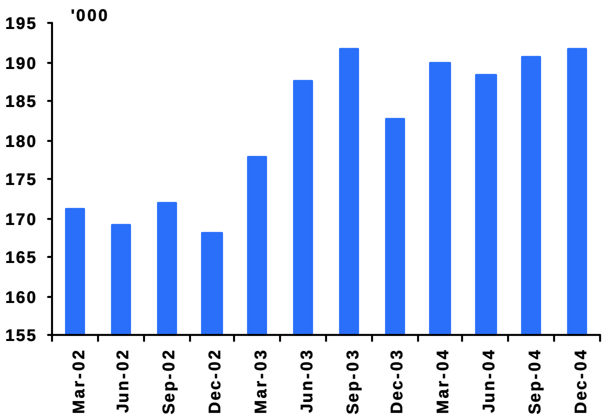
Economics@ANZ

The outlook for Australian new motor vehicle prices

Recent trends in motor vehicle prices

Motor vehicle prices increased by 1.5% in the December quarter, the biggest quarterly increase in over three years, and well above our expectation for a small fall in prices in this period. This strong quarterly price rise was attributed by the ABS to strong domestic trading conditions (Chart 1), which allowed a reduction in bonuses and other incentives offered by dealers. This appears to have more than offset the impact of the higher A$ (which increased by about 4% in trade weighted terms in the December quarter). Strong trading conditions also appears to have allowed dealers to minimise 'pre-emptive' discounting ahead of the 1 January 2005 tariff cuts on imported passenger motor vehicles.

Chart 1: Motor vehicle sales



Source: ABS

Despite the uptick in prices in the December quarter, Australian new car prices still fell by 3.3% in calendar year 2004. This reflects the combination of a rising A$ (which on average over 2004 was 7% higher then 2003 on a trade-weighted basis) and easing 'underlying' inflation (which declined from 2.0% in 2003 to 1.3% in 2004).

The model

The Economics@ANZ motor vehicle price model aims to forecast the price index for new cars as published by the Australian Bureau of Statistics in the quarterly Consumer Price Index release.

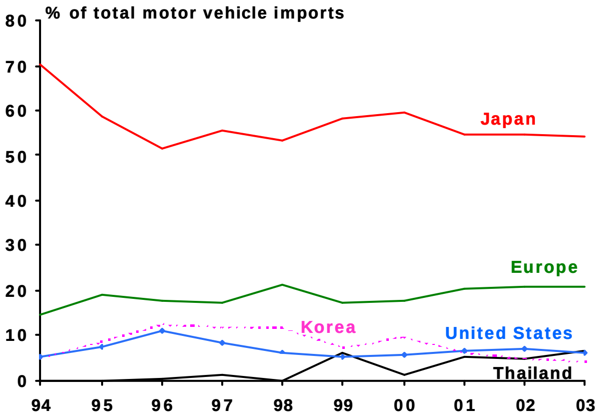
The forecasts should be used with caution for the following reasons.

- The forecasts are for new cars rather than used cars. In countries such as New Zealand that have reliable used car indices, it can be shown that the relationship between new and used cars is reasonably stable. Nevertheless price movements in new cars can diverge from those of used cars.
- The index is an average across all new makes and models. Average movements can mask different price paths for individual models.
- The price index is quality-adjusted and can therefore not easily be directly compared to nominal price changes. If a manufacturer releases a new model of a vehicle that is better than its predecessor at the same price, then this is reflected as a price fall. Similarly if the same car is released at the same price, but is sold with previously optional extras as standard, then this is also considered a fall in price.

Pricing in the Australian motor vehicle market, which is extremely competitive, is predominantly affected by domestic input costs, such as the price of labour. In addition, local economic conditions can also be shown to affect *quality-adjusted* motor vehicle prices, with strong domestic demand sometimes allowing motor vehicle sellers to cut down on 'optional extras' for example.

