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ANZ Economic Outlook

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- The downturn in the global economy appears to have ended around the turn of the year and a recovery is now under way. The improved outlook stems mainly from the United States, which is in turn assisting recovery elsewhere. (*Saul Eslake*: page 2)

Asian outlook

- While confidence that East Asia will experience a clear recovery in GDP growth in 2002 has risen, the region is not expected to experience as strong a rebound as in 1999.
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- The Australian economy defied the world economic slowdown in 2001 and the outlook remains positive. The main issue for the economic outlook is now the transition from housing to other sources of growth.
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- Interest rates are heading up globally, with the RBA also likely to soon start taking back last years 'insurance' cuts. The $A appears to be increasingly driven by fundamentals and further gains are expected.
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- The domestic rather than the external sector is expected to be the main engine of growth this year, with New Zealand's predominantly agricultural commodity markets likely to remain under pressure for some time yet.
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- The manufacturing sector's contribution to the overall economy has contracted over time, although the weakness in activity has not been across-the-board, with a substantial improvement in a few key industries.
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International outlook

The global business cycle has turned

The downturn in the global economy appears to have ended around the turn of the year and a recovery is now under way. Moreover that recovery, at least in its initial stages, appears to be somewhat stronger than we had expected. As a result, we have revised upwards our forecast for global growth this year from 2% to 2¾%, while the forecast for 2003 has also been shaded upwards from 3¾% to 4%.

The improved outlook stems mainly from a stronger than expected turnaround in the United States, where orders, production and employment have rebounded as businesses look to rebuild inventories which were depleted at a record rate in the final quarter of last year, when household spending held up much better than businesses had anticipated. Information technology spending is also recovering from last year's slump. Stronger US demand is in turn assisting recovery elsewhere, particularly in Asia. There are also some encouraging signs of an upturn in economic activity in Western Europe after a disappointing end to 2001.

The prospect of a rebound in global growth is clearly signalled by the OECD's composite leading indicator, which has consistently led turning points in our 42-country series of world industrial production by around six months. It now suggests that annual growth in industrial production will have turned positive by the middle of this year.

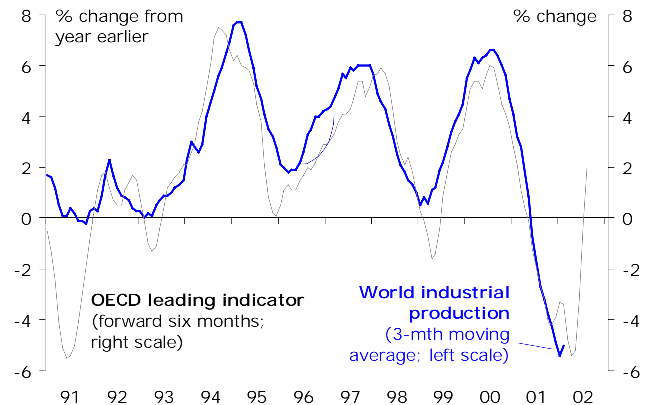
A broader recovery in global economic activity is also signalled by the marked steepening in the slope of the yield curve. Historically, the G7 yield curve has led turning points in global GDP growth by around nine months. The present steepness of the yield curve highlights the role played by central banks (and especially the Fed) in averting a sharper downturn in economic activity and in laying the basis for the recovery which is now getting under way. It also underscores the extent to which financial markets anticipate that interest rates will rise this year as the global upturn gathers momentum.

A possible threat to the prospect of stronger global growth this year is the rise in oil prices from under $US20 per barrel at the end of last year to over $US27 by early April. The rise in oil prices stems largely from concerns over the possible effects on oil supplies of the escalating violence in the Middle East, and of mooted US military action against Iraq.

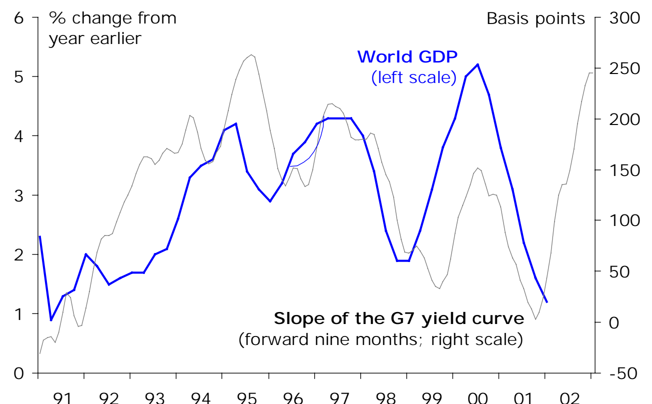
OECD simulations suggest that a $US10 per barrel increase in oil prices reduces OECD area growth by about ¼ pc point, on average, in the following year.

If oil prices were to be sustained at the current level or higher for any length of time, the emerging upturn in global growth might well be curtailed.

Leading indicators of the global economy



Note: the OECD leading indicator is expressed as a 6-month smoothed annualized rate of change, ie the ratio of the current index to the average for the preceding 12 months raised to the power 12/6.5 *Sources:* OECD; Datastream; ANZ.



Note: the G7 yield curve is the weighted average spread between 10-year bond and 3-month bill yields in seven largest industrial economies and is expressed as a 3-mth moving average. *Sources:* Datastream; national agencies; Economics@ANZ.

Outlook for world economic growth

	% change -			
	2000	2001	2002 (f)	2003 (f)
North America	4.4	1.1	2¼	3¼
Western Europe	3.5	1.7	1½	3
Japan	2.2	-0.4	-1¼	1½
Australia and NZ	3.3	2.4	3¾	3¼
China	8.0	7.3	7	7½
Other East Asia	6.5	1.9	4	5¼
South Asia	4.3	4.8	5½	5¾
South America	3.3	0.9	0	3¼
E. Europe & Russia	6.1	4.0	3¼	4
World (a)	**4.6**	**2.3**	**2¾**	**4**

(a) 55 countries (including 4 outside the above regions) weighted using GDP expressed in US$ at purchasing power parity (PPP) exchange rates.

US economy rebounding strongly

The US economy is rebounding more strongly than expected from last year's recession. In one respect, this recession was the mildest of the post-War era. Real GDP declined for just one quarter (the September quarter) by 0.3%, compared with an average decline during the nine previous recessions of 2.3%.

