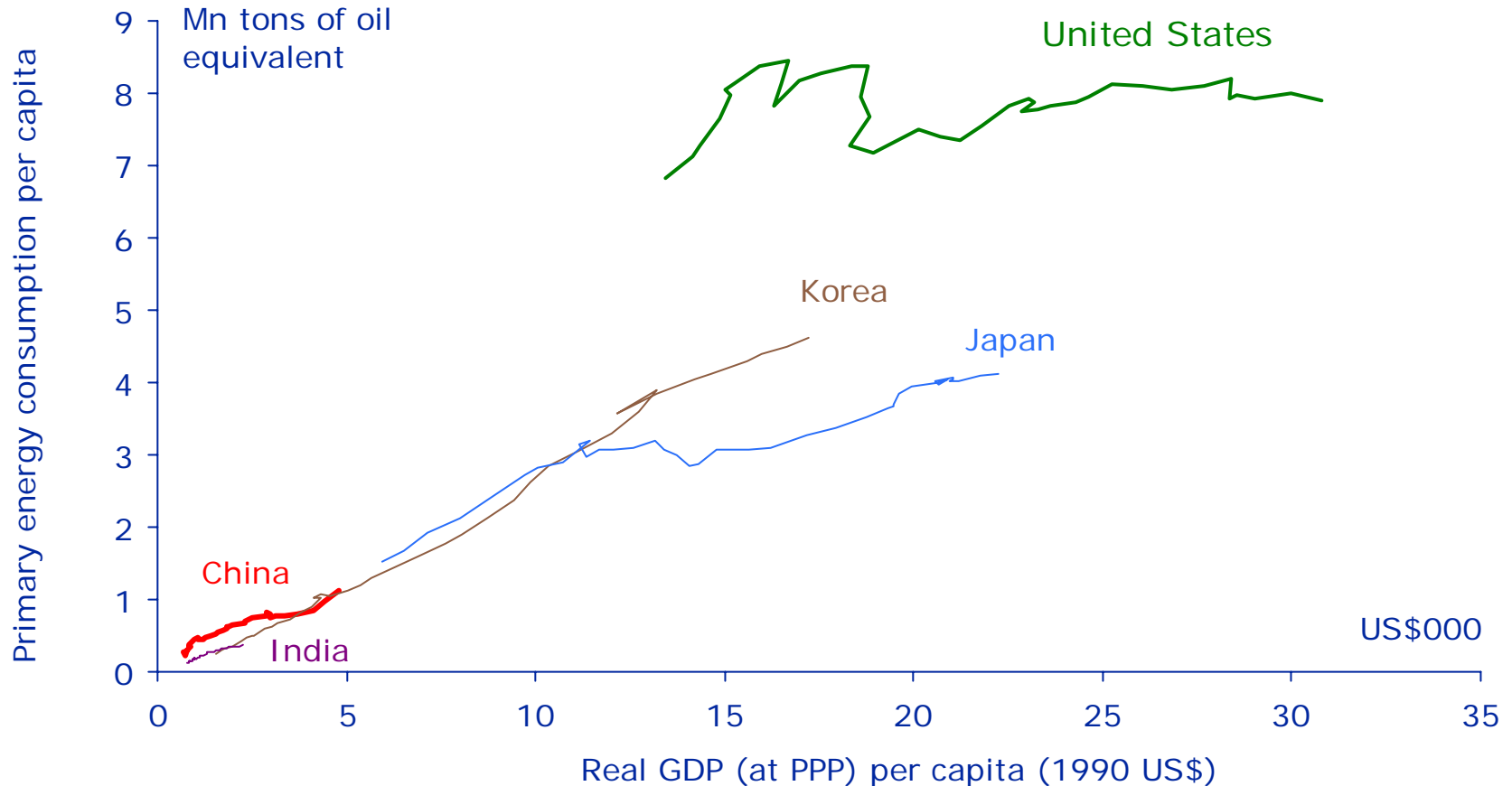


Note: Includes emissions from fossil fuel-burning, cement production and gas flaring.

Source: US Department of Energy Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory

... particularly given the rate at which energy consumption is likely to rise in China and India

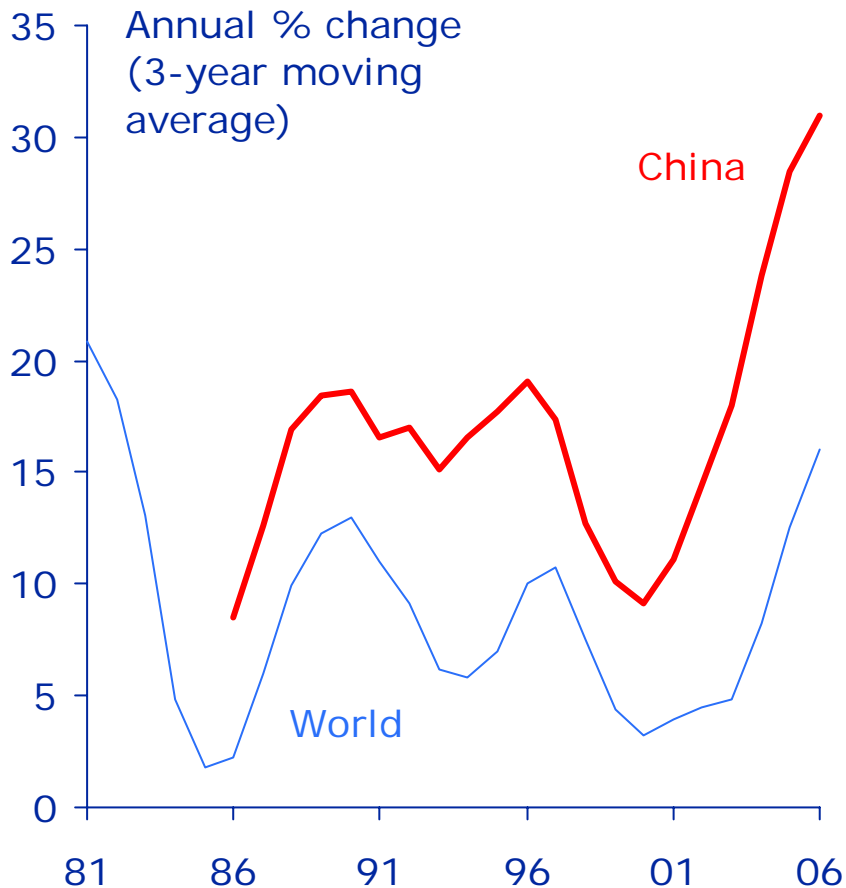
Primary energy consumption and GDP per capita, 1965-2005



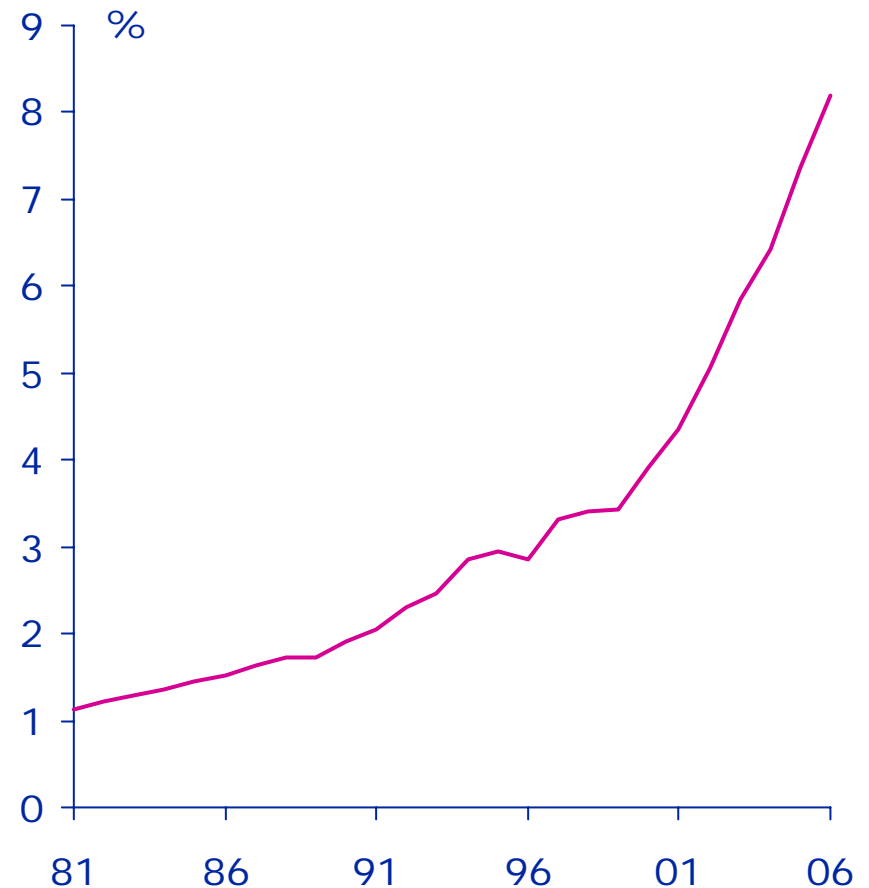
Sources: Groningen Growth and Development Centre *Total Economy Database*; BP *Statistical Review of World Energy* (2006); Economics@ANZ.

China's increasing share of global exports may trigger a protectionist backlash

Merchandise exports



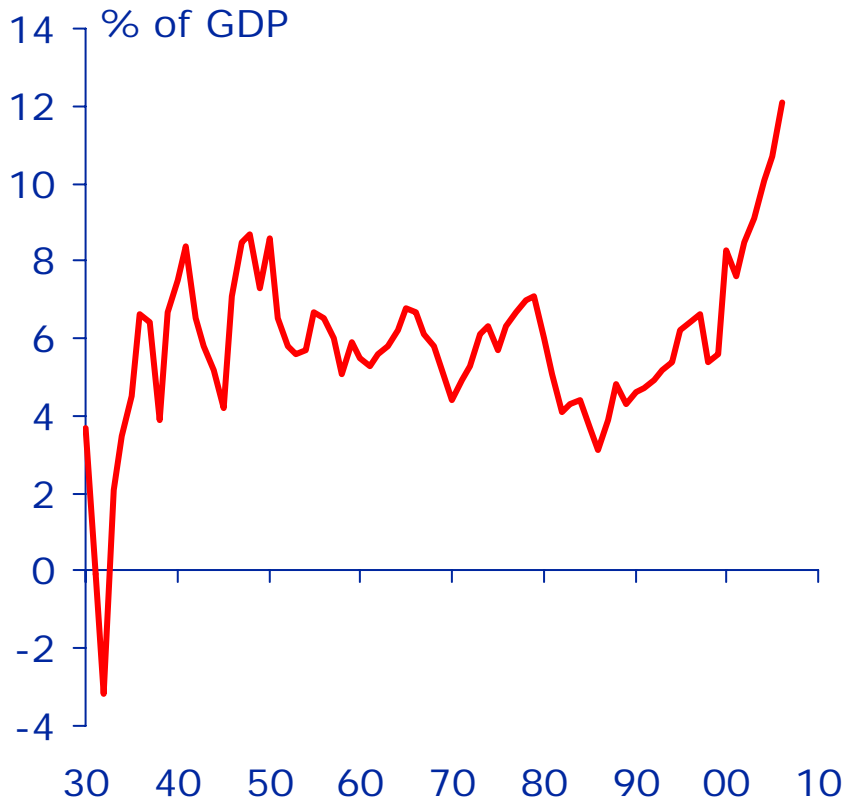
China's share of world exports



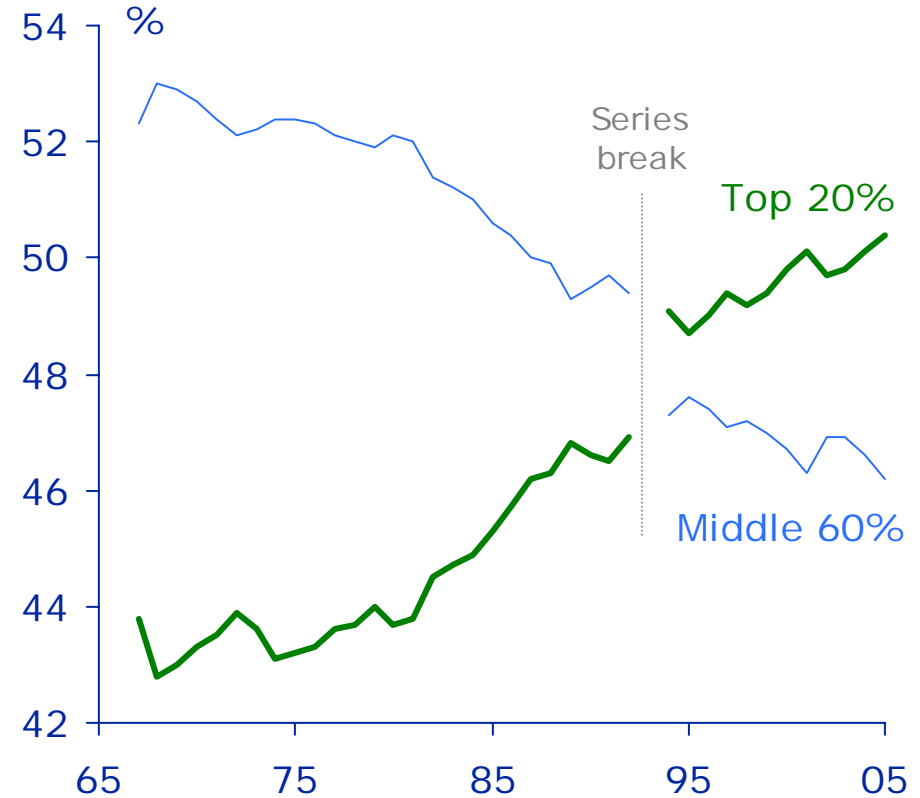
Sources: IMF, *Direction of World Trade Statistics*;
Economics@ANZ.

The risk of 'populist' policies in the US is heightened by trends in the distribution of income

US: after-tax 'book' profits as a share of GDP



US: shares of selected income groups in total pre-tax income



Sources: US Bureau of Economic Analysis; US Census Bureau.

China is now the major influence on global demand for base metals and steel

	1993-2002			2002-2005		
	World consumption growth [†]	Contribution to growth (%) of		World consumption growth [†]	Contribution to growth (%) of	
		China	Other EMs*		China	Other EMs*
Aluminium	3.8	38	9	7.6	48	9
Copper	3.5	43	15	3.8	51	41
Lead	3.0	42	15	4.3	110	-7
Nickel	4.4	12	-11	3.6	87	-11
Steel	3.4	38	11	9.2	54	8
Tin	1.3	34	16	8.1	86	2
Zinc	3.4	42	10	3.8	113	7

† % pa * Emerging Markets (India, Russia, Brazil and Mexico)

Source: IMF *World Economic Outlook*, September 2006 Table 5.3.

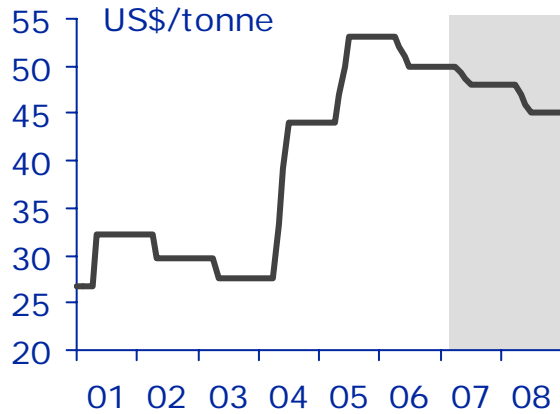
Modest increases in global production of most major mineral commodities now in prospect

	% change from previous year			
	1999-2004*	2005	2006 (e)	2007 (f)
Coal	5.0	9.6	8	7½
Iron ore	5.9	10.3	12	9¾
Alumina	5.0	2.4	21	4¼
Aluminium	4.7	7.0	5½	9
Copper	1.7	4.9	5	4¾
Lead	1.7	8.5	6½	4
Nickel	3.3	3.4	1¾	4¼
Zinc	4.0	-1.2	3	4¾
Gold (mine)	-0.6	2.0	-½	3¼

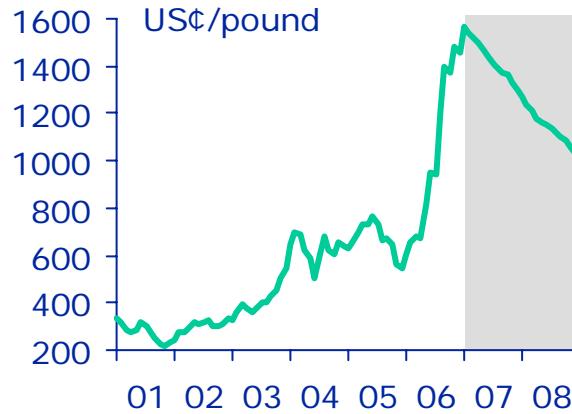
* Average annual rate. Sources: ABARE, *Australian Commodities* December quarter 2006; Economics@ ANZ.