Given the increasingly globalised nature of motor vehicle manufacturing, it is also no surprise that Australian car prices are strongly affected by price movements of foreign manufacturers as well as fluctuations in the Australian exchange rate. The top five sources of motor vehicle imports in Australia are Japan, Europe, Thailand and the United States. The emergence of Thailand to become the third most important import source of motor vehicles has occurred over the last eight years, with Thailand increasing its share of the Australian motor vehicle import market from under 1% in 1996 to 6% in 2004 (chart 2). This increase in Australian market share has occurred mainly at the expense of South Korean, Japanese and United States imports. This development reflects increasing consolidation and 'export positioning' of global motor vehicle production, with Japanese and United States' companies shifting production offshore to Thailand, creating a 'hub' from which to export motor vehicles into Asia (including Australia).

Chart 2: Source of Australian motor vehicle imports



Source: ABS

The forecasts for Australian motor vehicle prices attempt to take into account all of the above factors. These forecasts are based on an econometric model, last estimated in February 2005, with the following explanatory variables: Australian underlying inflation[1], non-farm GDP growth and a composite import price variable that approximates the cost of importing vehicles from Japan, Euro-zone, Thailand and the United States into Australia[2]. The import price variable is based on:

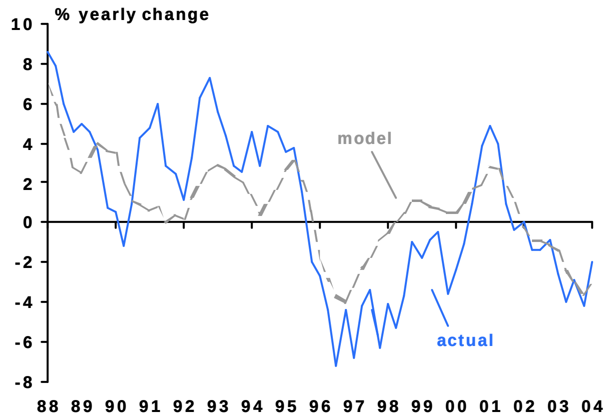
- The AUD/YEN exchange rate
- The AUD/USD exchange rate
- The AUD/EUR exchange rate
- The AUD/THB exchange rate
- Australian motor vehicle import tariffs.

The results of the new model yield three main 'rules-of-thumb':

- A 1% rise in underlying inflation leads to a 1.4% rise in motor vehicle prices over 1 quarter.
- A 1% rise in non-farm GDP growth leads to a 0.2% rise in motor vehicle prices over 1 quarter.
- A 1% rise in the import price variable leads to a 0.2% rise in motor vehicle prices over five quarters.

Chart 3 plots the historical fit between the actual car price movements and the latest specification of the model. As can be seen from the chart the ANZ car price model has a reasonable relationship with the index of new car prices as published by the ABS over the estimation period.

Chart 3: ANZ's car price model



Source: ABS, Economics@ANZ

Forecasts

The latest forecasts for motor vehicle prices are outlined in Table 1. Prices are expected to experience a small fall in 2005 before rebounding to post a small rise in 2006.

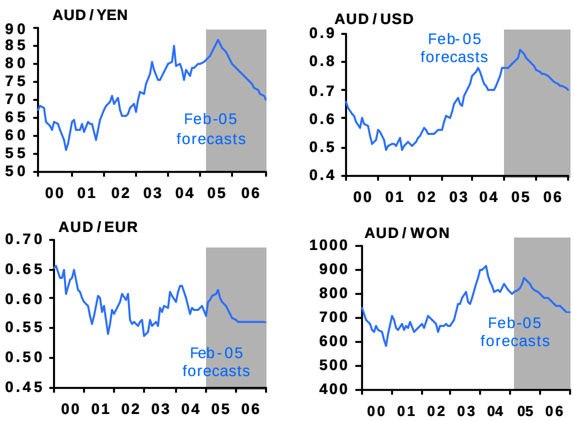
Table 1: Motor vehicle price forecasts, February 2005

	Calendar year	
	Index	Ann. % Change
1998	108.4	-4.5
1999	105.1	-3.0
2000	103.2	-1.8
2001	105.4	2.2
2002	106.6	1.1
2003	104.9	-1.6
2004	101.5	-3.3
2005	101.0	-0.5
2006	101.7	0.2

[1] Market goods and services CPI excluding 'volatile' items and GST.
[2] These markets account for around 87% of motor vehicle imports in Australia.