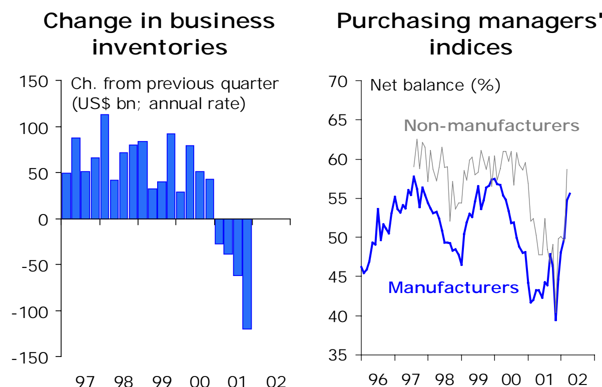
In two important respects, however, last year's recession was unusually severe. First, after-tax corporate profits fell by 21% from the pre-recession peak (in the June quarter 2000) to the September quarter last year, nearly double the declines in the recessions of 1981-82 and 1990-91. As we argued in the previous issue of this publication, it was this sharp fall in profits which precipitated last year's recession, rather than the impact of higher interest rates on household spending as has more typically been the case. It largely explains the abrupt rise in unemployment relative to the fall in GDP (the unemployment rate rose by 1.9 pc points, more than it did during the recession of 1990-91, when real GDP shrank by 1.3%), and also the severe downturn in 'discretionary' business expenditures such as on advertising and consultants.

Second, the level of inventories was run down by 4.1% - more than double the average for previous recessions. Inventories plummeted by US$119bn at an annual rate in the December quarter of last year, proportionately the largest run-down ever recorded. To some extent, this stock run-down was part of planned responses to the downturn in profits (as intended, for example, by car-makers' 0% financing offers during October and November). However, many businesses appear to have been surprised (as were most economists) by the resilience of household spending in the aftermath of the September 11 terrorist attacks, so that stocks were depleted even more rapidly than had been intended.

As a result, the early months of this year have seen orders and production rebound as businesses have sought to rebuild stocks back to more sustainable levels. On its own, this re-stocking process is likely to have boosted GDP growth in the March quarter by more than 4 pc points (at an annual rate). It has also been sufficient to halt the upward trend in unemployment which began in November 2000.

A second contributor to the unexpected strength in the US economy in the early months of 2002 has been the turnaround in spending on technology. Spending on computers by US businesses fell by 16% in real terms over the first three quarters of last year, but retraced almost half that decline in the December quarter. Reflecting this, production of IT goods has risen 4% since September, after falling 16.7% over the previous nine months.

Inventory rebuilding powers recovery



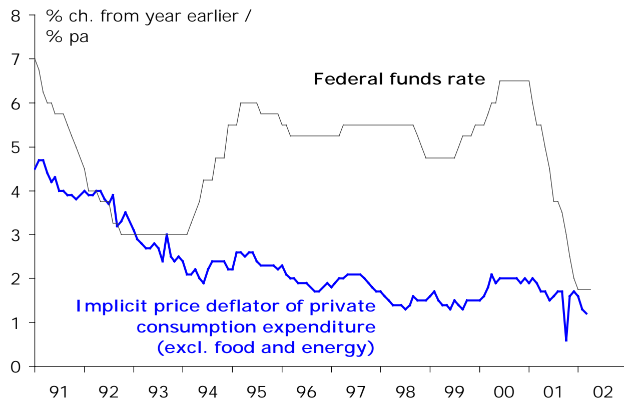
Sources: US Bureau of Economic Analysis; Insitute of Supply Management (formerly National Association of Purchasing Management)

However, while the inventory cycle and IT spending are the most visible drivers of the earlier and stronger than expected recovery in the US economy, the key underlying force has been the resilience of household demand. It had been widely thought that of all the various components of aggregate demand, household spending would have been the most vulnerable to falling share prices, rising debt and of course to the shocks of 11 September 2001. Yet over the five months since September last year for which data are available, consumer spending has risen at an annualized rate of 8.0% in real terms.

The resilience of household spending owes a good deal to unusually well-timed economic policy. Albeit partly for reasons that could not have been foreseen, the Administration's income tax cuts took effect at precisely the right moment; while the Federal Reserve began aggressively cutting interest rates well before households had begun to sense that the economy had slipped into recession. Lower interest rates enabled households to refinance nearly US$1 trillion in mortgage debt during 2001, freeing up cash flows for additional spending. The plunge in oil prices after September 11 reinforced this effect.

The on-going strength of household spending over the past six months also means, however, that the pent up demand for housing and consumer durables which typically builds up during a recession, and which has been a major driver of above-trend growth during the first year after the trough of previous recessions, is not present at the outset of the current cyclical upswing. Since household spending accounts for nearly three-quarters of GDP, this is in turn a key reason for expecting only a gradual return to trend growth in this cycle. Indeed, GDP growth will probably slow from an annual rate of around 3½% in the first half of this year to around 2½% in the second half once the present impetus from inventory re-building fades, before returning to an above 3% pace in 2003 as capital spending accelerates and exports begin to recover.

Low inflation gives the Fed latitude



Sources: US Bureau of Economic Analysis; Federal Reserve Board

Such considerations also suggest that the Fed is unlikely to hike rates as aggressively as the financial markets anticipate. To be sure, the need for rates to remain at a 40-year low to support economic growth is receding. But 'core' inflation, as measured by the implicit price deflator of consumer spending excluding food and energy (the Fed's preferred measure) is also at close to 40-year lows, and is below the Fed funds rate. It is thus difficult to argue that monetary policy is excessively loose.

The relatively robust performance of labour productivity through last year's recession (troughing at 1.3% over the year to the September quarter, compared with outright declines in every previous recession in the previous 40 years) implies that the *potential* growth rate of the US economy is still likely to be around 3½% per annum. As such, there is likely to be sufficient spare capacity in the US economy to prevent the emergence of inflationary pressure until 2004 at the earliest. The Fed will of course need to be tightening monetary policy ahead of that time, but again there seems to be little cause for rapid rate increases over the next year or so.

With the US emerging earlier and more strongly from a relatively mild recession, ahead of most of its trading partners and with a still-strong currency, the current account deficit will widen anew from a rather large starting point of just under US$400bn or 3.9% of GDP. The US has thus far been able to attract more than enough inflows of private equity and debt capital to finance its external deficit, although in recent months there have been signs of a cooling in investors' appetite for adding to their holdings of US$-denominated assets at the same rate. The Administration's ill-considered decision to impose 30% tariffs on steel imports may signal some otherwise unspoken qualms with the 'strong dollar' policy. With the current account deficit set to widen to an unprecedented 5% of GDP in 2003, the adequacy or otherwise of capital inflows may be a key influence on the performance of the US economy.

Japan avoids financial crisis

Japan's economy contracted by 2.9% between the June and December quarters last year, the first time since the end of the Second World War that real GDP has declined for three consecutive quarters. With prices also falling across the board, as they have now been for some seven years, the decline in nominal GDP was even worse, at 3.5%. Shrinking nominal GDP has in turn exacerbated the problem of bad debts afflicting Japan's banks.

