

Open partnerships
Open possibilities

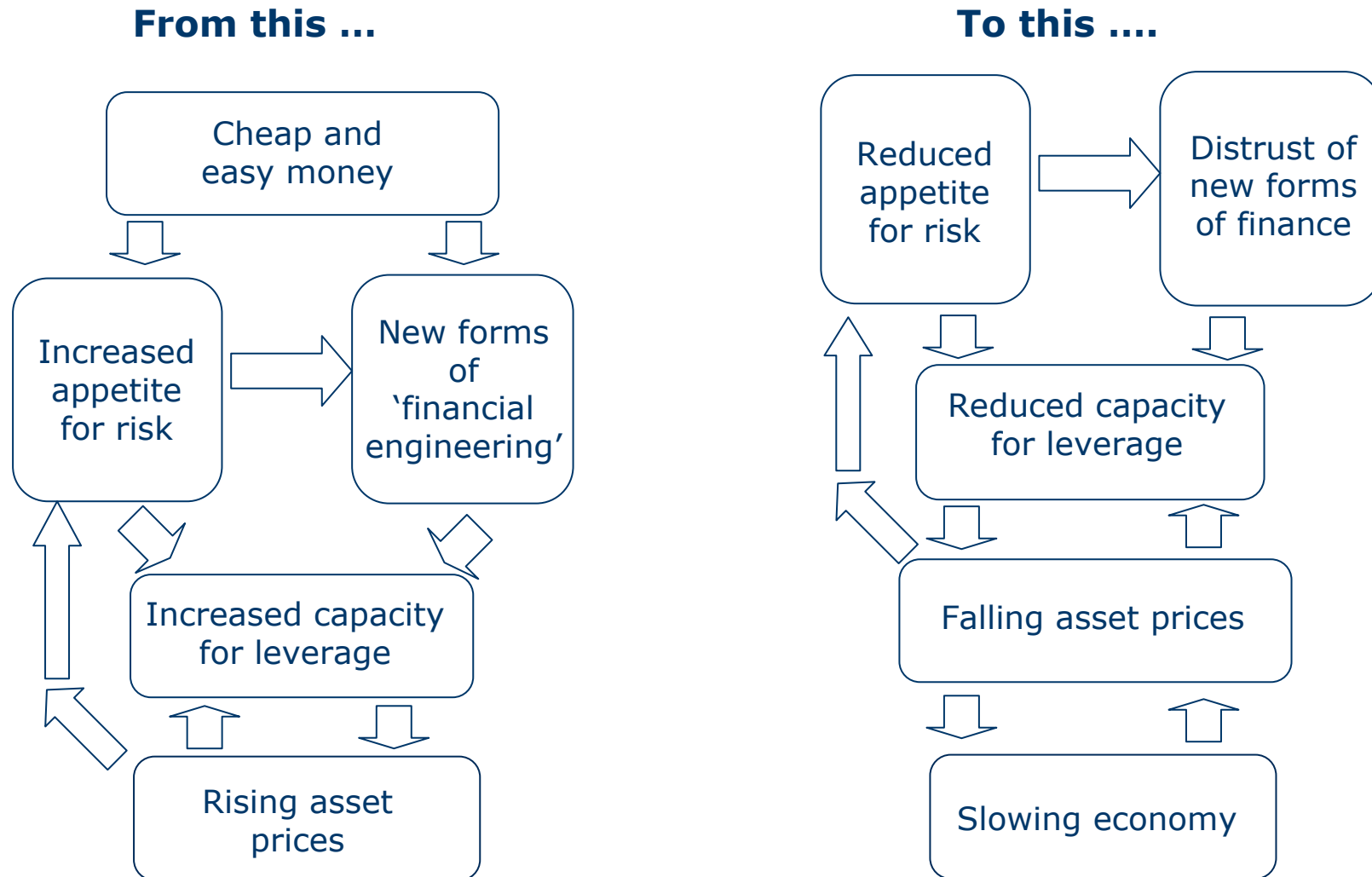
Turbulent times for the global and Australian economies

Presentation to ASA/ASX Investor Hour

RMIT University, Melbourne
6th August 2008

Saul Eslake
Chief Economist

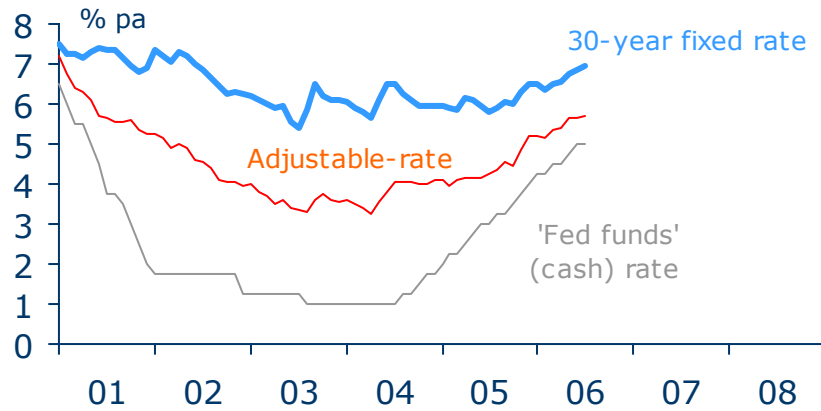
The current global financial crisis stems from the bursting of a 'credit market bubble'



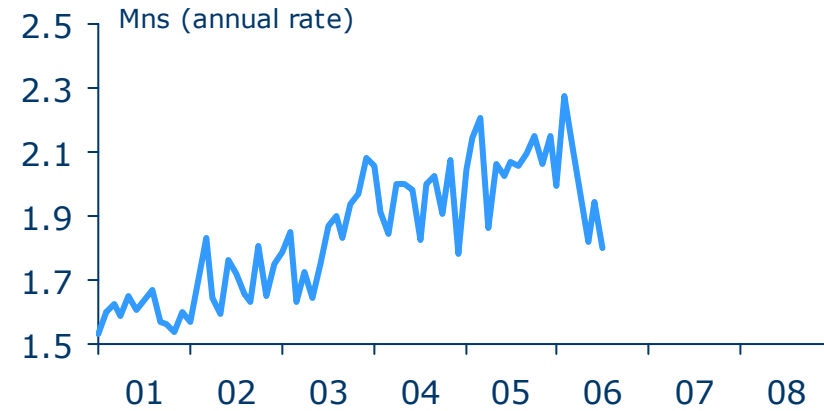
For a time, low interest rates and the explosion in 'sub-prime' lending created boom conditions in the US housing market

US housing market indicators up to mid-2006

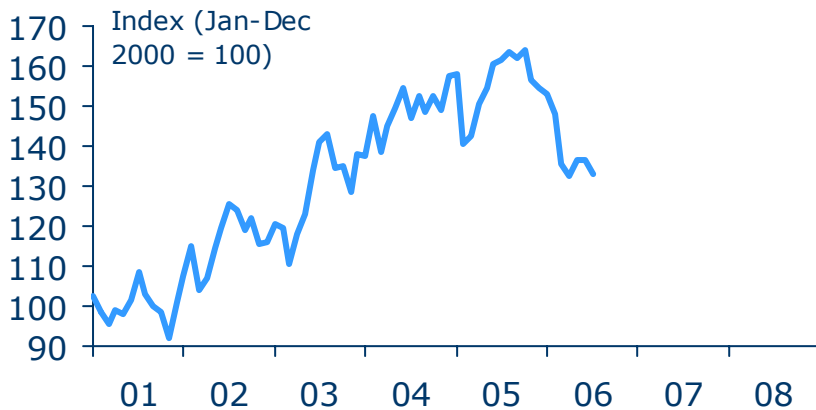
Mortgage interest rates



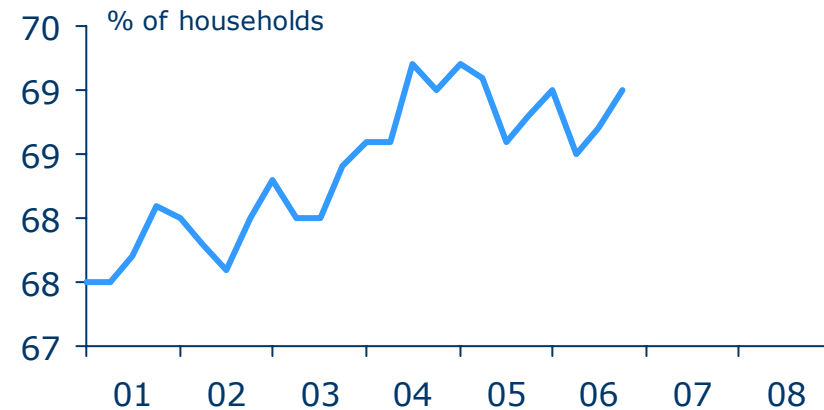
Housing starts



Mortgage applications



Home ownership rate



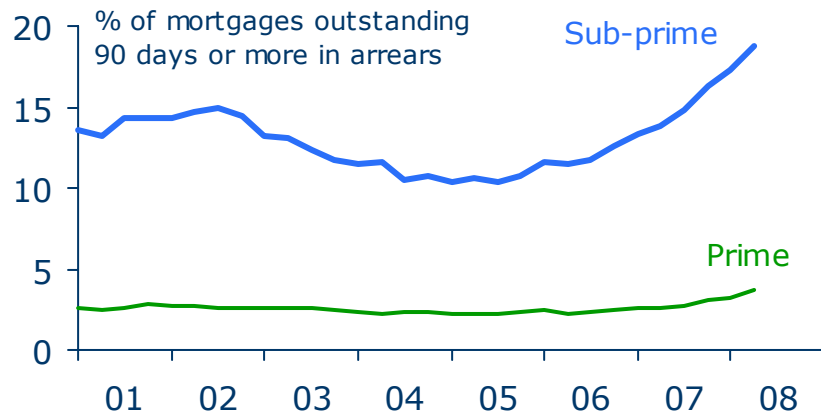
Sources: Mortgage Bankers' Association of America; US Commerce Department.



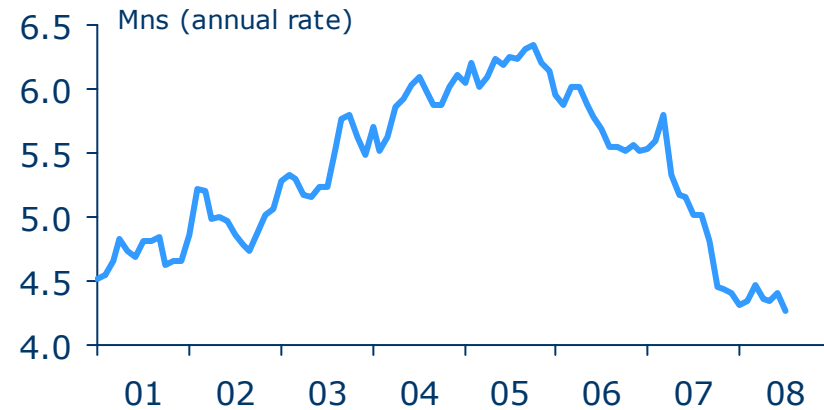
Once US interest rates began rising, however, borrowers began defaulting and house prices began falling ...

US housing market indicators

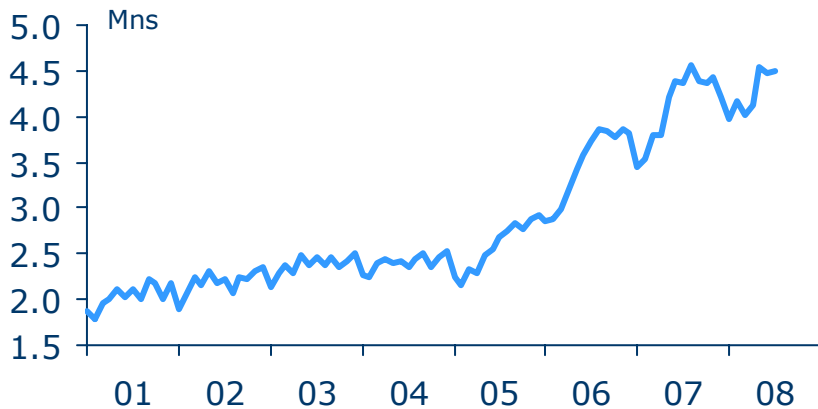
Mortgage delinquency rates



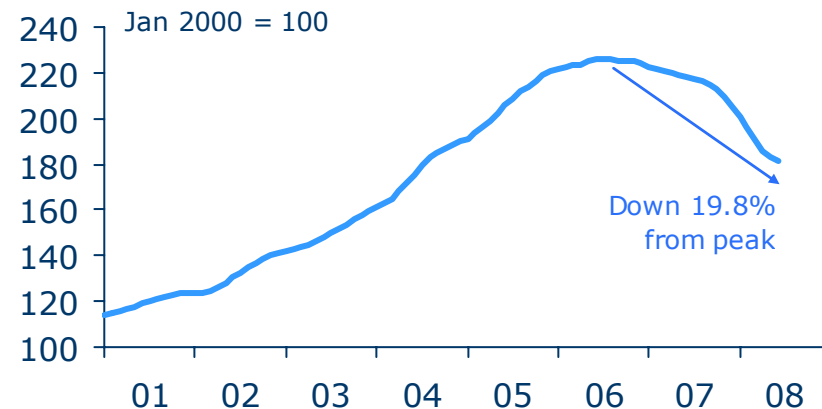
Existing home sales



Existing houses for sale



Existing home prices



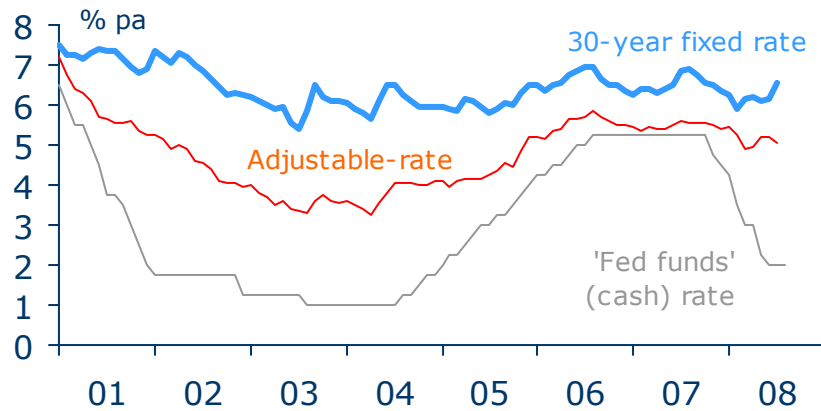
Sources: Mortgage Bankers' Association; US National Association of Realtors; Commerce Department; S&P (the Case-Shiller index).



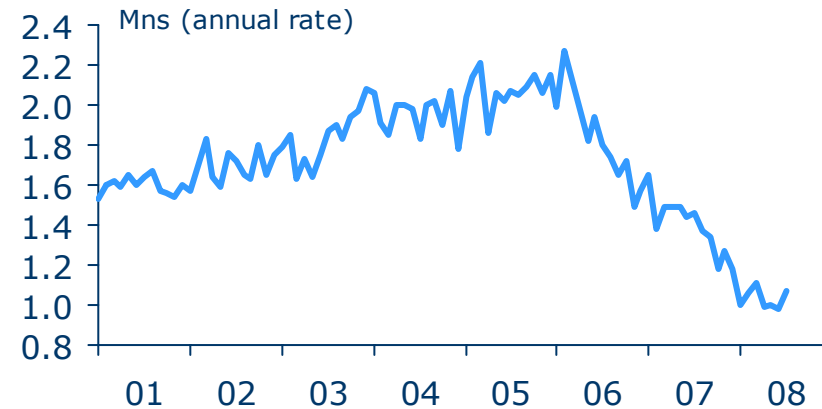
... and the housing boom turned into a bust, which is continuing despite sharp cuts in the official cash rate

US housing market indicators

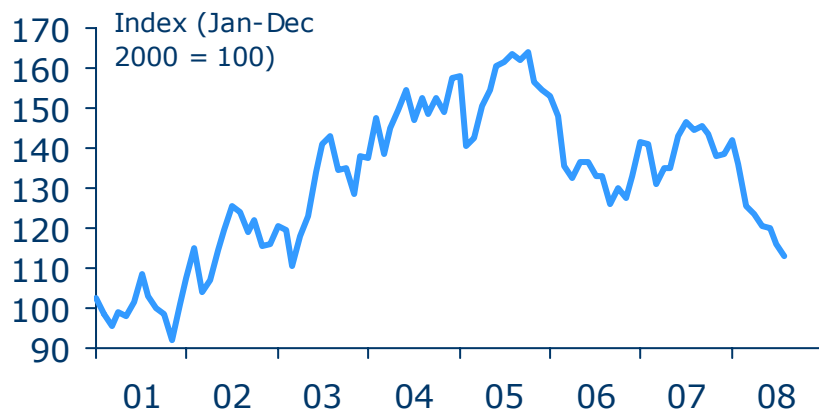
Mortgage interest rates



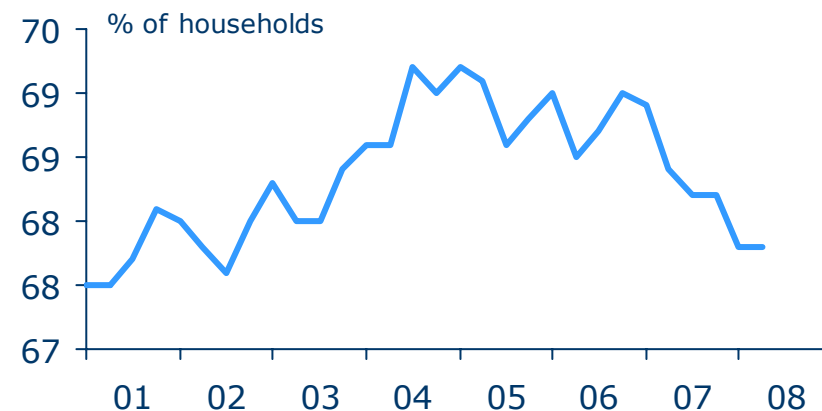
Housing starts



Mortgage applications



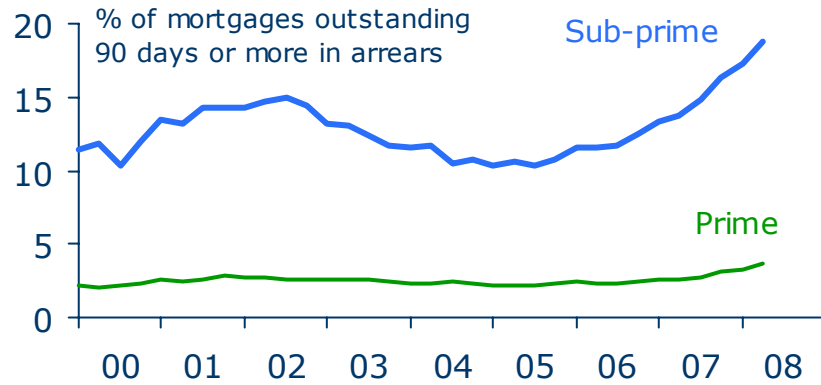
Home ownership rate



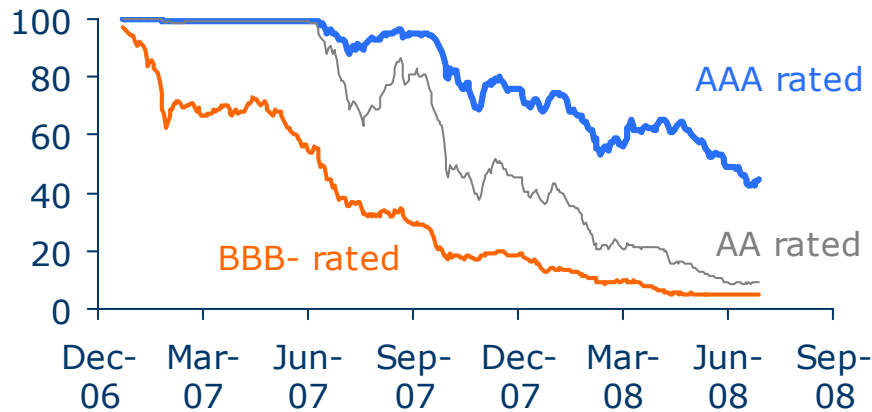
Sources: Mortgage Bankers' Association of America; US Commerce Department.

The US mortgage market meltdown has prompted a tidal wave of losses and write-downs by banks around the world

US mortgage delinquencies



ABX index of prices of US mortgage-backed securities



Losses announced by major banks since mid-2007

Bank	Total (US\$ bn)
Citigroup	54.6
Merrill Lynch	54.6
UBS	38.2
Wachovia	22.0
Bank of America	21.2
HSBC	19.5
IKB Deutsche	16.3
Royal Bank of Scotland	15.6
Washington Mutual	14.8
Morgan Stanley	14.4
JP Morgan Chase	12.8
Wells Fargo	10.0
Credit Suisse	9.6
Credit Agricole	8.3
Lehman Brothers	8.3
Deutsche Bank	7.7
HBoS	7.2
Bayerische Landesbank	6.8
Total (incl. others not shown above)	473.7

Sources: US Mortgage Bankers' Association; Bloomberg; ANZ Economics & Markets Research.