Commodity prices will thus remain high though easing as increased supply comes on stream

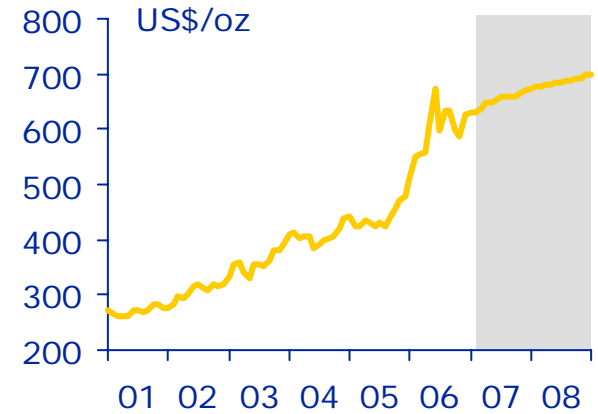
Thermal coal



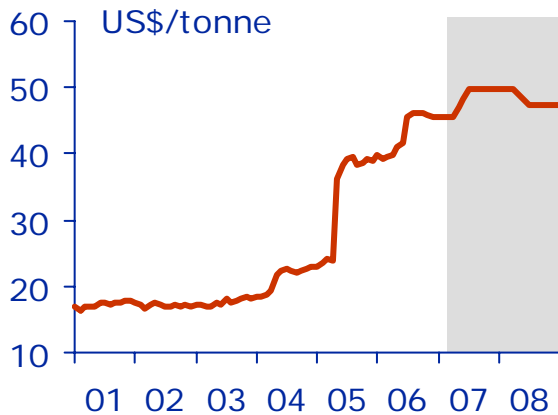
Nickel



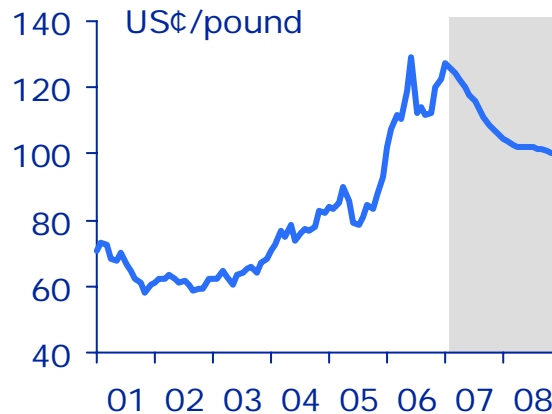
Gold



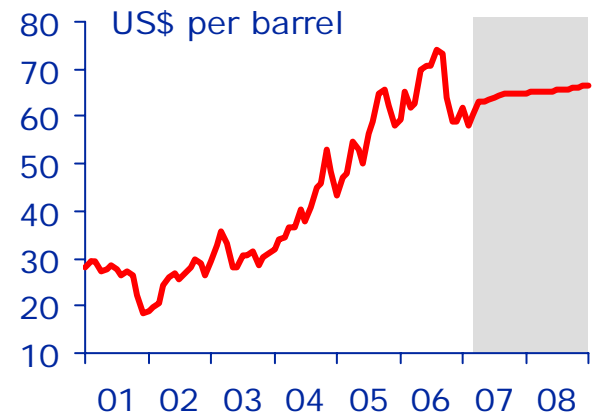
Iron ore



Aluminium

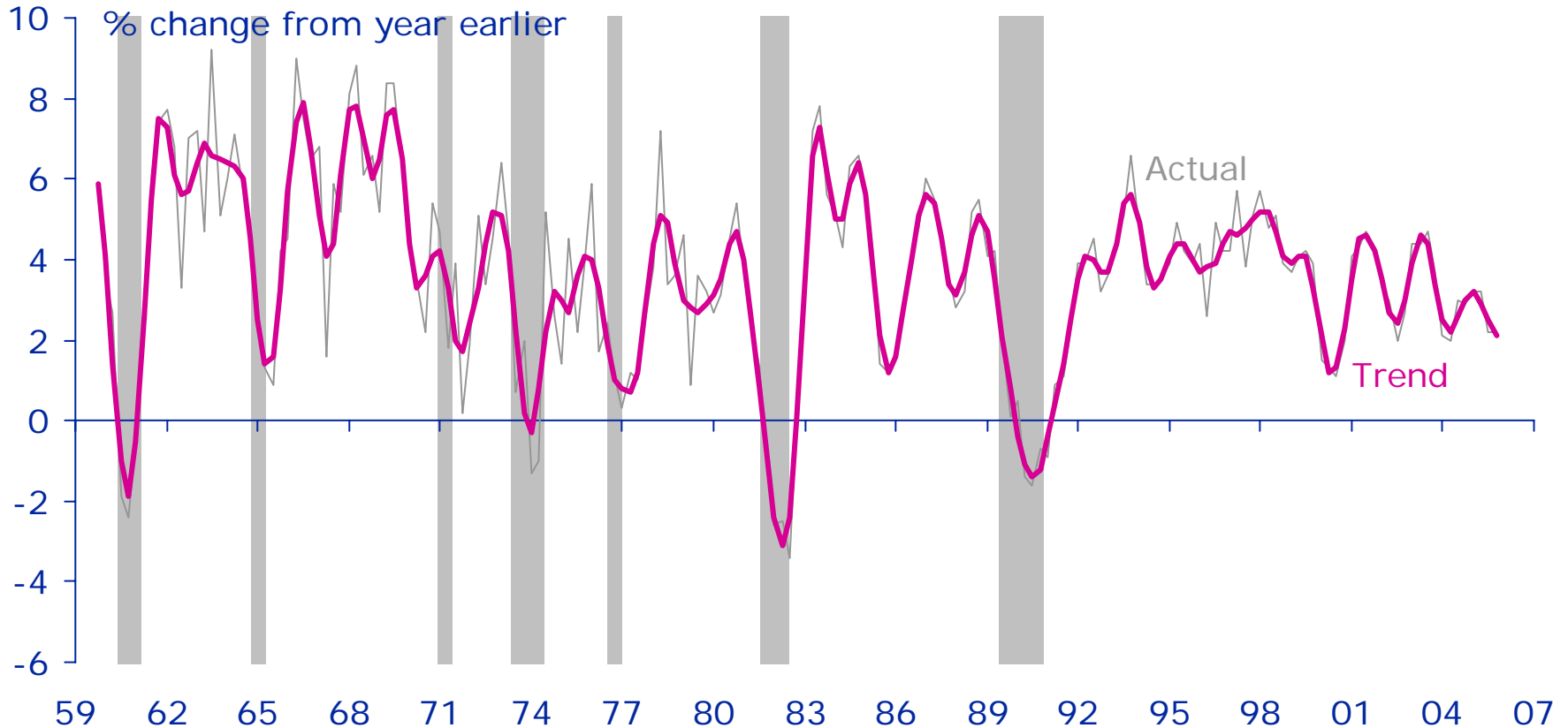


Oil



Australia has now gone more than 15 years without recession, the longest in its history

Real GDP growth



Note: shaded intervals denote periods in which real GDP growth was negative for two or more quarters, or during which real GDP declined from the year-earlier quarter.

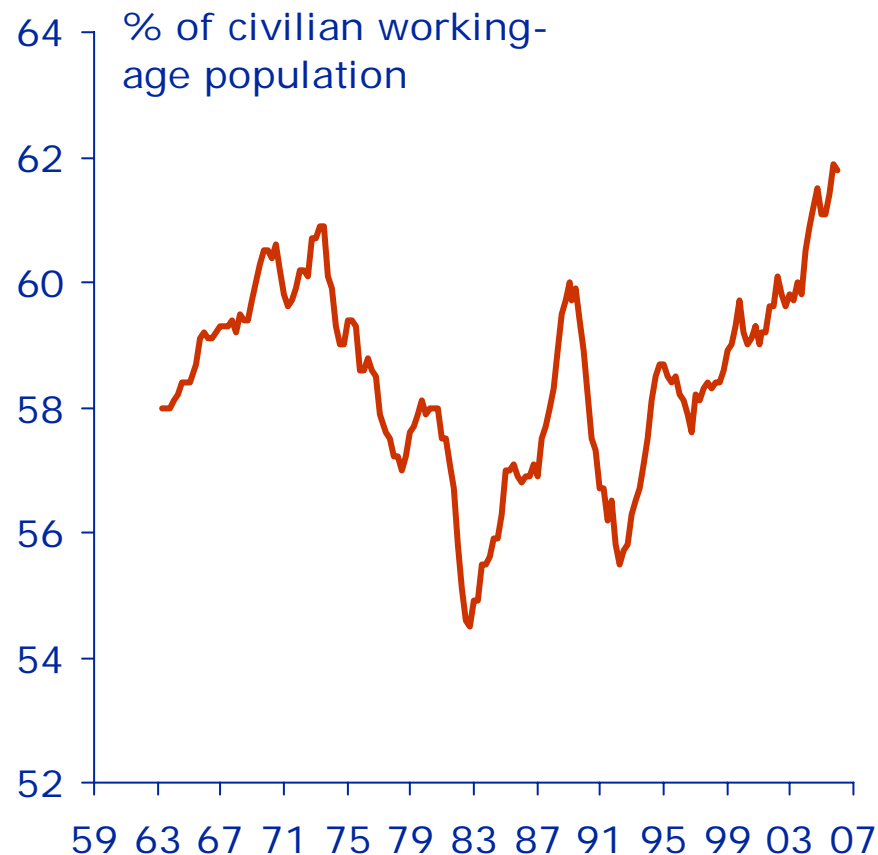
Sources: Australian Bureau of Statistics; Economics@ANZ.

Unemployment is at a 30-year low, while a record proportion of the population is employed

Unemployment



Employment-to-population ratio



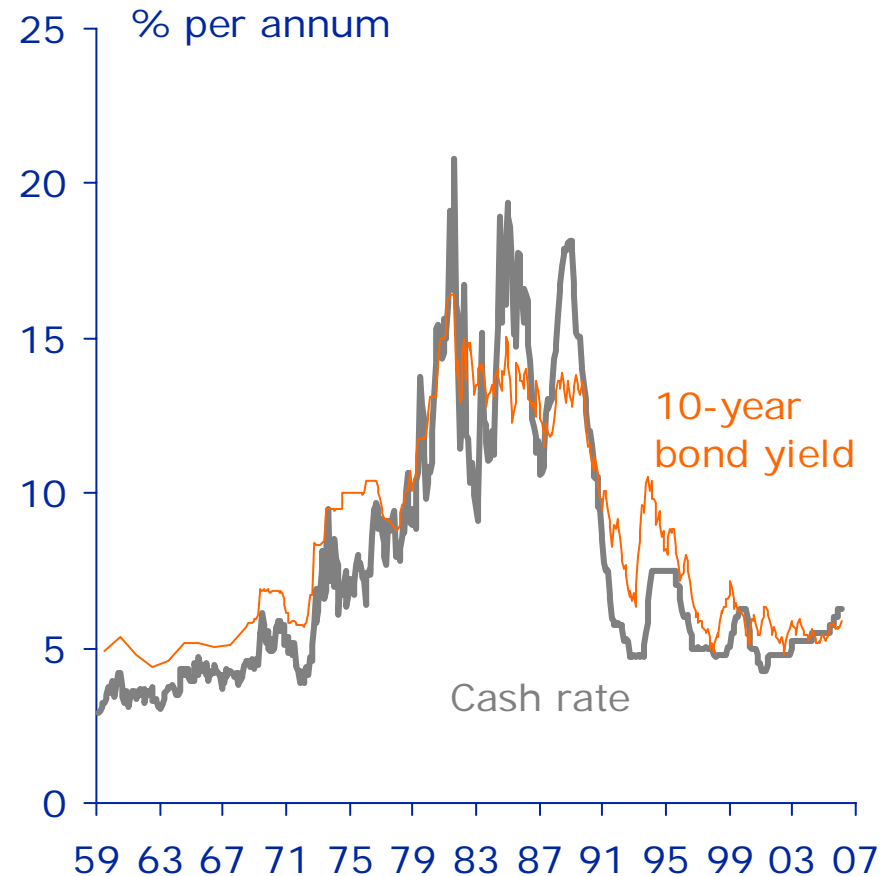
Sources: ABS; Economics@ANZ.

Inflation and interest rates, though rising, are still low by historical standards

Inflation



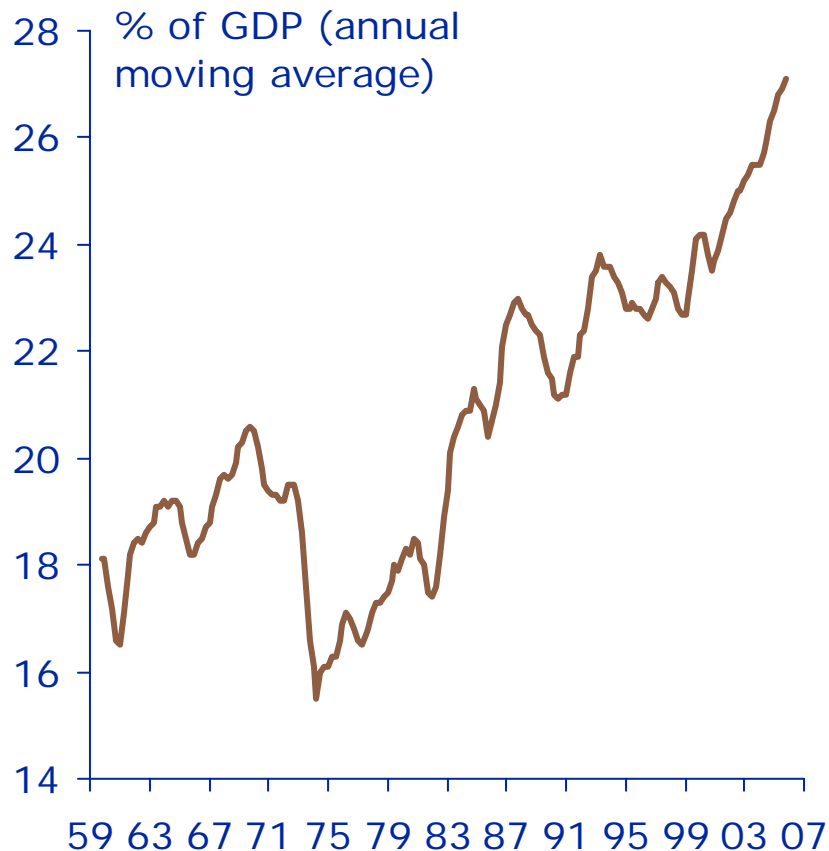
Interest rates



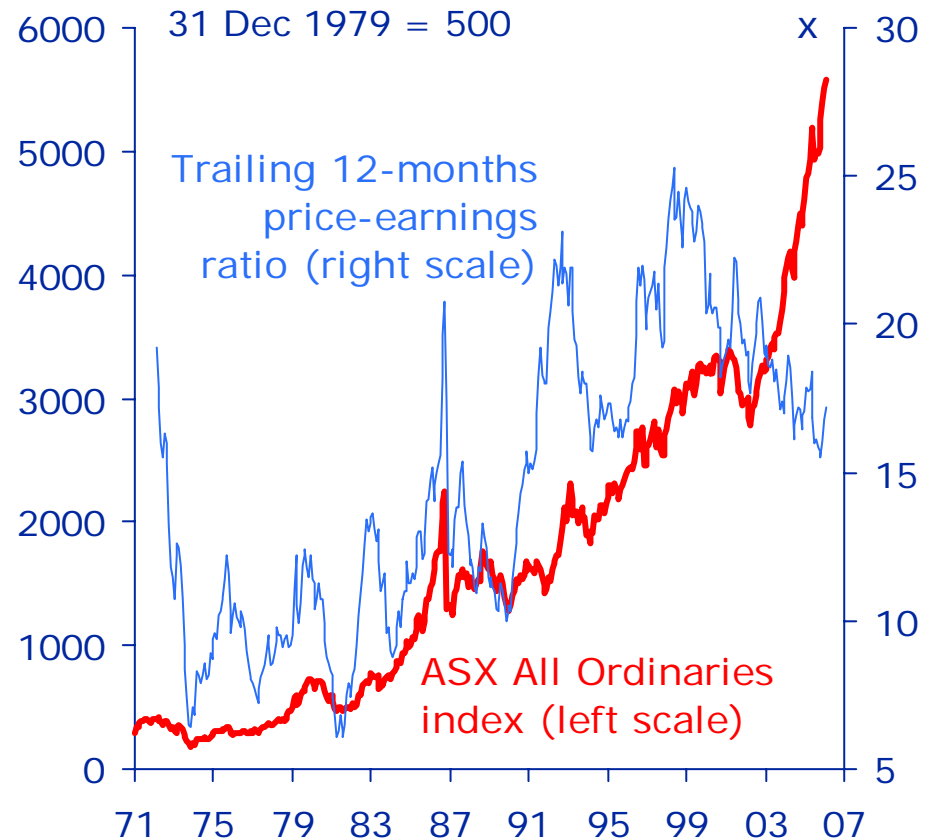
Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

Corporate profits and the share market are at record highs – but the market isn't 'over-valued'

Non-financial corporate gross operating surplus



Australian sharemarket



Sources: Australian Bureau of Statistics; Australian Stock Exchange; Thomson Financial Datastream.