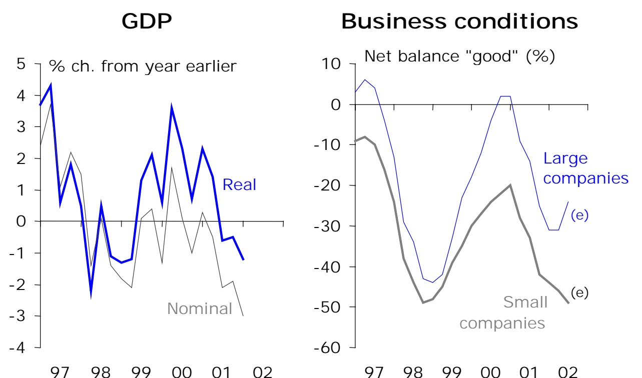
Earlier this year it had seemed plausible that the combination of falling share prices (eroding the value of shareholdings which Japanese banks are allowed to count towards their capital adequacy requirements) and inexorably rising bad debts could have precipitated a major loss of confidence in the banking system, with the removal of government guarantees of time deposits of over ¥10mn from the beginning of the new Japanese fiscal year (1 April).

That possibility has been headed off for now by a sharp rally in the share market (prompted by administrative measures aimed at discouraging short selling), and by depositors transferring funds into current deposits (for which deposit insurance will continue to apply for another twelve months).

However, concern about the health of the banking system is likely to persist while the bad loan problem is allowed to fester. And while the problem of mounting bad debts remains unresolved, so-called 'zombie companies' (which remain in business only because of the reluctance of banks to foreclose on them) will continue producing goods and services at a loss, perpetuating deflationary pressures and undermining the profitability of more viable firms.

However, even if the bad debt issue were somehow to be resolved overnight, persistent weakness in household and business sector demand would still preclude a return to stronger economic growth.

Japanese economic outlook remains poor



Sources: Japan Cabinet Office; Bank of Japan *Tankan* survey. June quarter 2002 *Tankan* readings are expected rather than actual.

Japanese exports are beginning to benefit from the emerging recovery in world trade, particularly in information technology products, and from the nearly 20% decline in the yen since the beginning of 2001. The pace of inventory liquidation appears to be lessening, although since the aggregate stocks-to-sales ratio remains relatively high by historical standards (nearly 13% above the previous low in August 2000), it is unlikely that contribution of the stock cycle to growth in 2002, though positive, will be substantial.

Given the improving outlook for the world economy, the recovery in exports will eventually be sufficient to underwrite a return to positive overall growth, although this is unlikely to be before the second half of the year. Household spending is likely to remain weak in the face of further increases in unemployment but business investment is expected to begin growing again next year.

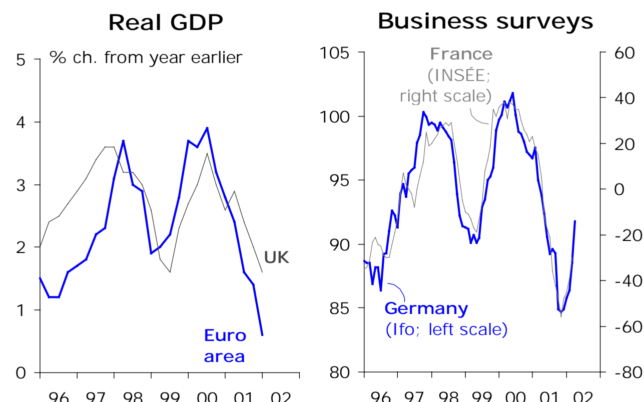
Responding to pressure for more unorthodox monetary policy responses to persistent deflation, the Bank of Japan has further expanded its outright purchases of government and private sector securities, with the result that growth in narrow measures of the money supply is now approaching 20% per annum. With demand for credit from the private sector still very weak, little of this is reaching the broader economy; however, it is enabling the financing of the government's huge budget deficits with little upward pressure on long-term interest rates. With the usual fiscal year-end repatriation of capital completed, the yen will likely resume its downward trend, towards a low of around ¥140 to the $US in the September quarter.

Europe turning after a disappointing 2001

Growth in the euro area economy is set to pick up this year after a disappointing end to 2001. Euro area GDP declined by 0.2% in the December quarter, resulting in growth for the year as a whole of just 1.6%. This was only 0.4 pc point more than the US, despite the advantage of a weak currency, less exposure to falling share prices and ostensibly fewer economic imbalances than in the US.

Whereas the mildness of the downturn in the US owed much to the resilience of household spending, in the euro area consumer spending was a major drag on overall growth. Household incomes were crimped by higher food and energy prices, with headline inflation averaging 2.5% in 2001, the highest for six years. Largely because of this increase in inflation, the European Central Bank cut interest rates by only 1.5 pc points, less than one-third as much as the Fed (although European household finances are in any event less sensitive to movements in short-term interest rates than is the case in the US).

Europe set for stronger economic growth



Sources: Eurostat; UK Office of National Statistics; Ifo Institüt; INSÉE.

The impact of the US downturn on Europe was greater than expected, not only because of the impact on exports but also through the effect on business income and confidence of the fall in earnings of European companies' US affiliates.

Lower inflation, the emerging upturn in the US economy, and a turn in the inventory cycle should result in stronger economic growth in the euro area through 2002. This prospect is underscored by the significant improvement in business confidence – which is typically a reliable leading indicator of European economic activity – since late last year. However with less stimulus from economic policy and the inventory run-down having been less dramatic than in the US, the upturn in euro area growth will be more gradual, averaging about 1½% this year.

The British economy also slowed last year but not to the same extent as the euro area; indeed at 2.2% on average in 2001 Britain's growth rate was the fastest of any G7 economy. While exports and business investment were adversely affected by the global downturn (and the strong pound), economic policy was more supportive of growth than in the euro area. The Bank of England cut interest rates earlier and by ½ pc point more than the ECB, while fiscal policy was eased by the equivalent of about ¾% of GDP whereas (reflecting the constraints imposed by the Maastricht Treaty) the stance of fiscal policy was essentially unchanged in the euro area. Rapidly rising house prices also lent considerable support to household spending in the UK.