The IMF has estimated that total losses could eventually reach almost US\$1 trn, nearly half of which would be by banks

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Potential ultimate losses on unsecuritized loans

Type of loan	US\$bn	
	Out-standing	Estimated losses
Sub-prime	300	45
'Alt-A'	600	30
Prime	3 800	40
Commercial real estate	2 400	30
Consumer loans	1 400	20
Corporate loans	3 700	50
Leveraged loans	170	10
Total	12 370	225
of which, banks		100-130

Potential ultimate mark-to-market losses on securities

Type of security	US\$bn	
	Out-standing	Estimated losses
ABS	1 100	210
CDOs	400	240
Prime MBS	3 800	0
Commercial MBS	940	210
Consumer ABS	650	0
High-grade corporate	3 000	0
High-yield corporate	600	30
CLOs	350	30
Total	10 840	720
of which, banks		340-380

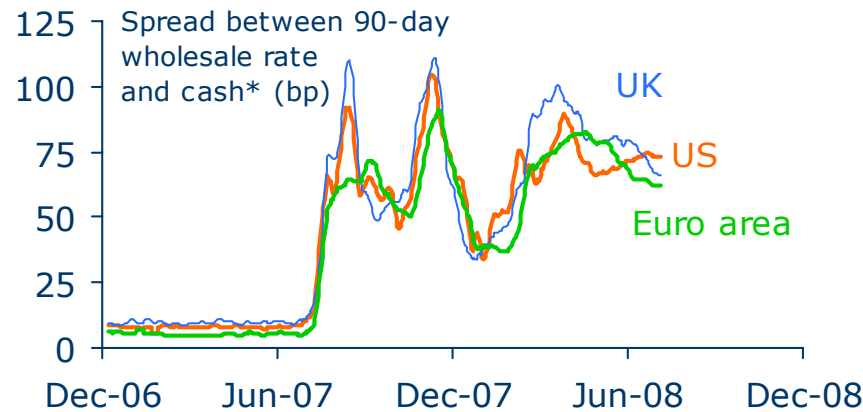
Notes: 'Alt-A' means 'low-doc' or 'no-doc' mortgage loans. ABS = asset-backed securities; CDOs = collateralized debt Obligations; MBS = mortgage-backed securities; CLOs = collateralized loan obligations.

Source: IMF Global Financial Stability Report April 2008, p. 12; affirmed in GFSR Market Update 28 July 2008.

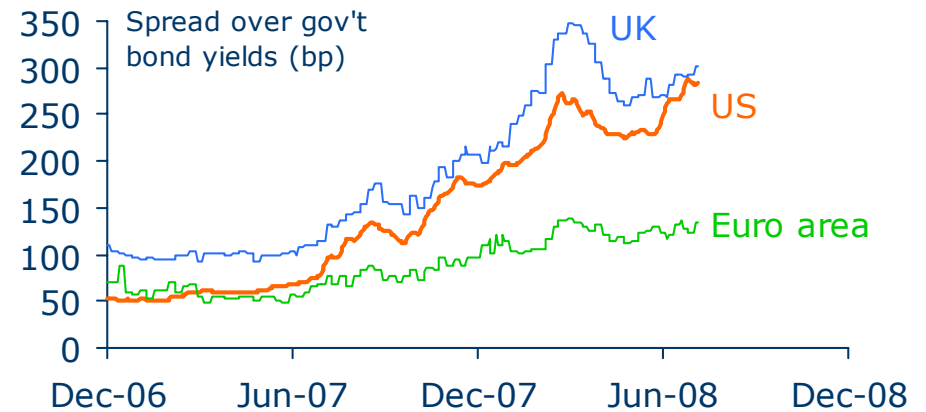


Financial market stress has continued and affected the money, swap, bond and share markets 8

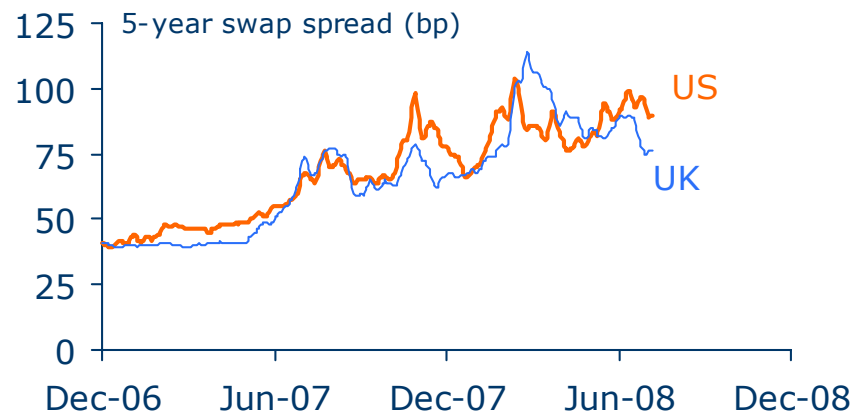
Banks' short-term funding costs



Corporate bond yield spreads



Banks' long-term funding costs



Share prices

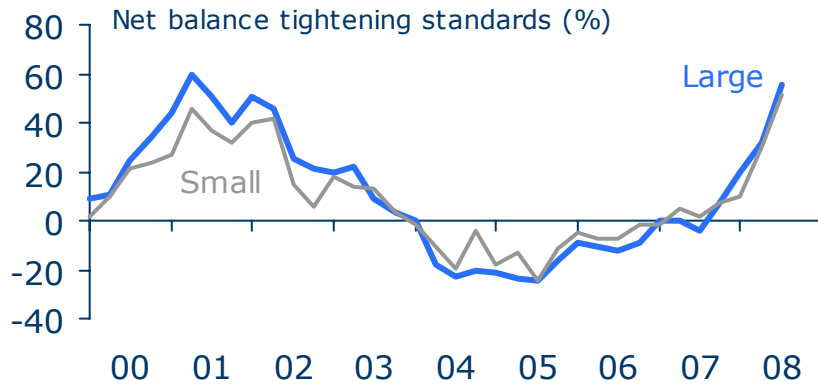


Note: all data shown as 5-day moving averages. Sources: Bloomberg; Datastream.

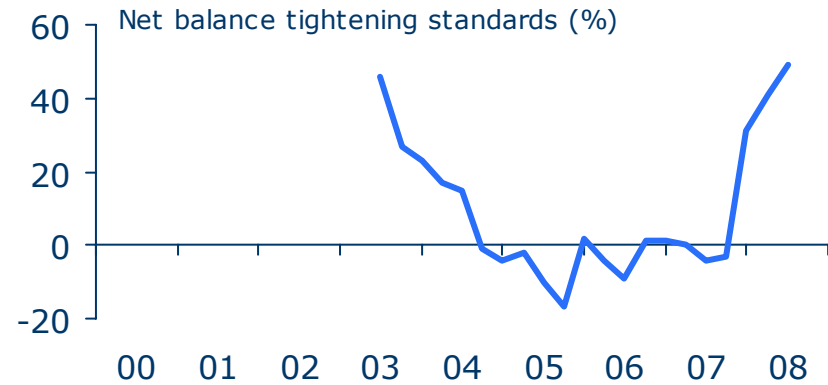


Banks in the US and the euro area are tightening credit standards

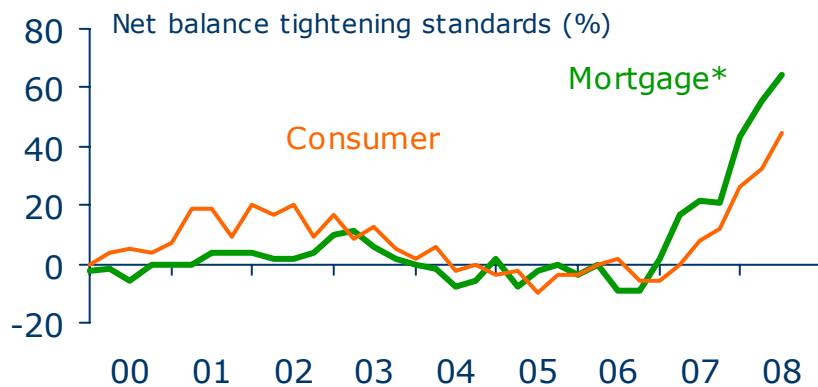
US banks Commercial & industrial loans



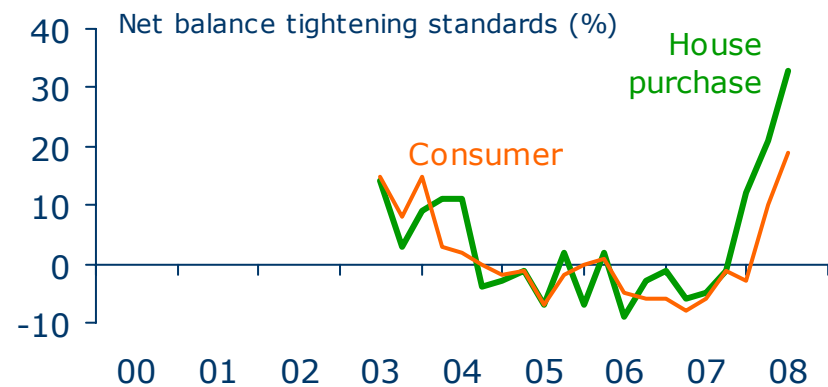
Euro area banks Loans to enterprises



US banks Mortgage and consumer loans



Euro area banks Mortgage and consumer loans



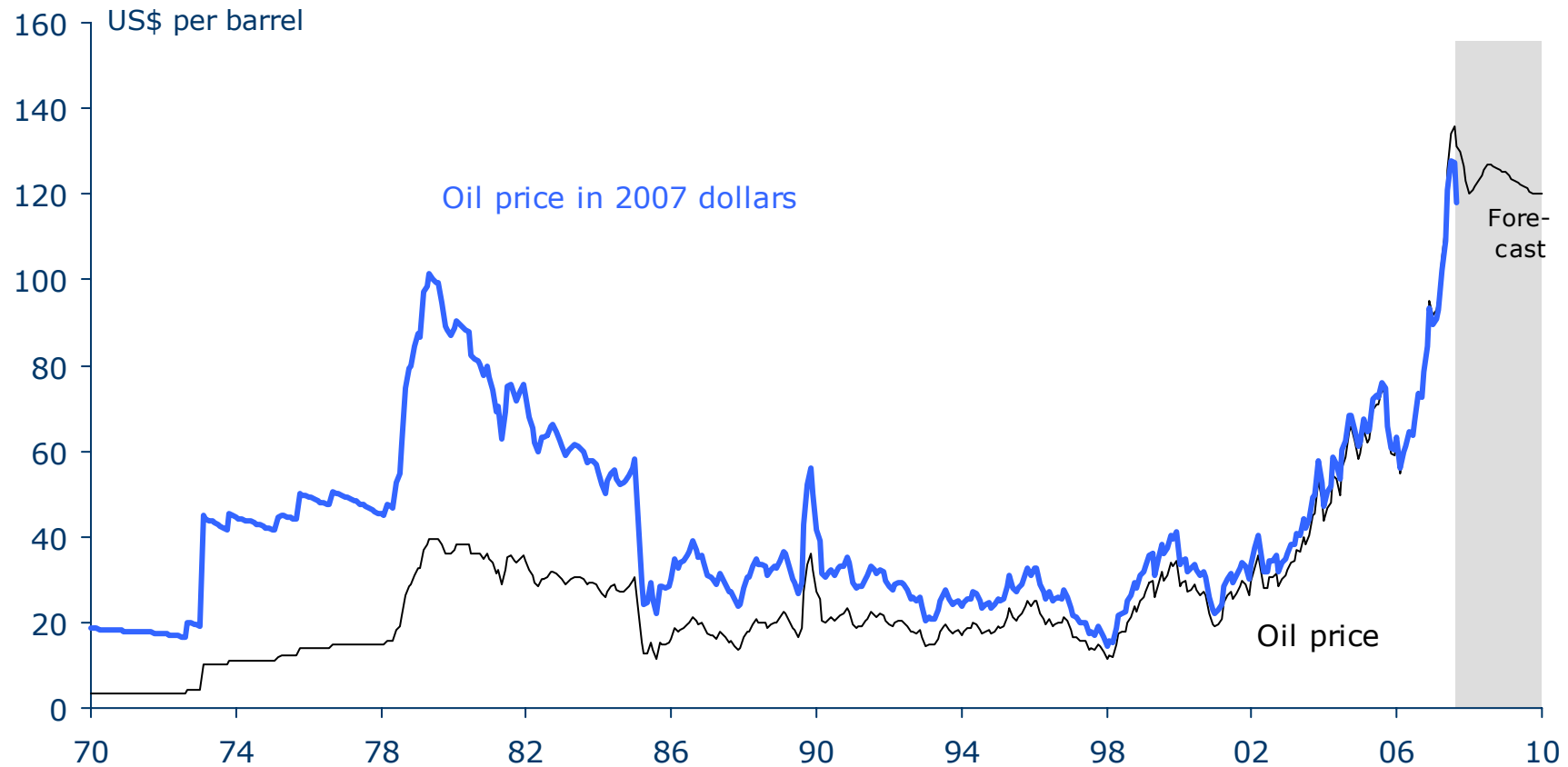
* Weighted average of prime & sub-prime after June 2007

Sources: US Federal Reserve and European Central Bank surveys of loan officers.



Oil prices appear to have peaked for now but are still well above their previous high in inflation-adjusted terms ¹⁰

Oil prices



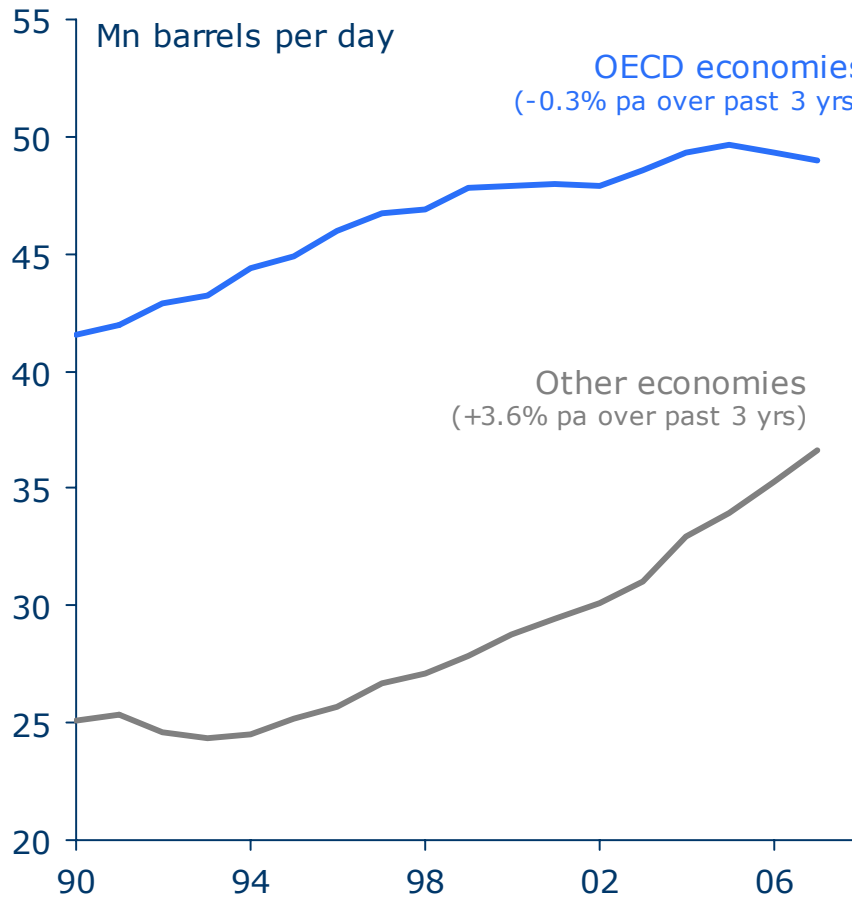
Note: Oil price is West Texas Intermediate.

Source: Thomson Financial Datastream; US Bureau of Labor Statistics; ANZ.

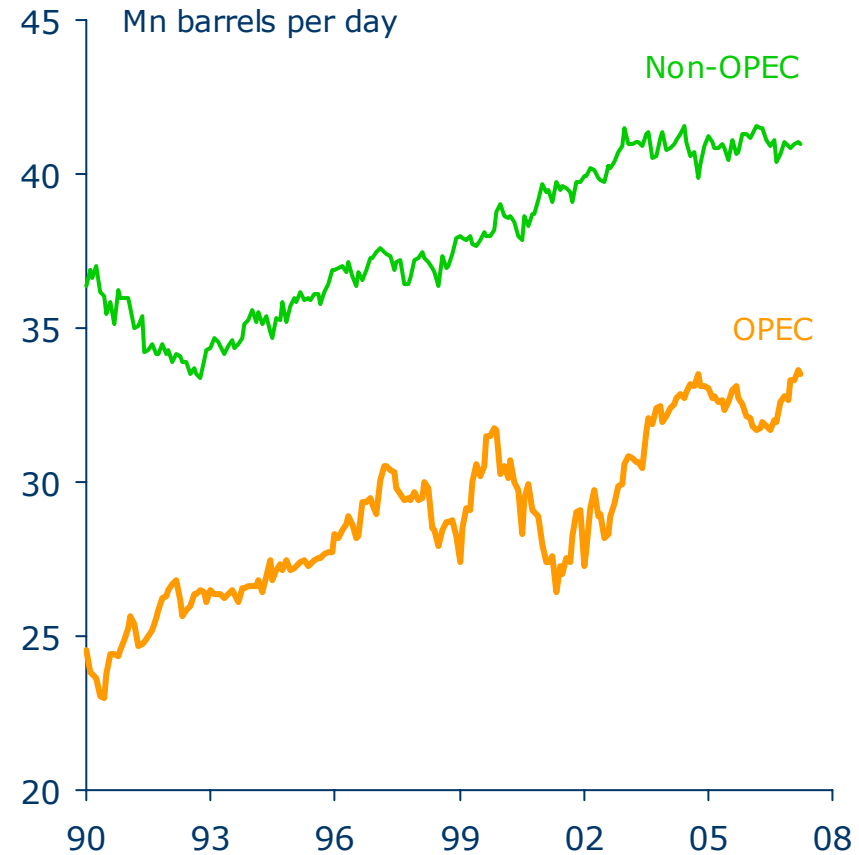


Persistently rising oil prices partly reflecting rapid growth in developing country demand, and flatlining in non-OPEC output

Oil consumption



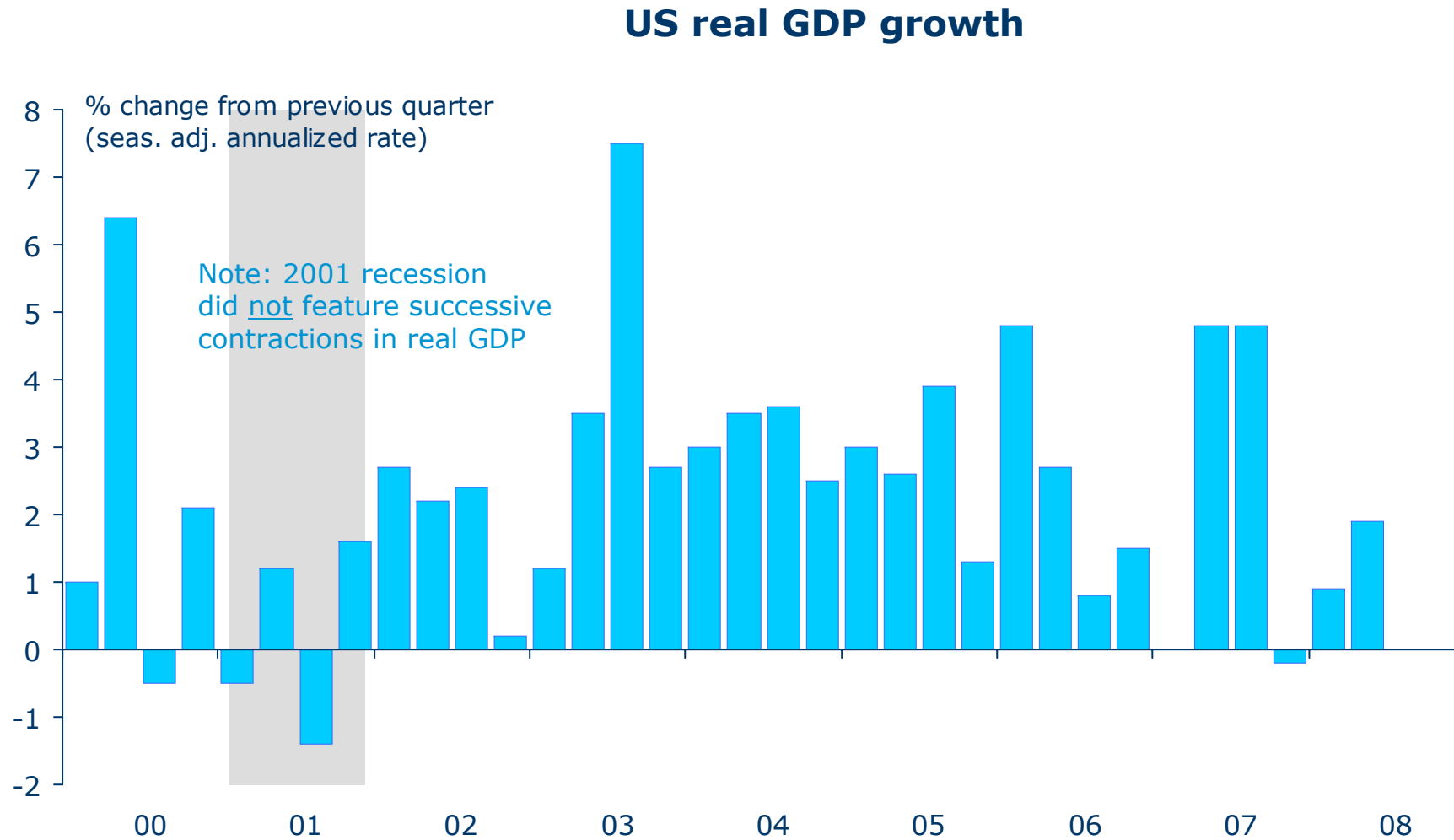
Oil production



Sources: US Department of Energy; ANZ.