Australian corporate finances are in a very sound condition compared with the 80s and early 90s

Non-financial corporate sector debt-equity ratio



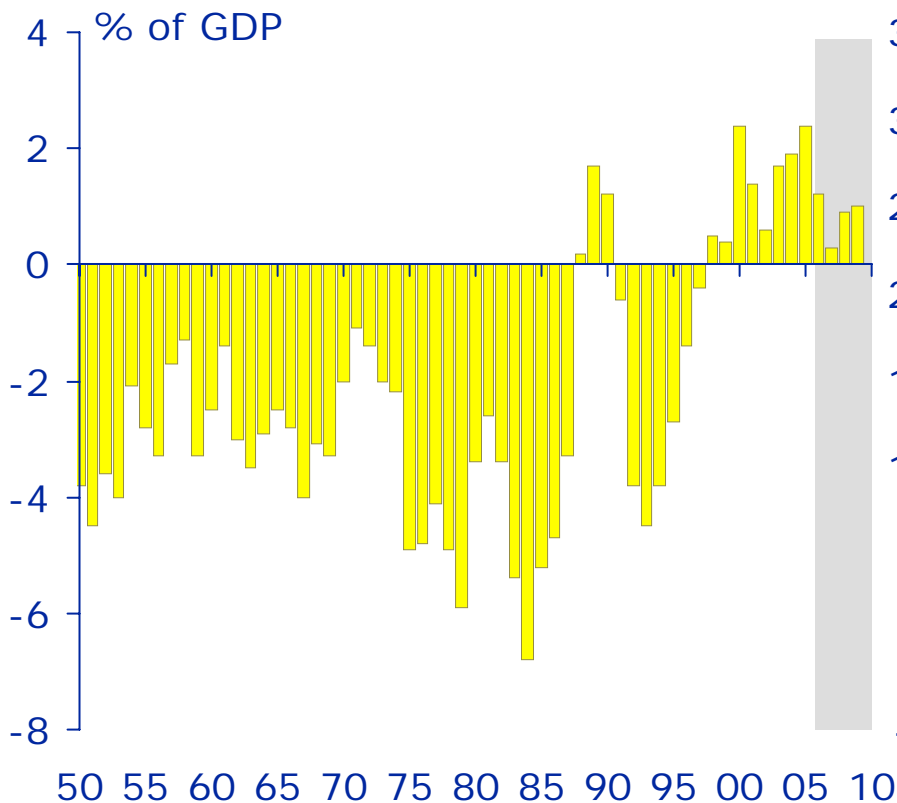
Non-financial corporate sector interest cover



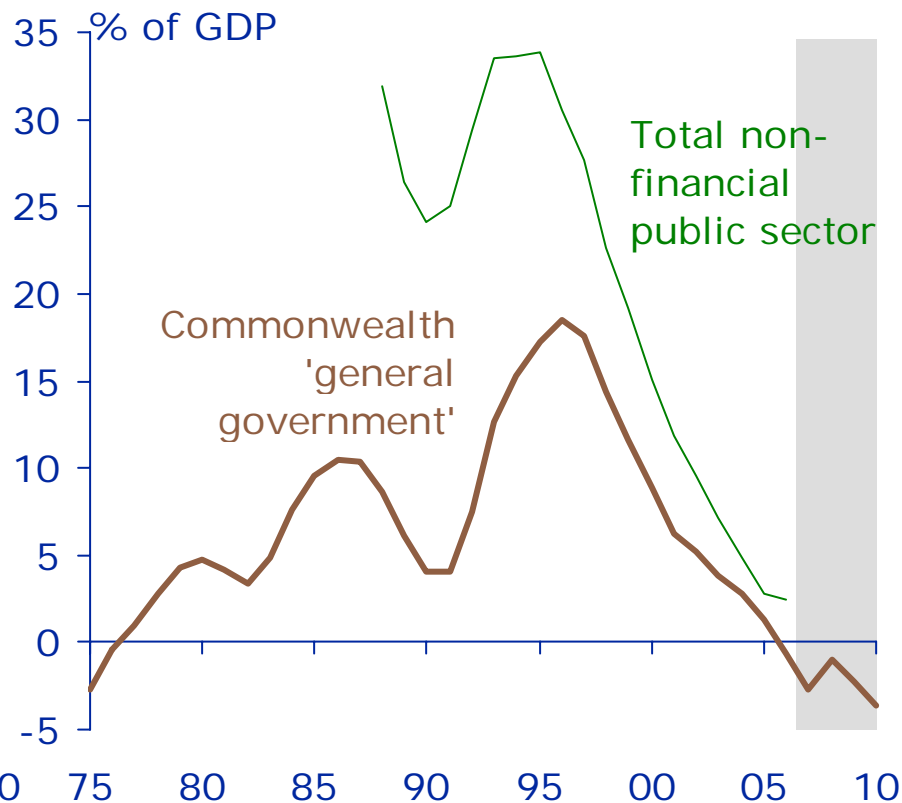
Note: 'interest cover' is the ratio of gross operating surplus (roughly equivalent to EBITDA) to net interest paid. Sources: ABS; Economics@ANZ.

Australian public sector finances are among the strongest in the developed world

'General government' cash balance



Public sector net debt



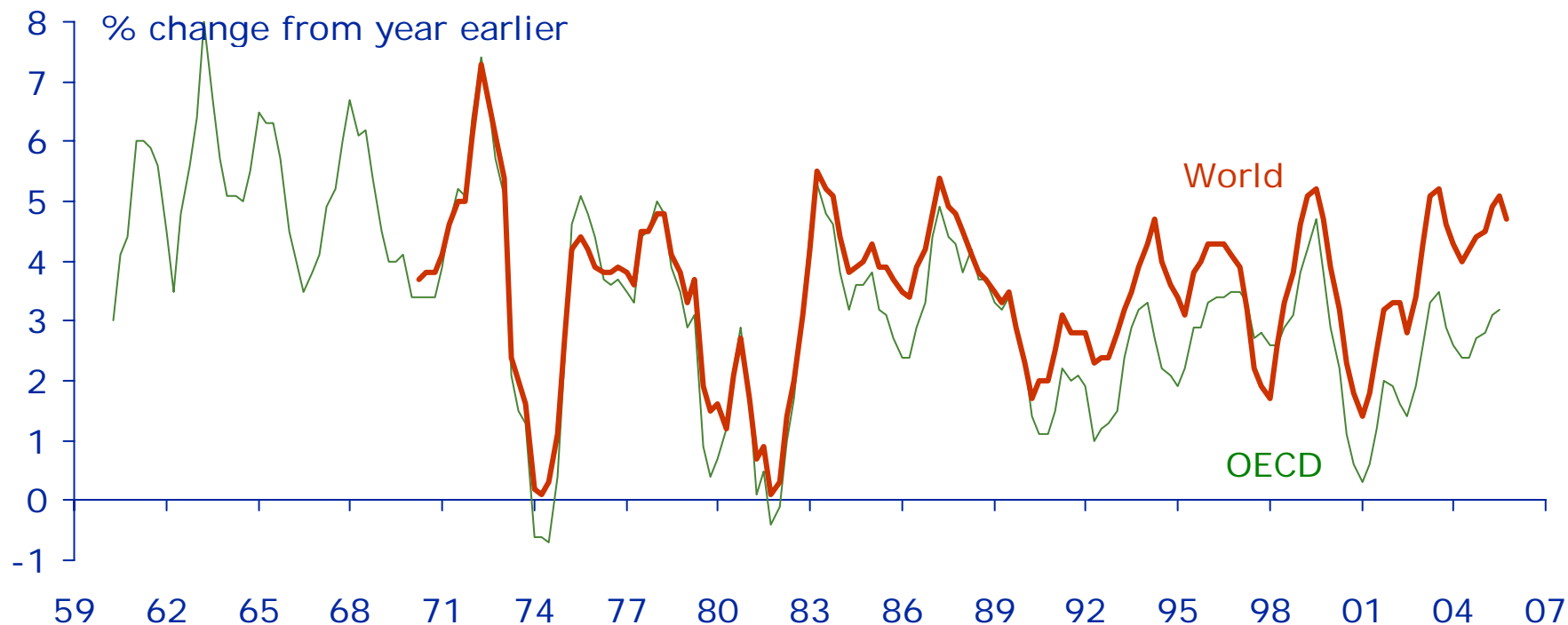
Note: Shaded areas denote official forecasts. Figures are for financial years ended 30th June.

Sources: 2006-07 Commonwealth Budget Paper No. 1, Statement 12;

Reserve Bank *Statistical Bulletin*.

Global economic growth has been stronger and less volatile since the early 1990s

Global real GDP growth

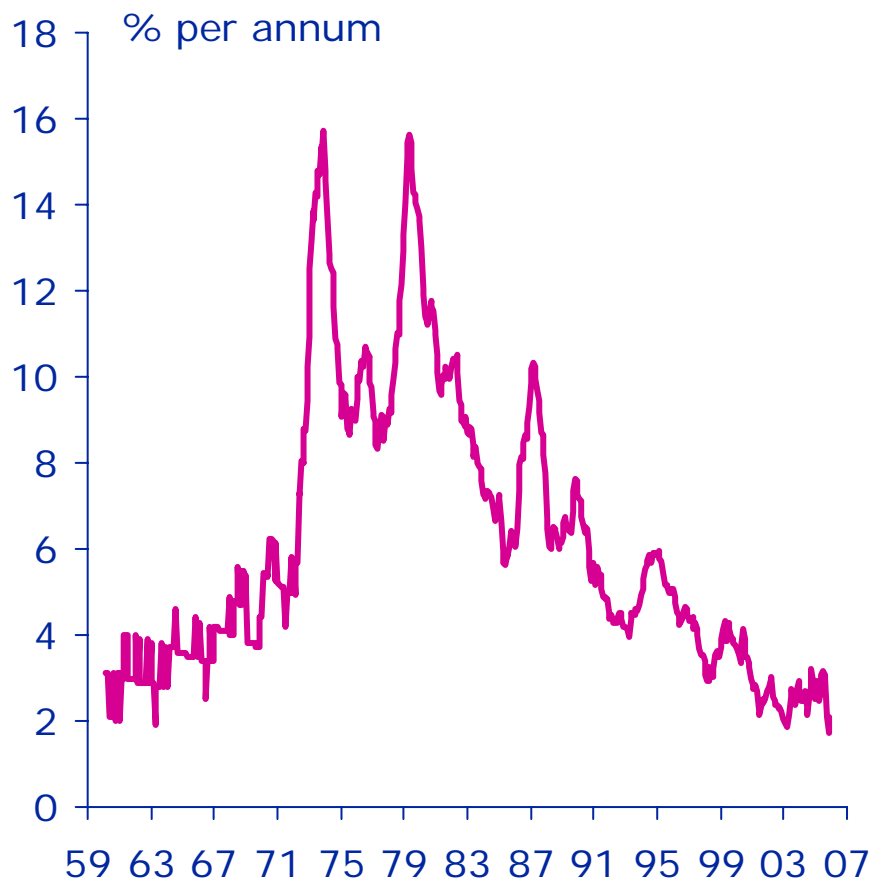


	Mean (% pa)				Standard deviation (pc pts)			
	1970s	1980s	1990s	2000s	1970s	1980s	1990s	2000s
OECD	3.4	3.0	2.6	1.8	2.0	1.4	0.9	0.9
World	2.9	2.8	3.2	3.4	1.7	1.4	1.0	1.2

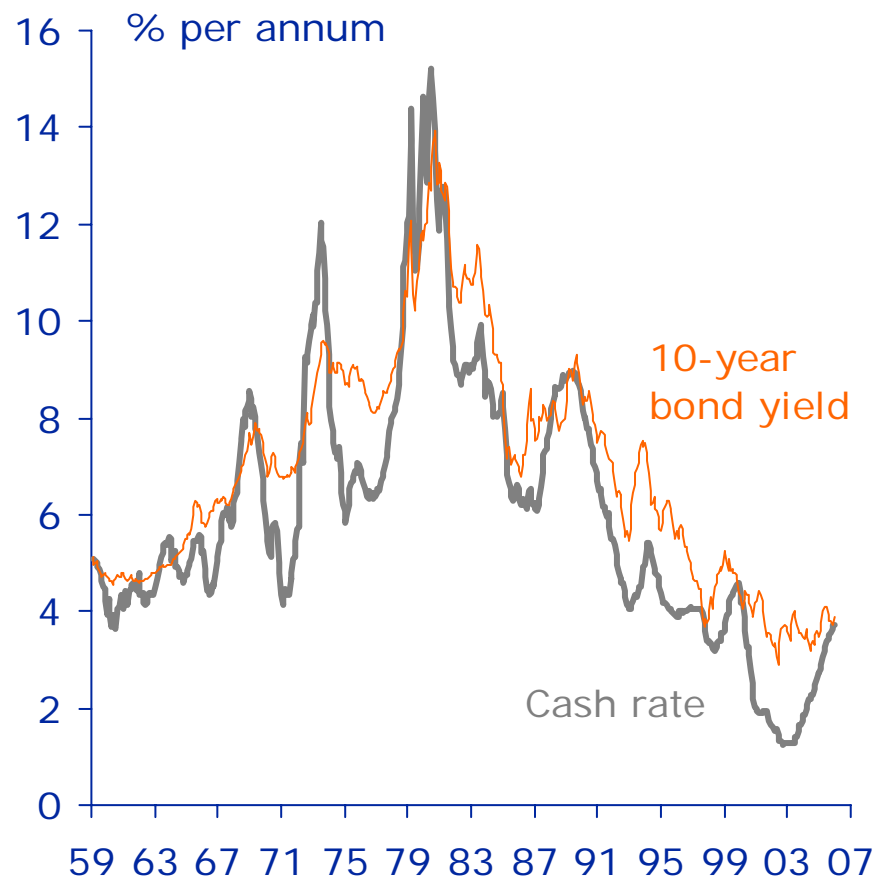
Sources: OECD; national statistical agencies and central banks; Thomson Financial Datastream; Economics@ANZ.