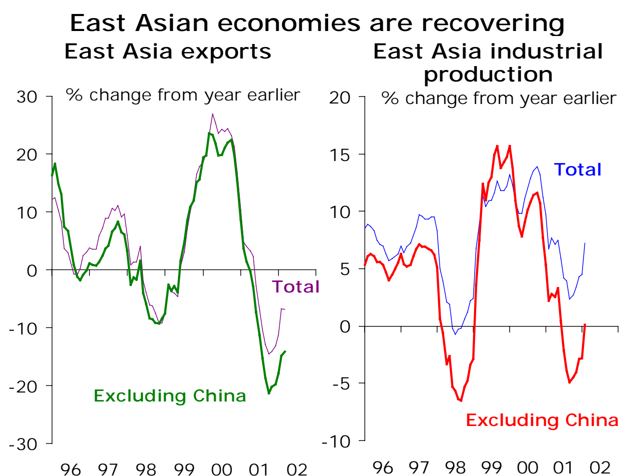
Although exports and investment are likely to rebound this year, economic policy settings will be tightened. With 'core' inflation already rising again, the Bank of England is likely to raise short-term interest rates by ¾ pc point over the remainder of the year. And the forthcoming Budget is expected to include increases in personal taxes, more than offsetting the recent concessions in corporate taxes.

Asian Outlook

The economic slowdown in East Asia in 2001 was much more severe than had been forecast at the beginning of last year, but the economic outlook is now less gloomy than had appeared likely in the aftermath of last September's terrorist attacks on the US. Last year's slowdown was broadly-based across the region and reflected much weaker external demand, triggered by the collapse of the 'technology bubble' and the subsequent US and global economic slowdowns.

While the adverse impact on Asian exports and production was much more severe than had initially been projected, a significant improvement in the balance of payments and external debt ratios since the 1997-98 crisis significantly reduced the risk of this shock to the real economy becoming the trigger for another regional financial crisis.

East Asian economies are recovering



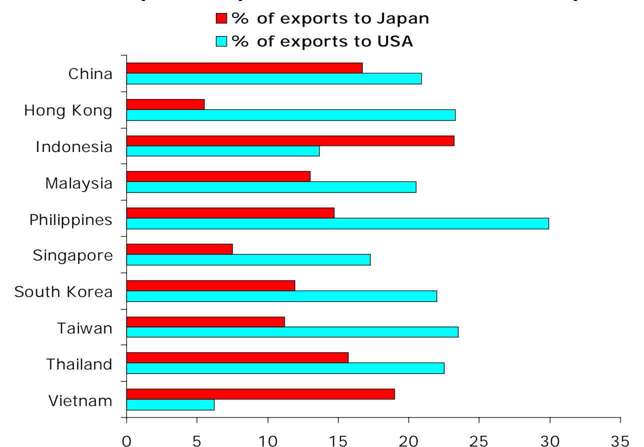
Source: National statistical agencies, Datastream, Economics@ANZ

Most East Asian economies appear to have bottomed in the third quarter of last year, with a number of countries recording stronger–than-expected GDP growth in the final quarter of 2001. Prospects of economic recovery in Asia are being bolstered by the recent pick-up in activity in the US economy, following the mild slowdown experienced last year, and by the region's strong linkages to the Information/Communication/Technology production chain which has begun to recover after the sharp downturn in 2000 and 2001.

While confidence that East Asia will experience a clear recovery in GDP growth in 2002 has risen, the region is not expected to experience as strong a rebound as in 1999. Potential obstacles that could impede economic recovery include the strength and pattern of global recovery and demand for electronics goods, as well as the impact of poor economic conditions in Japan on the rest of Asia. In addition there are some country-specific obstacles.

Interest rates in most East Asian countries are expected to be on a gradual upward trend in the second half of this year and 2003. However with inflationary pressures subdued in most countries (Indonesia is the exception), and China, Hong Kong and Taiwan experiencing deflation, any interest rate rises are likely to be modest and much less than those expected in the US over this period.

Asia's export dependence on the US & Japan



Source: IMF, Data relates to 2000

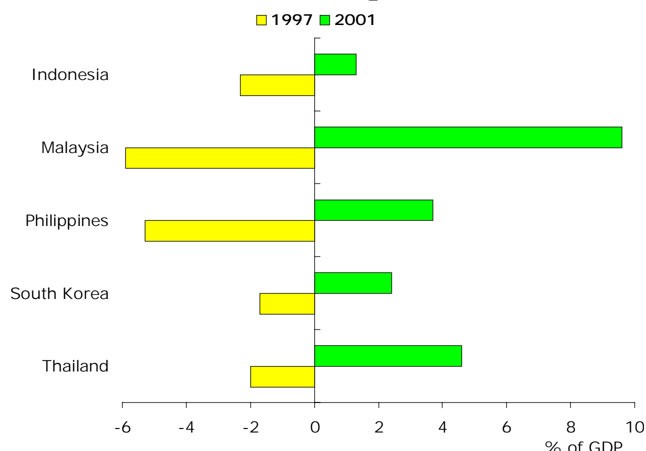
Taiwan and Korea expected to lead upturn

Countries that are likely to be among the main beneficiaries of the recovery in demand for electronics products in 2002 include Taiwan, South Korea, Malaysia, and Singapore.

The Taiwan economy was particularly badly hit by the slowdown in the US and weaker global demand for electronics. GDP actually declined for four successive quarters (October 2000 to September 2001) and, for 2001 as a whole, the economy contracted by 1.9%. However, there were signs of an improvement late in 2001, with the fourth quarter showing positive growth of 2.1% seasonally adjusted, compared with the previous quarter. This unexpectedly strong rebound was driven by external demand while spending associated with the December elections for the legislature probably moderated the decline in domestic demand.

Growth this year could surprise on the upside. There has been a substantial rundown of inventories over the past six quarters, amounting to 2% of 2001 GDP. A turnaround will produce a very significant boost to 2002 growth. Even a slower rate of decline will make a positive contribution, which combined with a modest recovery in domestic demand and a significant contribution from net exports which now seems assured, produces ANZ's forecast of 4½%.

Current accounts are stronger than in 1997..



Source: Economist Intelligence Unit

.. and short-term external debt is less onerous

Source: Economist Intelligence Unit, IMF

South Korea has been one of East Asia's strongest performing economies since the 1997-98 crisis. Although there was a sharp slowdown in GDP growth last year following an impressive economic performance in 1999 and 2000, real GDP growth of 3% in 2001 compares favourably with many other East Asian economies and reflects its more diversified industrial base. Real GDP is forecast to rise by around 5% this year. Consumer spending is expected to hold up well and business conditions are likely to improve, underpinned by domestic demand as well as a recovery in external demand. One-off events such as the soccer World Cup finals, in which South Korea is co-host with Japan (31 May-30 June 2002), as well as the hosting of the Asian Games (29 September-14 October 2002), are positive for the economy. In addition, the government intends to front-load about 65% of its spending to the first half of this year in a bid to underpin domestic demand.

While economic prospects for South Korea in 2002 are moderately favourable, the scope for more rapid economic expansion over the medium-term is impeded by the slow process of chaebol restructuring and the persistence of inefficient business operations. Another risk to economic growth is the threat that a weak yen poses to the competitiveness of South Korean exporters who compete closely with Japan in a number of industries including automobiles, telecommunication equipment, petrochemicals and shipbuilding. China could also become a more formidable competitor over time as inflows of foreign investment, bolstered by its entry to the WTO, produce further modernisation and upgrading of its industrial base.