The US hasn't experienced consecutive quarters of negative GDP growth (yet) ¹²



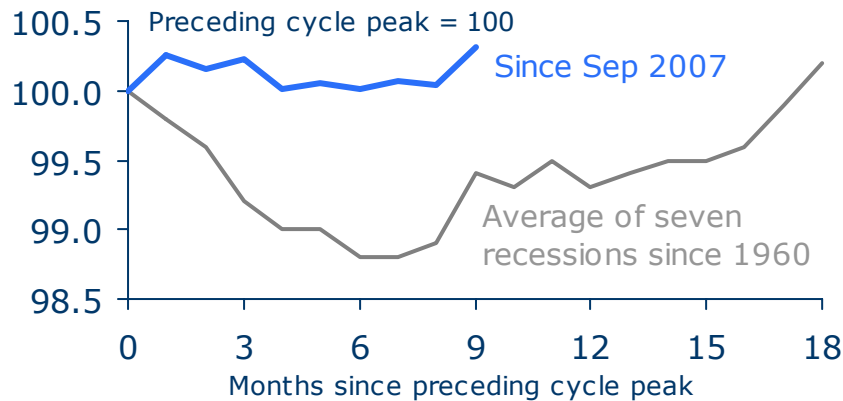
Source: US Bureau of Economic Analysis. Shaded area denotes 2001 recession as designated by National Bureau of Economic Research.



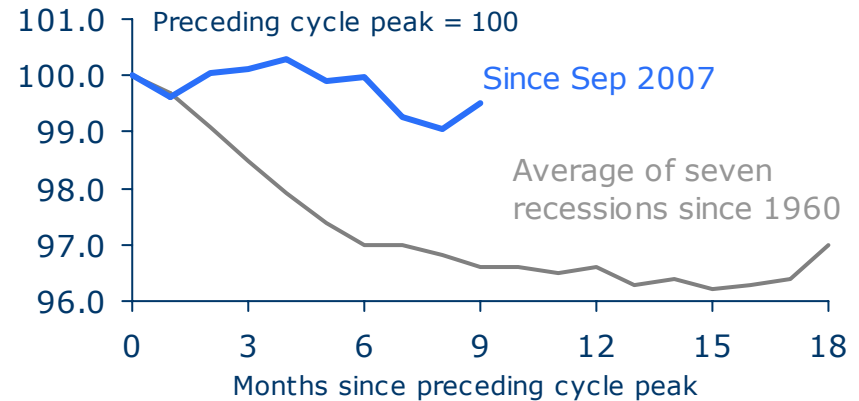
The four key indicators used to delineate recession in the US have not yet turned down sharply as in previous recessions

NBER's key recession gauges since Sep 2007 cf. previous recessions

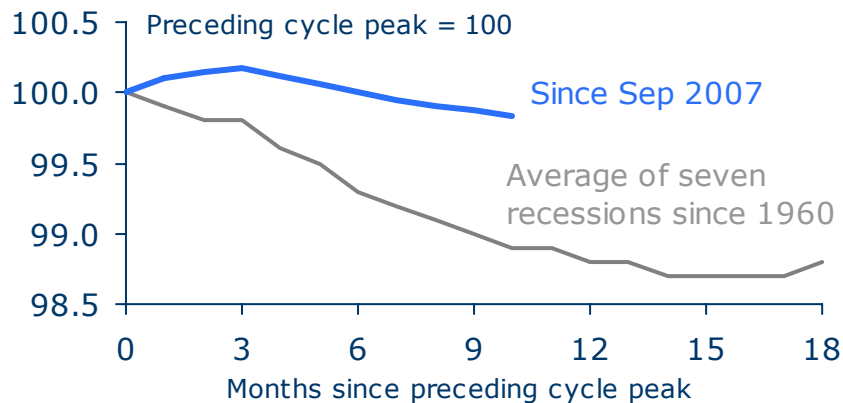
Real personal income less transfers



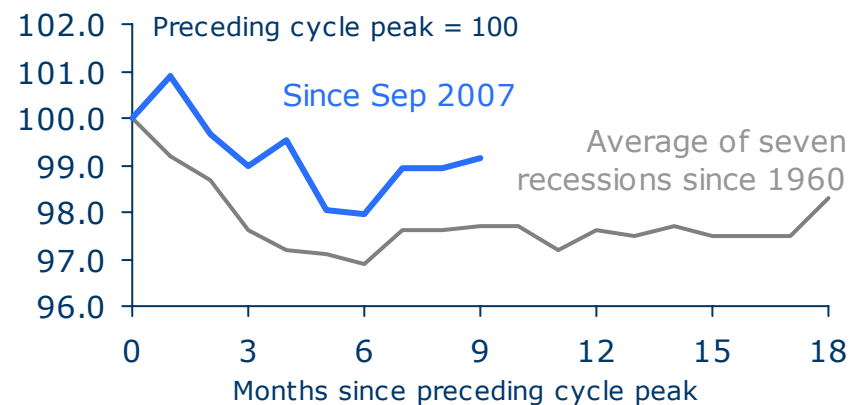
Industrial production



Employment



Real business sales



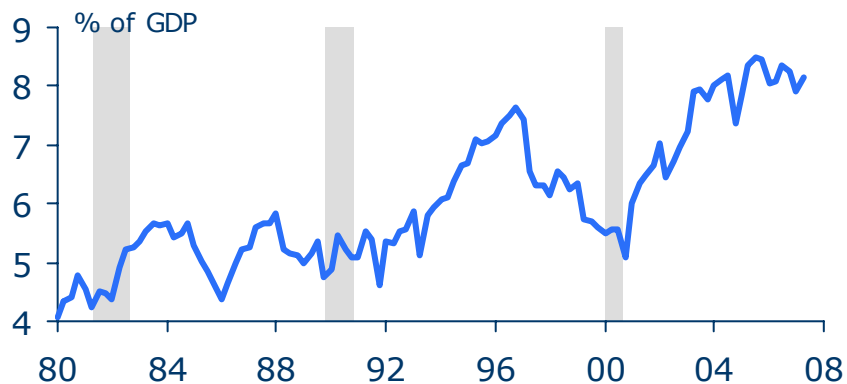
Sources: US Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Commerce Department; ANZ Economics & Markets Research.



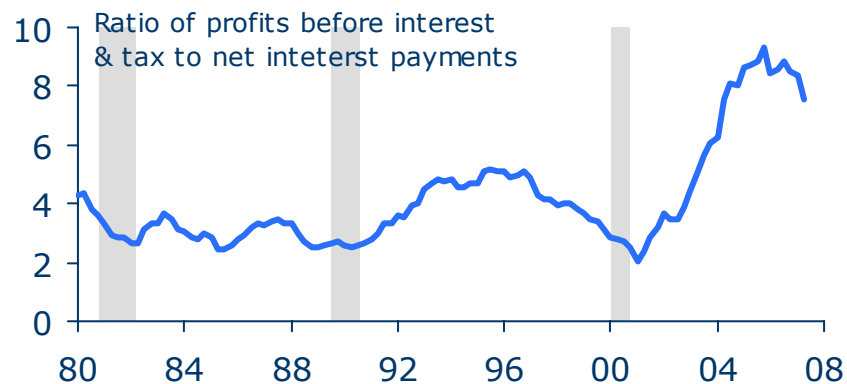
The US non-financial corporate sector isn't under the sort of pressures that typically precipitate recessions

US non-financial corporate sector

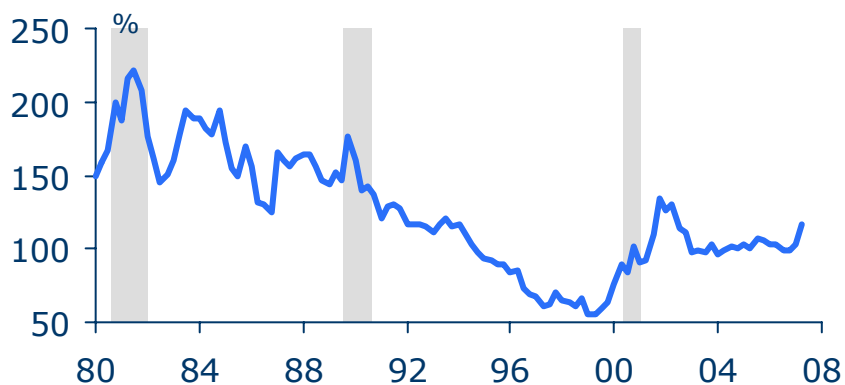
Corporate profits



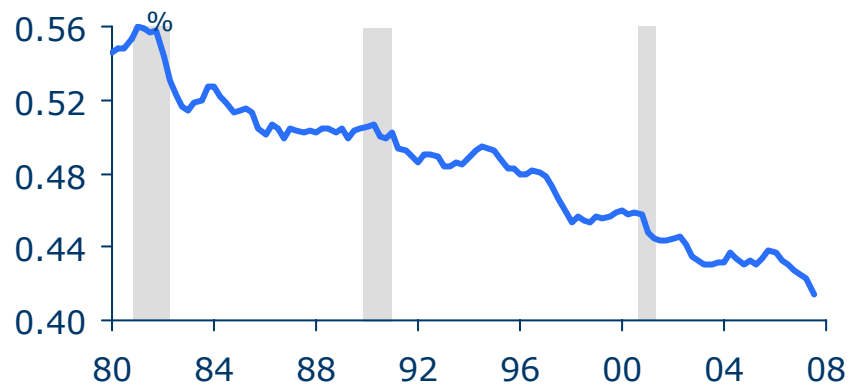
Interest cover



Corporate debt-equity ratio



Non-farm stocks-to-sales ratio



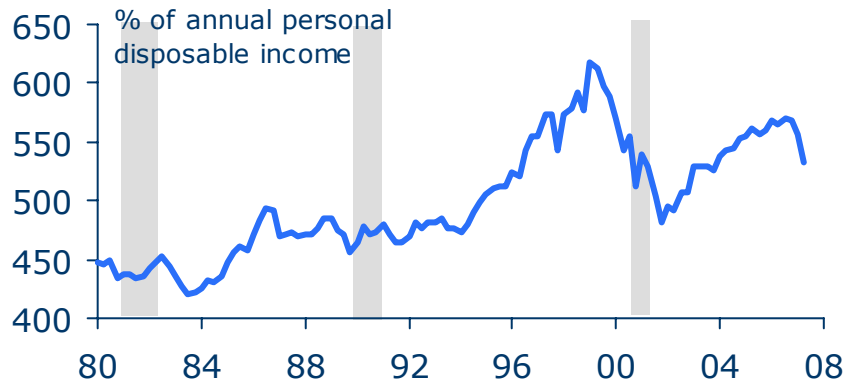
Note: Shaded areas denote recessions as defined by the National Bureau of Economic Research.
Sources: Commerce Department; Federal Reserve Board; ANZ.



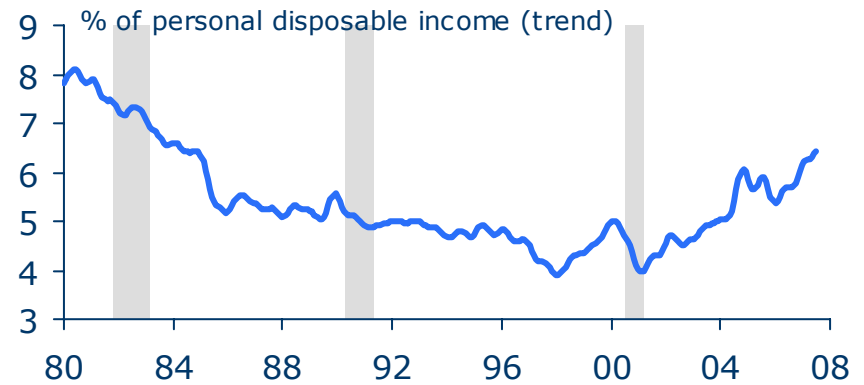
However US household finances are under considerably greater ¹⁵ financial pressure than ever before

US household sector finances

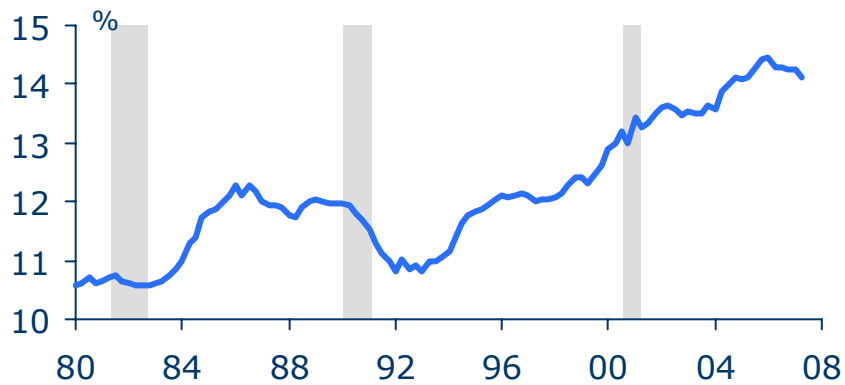
Household net worth



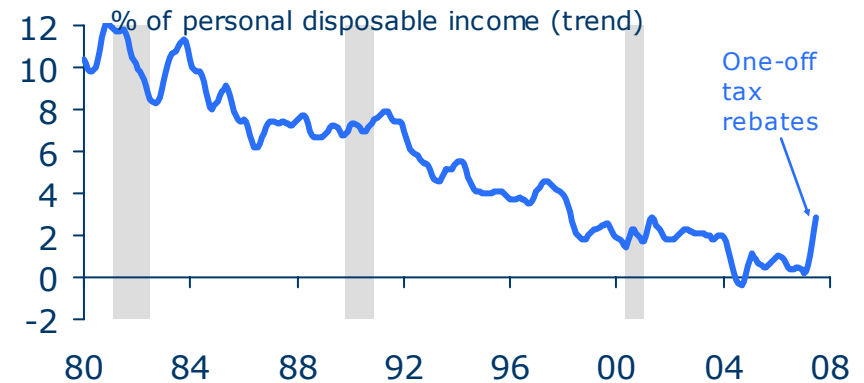
Household spending on energy



Household debt service ratio



Personal saving rate



Note: Shaded areas denote recessions as defined by the National Bureau of Economic Research.

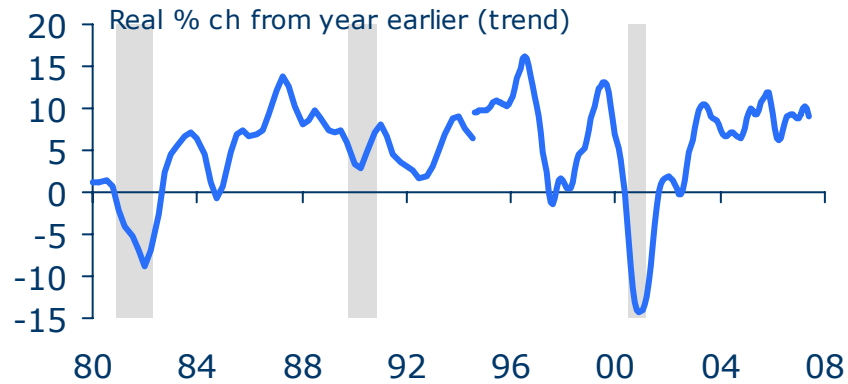
Sources: Commerce Department; Federal Reserve Board; ANZ.



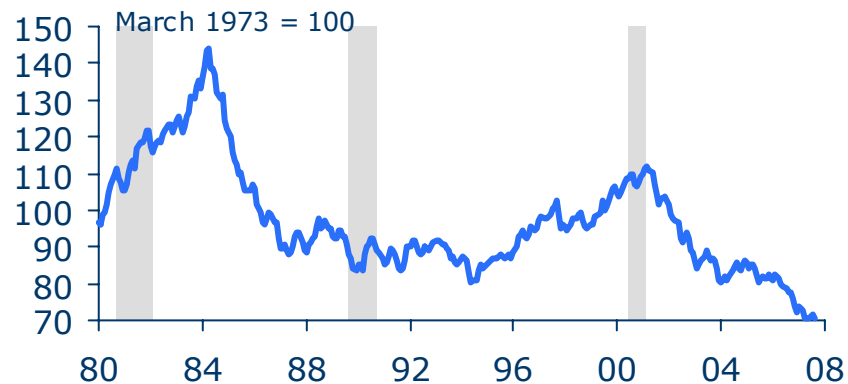
Rising exports, aided by a weaker US\$, have more than offset the impact on GDP growth of falling housing construction

US dollar, exports and housing

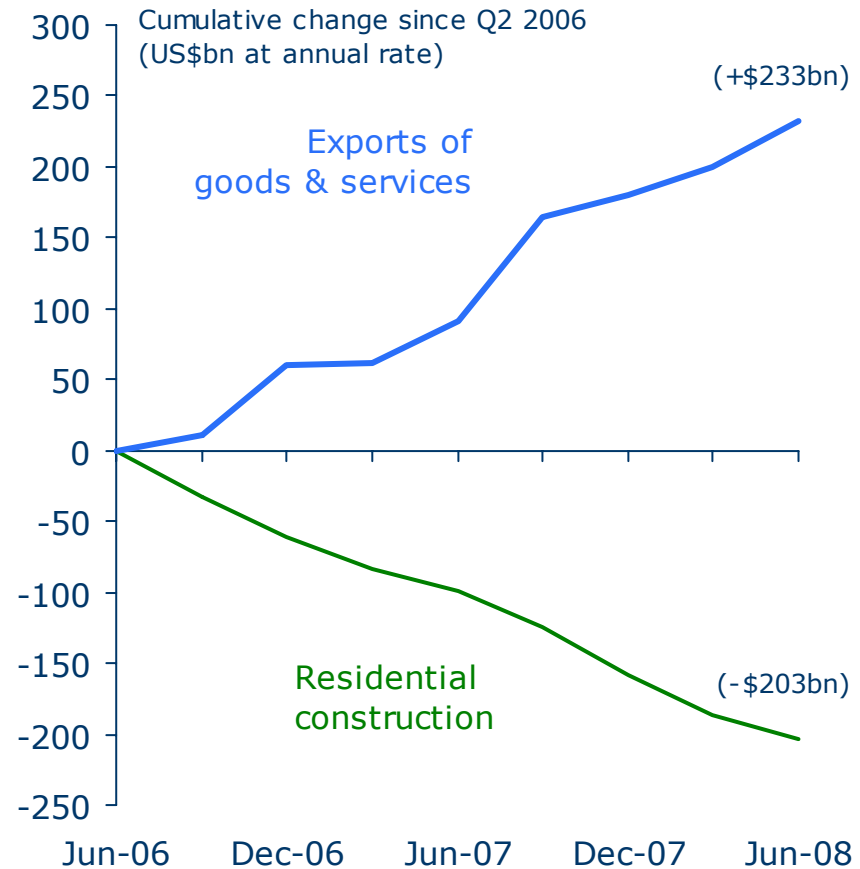
Exports of goods and services



Trade-weighted value of US\$



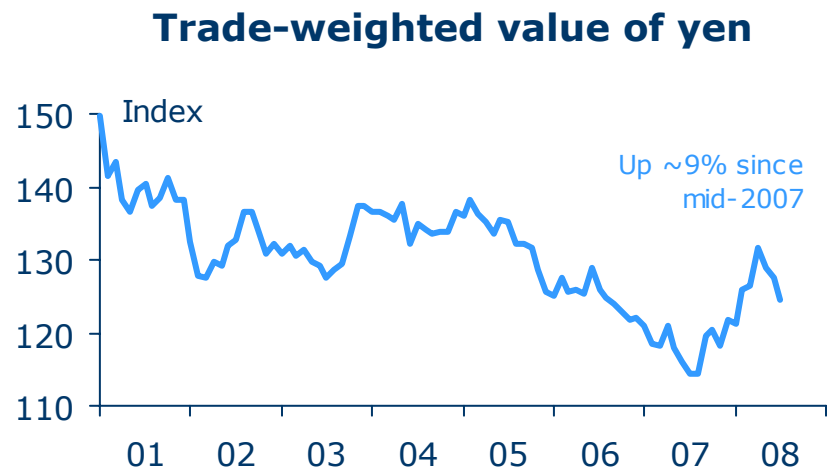
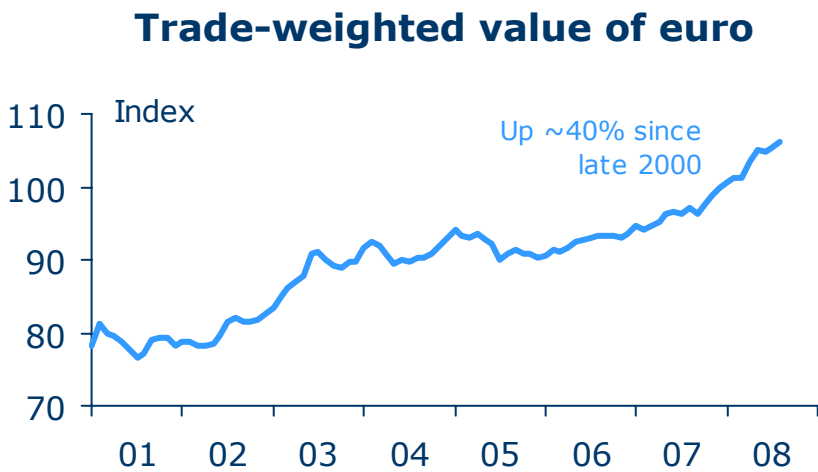
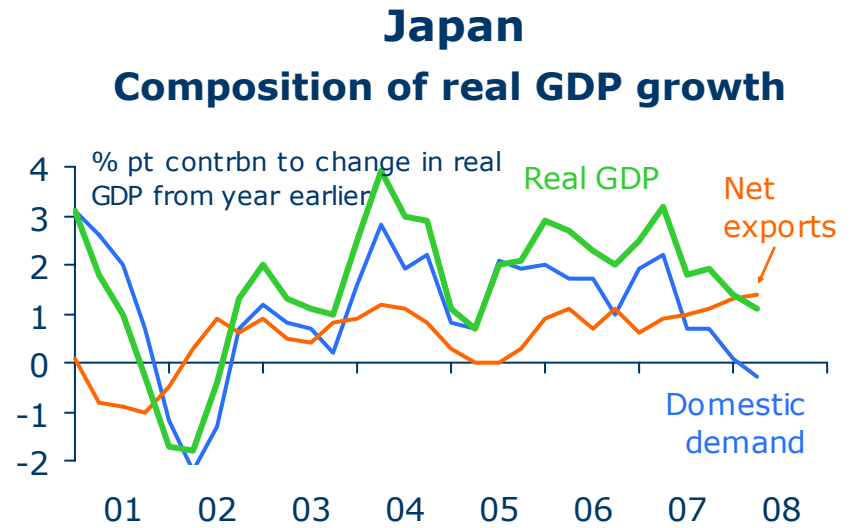
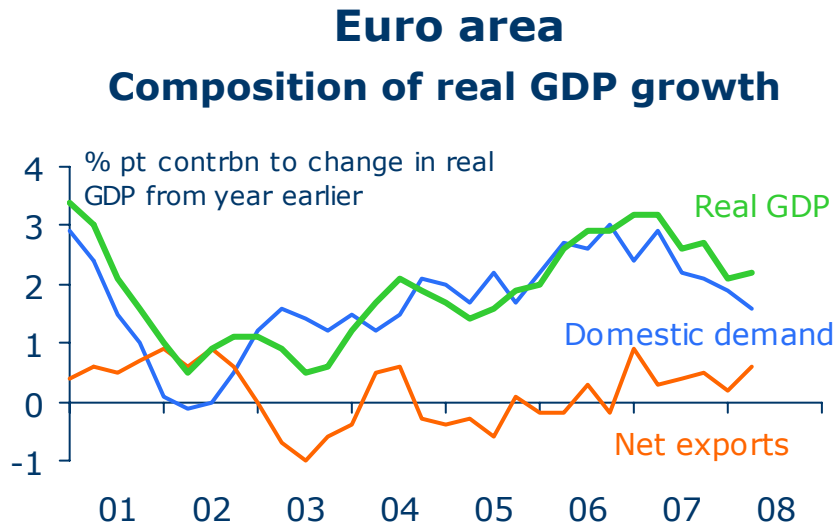
Exports and housing



Sources: Thomson Financial; US Bureau of Economic Analysis; ANZ.