This forecast profile partly reflects the impact of expected movements in the Australian exchange rate. A continued structural weakening in the US$[3] is expected to see the A$/US$ appreciate over the next six months. In addition, strong resource commodity prices[4] and a likely rise in Australian interest rates are both expected to underpin some 'outright' appreciation in the A$, allowing the A$ to rise against all of other the major currencies in the first half of 2005 (Chart 4). As movements in the exchange rate take around a year to pass through to final motor vehicle prices, this expected A$ appreciation is likely to continue to dampen prices until mid-2006.

Chart 4: Exchange rate forecasts

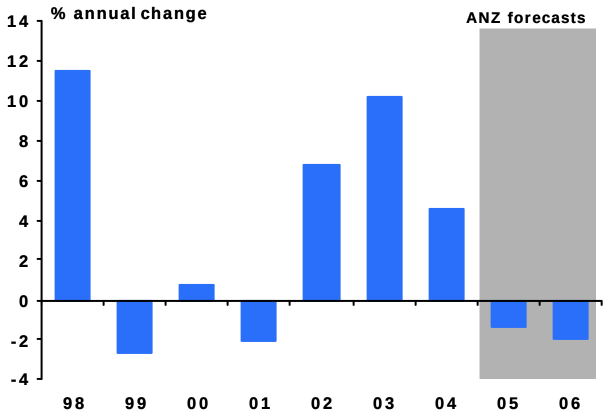


Source: Reuters, Economics@ANZ

From mid-2006, weaker commodity prices and a narrowing interest rate differential between Australia and other major economies will likely see demand for the A$ start to diminish. As such, the A$ is expected to resume a modest depreciation against most major currencies from the second half of 2005, continuing over 2006. This currency depreciation is expected to put upward pressure on Australian motor vehicle prices from mid-2006.

Another factor that is likely to keep motor vehicle prices subdued over the coming year is slower economic growth. Australian economic growth is expected to ease from a (expected) solid 3½% in 2004 to around 3% in 2005. This is slightly below trend and largely reflects a moderation in domestic demand on the back of an anticipated (modest) downturn in the housing sector and an easing in household consumption growth. While January Vfacts figures suggest Australian car sales have started 2005 sensationally[5], softer economic growth, particularly softer household consumer spending, will likely see demand for motor vehicles drop off a little over the course of 2005. As such, ANZ's latest forecast is for motor vehicle sales to ease by around 1.4% in 2005 (Chart 5).

Chart 5: Motor vehicle sales forecasts



Source: ABS

In 2006 Australian economic growth is expected to rebound to around 3½%. However, this forecast turnaround largely reflects a further improvement in export growth, with domestic demand expected to continue to ease. As a result, demand for motor vehicles is likely to continue to moderate with ANZ forecasting a further 2% fall in sales in 2006. Softer sales will likely keep pricing in the motor vehicle market extremely competitive over the next couple of years and will see most dealers remain 'price-takers' rather then 'price-makers'.

In the short-term, the reduction in tariffs on imported passenger motor vehicles, from

[3] The US$ is expected to continue to be weighed down by the massive funding requirements of the US 'twin deficits'. For more details, see the March quarter 2005 ANZ Economic Outlook at <http://www.anz.com/go/economics>

[4] Australia's large resource export sector means that commodity prices have a big influence on Australian export returns. When commodity prices are higher, they garner greater export income generally denominated in foreign currency (usually US$). This increases the demand for domestic currency, as export revenue must be converted to A$. Hence, higher commodity prices, all other factors unchanged, can be expected to have a positive impact on the A$. This is why the A$ is often referred to as a 'commodity currency'.