Malaysia and Singapore are also well placed

Real GDP growth in Malaysia plummeted from 8.3% in 2000 to just 0.4% in 2001, but some recovery in economic activity was evident in the final months of last year. Malaysia is well-placed to benefit from the recovery in the global electronics industry and economic growth of around 4% is forecast for 2002. The authorities have relied on expansionary fiscal policies to partially alleviate the detrimental impact of the subdued international environment. With external demand expected to be a positive impact on the economy this year, the authorities are likely to adopt a more cautious fiscal stance later this year. However public sector debt remains manageable, so there is scope for new fiscal stimulus measures if international recovery falters.

Corporate sector restructuring is speeding-up, a positive development for investor confidence. If this heralds a shift away from the relationship-based economic system to one that is more open and based on market forces, the prospects of Malaysia once again becoming one of the strongest performing economies in Asia will improve.

Singapore experienced a much more severe slowdown than Malaysia in 2001, with real GDP contracting by 2% in 2001 as external demand and domestic consumption slumped. Over the year to Q4 2001, the economy shrank by 6.6%. However, real GDP grew by a seasonally-adjusted annualised rate of 5.6% in the December quarter, the first increase following three consecutive quarters of declines averaging 10%, amidst signs that weakness in the manufacturing sector, the backbone of the economy, is abating. There is growing optimism that real GDP will expand by over 3% in 2002, underpinned by a pick-up in the US economy, its main export market, and a gradual recovery in global electronics demand.

The severe recession coupled with consolidation within the banking industry have adversely affected employment prospects, with job losses mounting and the unemployment rate reaching 4.7% in December from 3.8% in September. A further deterioration in the unemployment rate is expected in the first half of the year, amidst on-going

restructuring and the lagged effect on the labour market of weak economic conditions. Wage cuts and freezes have been implemented to limit the adverse impact on unemployment and these measures are likely to remain in place during the year.

Hesitant reform hampers growth in Thailand

The Thai economy was surprisingly resilient in the final quarter of 2001, with a 2.1% rise from a year-earlier and a full-year increase of 1.8%. Annual figures show a 3.4% rise in private consumption in 2001, but investment rose by only 0.8% while the volume of exports fell by 4.2%. Although Thailand was not as severely affected by the poor international environment in 2001 as some other Asian economies, it is not expected to be one of the major beneficiaries of the improvement in external demand that is now under way. While the recovery in external demand will be reflected in faster GDP growth in 2002, ANZ considers it unlikely that growth will be much above 4%, a disappointing pace by both historical and regional standards.

Recent economic policy developments have been mixed. Official short-term interest rates, which had been raised in mid-2001 despite weak economic conditions, were reduced last December when the Bank of Thailand cut its benchmark 14-day repo rate by 25 basis points (bps) to 2.25%. A second reduction to 2.0% followed in January. This change in monetary policy, albeit belated, is welcome and represents a shift in focus from an emphasis on currency stability towards encouraging economic growth. Monetary policy is now complementing fiscal policy, which became more expansionary as the economic slowdown deepened. Medium term growth prospects, however, continue to be constrained by incomplete corporate sector restructuring and the government's reluctance to commit to faster economic reform that would bolster investor confidence.

Limited scope for faster growth in Philippines

The Philippines economy managed creditable growth of 3.4% in 2001. Agriculture grew by 4% and services by 4.3% but industry, representing 35% of the economy, grew by only 1.9%. Early indications are this pattern is continuing early in 2002, with buoyant production in agriculture, while manufacturing remains depressed.

Low food prices are helping to keep inflation down – over the year to February the CPI rose just 3.4%. This result probably encouraged the central bank to reduce rates by a further 25 bps in March - the third cut this year. Other policy changes introduced at the same time forced banks to cut their lending rates by a larger amount. Nevertheless, with bank lending rates at 9.75%, real interest rates are still high. However, with another El Nino threatening, there are supply-side risks to inflation later this year which may prevent further interest-rate reductions. The budget deficit for 2001 was relatively high at 4% of GDP and markets will be looking for some reduction in 2002.

In contrast to most other regional economies which are either recovering or building momentum in 2002, the Philippines may be hard pressed to match last year's growth rate, despite the improving demand for electronics goods which comprise well over 50% of exports. On the supply side, this view reflects the risk of an El Nino impact on agriculture which accounts for 20% of GDP. On the demand side, the government is likely to keep a tight reign on its outlays; spare industrial capacity and continued poor business sentiment will inhibit a recovery in investment spending; and, possibly most significant, if agriculture does experience a poor year, then the impact on household consumption will be negative.

Faster economic reform in Indonesia

Real GDP grew by 3.3% in 2001, supported by household and government consumption, which rose by 5.9% and 8.2% respectively. Consumers appear to have increased spending after President Megawati Sukarnoputri came to power in July 2001, lifting hopes for a stable political environment. The outlook for 2002, is for real GDP growth of around 3½% as exports are likely to pick up only in the second half of the year as external demand gains momentum. In addition, consumer spending is likely to be constrained by rising unemployment and higher utility and fuel prices.

The government has taken steps to push ahead with privatisation, despite strong nationalistic sentiment, and to stay firm in its dealings with debtors. The long-delayed sale of a 51% stake in Bank Central Asia, the country's largest retail bank, was finally announced in March 2002 to US investment fund Farallon Capital Management. This move is likely to lift investor interest as the government embarks on the sale of other state-controlled enterprises. The government's decision to stick to a loan repayment framework agreed in 1998 with the main shareholders of banks that failed during the crisis, instead of adopting a more lenient stance, is also likely to appease multilateral lending agencies' concerns over the government's resolve in tackling unpaid debt.

A series of high-profile arrests and criminal convictions signals a move by the government to clamp down on corruption. While these actions have been welcomed by Indonesians keen on stemming corruption and by foreign investors, the

depth of the commitment is still uncertain given the possible ramifications on the stability of the government. Nevertheless, the steps taken by the government to reform the economy and root out corruption are likely to be viewed positively by the IMF when reviewing its programme to Indonesia.