European and Japanese economies will be adversely affected by stronger currencies and (in Europe) tighter financial conditions ¹⁷



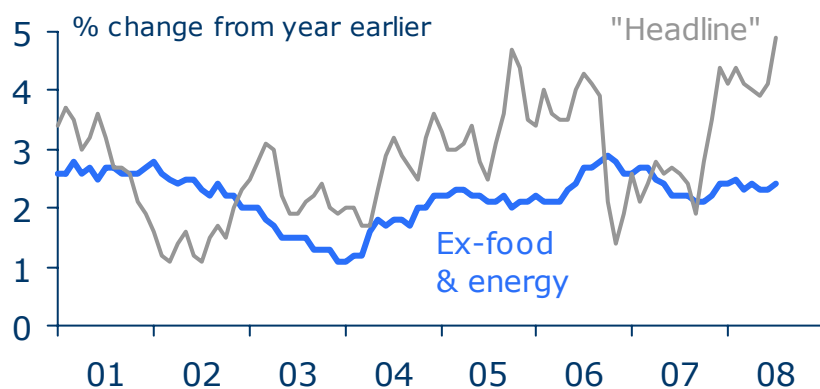
Sources: EuroStat; ECB; Japan Economic & Social Research Institute; Bank of Japan.



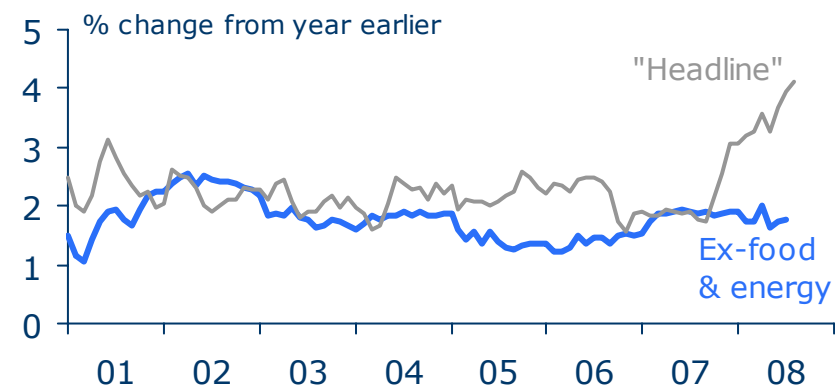
Although higher oil and food prices are pushing up headline inflation, 'core' inflation remains little changed in G7 countries

Consumer prices

United States



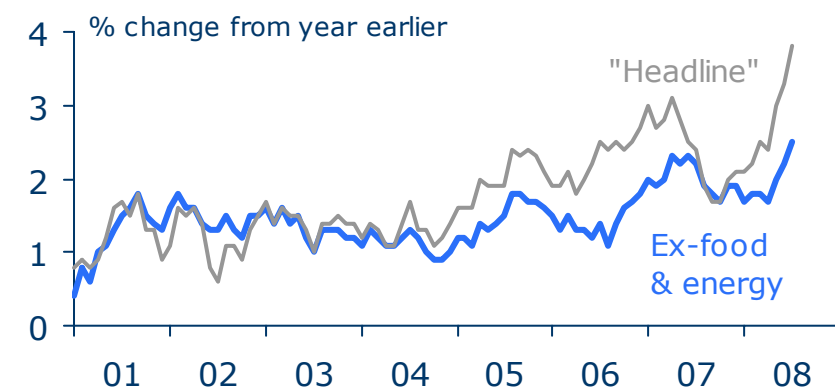
Euro area



Japan



United Kingdom



Sources: US Bureau of Labor Statistics; Eurostat; OECD.

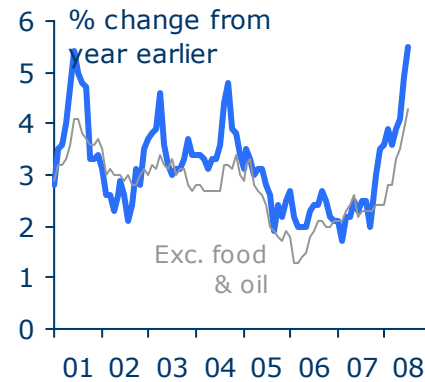
Inflation is rising sharply across Asia – partly though far from entirely driven by higher food prices

Asian economies – consumer prices

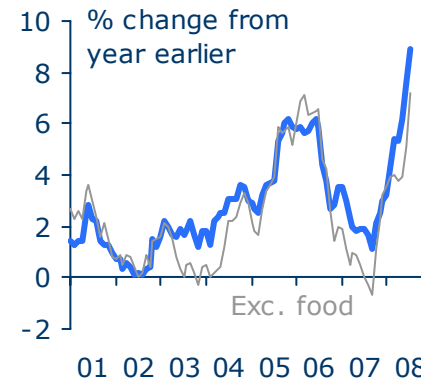
China



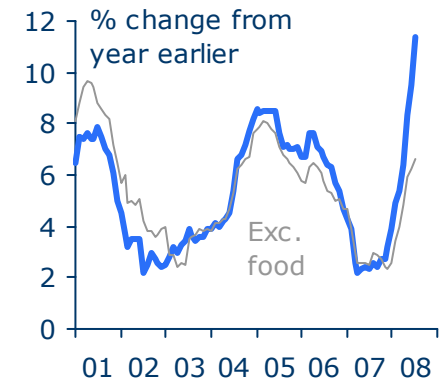
Korea



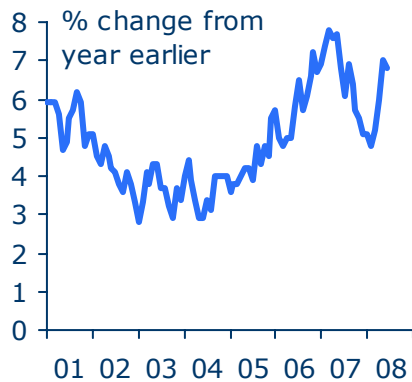
Thailand



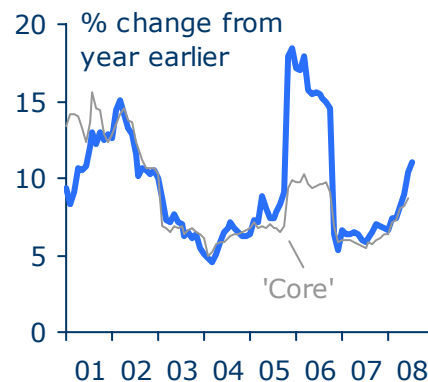
Philippines



India



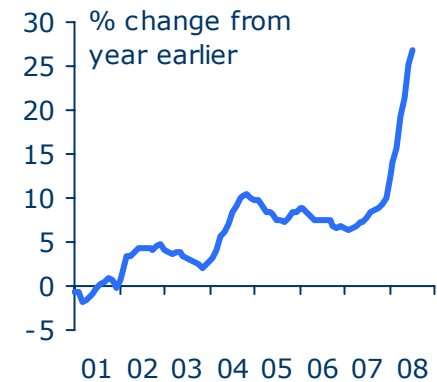
Indonesia



Malaysia



Vietnam



Sources: national statistical agencies; ANZ.



Inflation is also rising across other parts of the developing or emerging world

Selected other developing economies – consumer prices

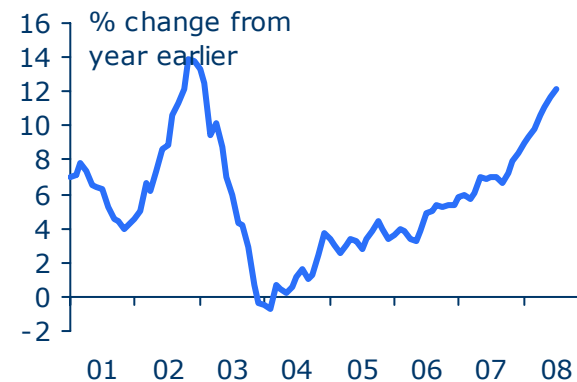
Brazil



Turkey



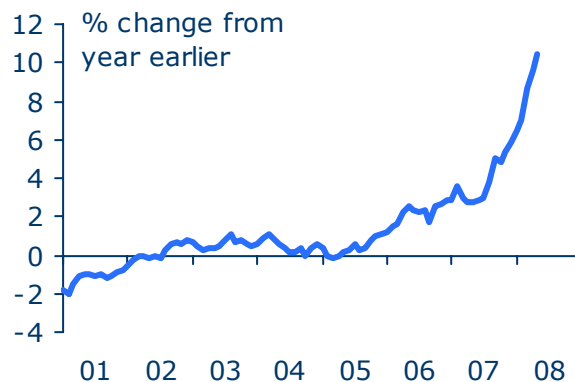
South Africa



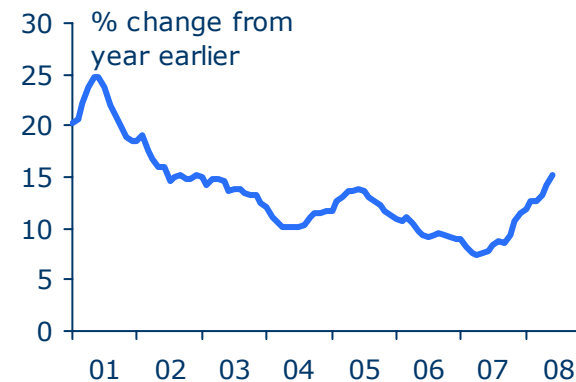
Chile



Saudi Arabia



Russia

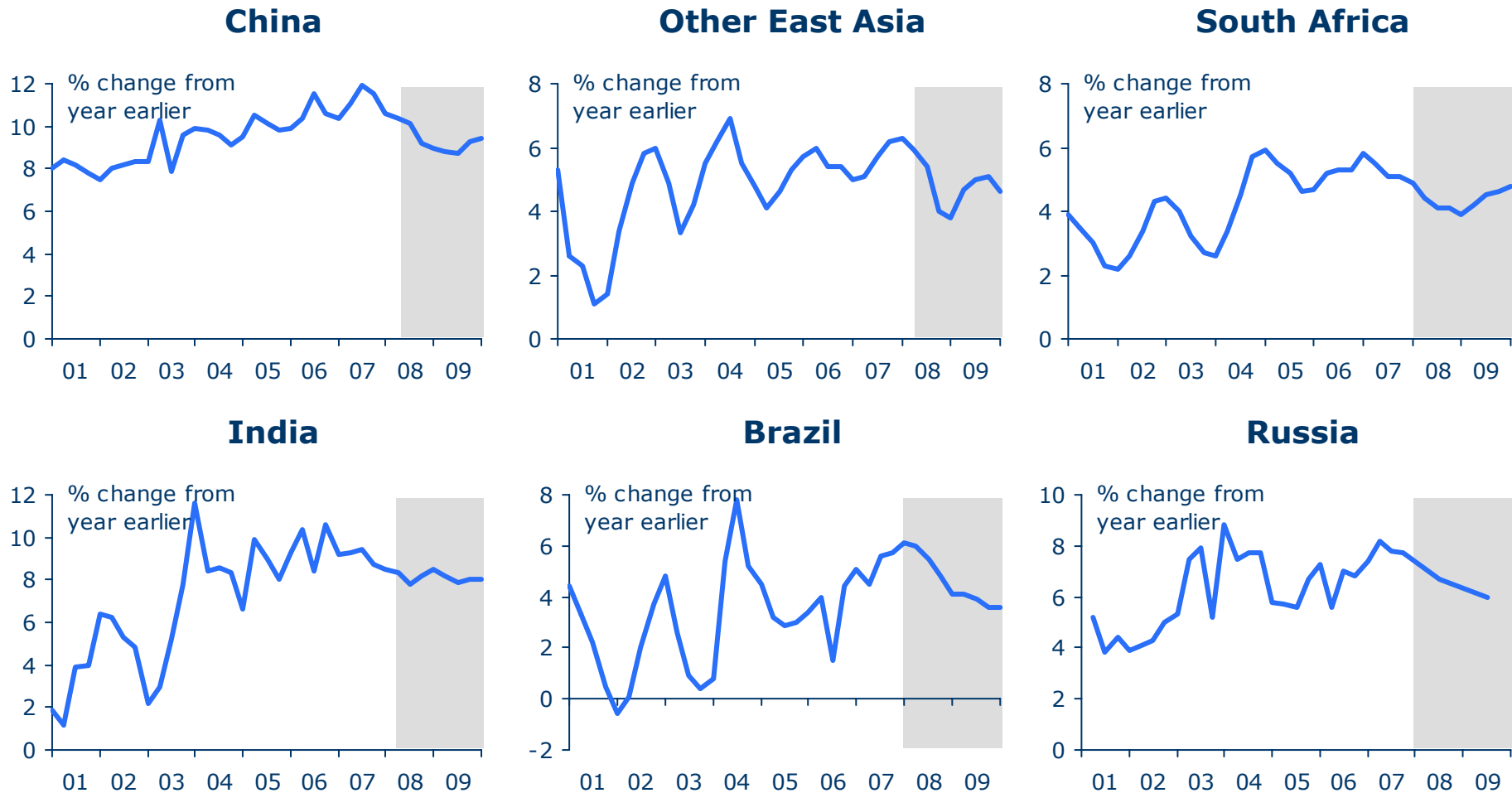


Sources: national statistical agencies; ANZ.



Growth is also slowing in the developing world, although growth rates there will still be strong by historical standards ²¹

Major developing economies – real GDP growth

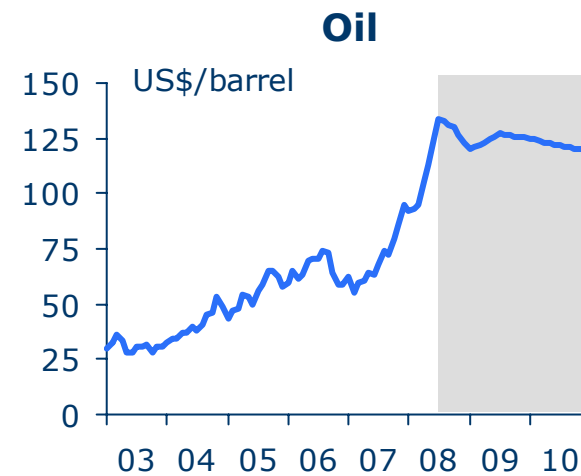
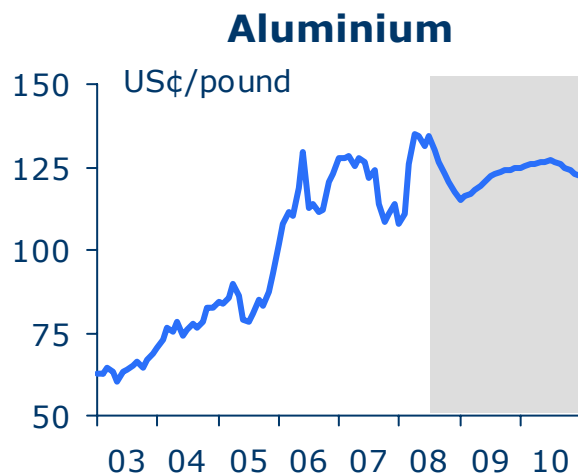
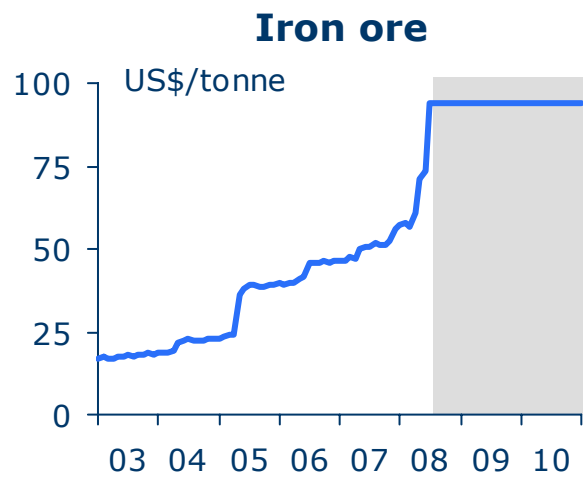
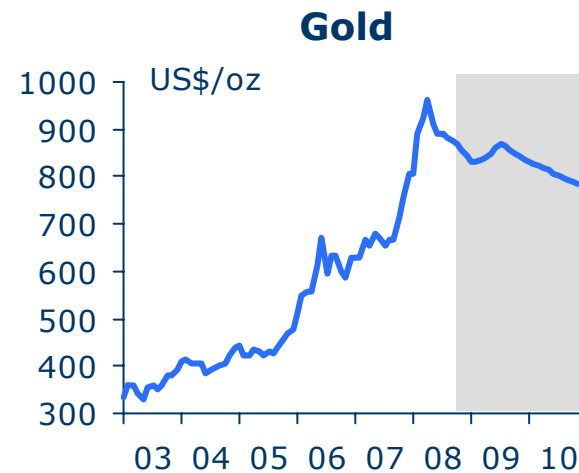
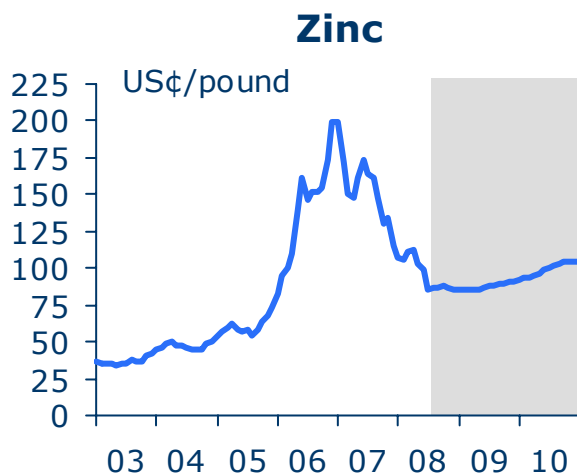
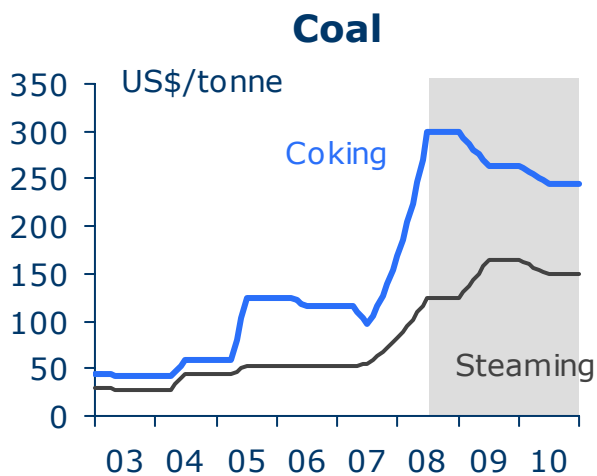


Sources: national statistical agencies; ANZ.



Resources commodity prices are unlikely to rise much further but will remain elevated by historical standards

Resource commodity prices

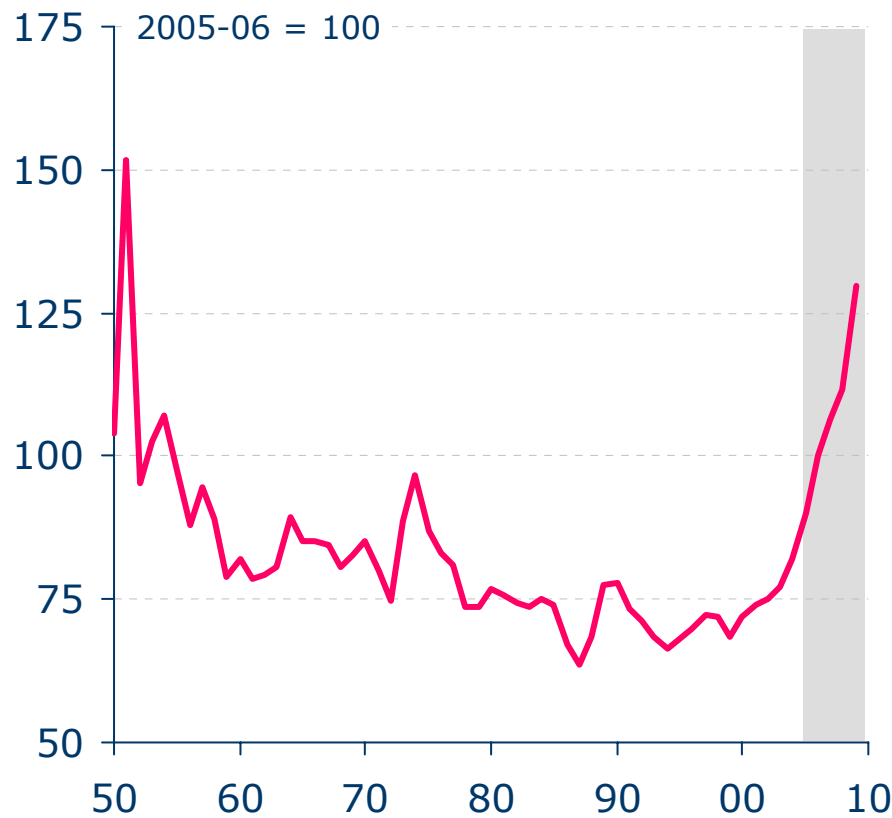


Sources: Thomson Financial; ANZ.