Inflation and interest rates have fallen around the world since 1990, not just in Australia

OECD inflation



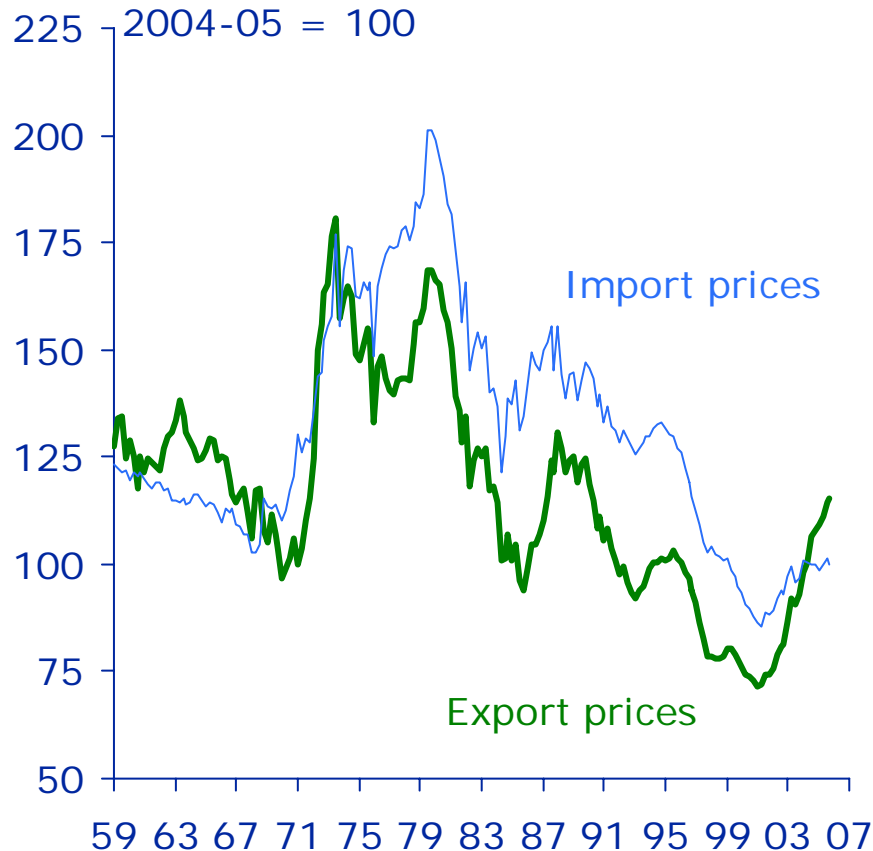
'G7' interest rates



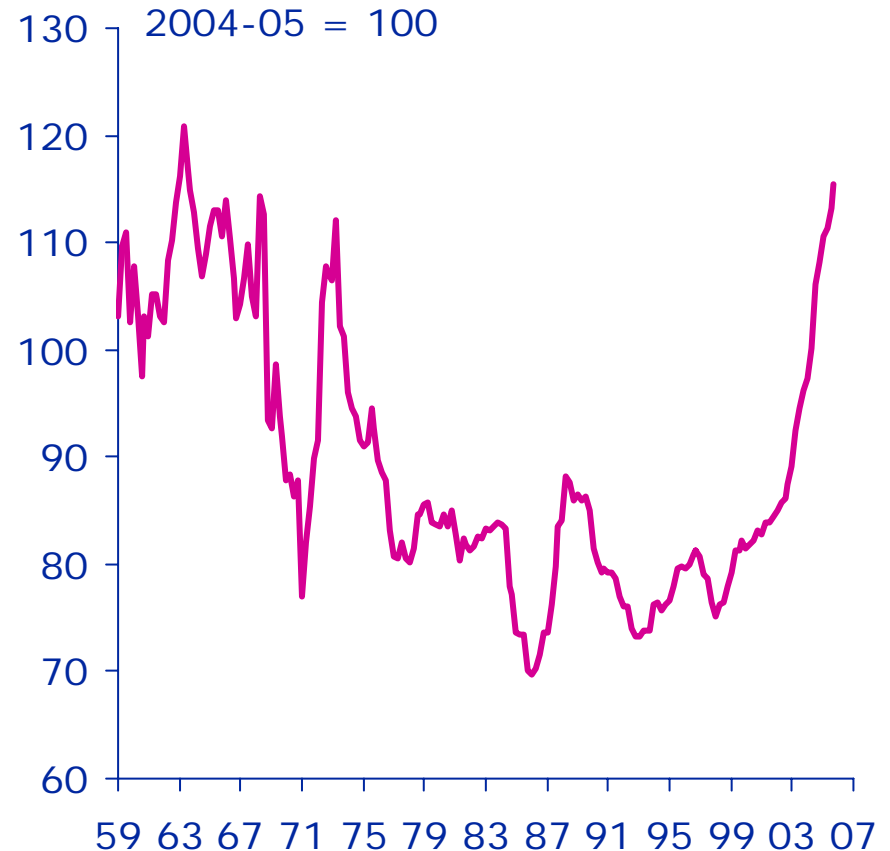
Note: G7 cash rate excludes France before January 1964; G7 bond yield excludes Japan before May 1966.
Sources: OECD; national central banks; Thomson Financial Datastream; Economics@ANZ.

Australia's terms of trade have improved since the early 90s, reversing the decline of the 70s and 80s

Australian export and import prices in real US\$ terms



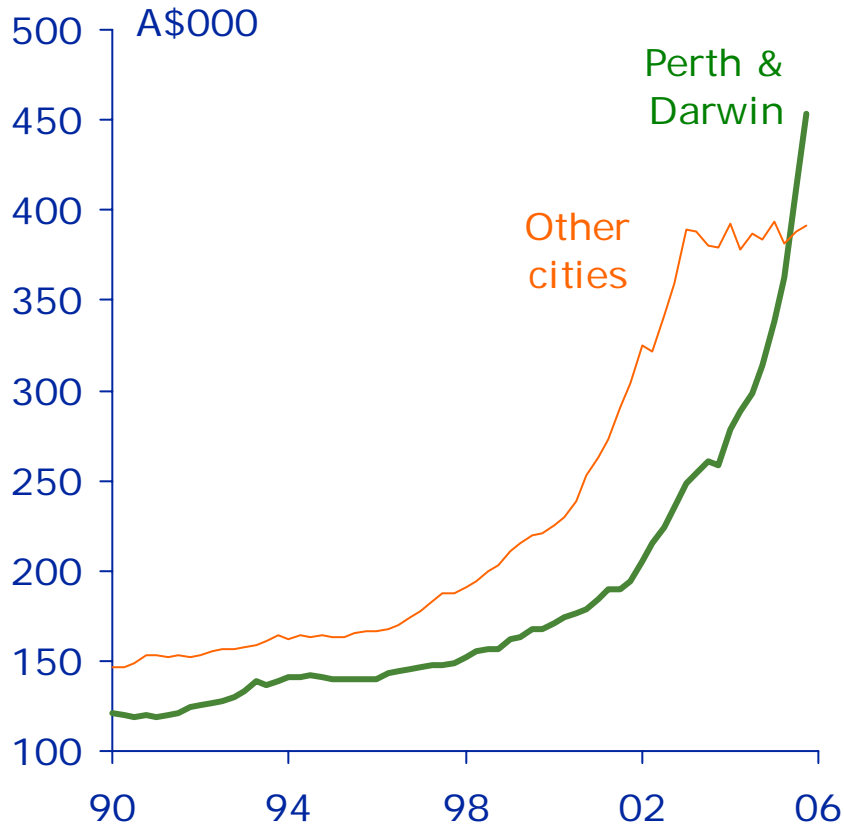
Australia's 'terms of trade'



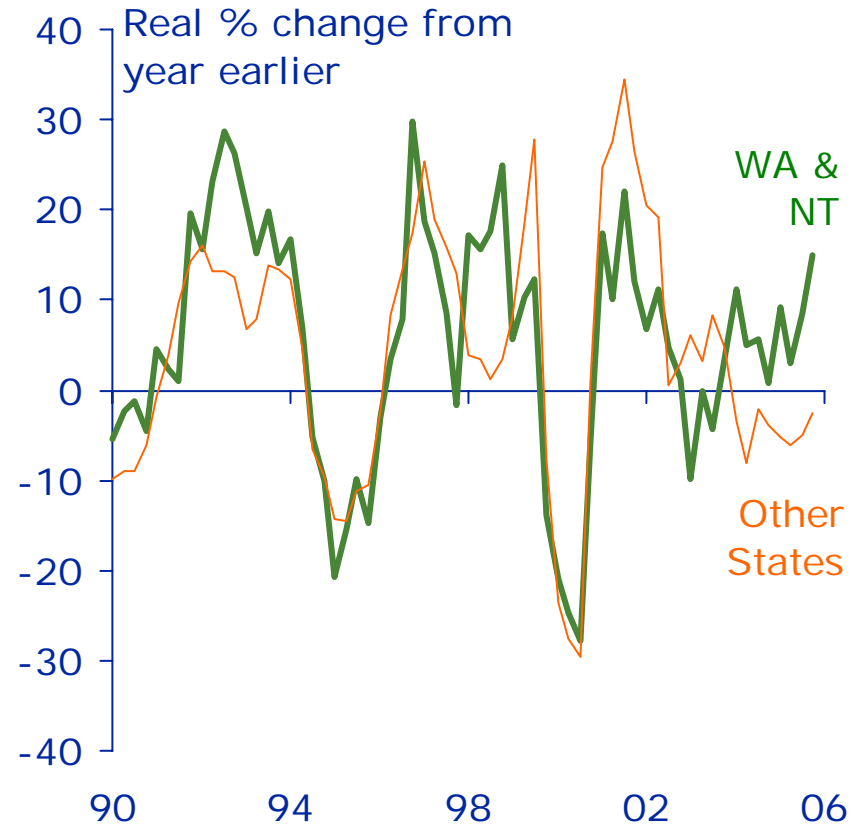
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ.

The housing boom is over, except in Western Australia and the Northern Territory

Established house prices



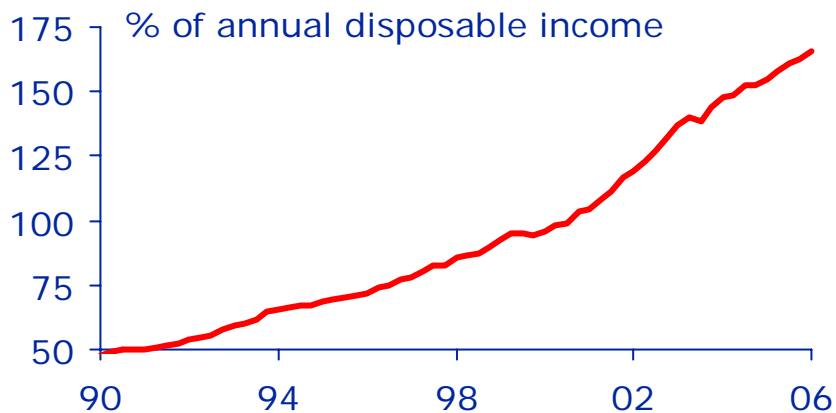
Dwelling construction



Sources: ABS; Economics@ANZ.

Higher interest rates and the end of the housing boom are making households more cautious

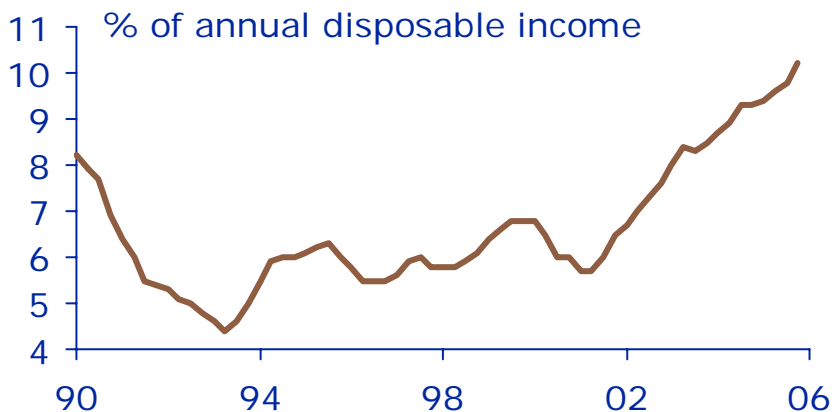
Household debt to income



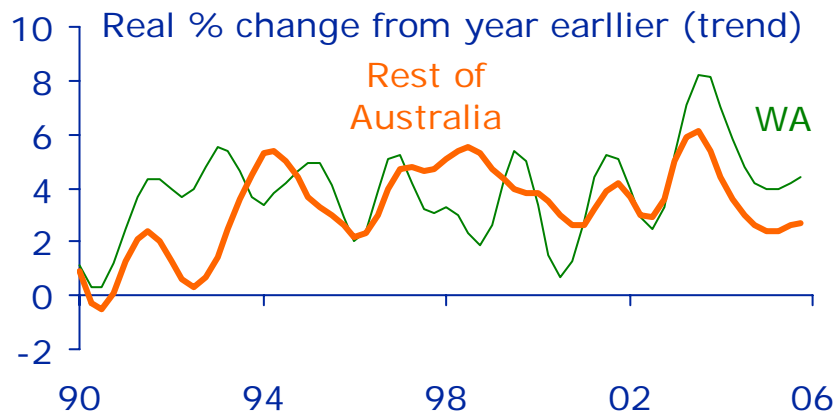
Household saving rate



Interest payments to income



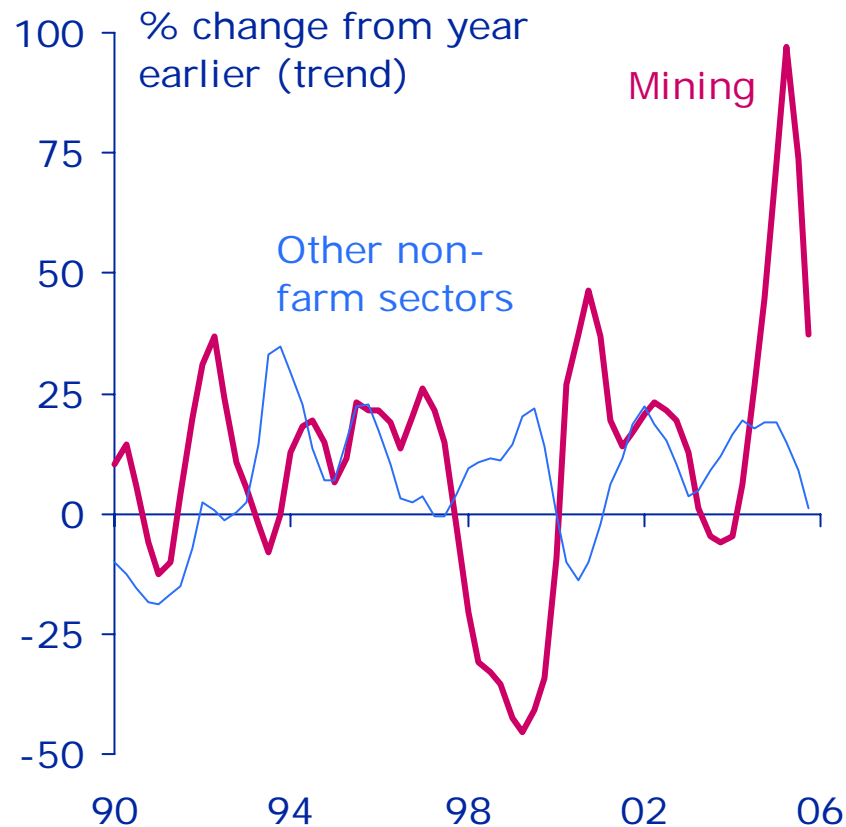
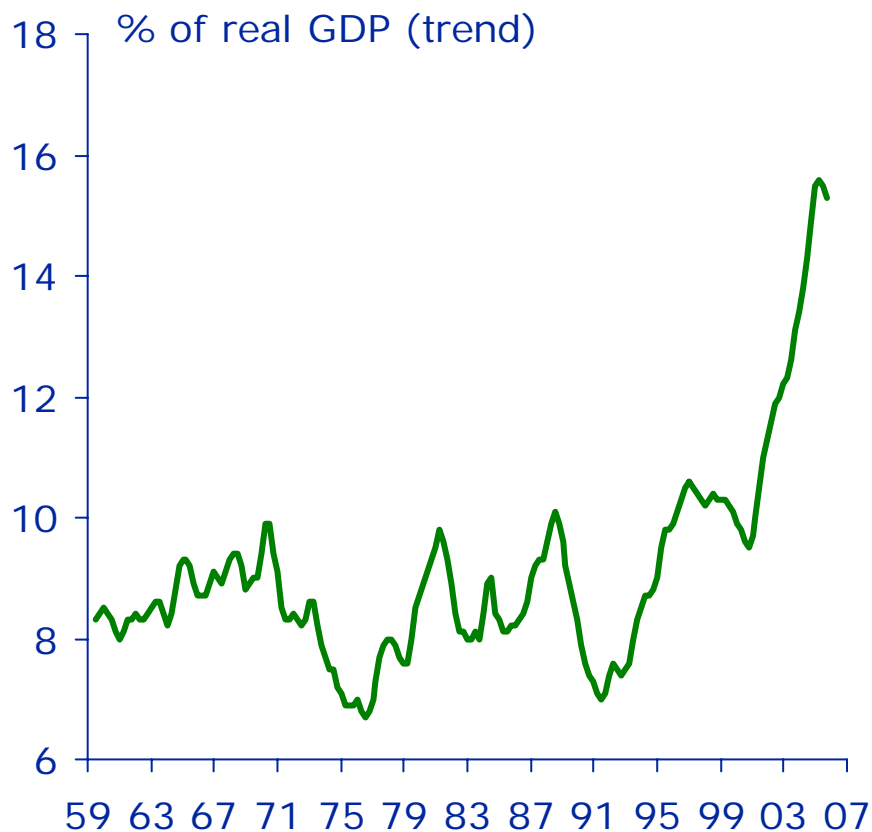
Consumer spending



Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

The business investment boom also appears to have reached a peak

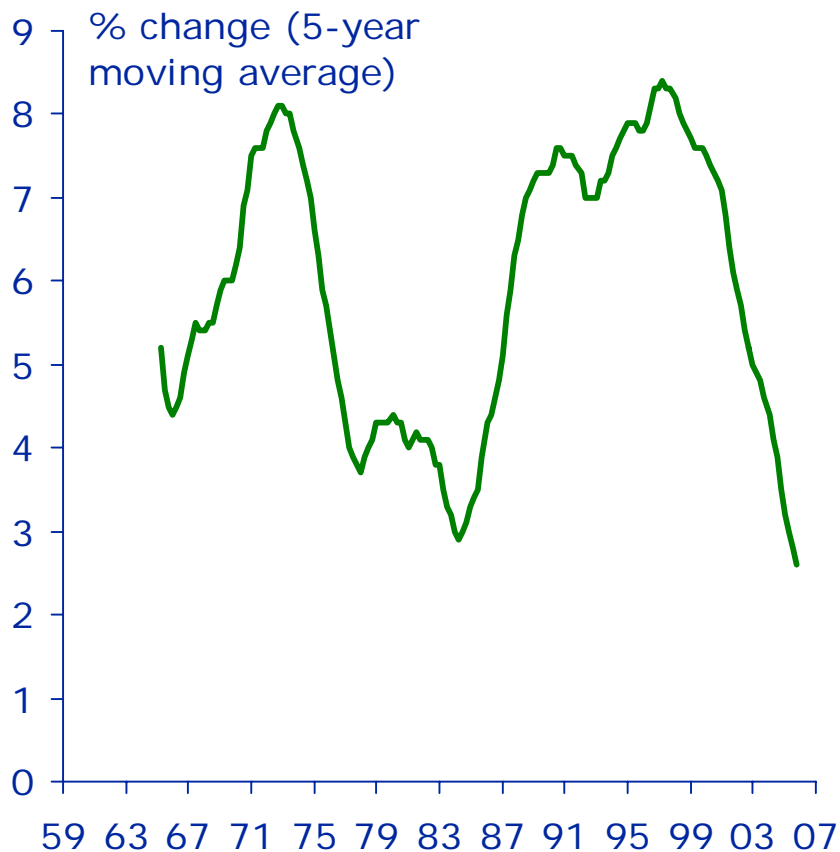
Business fixed capital expenditure



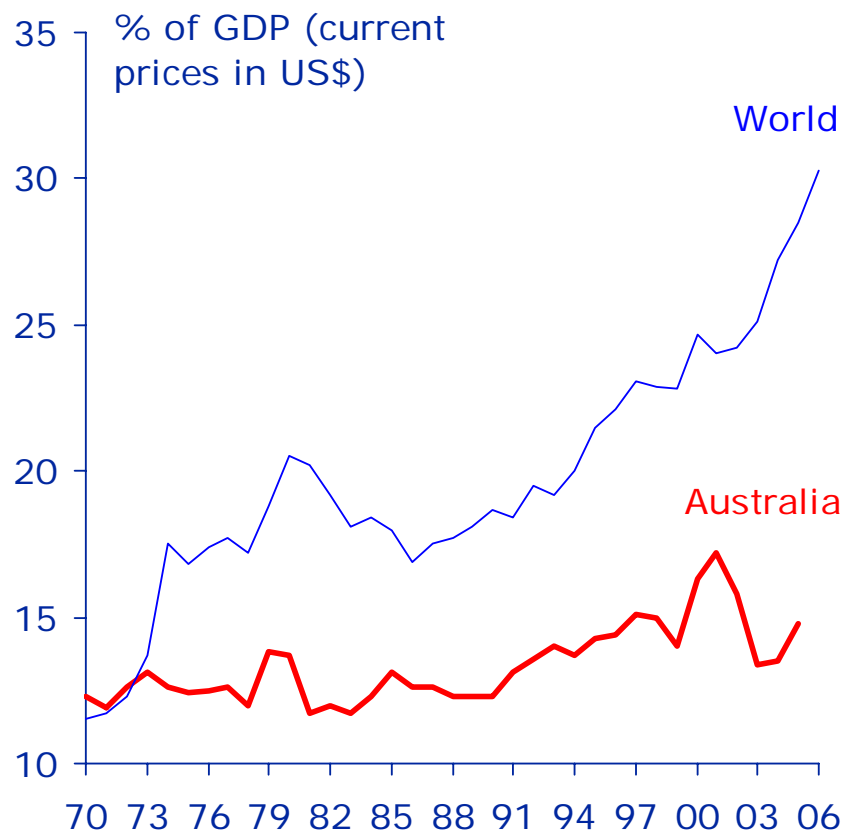
Sources: ABS; Economics@ANZ.

Australia's export performance since 2000 has been very poor

Export volumes



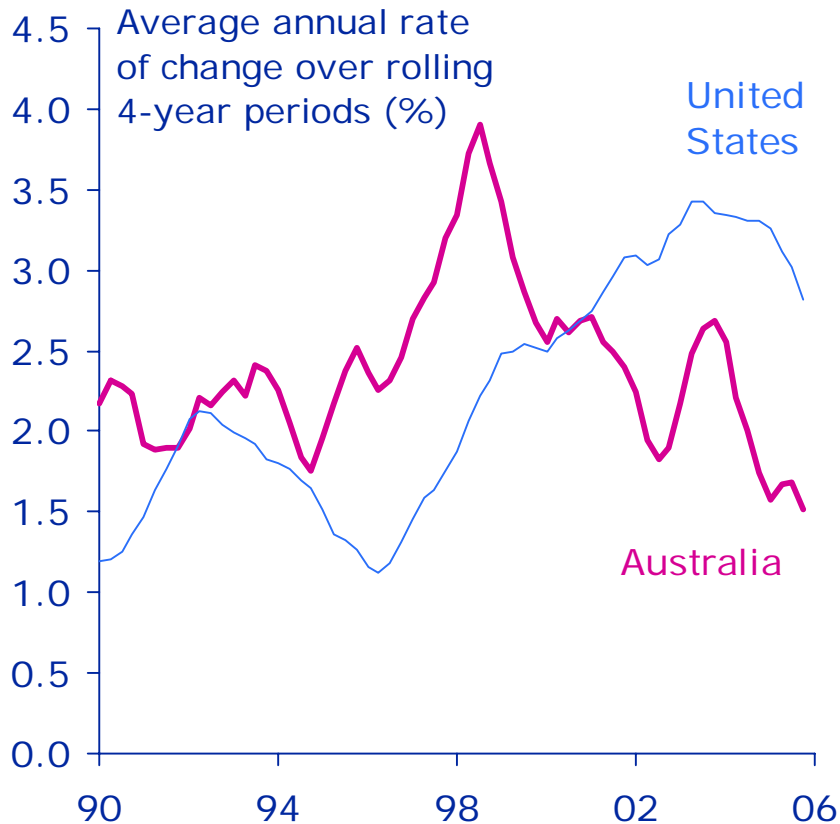
Exports as a pc of GDP



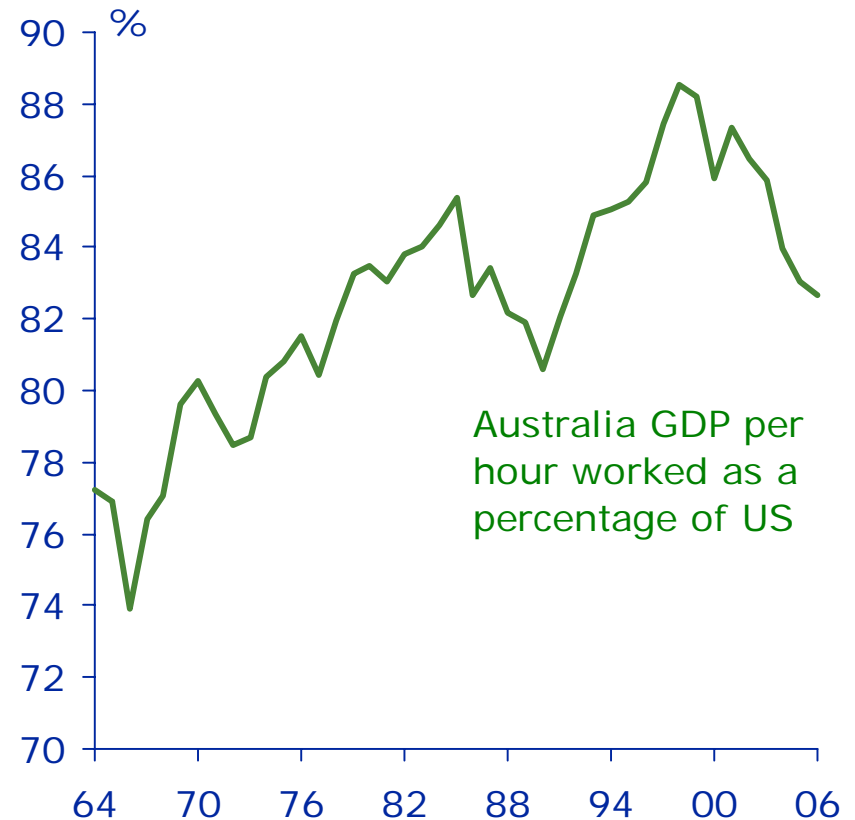
Sources: Australian Bureau of Statistics; International Monetary Fund *Direction of Trade Statistics* and *World Economic Outlook* database; Economics@ANZ.

Australia's 'productivity miracle' appears to have evaporated

Labour productivity growth



Labour productivity level

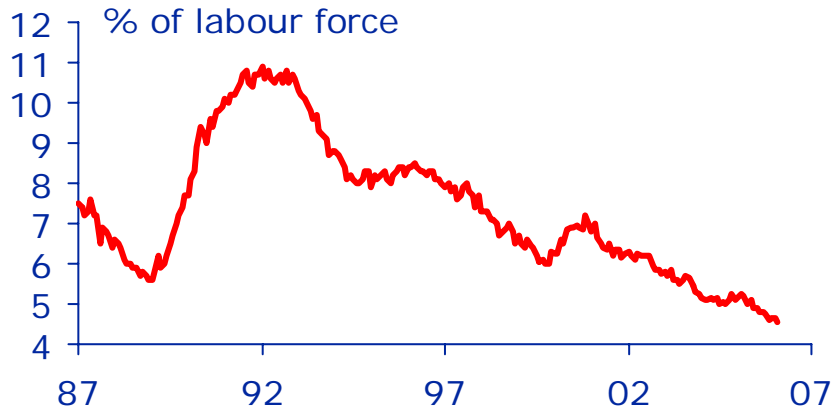


Note: labour productivity is output per hour worked in the non-farm business or market sector.

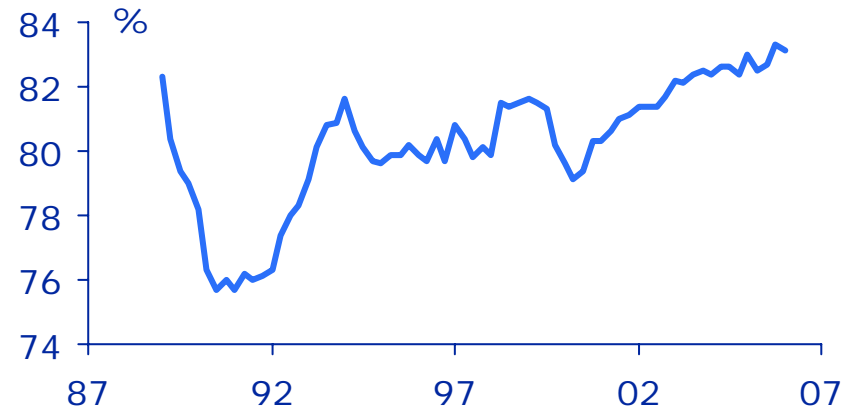
Sources: ABS; US Bureau of Economic Analysis; University of Groningen Growth and Development Centre *Total Economy Database* January 2007.

The Australian economy is bumping up against 'capacity constraints'

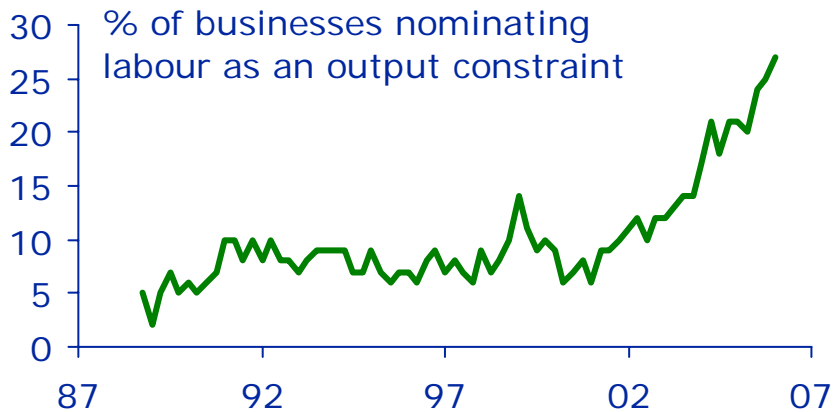
Unemployment rates



Capacity utilization



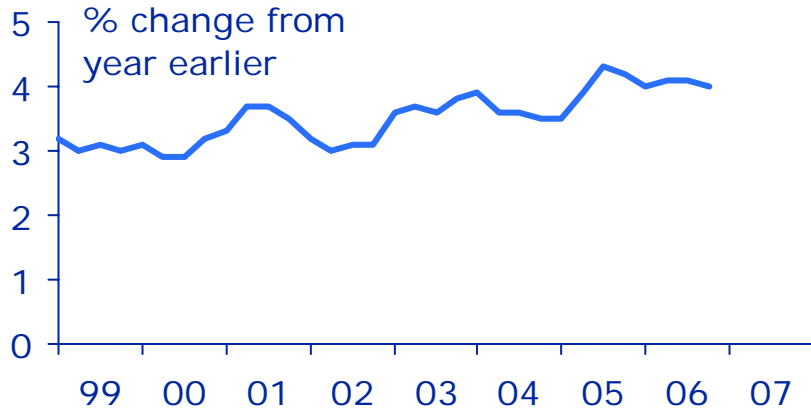
Labour shortages



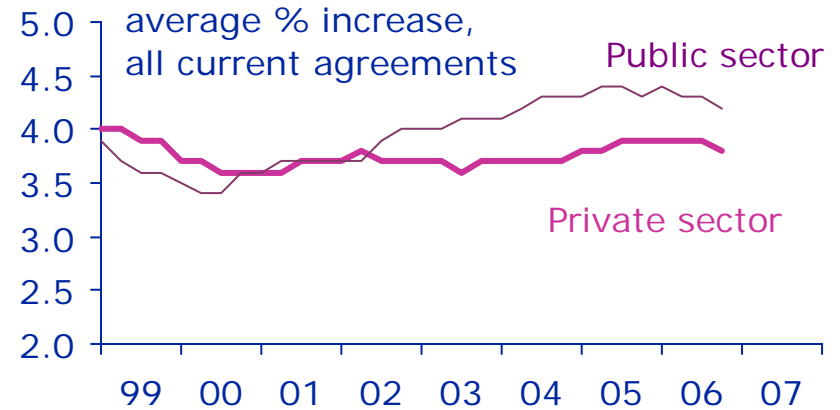
Sources: Australian Bureau of Statistics; National Australia Bank; Australian Industry Group.