Deflation in Hong Kong

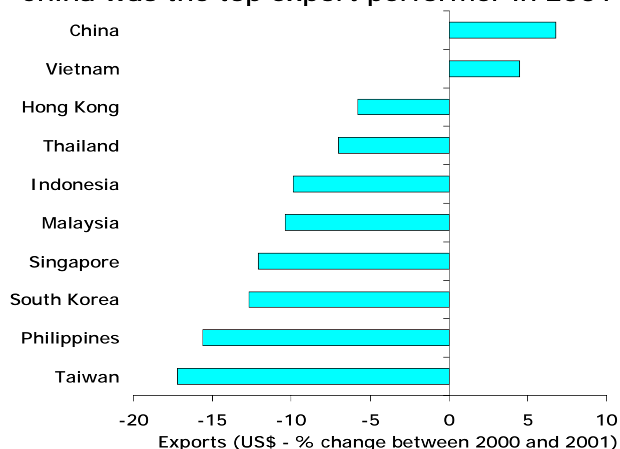
The Hong Kong economy is experiencing weak domestic demand, declining export earnings and a widening budget deficit. The prospects of economic recovery this year are more uncertain than in most other East Asian economies. Its rigid currency board arrangement severely limits the scope for discretionary macroeconomic management. Consumer prices have been falling for almost four years and asset prices for two years. Cyclical recovery will be driven by an improvement in external demand, but a return to sustained strong growth will require a lower real exchange rate, which in turn will require a continuation of the process of deflation for a while yet.

Growth in 2001 was just 0.1%, after 10.5% the previous year, with unemployment rising sharply from 4.5% in mid-2001 to 6.8% for the three months ended February. The best signals of hope are external - recovery in the US economy (which absorbs 31% of domestic exports and 22% of re-exports) and improving global demand for electronics goods (which comprise 34% of total Hong Kong exports). If these translate into improving exports, then given Hong Kong's high trade intensity (total exports at 124% of GDP), the positive impact on the economy will be meaningful.

Fiscal stimulus in China

China was less affected by the global slowdown in 2001 than most other Asian economies because of its lower relative dependence generally on foreign trade and specifically on electronics products within its overall export mix. For the same reasons China will not receive as big a boost from the recovery in the global economic environment that is now under way. However, China remains determined to sustain economic growth at an annual rate of close to 7% and remains willing to resort to government spending to meet this objective.

The budget for 2002, presented in March, envisages a widening in the deficit to 3% of GDP, from 2.6% last year. Spending measures are concentrated on supporting consumption, for example through social welfare programmes. In addition, there will be another RMB150 bn issue of special infrastructure bonds. In February interest rates were cut by around a half a percentage point - the first cut since May 1999. The undeveloped nature of the personal banking market means this move will not have a meaningful stimulatory effect on consumer demand. The main benefit will be to reduce the burden on the debt-laden industrial sector, and in that way to have some indirect effect on employment, profits and investment spending.



Source: National statistical agencies, Datastream

The ANZ growth forecast for this year is 7%. This figure could easily be exceeded if recent growth rates of exports, investment and consumer spending are sustained. However, risks are biased to the downside. There may be some front loading in state investment spending, which will inevitably be offset later in the year. Moreover, with quite pervasive excess capacity in the manufacturing sector, it is hard to see investment being a driver this year. The strong export growth rates recorded over the 12 months to December/January were boosted by weak base numbers and will not be sustainable. That leaves it all down to the consumer. Will poverty relief programmes and benefits for laid-off workers be sufficient to offset the natural tendency to save when jobs are becoming less secure?

Economic growth in Asia

% change	2000	2001	2002 (f)	2003 (f)
China	8.0	7.3	7	7½
Hong Kong	10.5	0.1	1½	3
Indonesia	4.8	3.3	3½	5
Malaysia	8.4	0.4	4	5½
Philippines	4.0	3.4	2¾	3½
Singapore	9.9	-2.0	3½	6¾
South Korea	8.8	3.0	5	6½
Taiwan	5.9	-1.9	4½	5½
Thailand	4.6	1.8	3¾	5
Vietnam	6.8	6.8	7	7
East Asia*	**7.6**	**5.3**	**6**	**6¾**
(ex China)	**6.5**	**1.9**	**4**	**5¼**

* weighted GDP at PPP exchange rates

Australian outlook

Australian economy remains resilient

The Australian economy defied the world economic slowdown in 2001, growing by 4.1% over the year, one of the highest rates of growth amongst advanced industrialised economies. The resilience of the economy to the global downturn reflected a combination of factors, not the least the last twenty years of economic reform, which have enhanced Australia's ability to withstand externally generated shocks and reduced its propensity to generate internal ones. In contrast to the United States, the Australian economy did not experience the financial imbalances and investment surge that accompanied the IT boom there, the unwinding of which drove the economy into recession. Furthermore, the RBA was quick to unwind the interest rate increases from 1999-2000, with the cuts starting in February and continuing over the year to reach 30 year lows by late 2001. Together with well-targeted fiscal policy measures, lower interest rates greatly assisted a timely and strong recovery in housing activity from its dramatic downturn in the aftermath of the introduction of the GST. Lower interest rates, lower petrol prices and fiscal policy measures also contributed to an upturn in consumer spending.

The outlook for the Australian economy remains positive, with growth of around 3¾% expected this financial year and 3¼% next. The main issue for the economic outlook will be the transition from housing to other sources of growth. Forward indicators now suggest that business investment is on track to take up the reins, with ex-housing GDP likely to grow by 4% over 2003. Exports should also improve as the world economic recovery picks up steam, but the pick-up in investment will drive imports higher and overall net exports are likely to continue to be a drag on growth.

Risks to growth and inflation remain

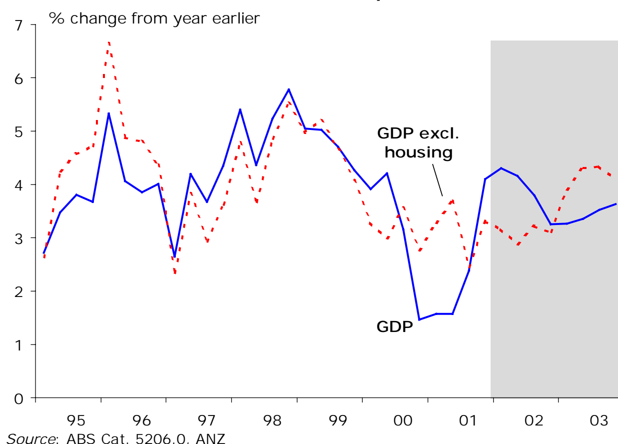
Nevertheless, there are some risks to this outlook, most notably if the global economy does not recover as expected and therefore adversely affect exports and business investment in Australia. Another important risk is that recent corporate collapses have reduced competitive pressures that have been an important constraint on prices and, combined with further margin building in other industries, could lead to inflation persisting above the RBA's target, and hence higher interest rates and weaker growth than forecast.