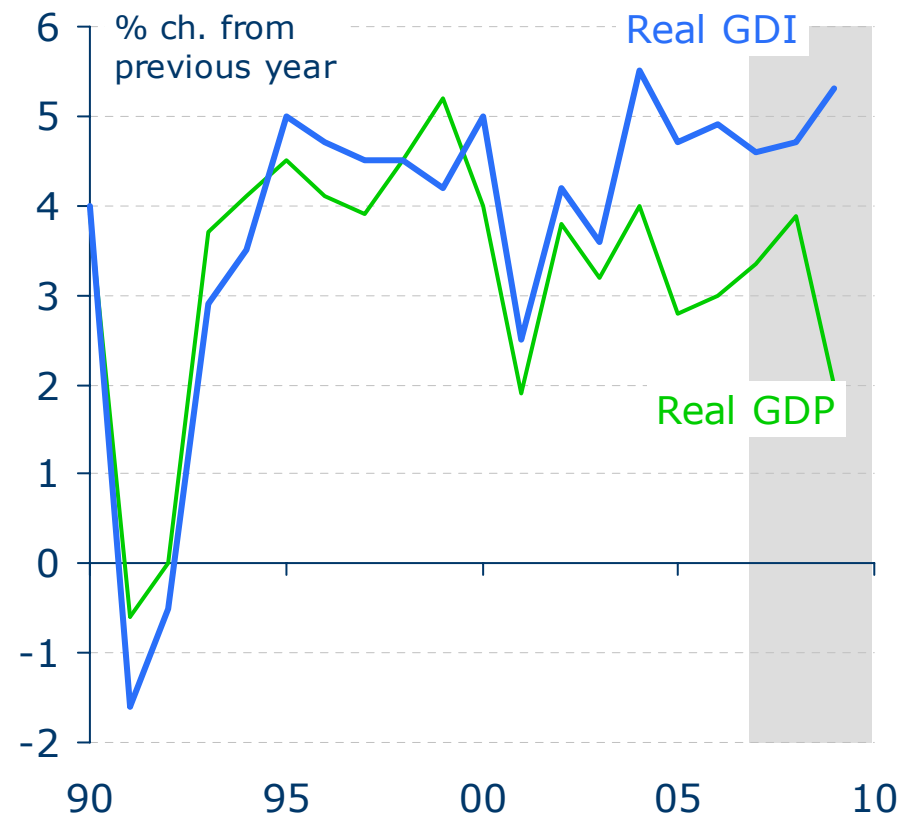


Australia's national income is continuing to get a huge boost from rising commodity prices

Australia's terms of trade (ratio of export to import prices)



Real gross domestic income (GDI) and product (GDP)

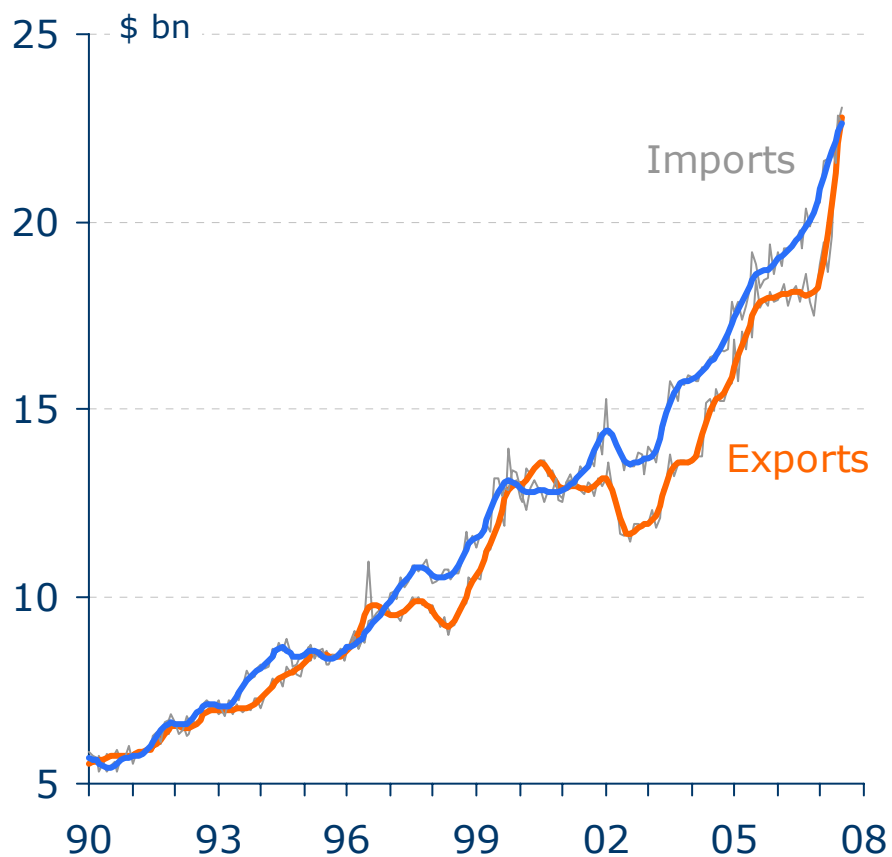


Sources: ABS; Budget Paper No. 1, Statement 3; ANZ Economics & Markets Research.



Australia is now starting to run trade surpluses for only the fourth time in two decades

Exports and imports



Trade balance

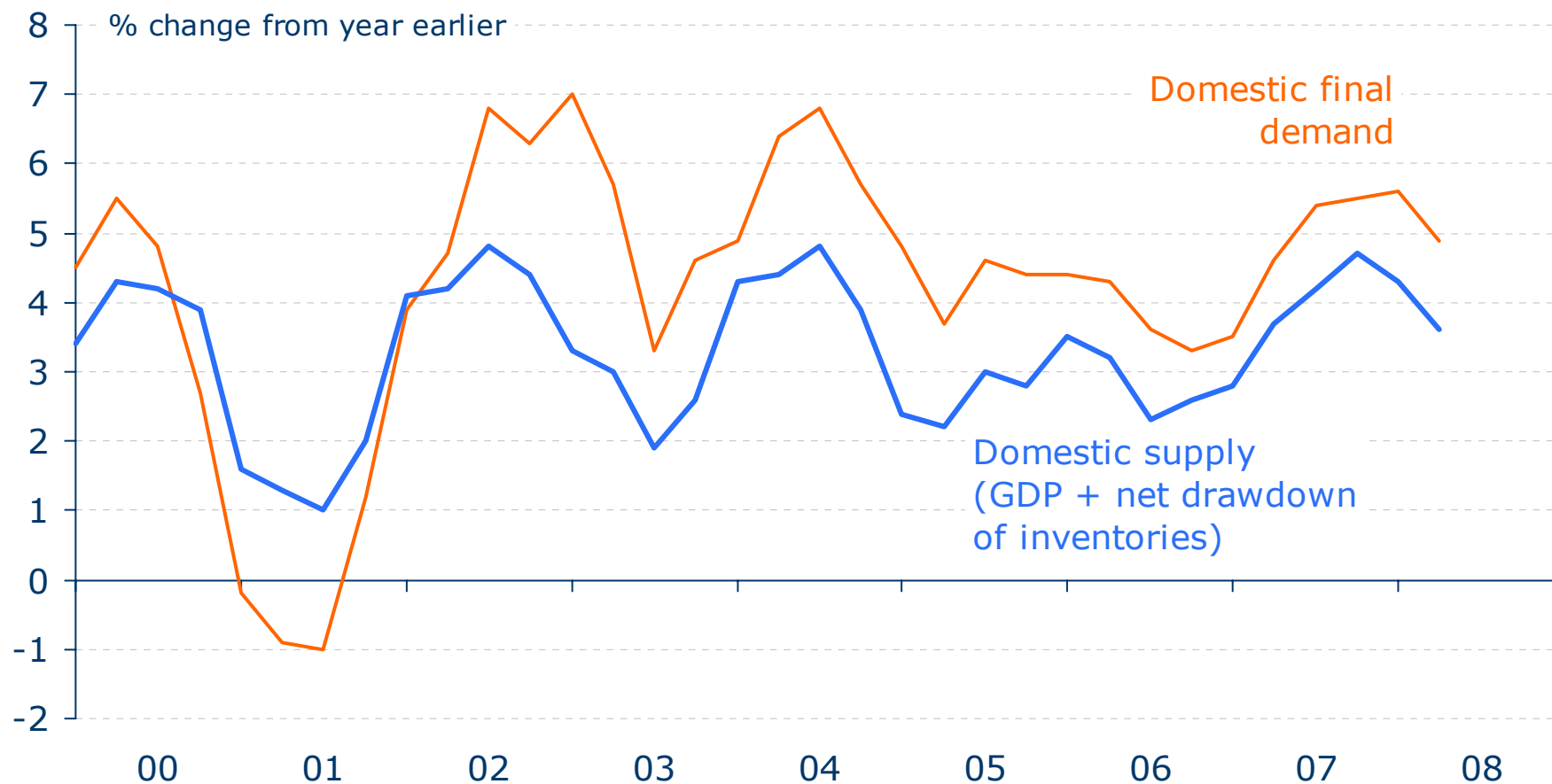


Sources: ABS; ANZ



Up until very recently most of the income generated by the commodities boom has been spent

Domestic demand vs 'supply'

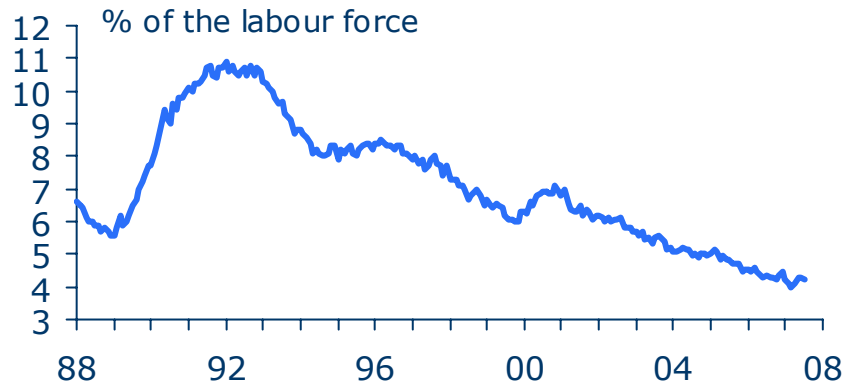


Sources: ABS; ANZ.

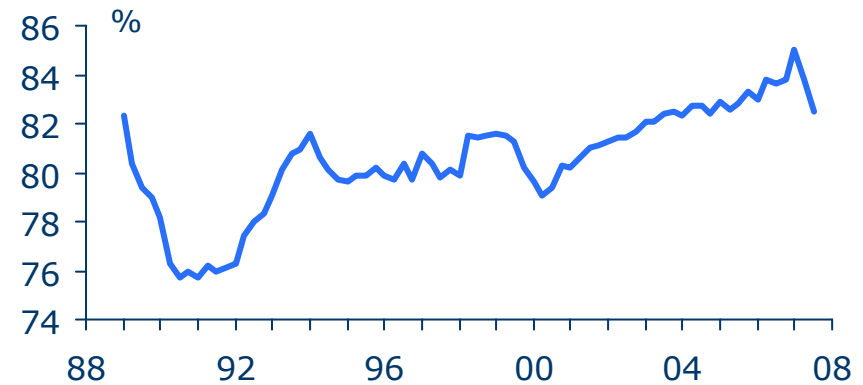
After nearly 17 years of continuous economic growth, Australia's economy has run into serious capacity constraints ²⁶

Indicators of 'spare capacity' in the Australian economy

Unemployment rate



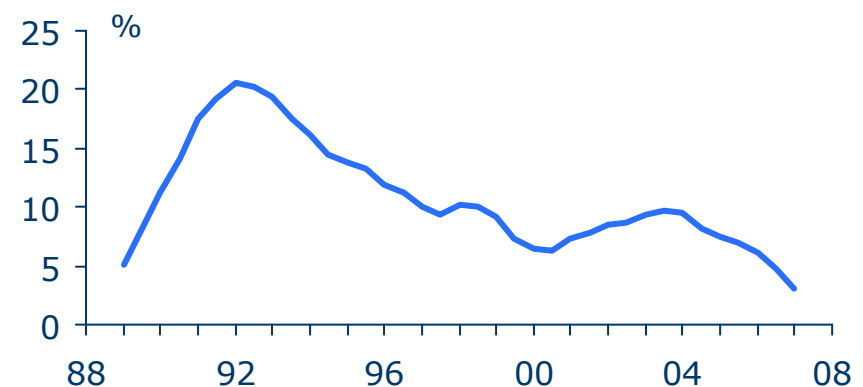
Capacity utilization rate



Businesses reporting labour shortages



Office vacancy rates

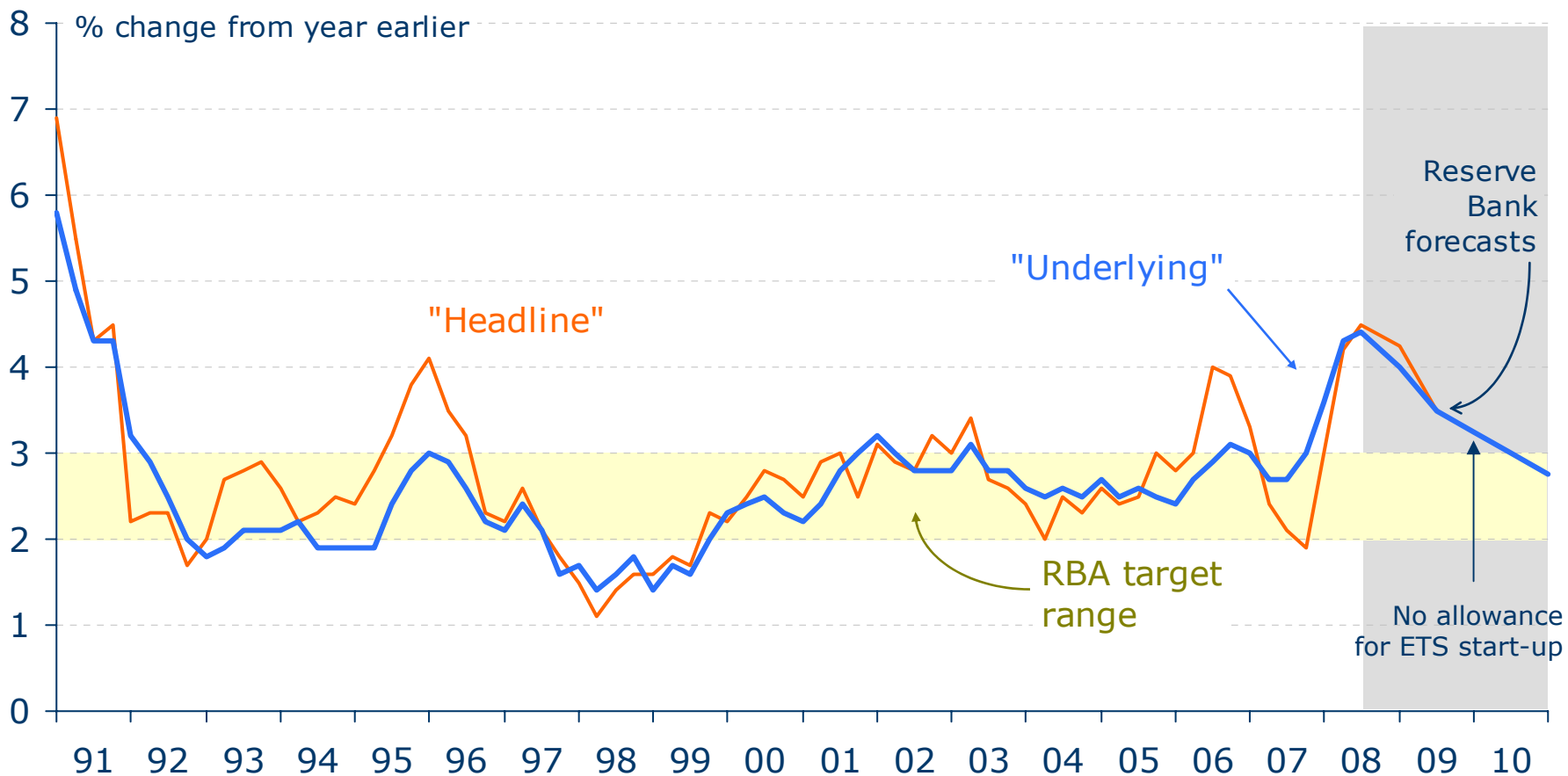


Sources: Australian Bureau of Statistics; nabCapital; Property Council of Australia.



Australia's 'underlying' inflation rate is now at its highest level since inflation-targeting began

Consumer prices

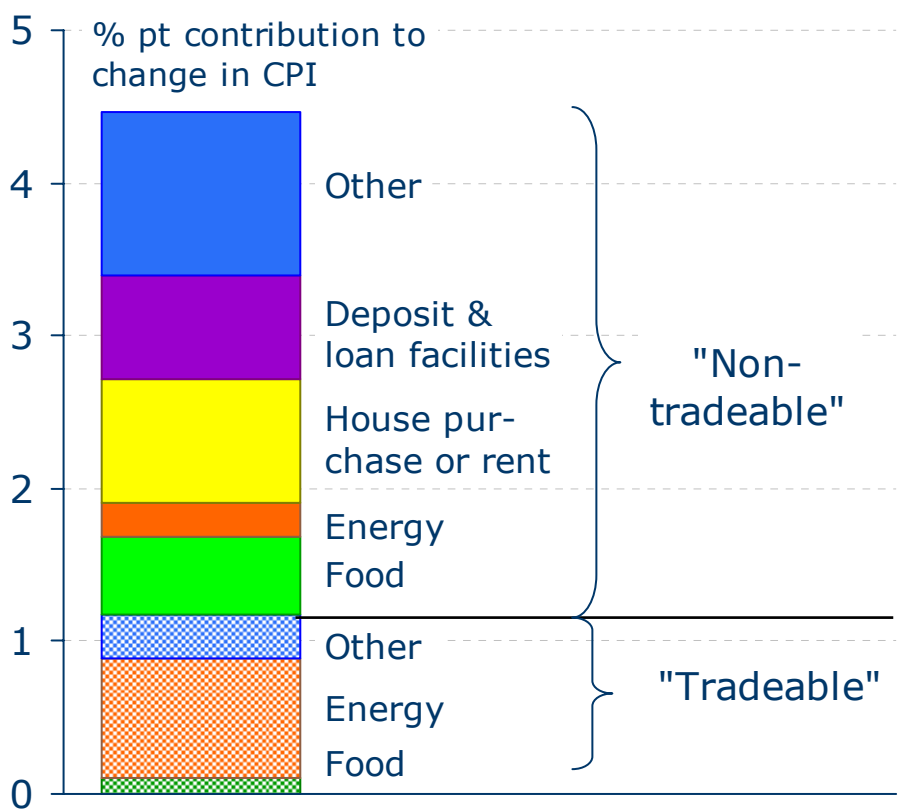


Note: excludes impact of introduction of GST and major health policy changes.
Sources: ABS; RBA.