Wage movements have been very restrained despite the tight labour market

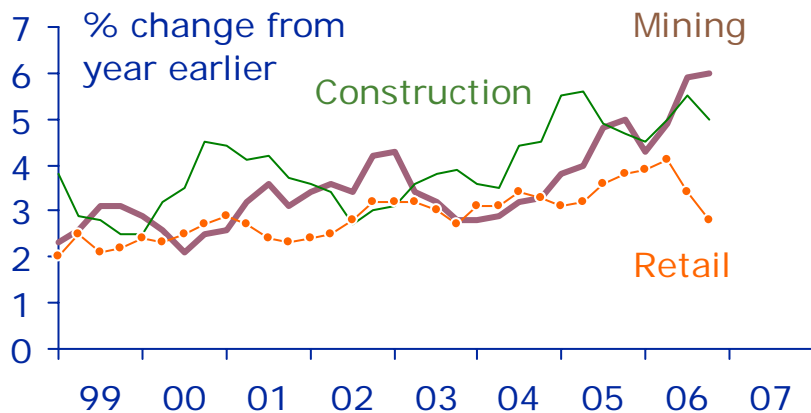
Wage cost index



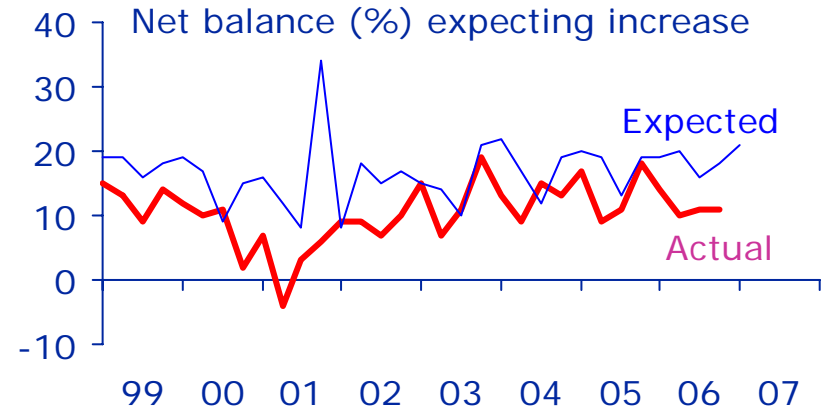
Enterprise bargaining



Wage costs: selected sectors



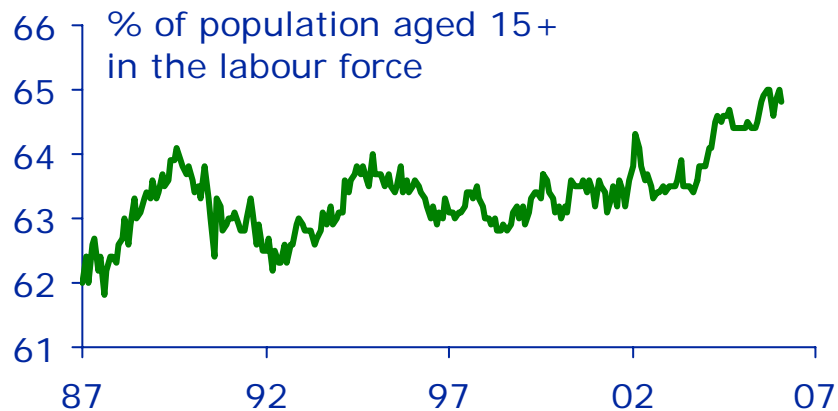
Small business wages bill



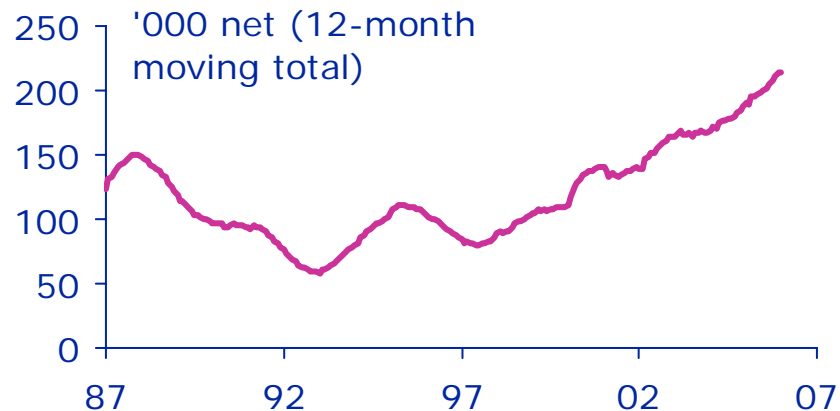
Sources: Australian Bureau of Statistics; Department of Employment & Workplace Relations; Sensis.

A number of 'safety valves' have increased the elasticity of labour supply

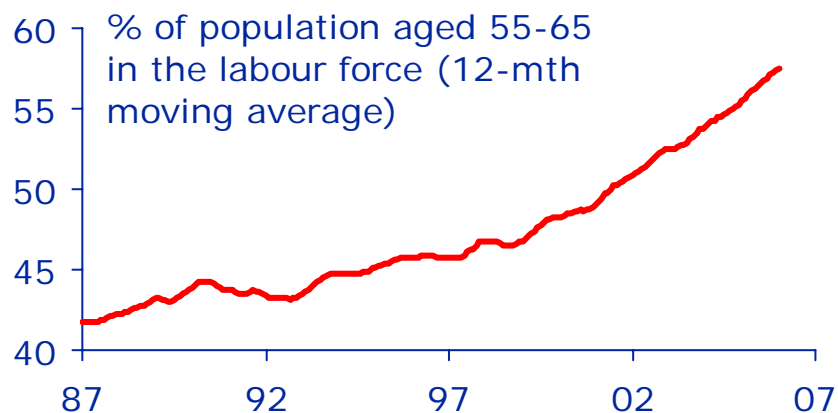
Labour force participation rate



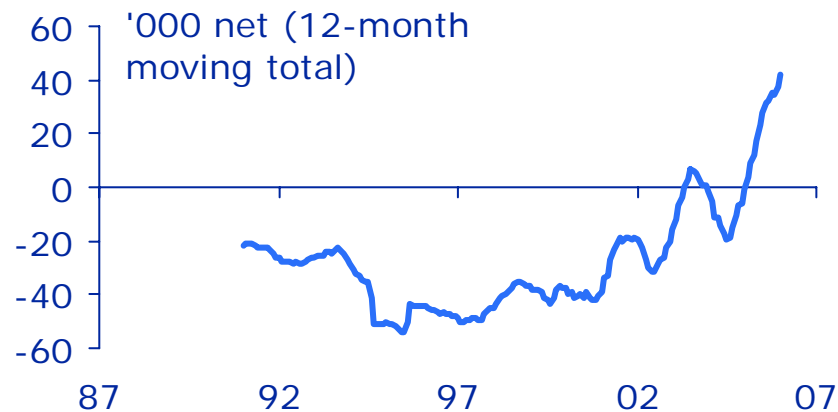
Permanent & long-term migration



Participation rate among 55-65s



Temporary migration 'for employment'



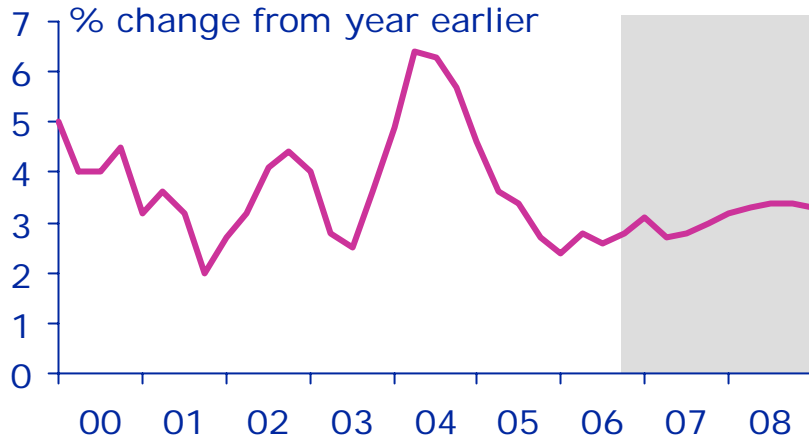
Sources: Australian Bureau of Statistics; Economics@ANZ.

So what does all this mean for the outlook for the Australian economy?

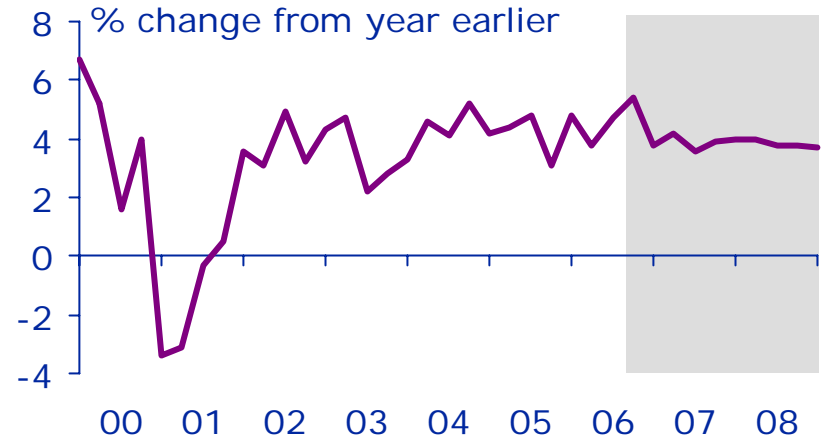
- There's no strong reason to expect a major downturn in the Australian economy any time soon
 - global economic conditions are likely to remain benign and real interest rates aren't high enough to induce a recession
 - indeed it's likely that interest rates have peaked, and that the next movement in rates (when it comes) could be down
- But, conversely, there's no obvious source of any renewed upturn in growth
 - aside from the lift in export volumes as major resource projects come on stream, recovery from drought and (in 2008) a modest upturn in housing construction
- With the economy operating at close to 'full capacity', and productivity growth having reverted to its (poor) long-term average, it's difficult to see the 'supply side' of the Australian economy growing at more than 3% pa
 - in the absence of specific policies to alter that prospect
- If monetary or fiscal policy seek to grow domestic demand at faster than 3% pa, the result will inevitably be higher inflation, a larger current account deficit (or both)

There are no obvious candidates for driving another spurt of rapid economic growth ...

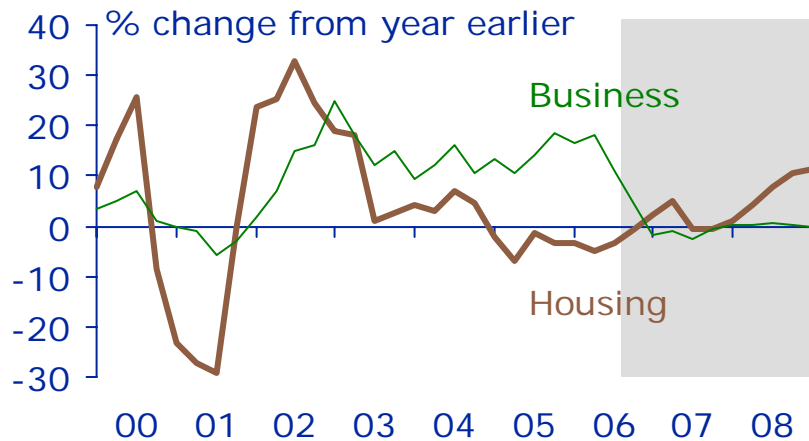
Household consumption



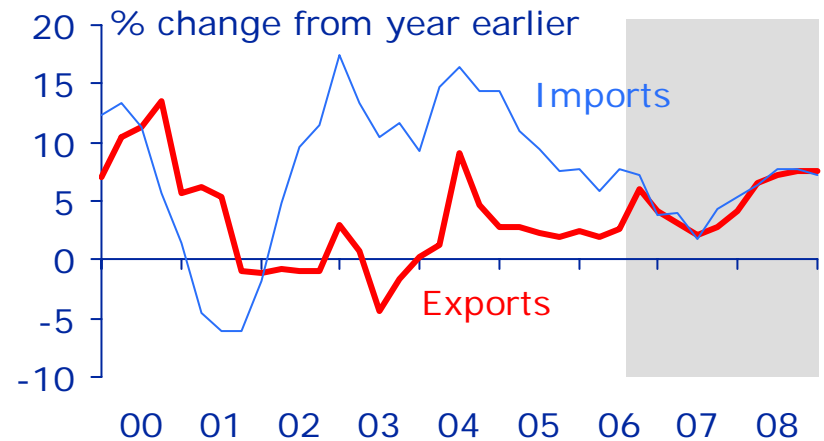
Public spending



Investment



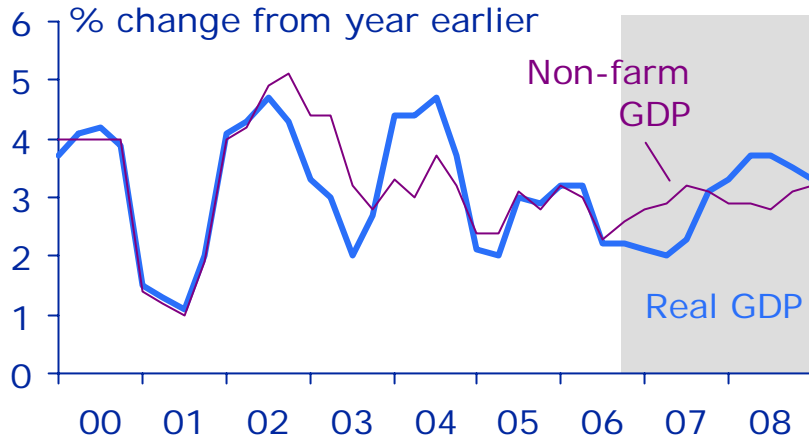
Exports and imports



Sources: ABS; Economics@ANZ.

... so the economy is likely to continue growing at close to its (reduced) potential rate

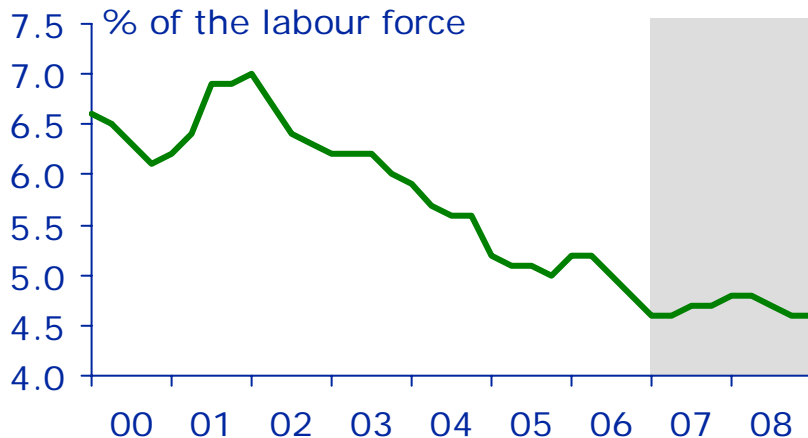
Real GDP growth



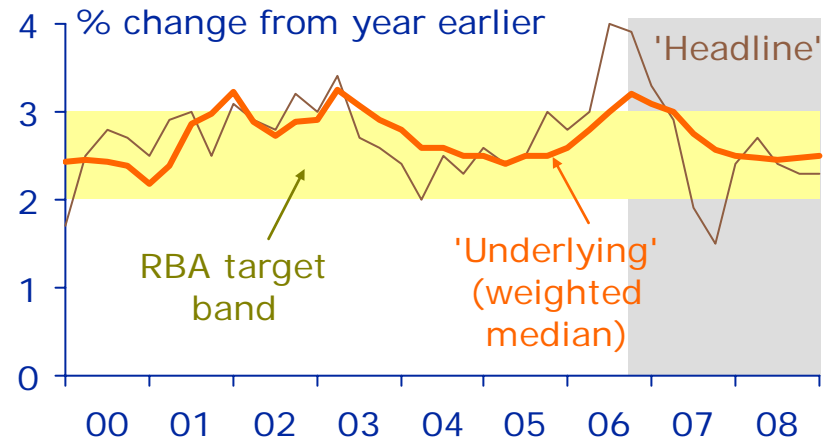
Current account balance



Unemployment



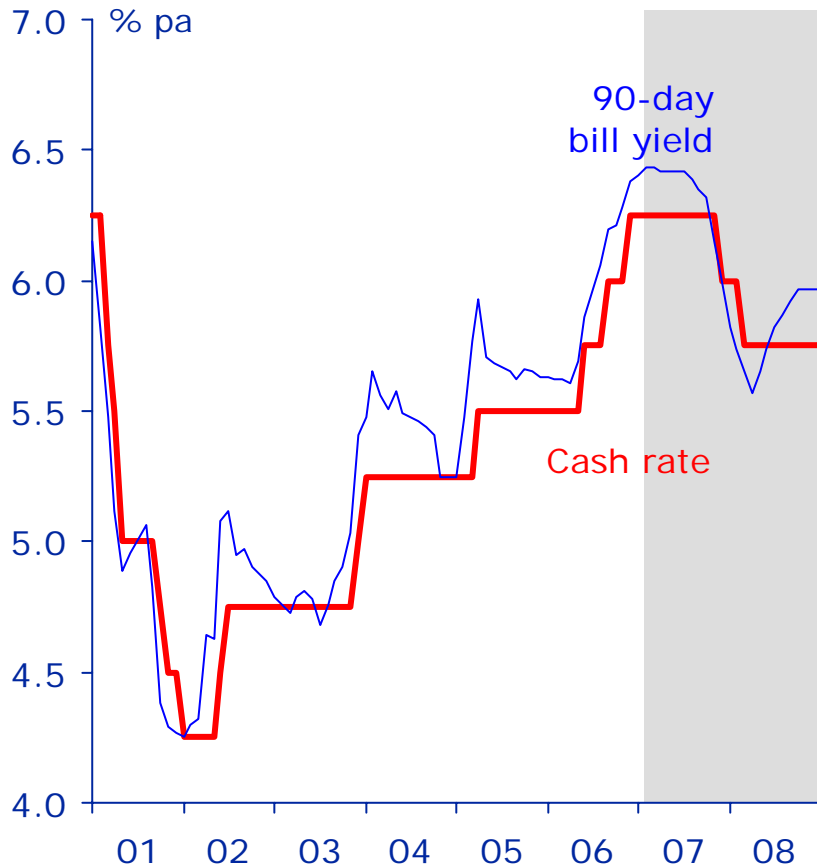
Inflation



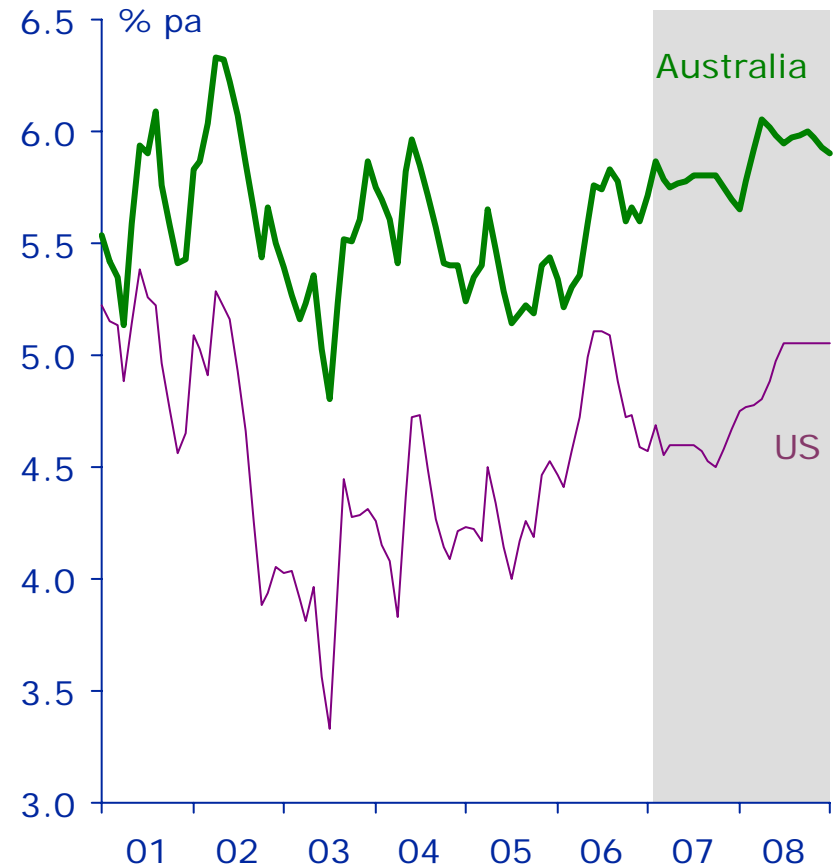
Sources: ABS; Economics@ANZ.