Housing market to peak mid year

Activity in the housing market remained strong in the December quarter, with strong growth in the construction of new dwellings offsetting some weakness in alterations and additions. New dwelling construction rose by 7.9% in the quarter, after growth in excess of 20% in the previous quarter, while alterations and additions fell slightly, after three quarters of relatively strong growth. As expected, forward indicators of housing activity now appear to have peaked, with building approvals easing back in the early months of 2002 and housing finance commitments generally moving sideways. While some of the recent softening reflects the phasing down of the first home owners grant, activity in the non-first homebuyer market has also moderated, perhaps reflecting the expectation of higher interest rates. Nevertheless, the strength of building approvals and dwelling commencements in the second half of 2001 will ensure that work done remains solid until the middle of this year. Thereafter, dwelling investment is likely to fall, with commencements forecast to decline from 164,000 in 2001-02 to 132,000 in 2002-03.

Ex-housing GDP to grow by 4% over 2003

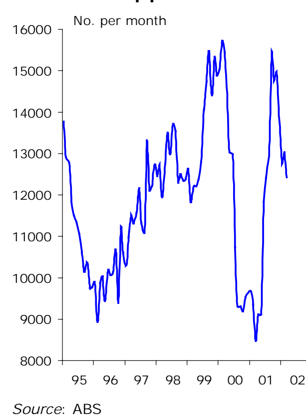
Gross domestic product



Source: ABS Cat. 5206.0, ANZ

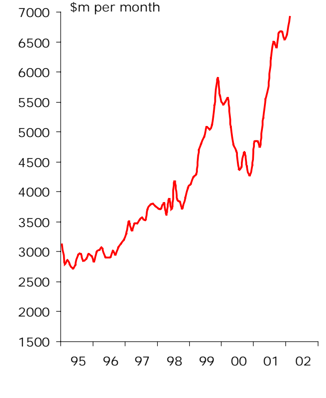
Forward-looking indicators have peaked

New private dwelling approvals



Housing finance commitments

(ex. refinancing)



Source: ABS

Apart from higher interest rates and the phasing down of the first home owners grant, an oversupply of dwellings will act as a brake on growth in dwelling investment over the medium-term. Rental yields have softened and vacancy rates have risen in most markets in recent months, and this trend is likely to continue as considerable dwelling stock is expected to be completed over the next couple of quarters. This is also likely to have implications for growth in house prices, which have shown little sign yet of abating, with established house prices rising by 15.5% over the year to December 2001. Melbourne house prices have continued to lead the way, although both Canberra and Sydney recorded house price growth in excess of 17% over the same period.

Consumer spending still strong...

Household spending continued to expand firmly in the December quarter, as lower interest payments as a result of cuts in official interest rates underpinned strong growth in disposable income. Household spending rose by 1.3% in the December quarter, to be 4.2% higher over the year, with both retail and non-retail spending rising solidly. Partial data available for the March quarter so far suggests that household spending has remained robust. Motor vehicle sales have remained strong in 2002 to date, while retail sales have continued to grow firmly.

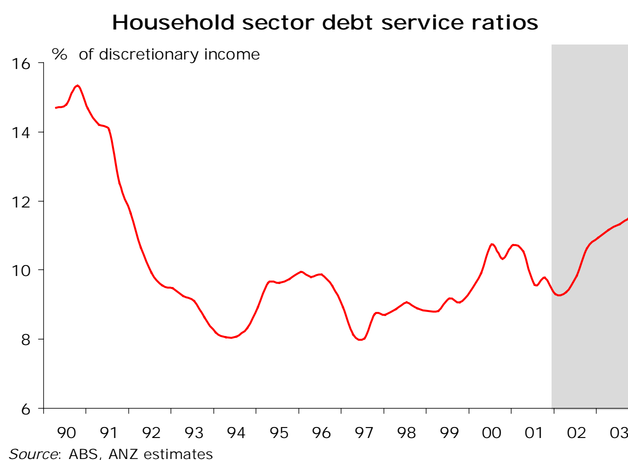
Household borrowing remains robust, with secured lending rising by 18.2% in February, the strongest rate of growth in nearly seven years. In contrast, unsecured lending has been much weaker, which could in part reflect households' use of equity in their homes to fund spending at lower rates of interest. Mortgage equity withdrawal also tends to be more prevalent when house prices are rising, as it provides a way for increases in housing wealth to be realised. More generally, rising wealth can impact on household confidence and spending by reducing the perceived need for saving. Nevertheless, the rise in household wealth in recent years – which has been predominantly driven by the housing market – has been offset by rising debt levels, leading to gearing remaining broadly unchanged over the last year. Furthermore, low interest rates have generally eased the debt servicing burden on households.

...although the risk of a slowdown has increased

Household spending is likely to remain firm over the forecast period, although there is some risk of a sharper slowdown from that forecast, were interest rates to rise faster or by more than we expect. We expect household consumption to rise by 3½% in 2002-03, following similar growth in this financial year. Employment growth should continue to pick-up over the course of the year, which will provide a boost to incomes and spending. However, higher interest rates will be a negative for household incomes, as the record levels of household debt means that debt servicing costs will rise quite rapidly. Indeed, the 75 basis point increase in interest rates that ANZ is expecting over the next year translates into the highest debt servicing burden since the early 1990s. Whilst we expect these two key influences to be broadly offsetting, the risk to household spending arises if households cut back on their spending more than forecast in response to the expectation of further substantial increases in interest rates. Furthermore, given that growth in household spending over the last year has partly reflected the increases in housing wealth, to the extent that expected future gains in housing wealth are unrealised, through a correction in house prices or otherwise, households may react by curtailing expenditure.