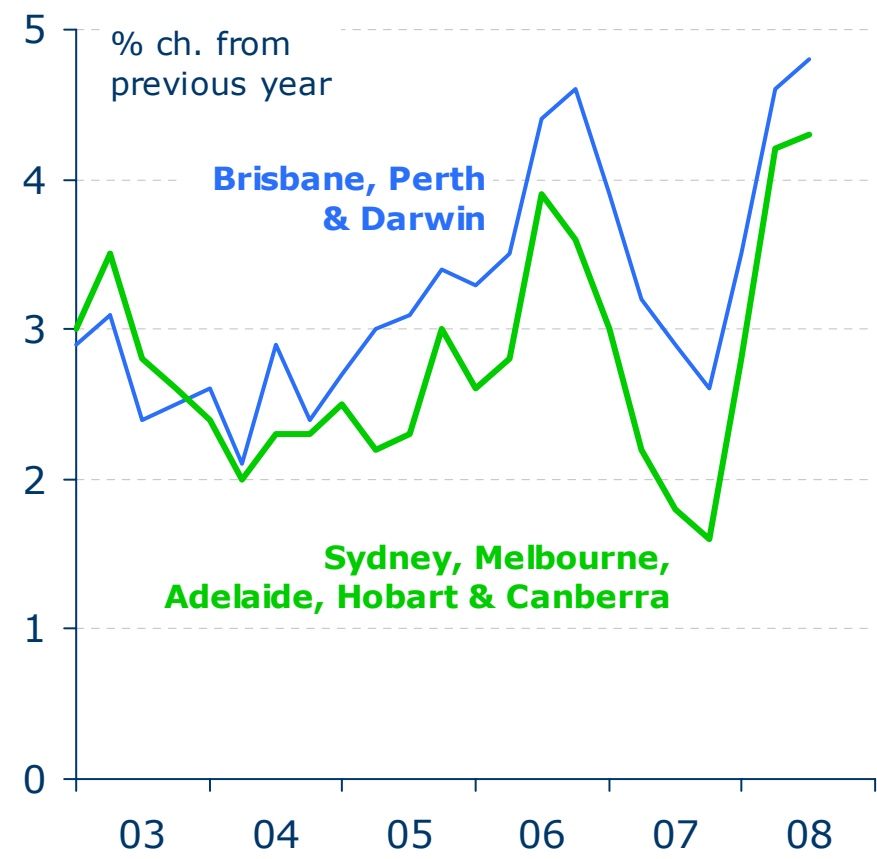


The rise in inflation has been broadly-based, and not solely due to global forces or in resource-rich States

Contributions to 'headline' inflation, year to June quarter 2008



'Headline' inflation, resource boom cities vs others

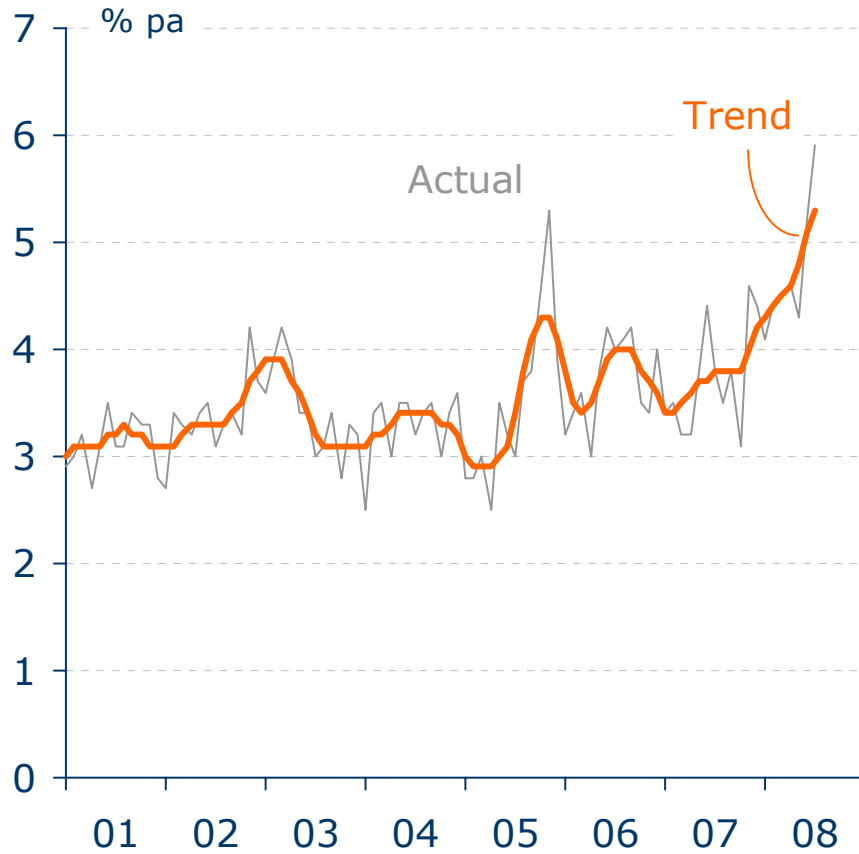


Sources: ABS; ANZ.

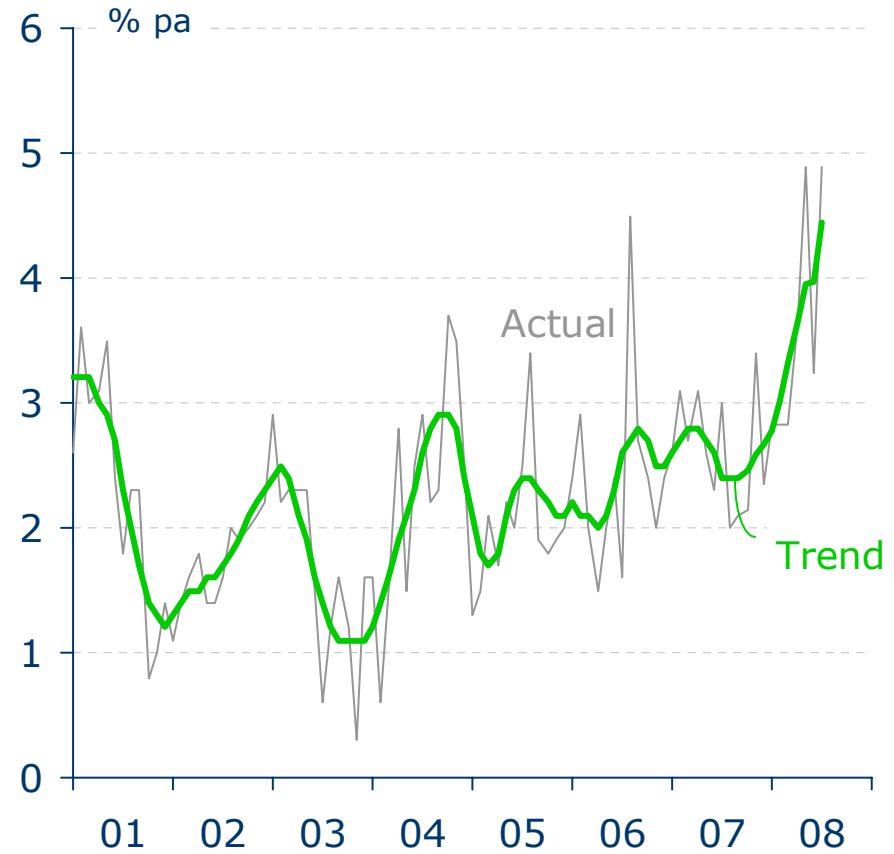


The upward trend in inflationary expectations has been particularly alarming to the Reserve Bank

Household inflation expectations



Business selling price expectations

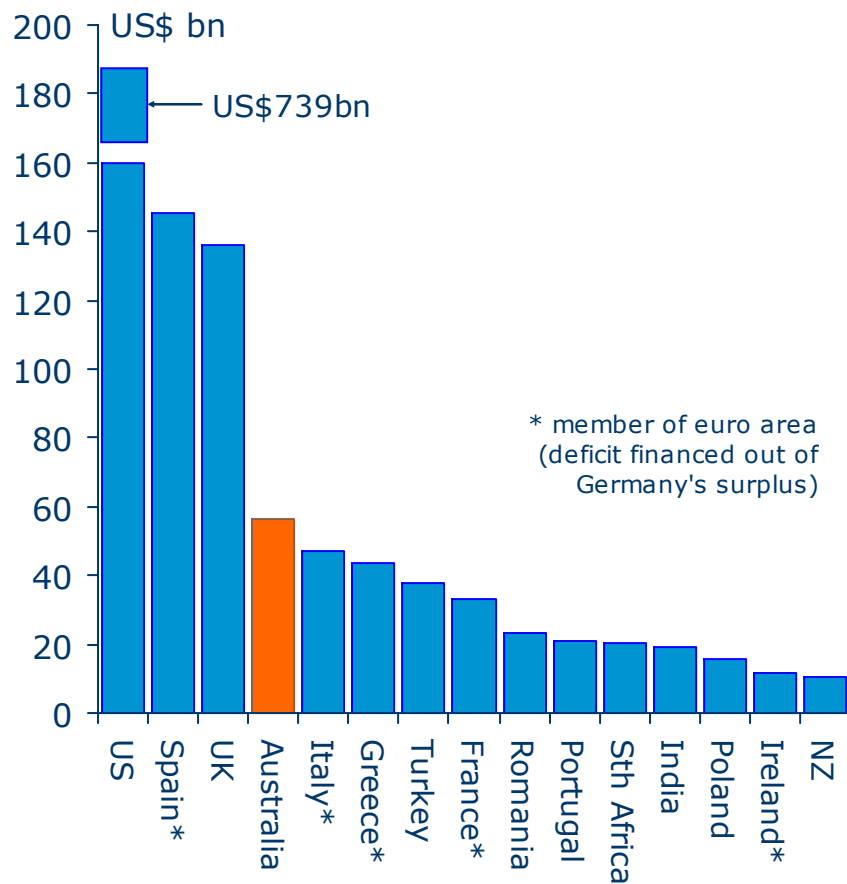


Sources: Westpac-Melbourne Institute; nab.

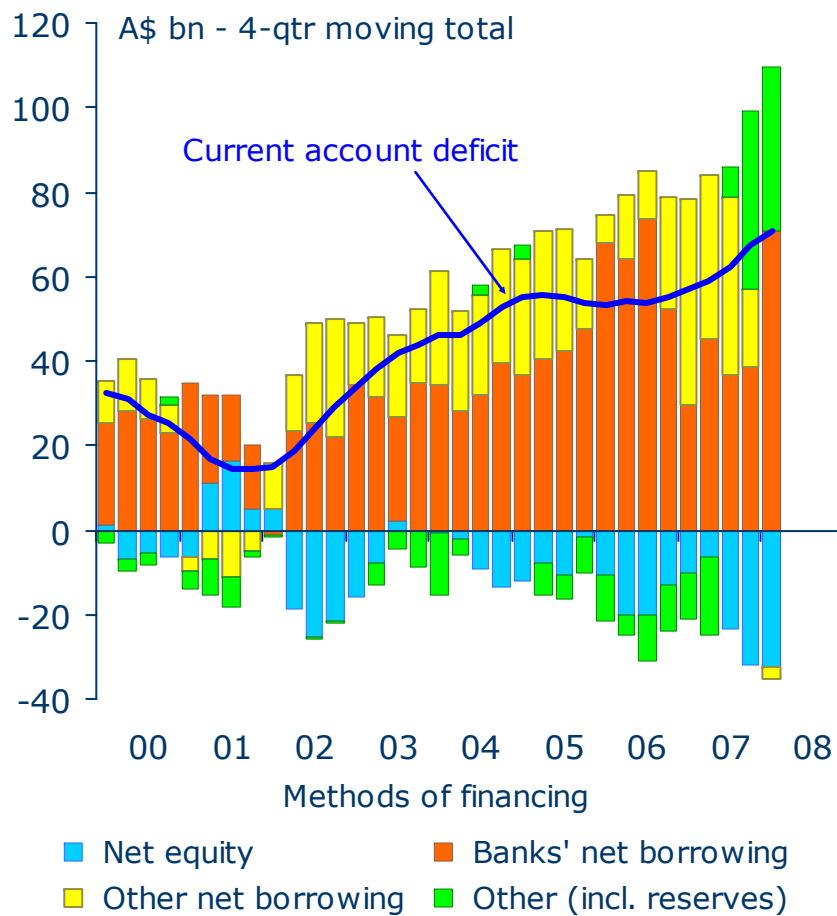


Australia is exposed to the global credit crunch because of our large external deficit and the way we finance it

Current account deficits 2007



Financing Australia's current account deficit

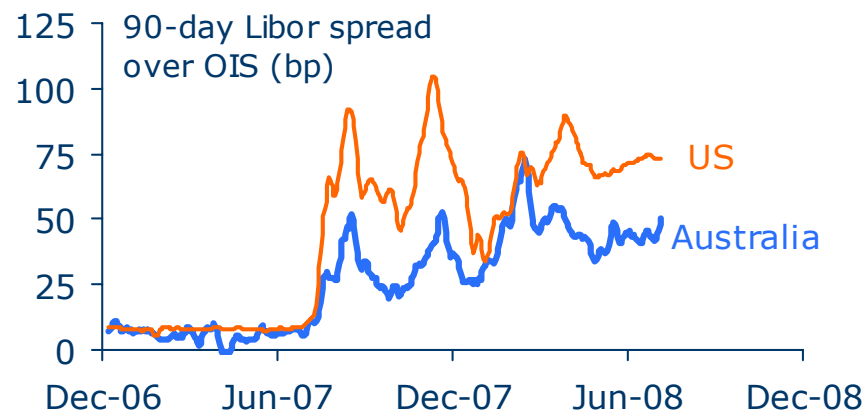


Sources: IMF; Australian Bureau of Statistics; ANZ.

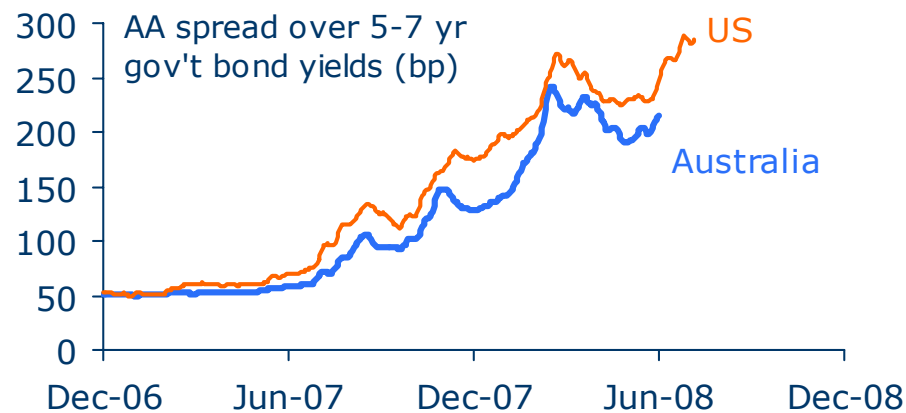


Australian financial markets have come under the same pressures as their overseas counterparts

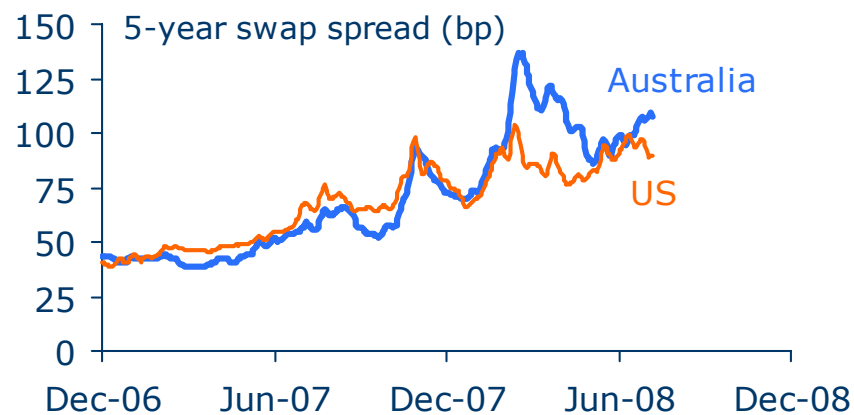
Banks' short-term funding costs



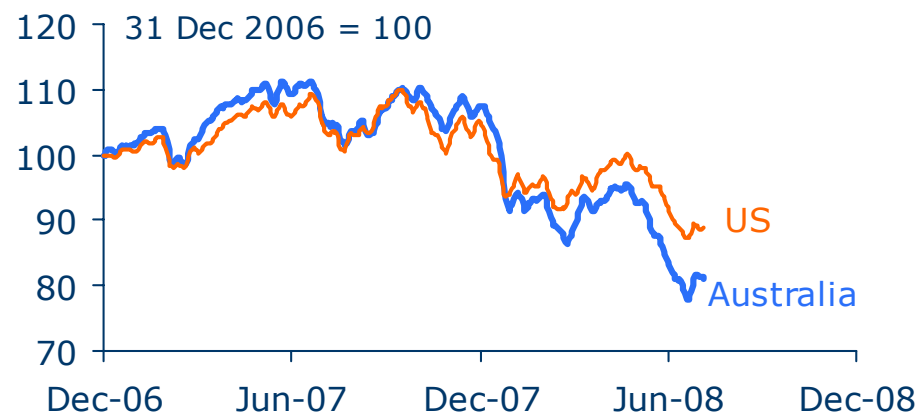
Corporate bond yield spreads



Banks' long-term funding costs



Share prices

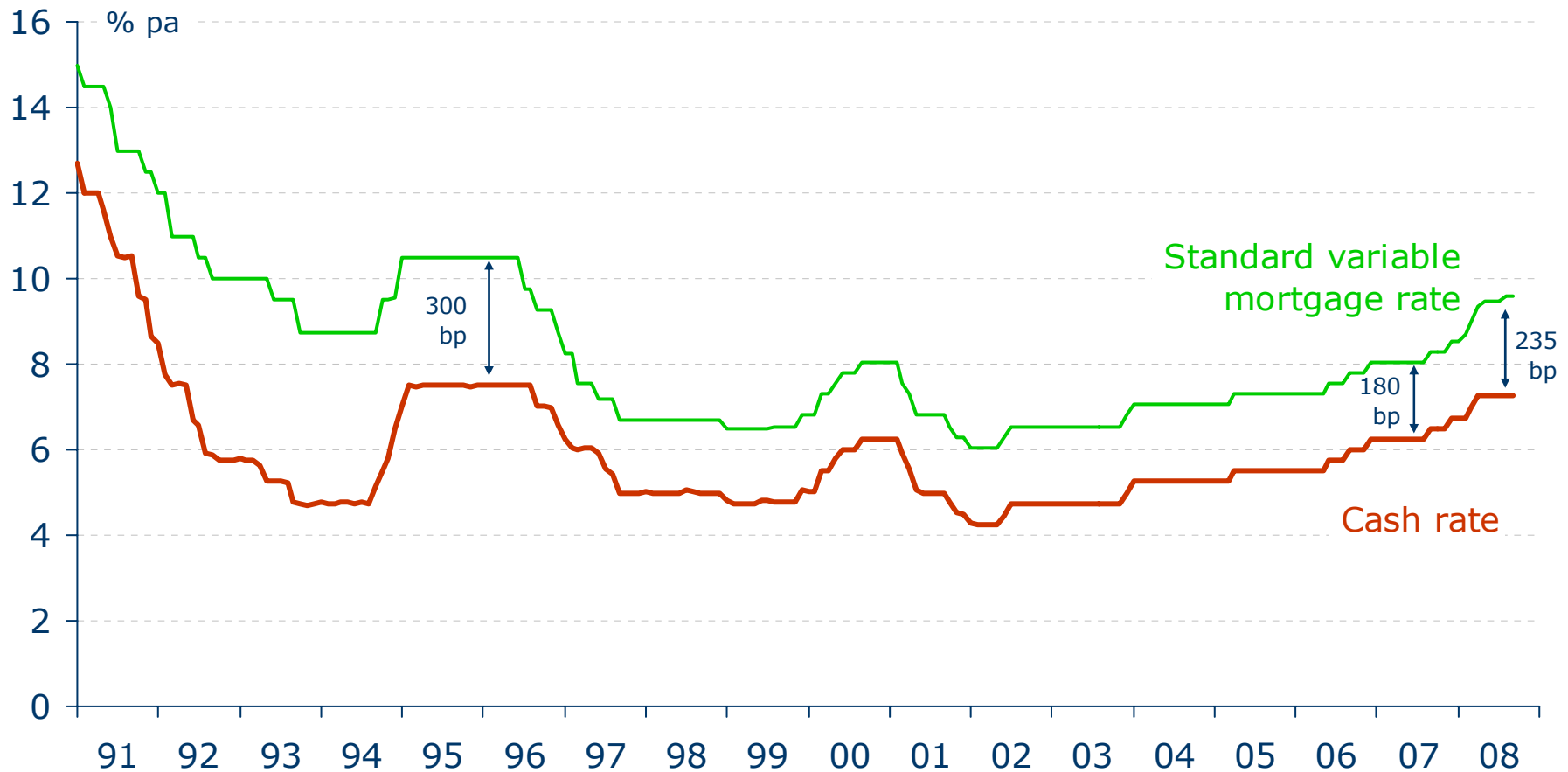


Note: all data shown as 5-day moving averages. Sources: Bloomberg; Datastream.



As a result, banks have raised lending rates by more than the increases in the Reserve Bank's official cash rate

Australian interest rates



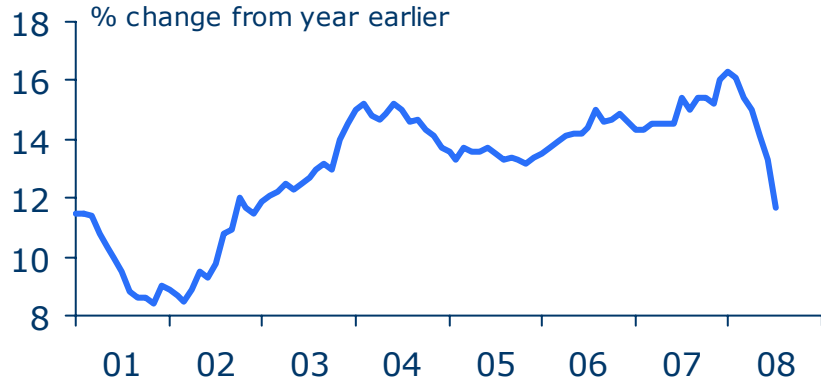
Source: RBA.