As a result Australian interest rates are likely to remain above 'neutral' for the next two years

Interest rates



Bond yields

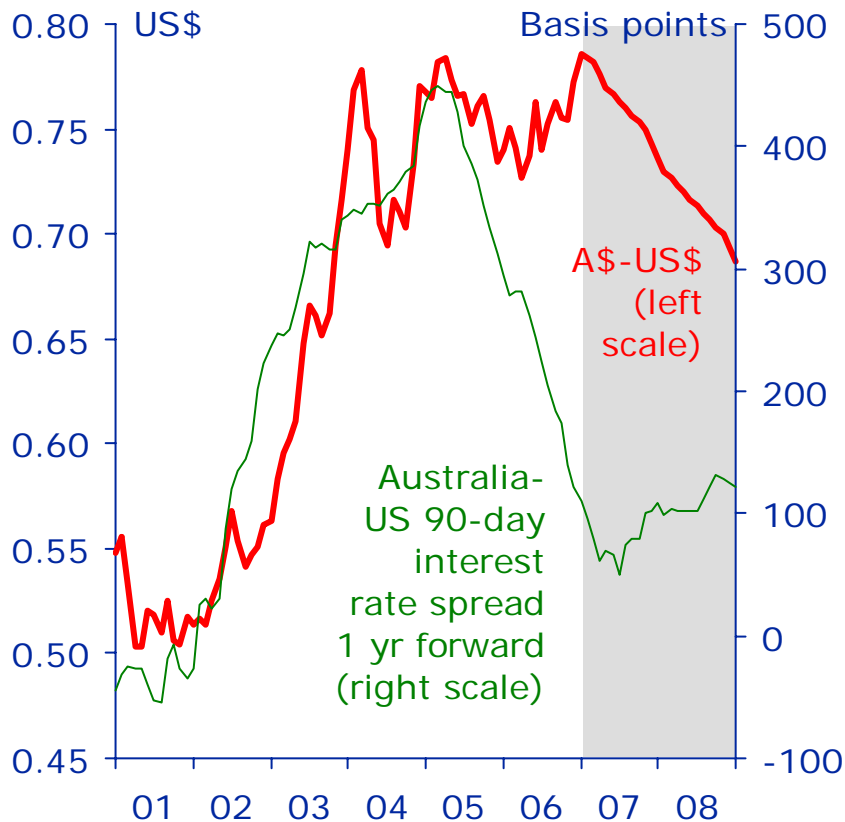


Shaded areas denote forecasts.
Sources: RBA; Datastream; Economics@ANZ.

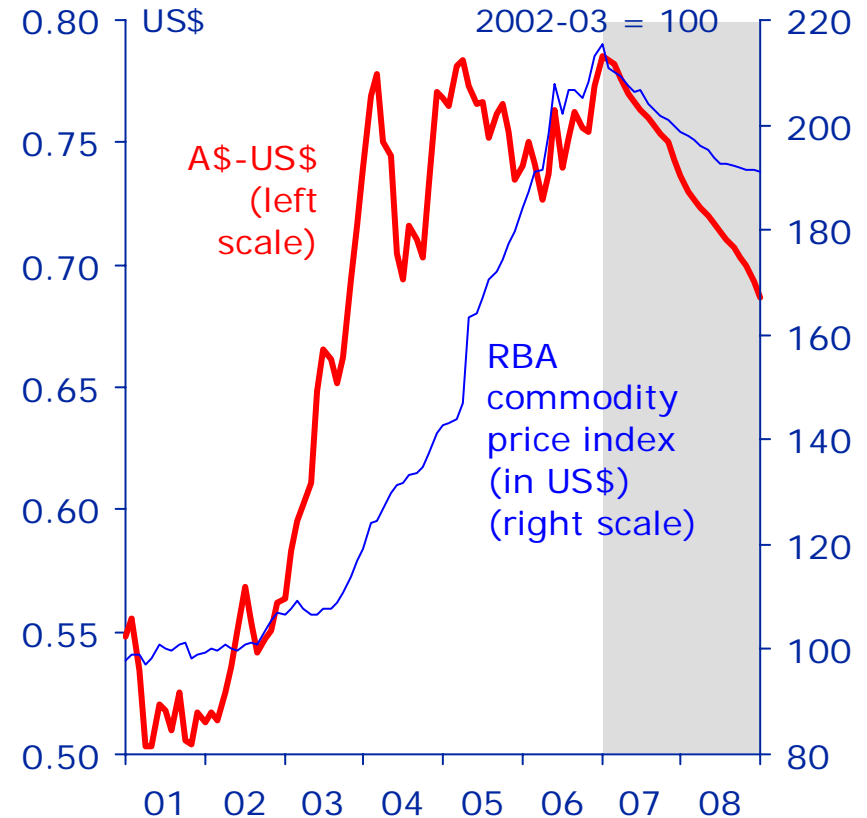
A\$ will ease in line with commodity prices though attracting some support from interest rate spreads

Economic influences on the value of the A\$

Interest rate spreads



Commodity prices



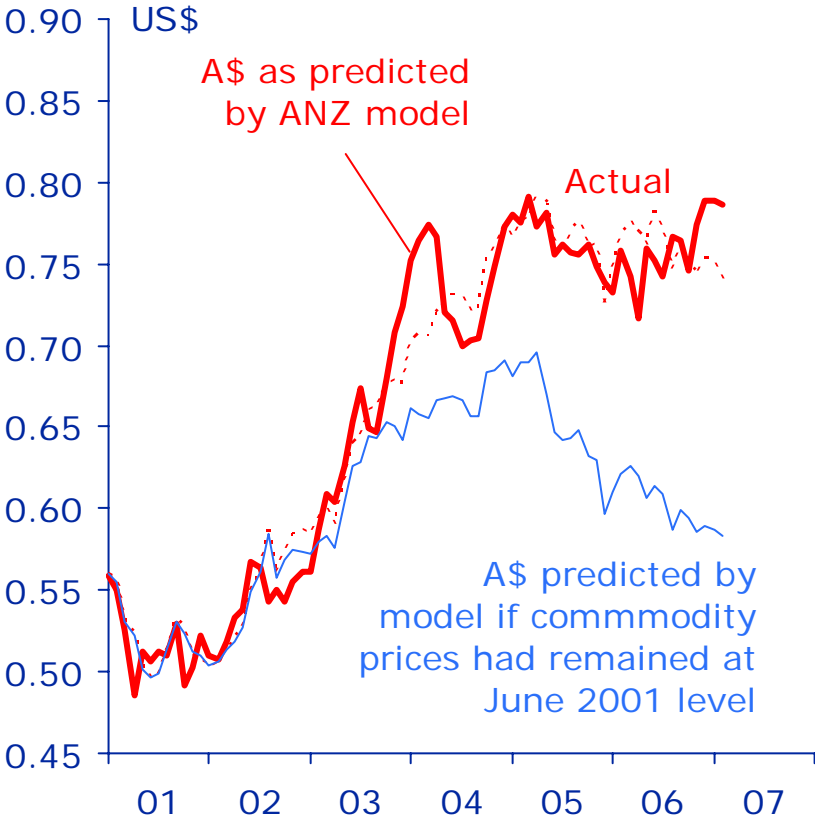
Shaded areas denote forecasts.

Sources: Datastream; RBA; Economics@ANZ.

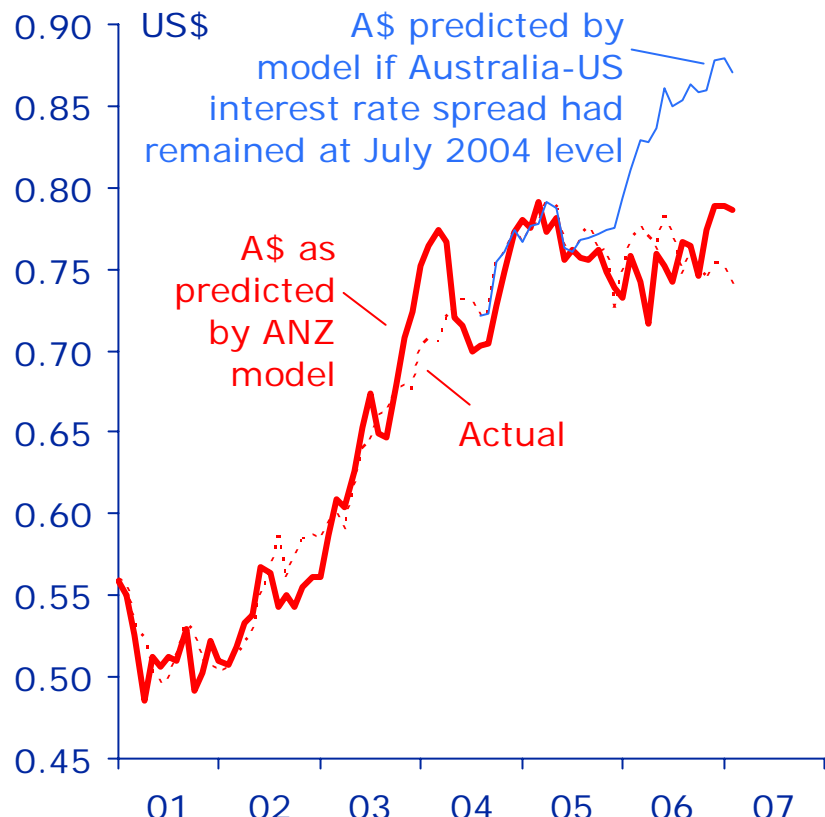
Commodity prices and interest rate differentials have been working in opposite directions on the A\$

Alternative hypothetical scenarios for the A\$

If commodity prices hadn't risen since June 2001



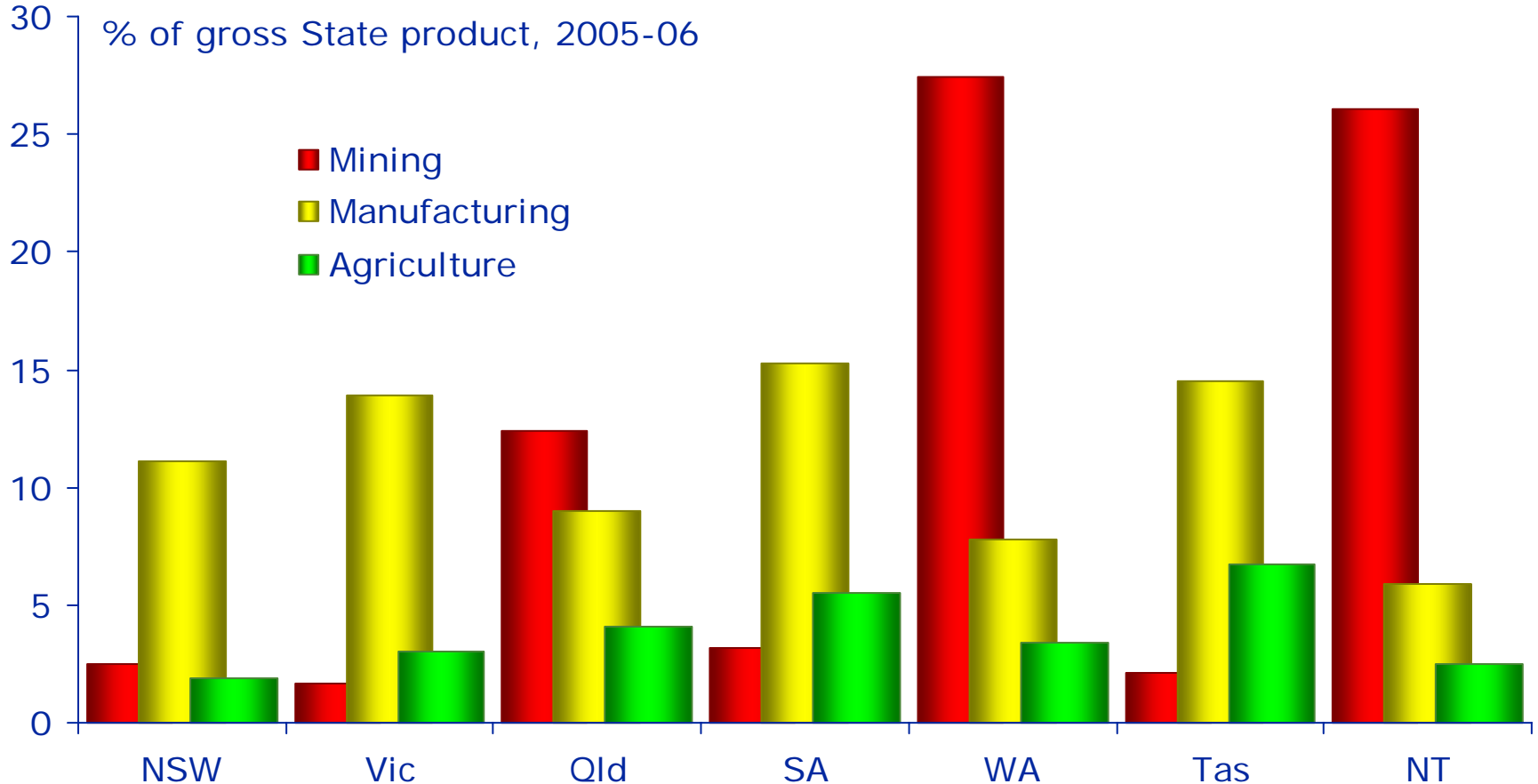
If the interest rate spread on the A\$ hadn't narrowed since July 2004



Sources: Datastream; Reserve Bank of Australia; Economics@ANZ.

It's inevitable that different States will grow at different speeds

Mining, manufacturing and agriculture as a share of State economies



Sources: ABS; Economics@ANZ.

Current differences between growth rates of different States are by no means unprecedented

Dispersion between fastest and slowest State economic growth rates

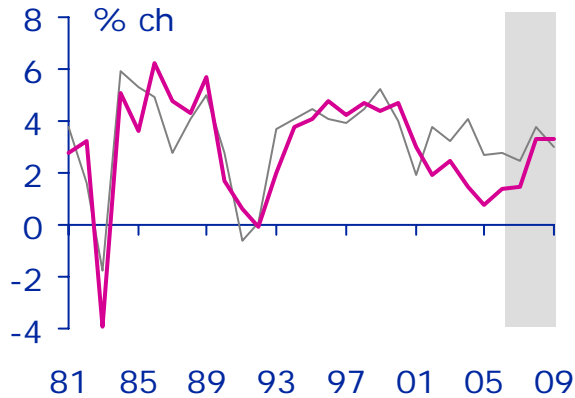


Sources: ABS State Accounts; State Budget Papers and Mid-Year Reviews 2006-07; Economics@ANZ.