[5] Car sales in January 2005 were up 7.4% from January 2004

15% to 10%, on 1 January 2005 is also likely to push down motor vehicle prices. History suggests that it takes around six months for the impact of such a policy change to pass through to final prices, given the lags involved between the wholesale purchase of imported vehicles, distribution to dealers and final sales of such vehicles. ANZ expects the reduction in tariffs will therefore dampen motor vehicle prices over the first half of 2005.

Free trade agreements

As well as the across-the-board cut in passenger motor vehicle import tariffs on 1 January 2005, the Australia-Thailand and the Australia-US free trade agreement also both came into place on this date. These agreements can be expected to exert some downward pressure on Australian motor vehicle prices over the coming period.

Of the two agreements, the Australia-Thailand free trade agreement is likely to have the biggest impact on prices. Under the terms of this agreement, Australia eliminated all tariffs on passenger vehicles, off-road vehicles, goods vehicles and other commercial vehicles of Thai origin. This policy change can be expected to exert considerable downward pressure in the first part of 2005 on prices for 'other vehicles' (ie. sports utilities and light trucks), with Thailand accounting for about 25% of Australian imports in this market. While Thai imports make up only around 1% of new passenger vehicles, the increasing preferences for 'other' vehicles amongst the traditional passenger vehicle buyers (eg. households) suggests that falling prices for 'other' vehicles will almost certainly put downward pressure on prices in the passenger vehicle market.

The free trade agreement with the United States is also expected to exert some downward pressure on local prices for 'other' (ie. non-passenger) vehicles. Under this agreement, all tariffs on commercial vehicles imported from the United States have been eliminated from 1 January 2005. With the United States currently supplying around 15% of total imports of 'other' vehicles into Australia, some notable degree of downward price pressure can be expected in this market in the first part of 2005.

Also under this free-trade agreement, tariffs on finished passenger motor vehicles imports from the United States will be phased out gradually between 2005 and 2010[6]. However, as the United States only supplies around 4% of passenger motor vehicle imports in Australia, and as the reduction in tariffs on these vehicles will be phased in gradually over the course of five years, the magnitude of the negative impact on passenger car prices from this policy change will be relatively diluted. Indeed, the impact on year-by-year price growth may prove negligible.

Summary of forecasts

In summary, an appreciating local currency (for the next six months), slower domestic demand and tariff cuts are all expected to keep motor vehicle prices relatively subdued over the coming period. Combined, these factors are expected to more then offset the impact on motor vehicle prices from a likely gradual rise in underlying inflation over 2005 and 2006.

Risks

To account for the introduction of the free trade agreements we have made a small quantitative downward adjustment to the forecasts for motor vehicle price growth in the first half of 2005. The exact impact of these agreements (in terms of both timing of price changes and magnitude of aggregate price changes) is however difficult to predict, such that there are considerable risks (in both directions) to this adjustment, and thus the forecasts.

As well as the uncertainties posed by the free trade agreements, there are also many other risks to the motor vehicle price forecasts presented in this paper. The accuracy of the forecasts produced by a model is only as good as the quality of its inputs. The extent to which inflation, exchange rate outcomes or non-farm GDP growth deviate from our forecasts is therefore a risk around the motor vehicle price forecasts presented.

Another significant risk to the short-term forecasts is the extent to which the pass-

[6] The 'across-the-board' tariff of 5% will still apply to motor vehicle imports

through of exchange rate fluctuations to imported car price fluctuations has changed. There is some evidence that movements in the exchange rate may now be passed through more quickly into final car prices then we would have expected a few years ago. If this is indeed the case, the ANZ model may be overestimating the period that final motor vehicle prices will remain affected by the expected AUD appreciation in the first half of 2005. This creates an upside risk to the forecasts for car prices over 2005.

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