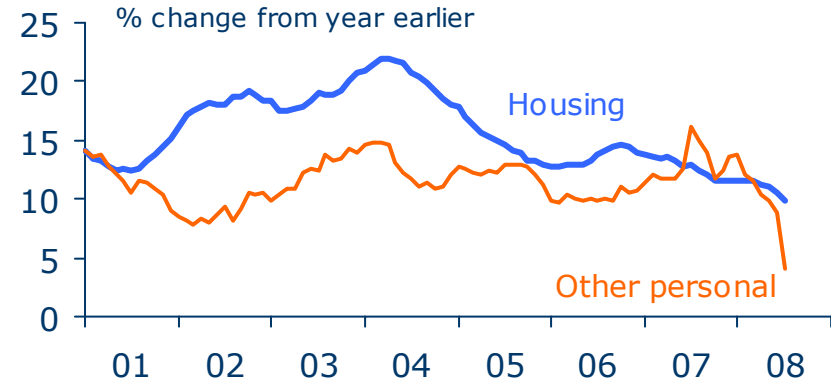
The 'credit crunch' plus the effect of higher interest rates on credit demand has led to a sharp slowdown in credit growth

Credit provided to the Australian private sector

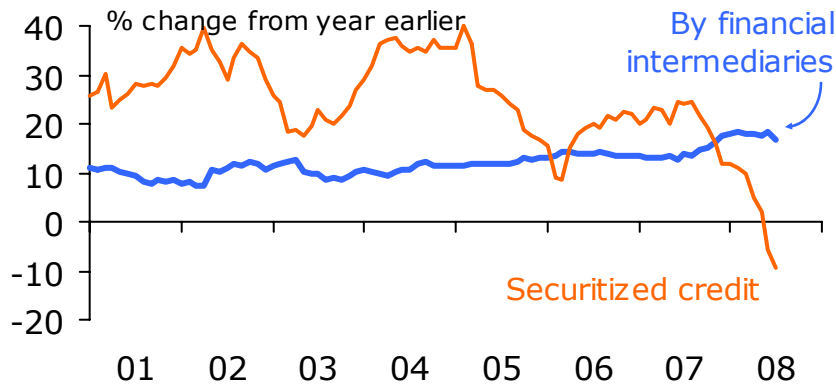
Total credit



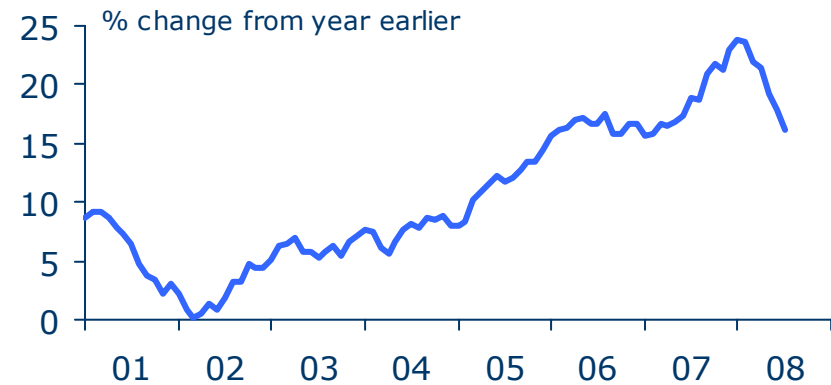
Credit to households



Credit by source



Credit to business

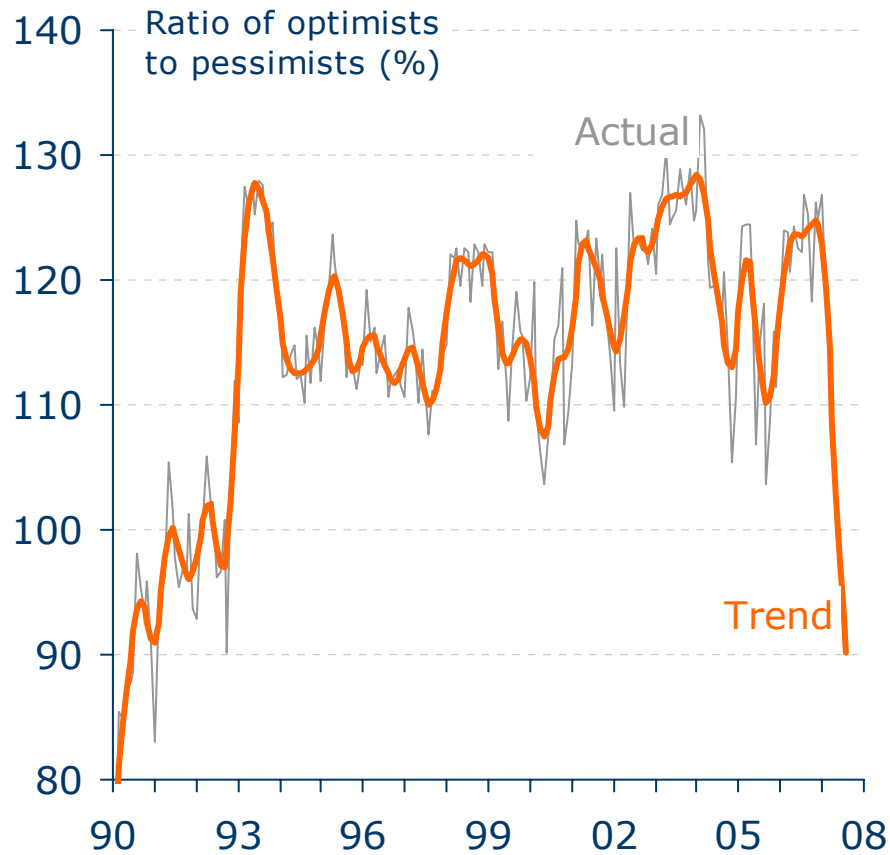


Source: Reserve Bank of Australia.

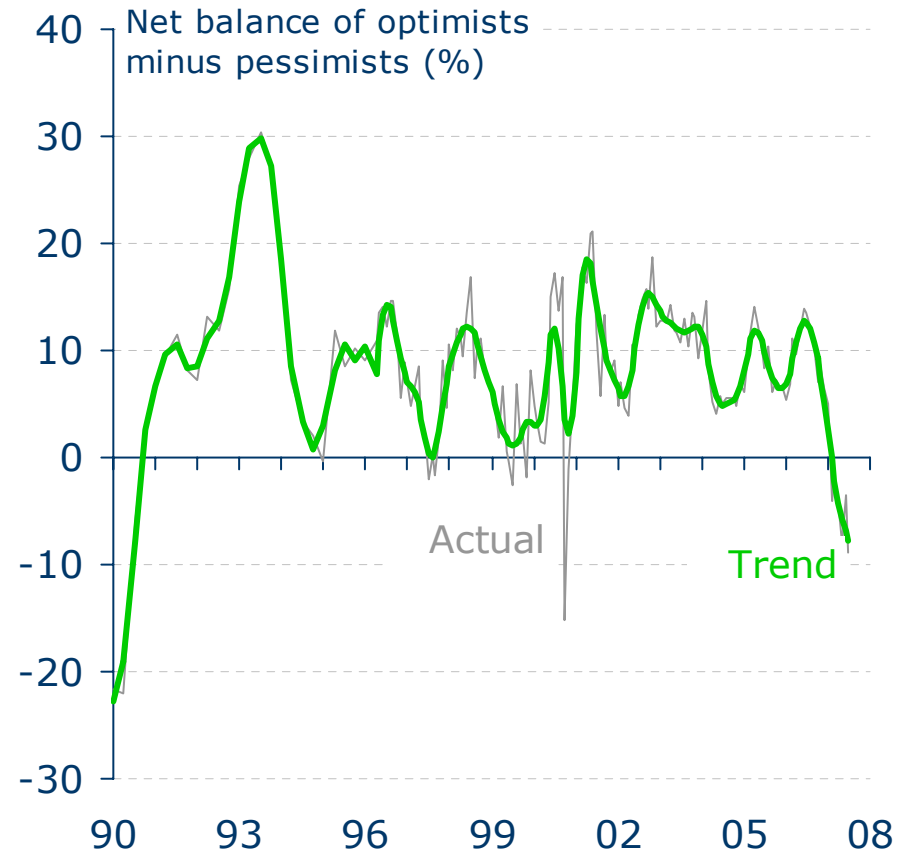


Tighter financial conditions and global uncertainty have contributed to sharp falls in confidence

Consumer confidence



Business confidence



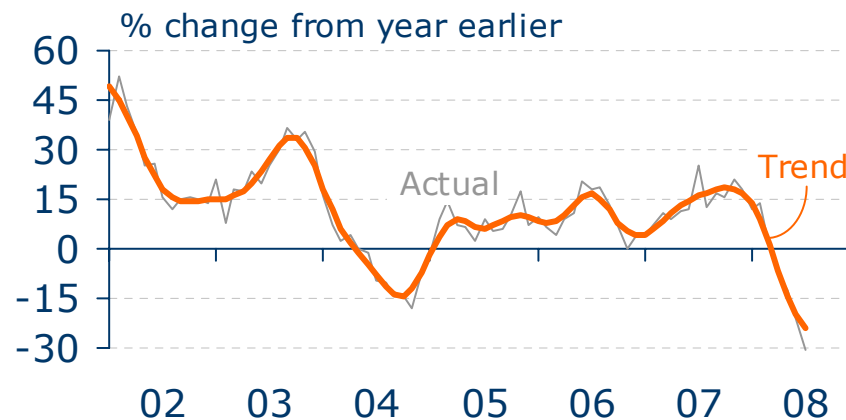
Sources: Roy Morgan Research; nab; ANZ

'Hard' data is also increasingly suggesting that the economy is slowing – more quickly, perhaps, than expected

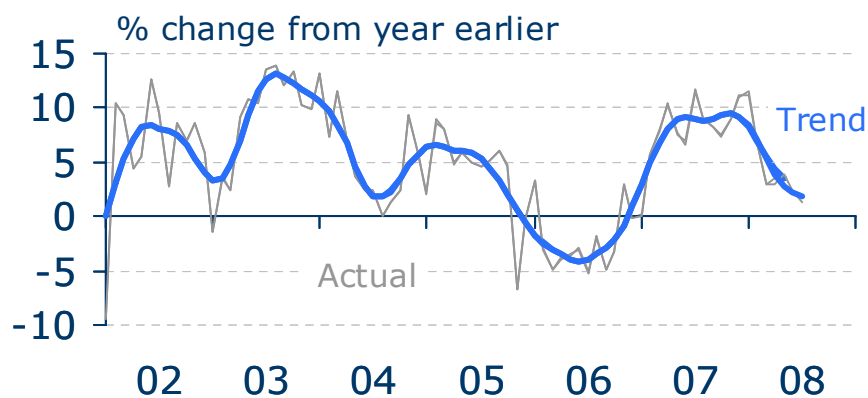
Retail sales



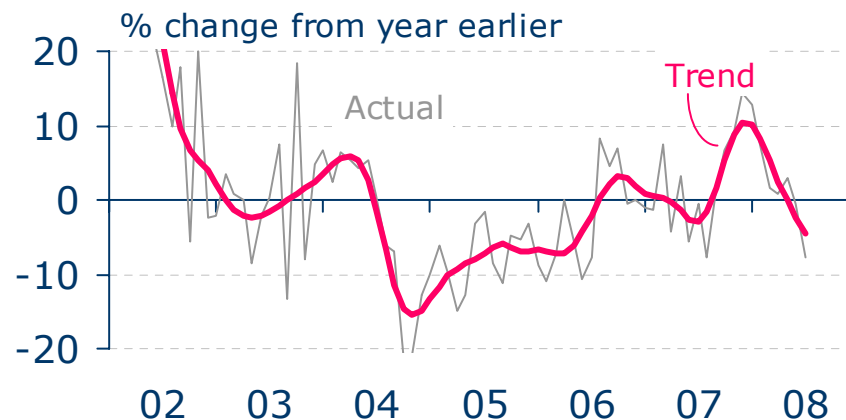
Housing finance commitments



Motor vehicle sales



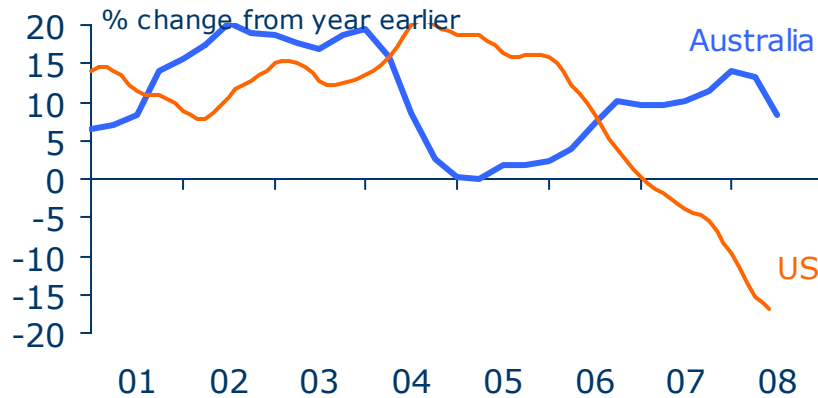
Residential building approvals



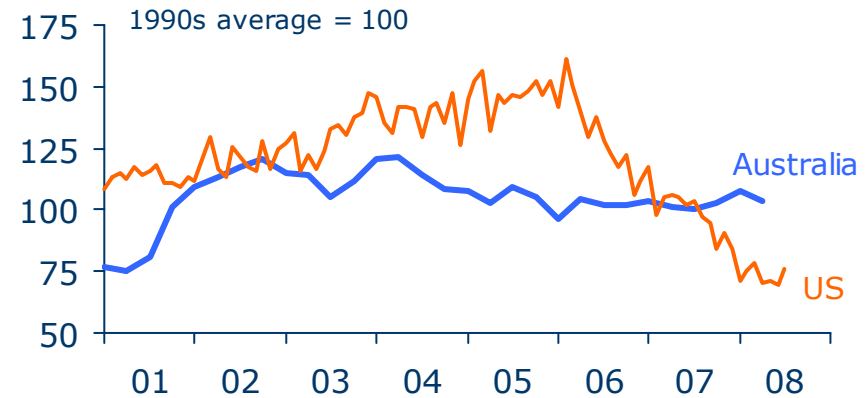
Sources: ABS; ANZ Economics & Markets Research.

Australia's housing market has clearly softened but is unlikely to become as dire as America's

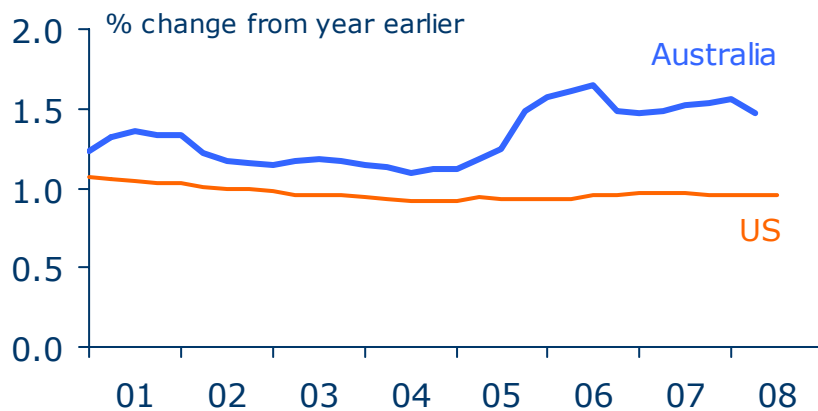
House prices



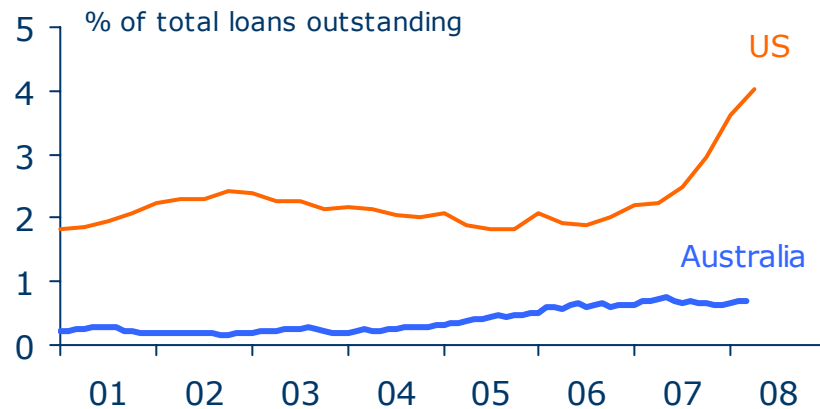
Housing commencements



Population growth



Mortgage delinquency rates*

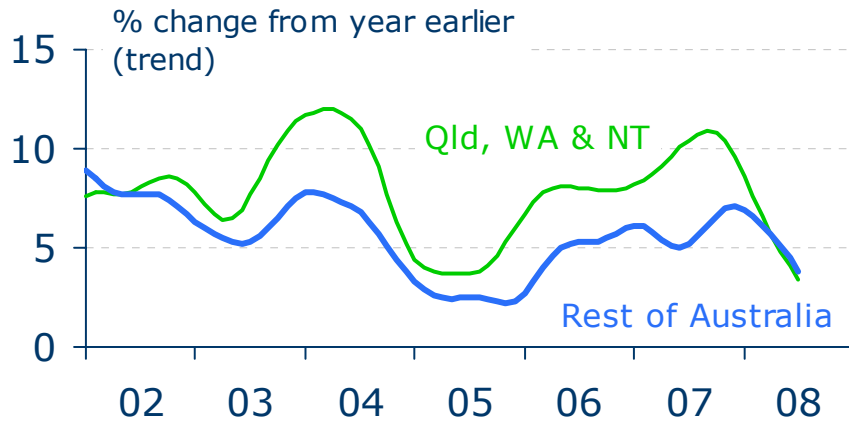


* 90 days or more past due. For Australia, securitized mortgages only. Sources: ABS; US Commerce Department; S&P; Mortgage Bankers' Association of America.

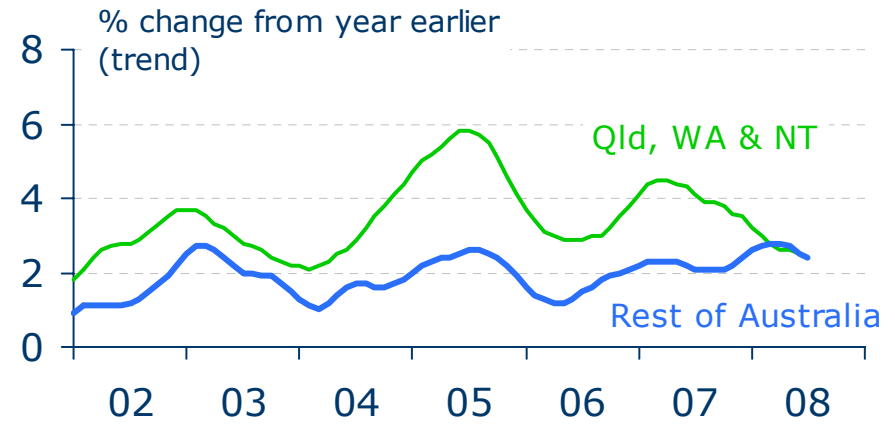


The 'resource boom States' appear to be slowing more markedly than the rest of Australia

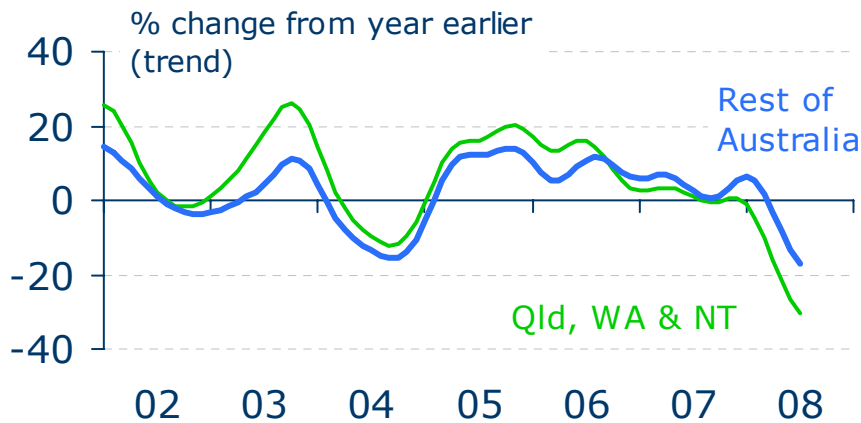
Retail sales



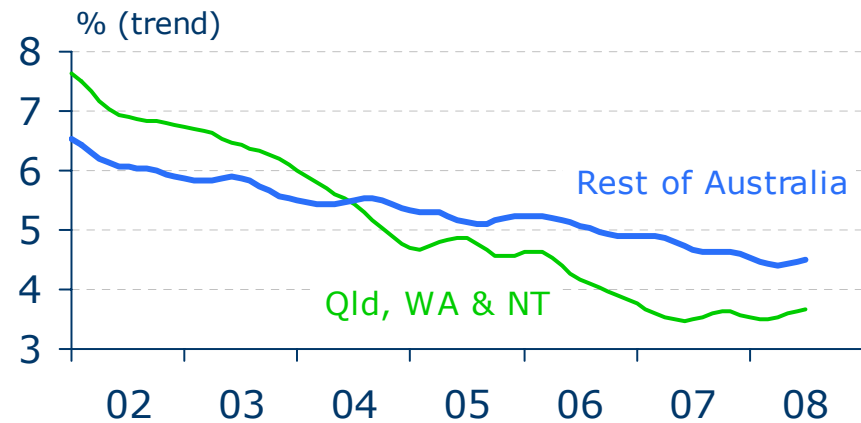
Employment



Housing finance commitments



Unemployment rate

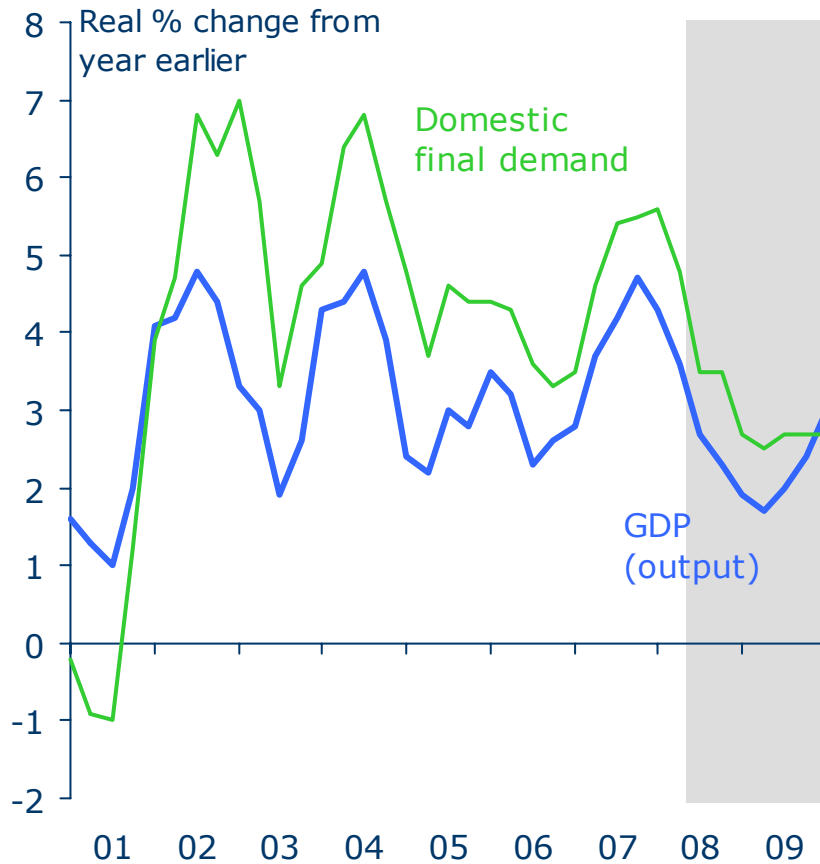


Sources: ABS; ANZ Economics & Markets Research.