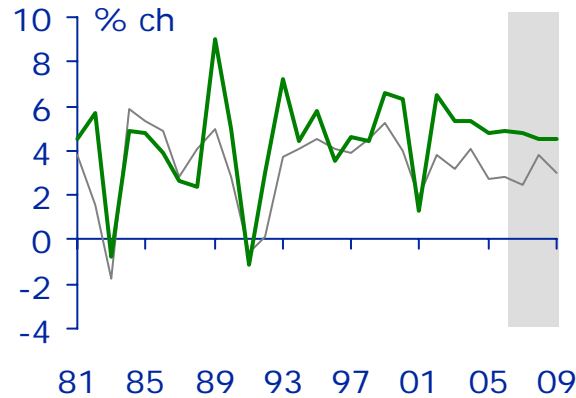
Different growth rates across the States aren't unusual: what is unusual is NSW coming last

State and national real gross product growth rates

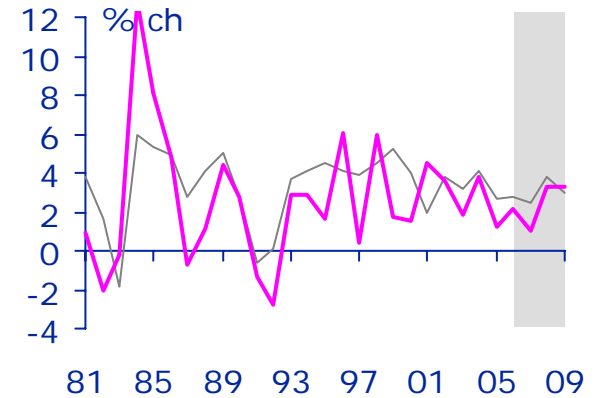
New South Wales



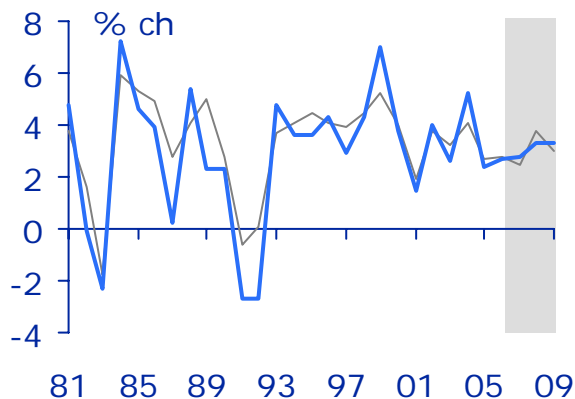
Queensland



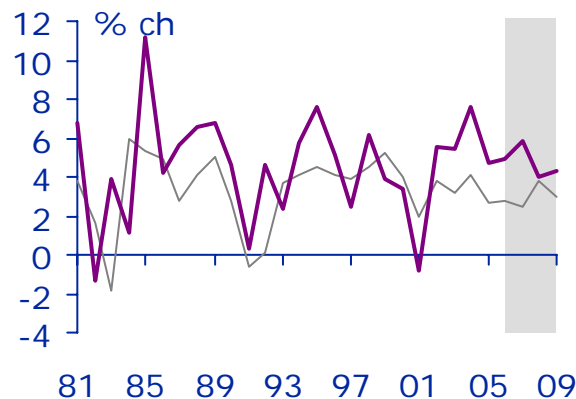
South Australia



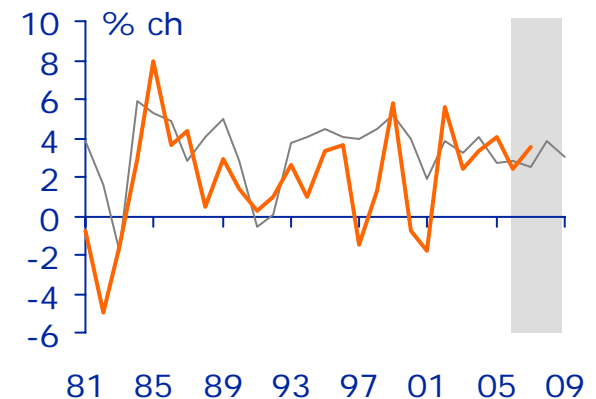
Victoria



Western Australia



Tasmania



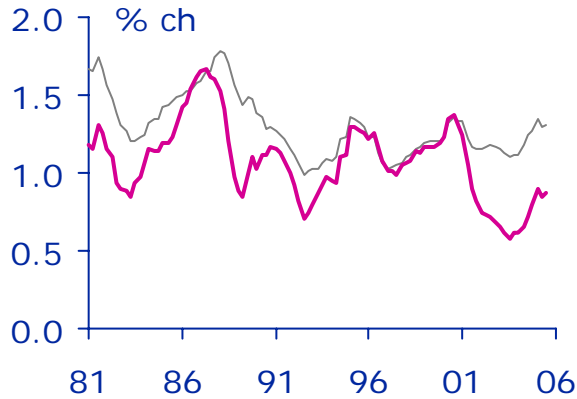
Note: Forecasts are from State Mid-Year Budget Reviews.

Sources: ABS; State Treasuries; Economics@ ANZ.

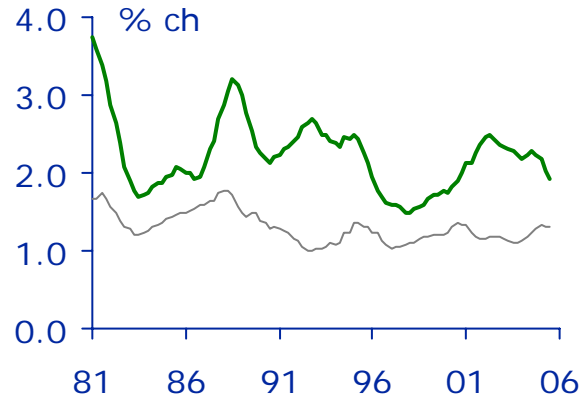
Below-average population growth is detracting from economic growth in NSW and SA

State and national population growth rates

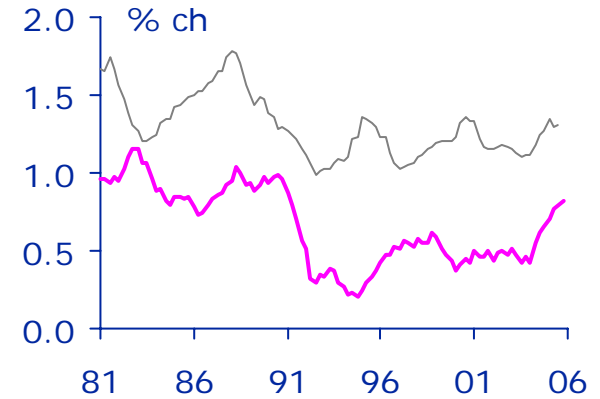
New South Wales



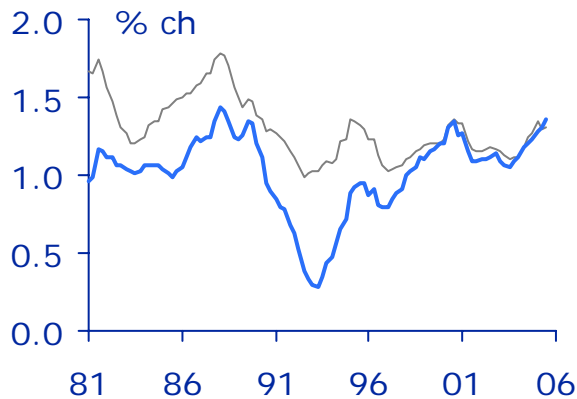
Queensland



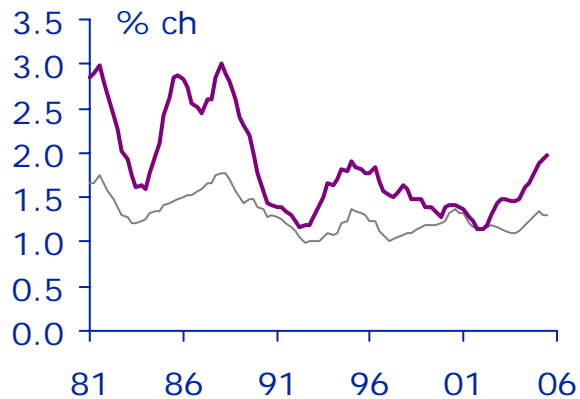
South Australia



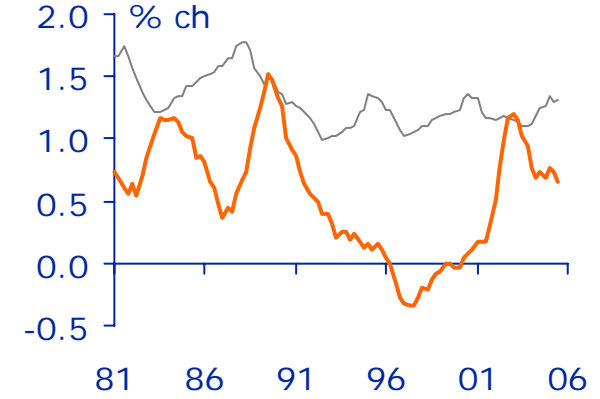
Victoria



Western Australia



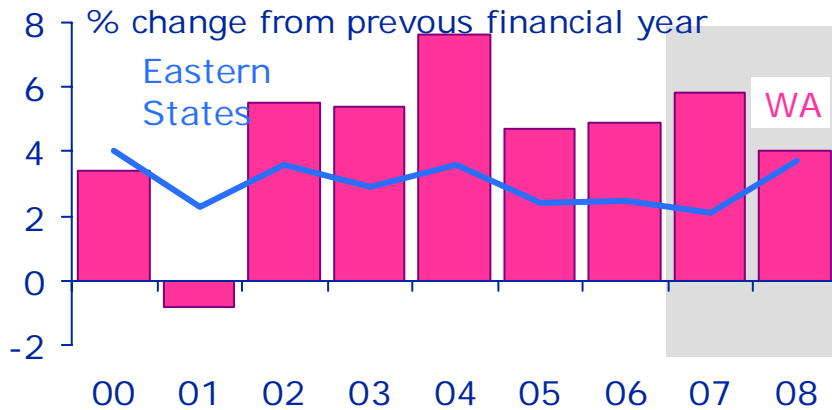
Tasmania



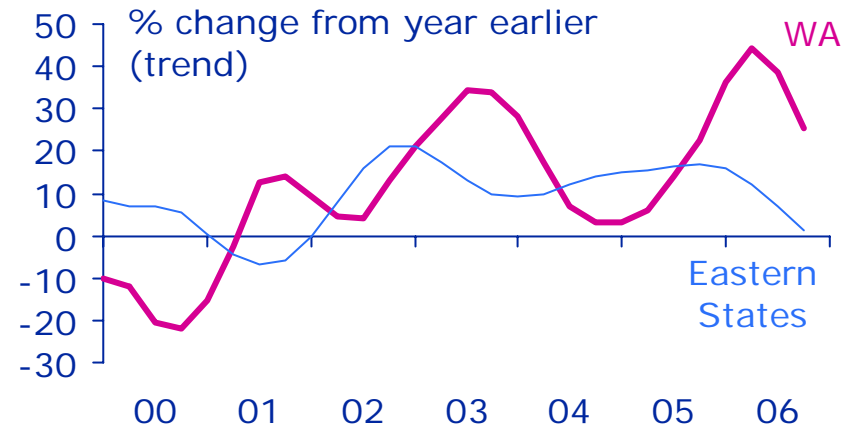
Sources: ABS; Economics@ ANZ.

Western Australia's economy is growing as fast as China's – easily outperforming the Eastern States

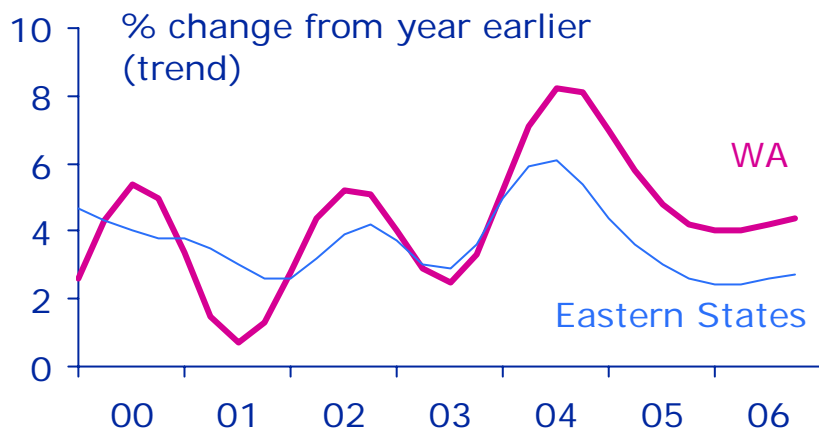
Real gross State product



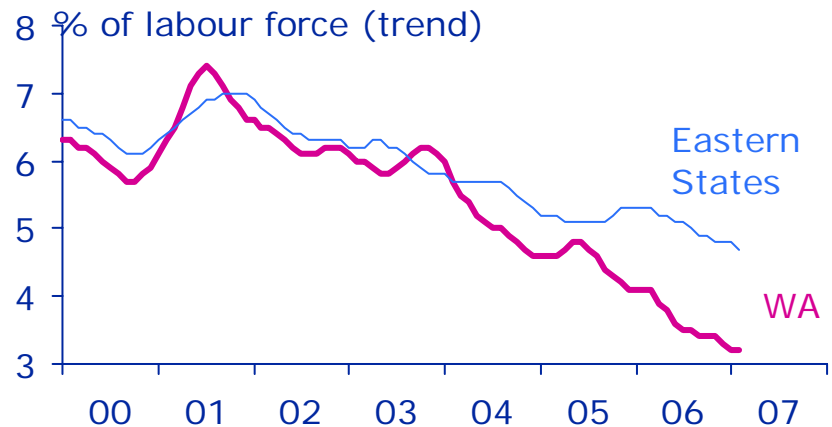
Business investment



Household spending



Unemployment



Sources: ABS; Economics@ANZ.

Summary

- The world economy is experiencing its longest run of above-trend growth in more than 30 years
 - driven largely by sustained growth in the developing economies
 - risks to this outlook are more geo-political than strictly economic
- Strong world growth, biased towards commodity-intensive activities, and a more globally consolidated mining industry, underpin a commodity boom that is likely to last longer than previous episodes
 - that doesn't mean commodity prices will keep rising – rather, that they will fall less and more slowly from their peaks
- The Australian economy looks exceptionally well situated ...
 - in global circumstances which have been very 'friendly' to Australia
- ... but it is now beginning to encounter a 'speed limit'
 - as it increasingly runs into capacity constraints
 - and as many of the growth drivers of earlier years fade away
- Provided government policy either accepts this speed limit (or seeks to lift it through productivity-enhancing reforms) inflation is likely to remain in the upper half of the 2-3% target band
 - so after three increases last year interest rates may have peaked
 - but it's unlikely that rates will fall until late this year
- There's nothing unusual about the 'two-speed' pattern of growth
 - WA should out-perform the eastern States for at least another three years

Summary of the economic outlook for Australia

	2005	2006	2007	2008
Real GDP growth (%)	2.8	2½	2¾	3½
Employment growth (%)	3.2	2.0	2¼	1¾
Unemployment rate (%) ^(a)	5.2	4.6	4¾	4½
Housing starts ('000s)	152	151	145	163
Motor vehicle sales ('000s)	992	1,000	1,010	1,030
CPI inflation (%) ^(b)	2.7	3½	2¼	2½
Wage cost (WCI) inflation (%) ^(b)	4.1	4	4¼	4
Current account deficit (\$bn)	54.1	51	54	48
Current account deficit (% GDP)	5.8	5	5	4¼
Net foreign debt (% of GDP) ^(a)	49	52	53	55

(a) December (b) Year to December quarter; all other forecasts are year-average

Australian currency and interest rate forecasts

	Dec 2006 *	Jun 2007	Dec 2007	Dec 2008
RBA cash rate	6.25	6.25	6.00	5.75
90-day bill rate	6.45	6.40	5.80	6.00
10-year bond yield	5.88	5.80	5.65	5.90
Standard variable mortgage rate	8.05	8.05	7.80	7.55
A\$ - US\$	0.79	0.76	0.74	0.69
A\$ - ¥	91.5	88.9	81.2	75.1
A\$ - €	0.60	0.59	0.57	0.56
A\$ - £	0.40	0.40	0.39	0.38
A\$ - NZ\$	1.12	1.12	1.19	1.29
Gold (US\$/ounce)	629	650	670	680

* actual