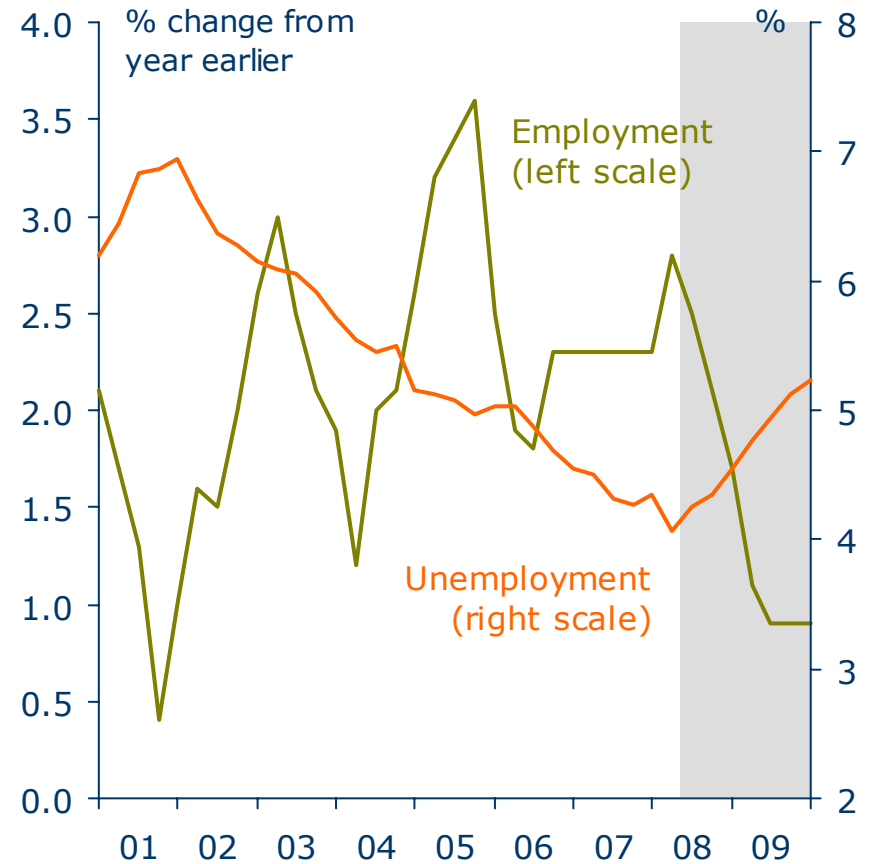


Economic growth will be much slower in 2008-09 than in recent years, and the unemployment rate will increase 38

Spending and output



Employment and unemployment

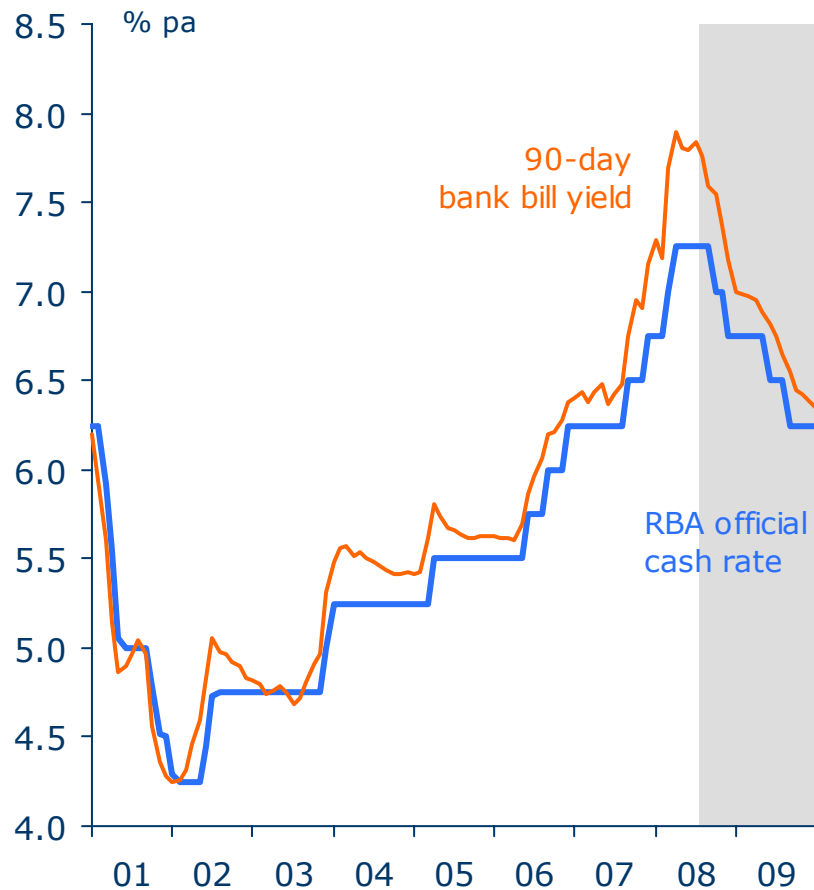


Sources: Australian Bureau of Statistics; ANZ.



The Reserve Bank has signalled that it will be cutting rates soon – probably beginning next month 39

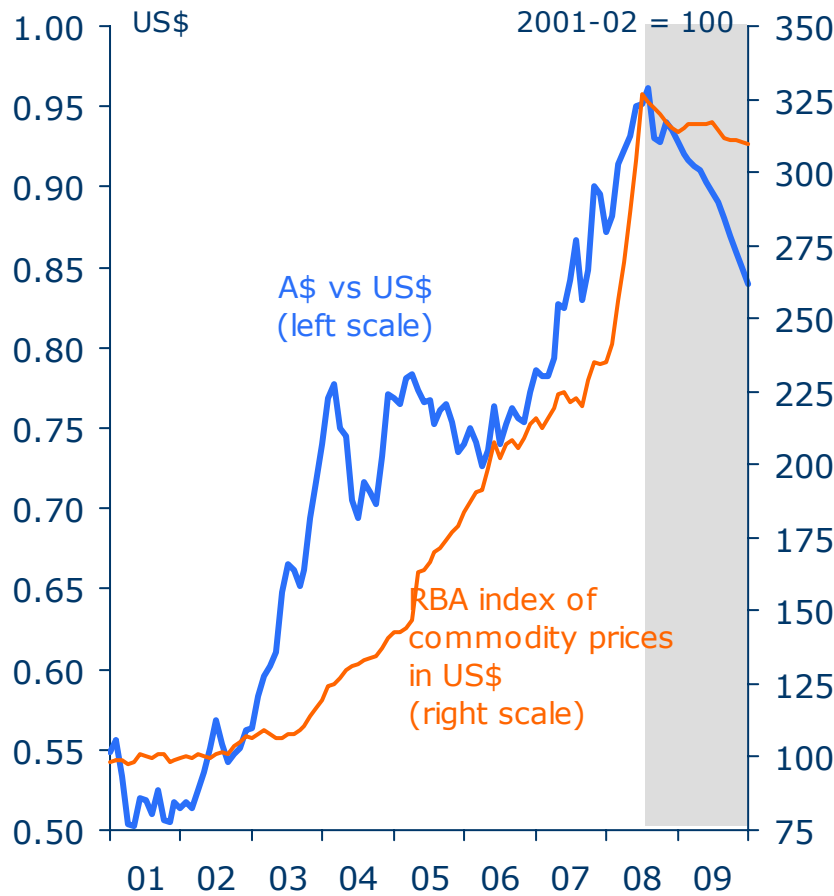
Short-term interest rates



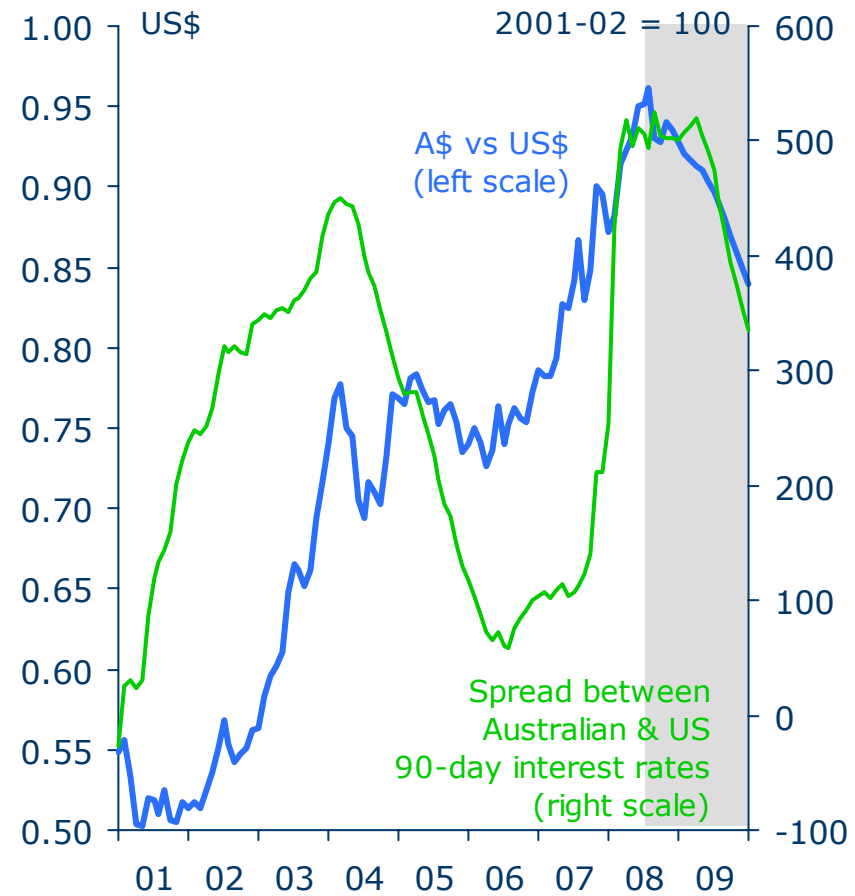
- Yesterday's RBA Board meeting left the cash rate unchanged at 7¼%, but signalled that 'scope to move towards a less restrictive stance of monetary policy in the period ahead is increasing'
- That probably means that they will cut the cash rate at next month's meeting
- This earlier-than-expected rate cut likely stems from two considerations –
 - the further increase in banks' lending rates in July (when the RBA thought no further lift in official rates was needed)
 - the marked slowing in the economy over the past couple of months (perhaps more than they wanted)
- There will likely be a second rate reduction before year-end (if only to ensure that lending rates do actually fall)
- Depending on the extent to which inflation begins to decline, rates will fall further during 2009

The prospect of lower interest rates and signs that commodity prices have peaked imply that the A\$ is now heading lower

A\$ and commodity prices



A\$ and interest rate spreads

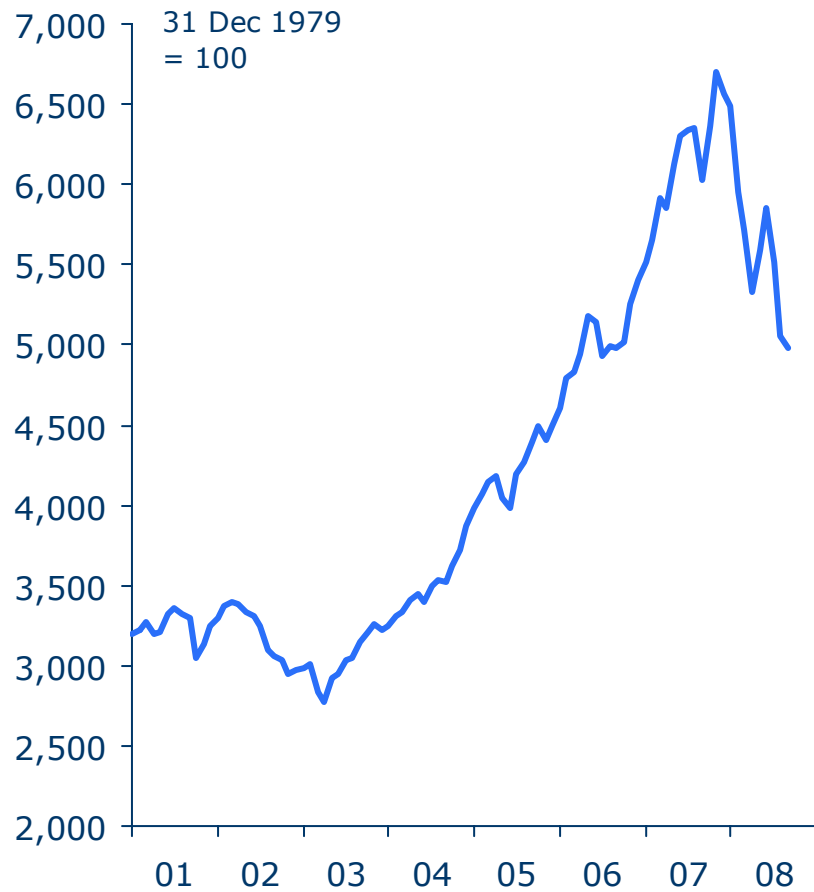


Sources: Datastream; Reserve Bank of Australia; ANZ.

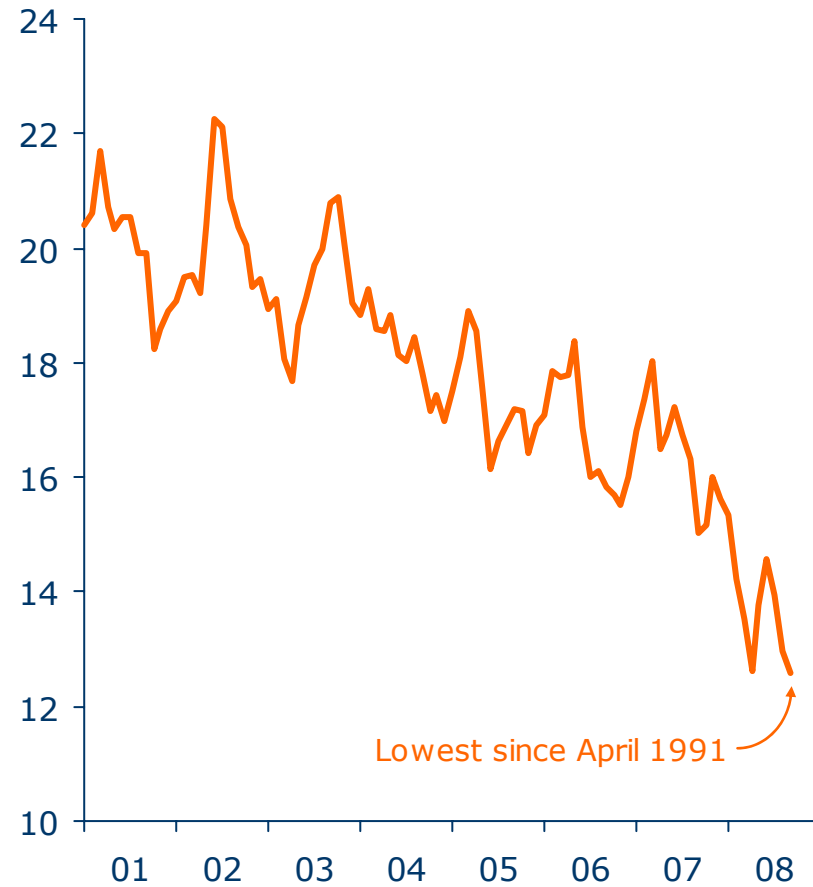


After falling 28% from its peak the share market looks 'cheap' – ⁴¹
but only if you are confident about the earnings outlook ...

ASX All Ordinaries



ASX trailing p/e ratio

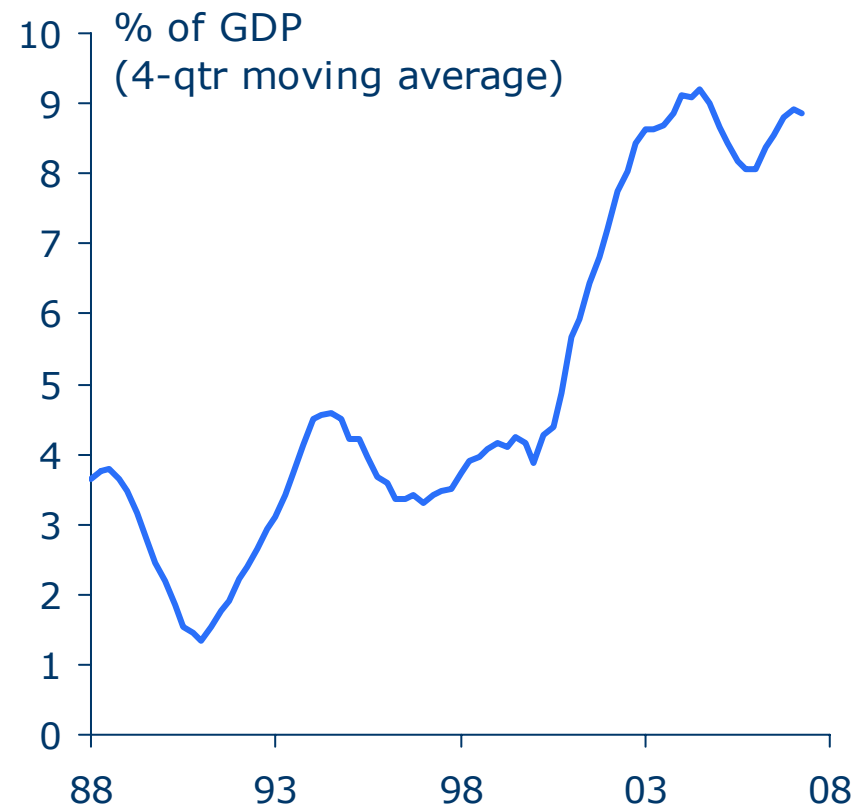
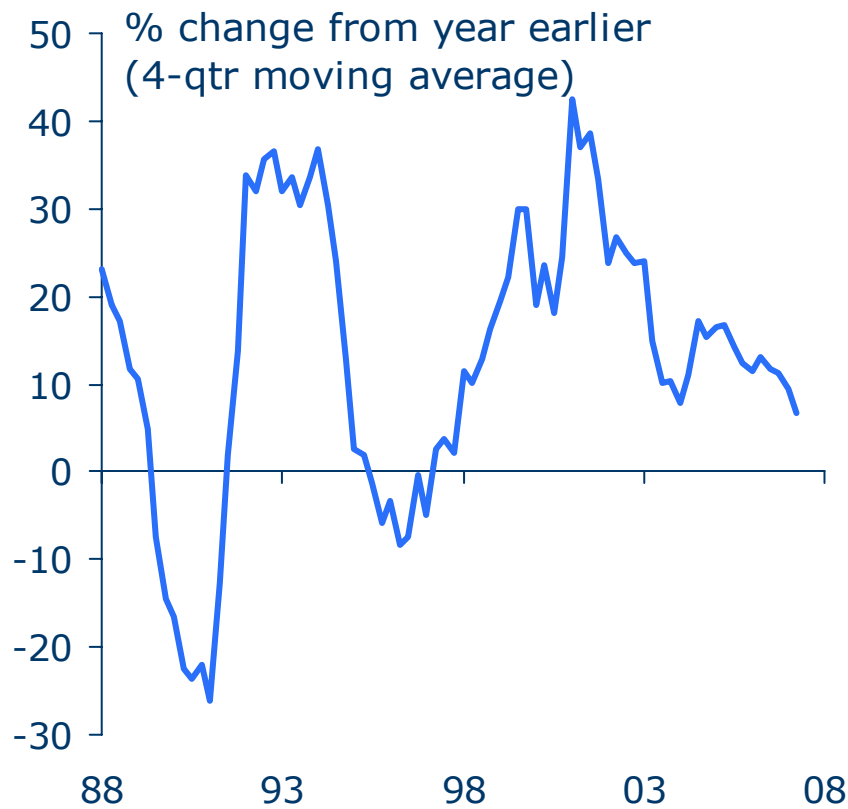


Sources: ASX; Thomson Financial.



Earnings projections are more likely to be revised downwards over the next few months

Pre-tax company profits (excludes financials)



Sources: ASX; Thomson Financial.



Summary

- The global credit crunch is continuing
 - and won't end until the US housing market bottoms out, which seems unlikely any time soon
- The world economy is slowing
 - the US hasn't experienced recession yet, but probably will during the next 12 months
 - some other advanced economies will also fall into recession
 - in the developing world, by contrast, inflation is a bigger risk than recession
- Australia's economy is also slowing noticeably
 - rapid developing-country growth benefits Australia via its impact on commodity prices
 - but Australia is also exposed to the global credit crunch via our large current account deficit and the way in which it is financed
 - the effect of that exposure has been magnified by the upward trend in Australian interest rates (and oil prices) over the past 12 months
- The next movement in Australian interest rates will be down
 - with the first rate cut now likely to come as early as next month
- The A\$ has probably peaked against the US\$
 - the US\$ may take another leg downwards against major currencies later this year as a US recession becomes more evident
 - but with Australian interest rates and commodity prices having peaked the A\$ is now on a downward trend