High debt burdens will dampen spending

Household sector debt service ratios

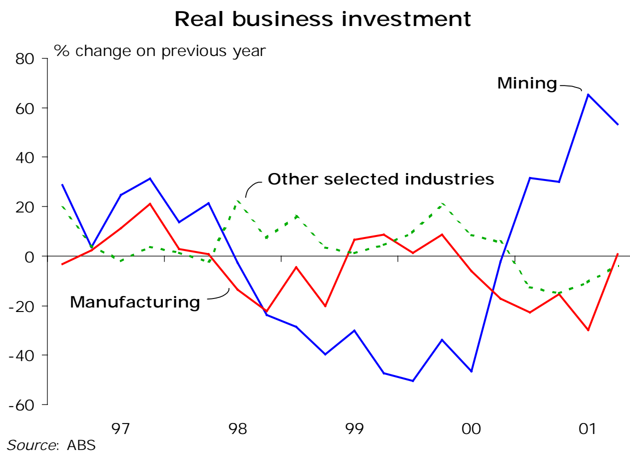


Source: ABS, ANZ estimates

Business investment to drive growth

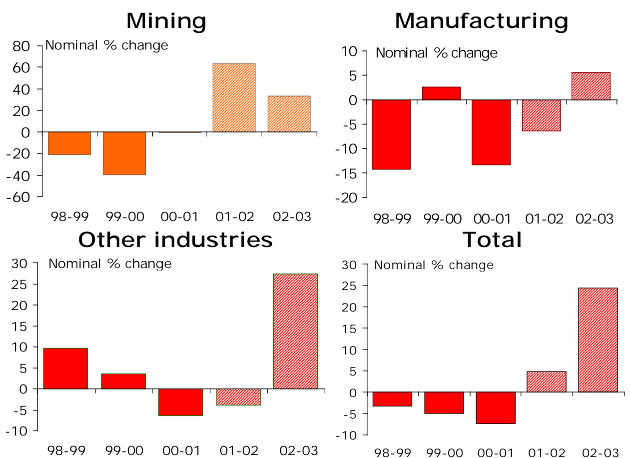
Growth in business investment in Australia remained lacklustre for most of 2001, reflecting the high level of uncertainty permeating the global economy and a squeeze on corporate profits. Strong competitive pressures limited the ability of businesses to pass through higher input costs, while a cyclical downturn in productivity underpinned a rise in unit labour costs in the first half of the year. However, the relative strength of domestic demand in the second half of 2001 helped the profitability of more domestically focussed industries, such as construction and retail, and drove growth in corporate profitability to nearly 8% in the December quarter. Business investment rebounded in the final quarter of 2001, with both plant and equipment investment and non-residential construction rising solidly. This largely reflected very strong investment by the mining sector, which has seen stronger growth in profitability than other industries in recent years.

Mining investment grows strongly in 2001



The outlook for business investment has strengthened, in part reflecting the large amount of engineering work yet to be done. Engineering commencements rose very strongly in the September quarter, driven by the commencement of the fourth LNG train on the North West Shelf. The December quarter ABS Capital Expenditure survey provides further evidence that business investment will be underpinned by the mining sector, with growth of over 60% in 2001-02[1] expected. In contrast, investment by 'other' selected industries (mainly private services) and manufacturing is expected to fall in 2001-02. However, the sheer size of the increase in mining investment expected this year suggests that business investment will rise solidly in 2001-02 and make a small contribution to GDP growth.

Investment to broaden out in 2002-03



Note: Est for 2001-02 & 2003-03 based on ABS Dec quarter capital expenditure expectations survey.

Growth in business investment in 2002-03 is likely to be more broadly based than the previous year, reflecting stronger profitability and rising business confidence. Furthermore, corporate balance sheets are in generally good condition, with gearing remaining at low levels. Both plant and equipment and non-residential construction are expected to grow strongly in 2002-03. Plant and equipment investment, which is currently well below its historical average relative to GDP, is expected to rise further as local and world economic conditions improve over the course of the year. Engineering construction will be underpinnned by further mining projects, while the recent rise in non-residential building approvals suggests that investment will continue to strengthen. We expect underlying business investment (ie net of transfers from the public sector) to grow by 11¾% in 2002-03, following growth of around 4½% in 2001-02.

Exports hit by global slowdown in 2001

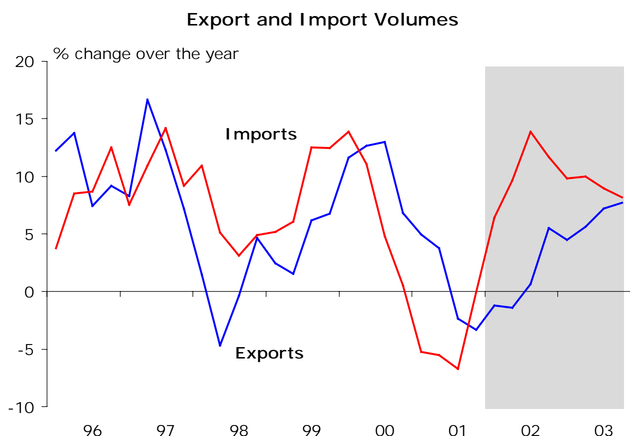
The impact of weaker global demand was clearly apparent in Australia's export performance in the second half of 2001. On an annualised basis, the volume of exports fell by 5.1% in the half year to December, while export prices also eased significantly, rising by just 0.8% over the same period. The volume of rural exports fell particularly sharply in the second half of the year, driven by falls in meat and wool exports. While rural commodity prices rose strongly over this period, it was at a slower pace than the first half of the year, leading to a small fall in the overall value of rural exports. The exception was the value of meat and cereals exports, which were buoyed by very strong price gains. In contrast, both the price and volume of resource exports fell in the second half of 2001. In particular, base metal prices fell sharply in 2001, reflecting global oversupply and the weak world economy. Services exports were also hit hard in second half of the year, especially in the December quarter, largely reflecting a sharp fall in global tourism as a result of the terrorist attacks on the US.

Net exports to detract from growth again

The outlook for exports varies by sector, with rural export revenues likely to be affected by a softening in prices over the course of the year. The outlook for minerals and energy exports is better, with prices expected to improve as the current oversupply of several commodities is worked off. Overall, growth in the volume of exports should continue to pick up as the world economic recovery gathers speed. However with business investment strengthening and household spending remaining firm, imports are expected to grow strongly and offset the improved export performance. As a result, net exports are expected to again detract from growth in 2002-03.

[1] Nominal growth, based on five year realisation ratios.

Strength of imports to again outpace exports

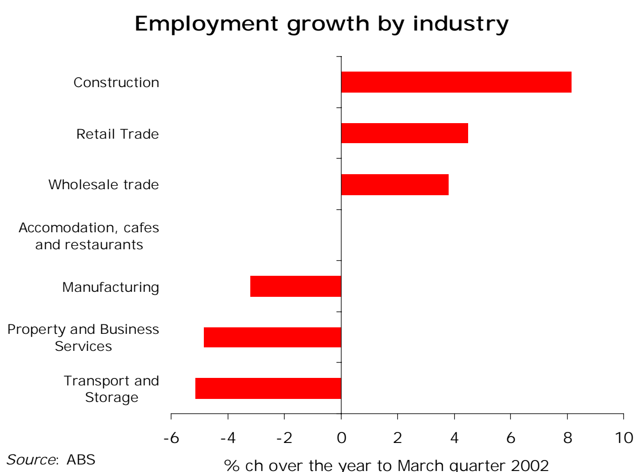


Source: ABS, ANZ estimates

Labour market conditions improve

The labour market strengthened considerably in the early months of 2002, with a pick-up in employment growth driving the unemployment rate down in February to its lowest level in nearly a year. The improvement has reflected a surge in part-time jobs, with the number of workers in full-time employment falling slightly over the year. This pattern partly reflects the strength of industries such as retail trade, which tend to have a higher proportion of part-time workers. Other industries, such as construction, have benefited from the strength of domestic demand, while the recent weakness of the global economy is clearly apparent in externally-exposed industries, such as manufacturing and more indirectly, property and business services.

Jobs growth varies considerably by industry



Source: ABS

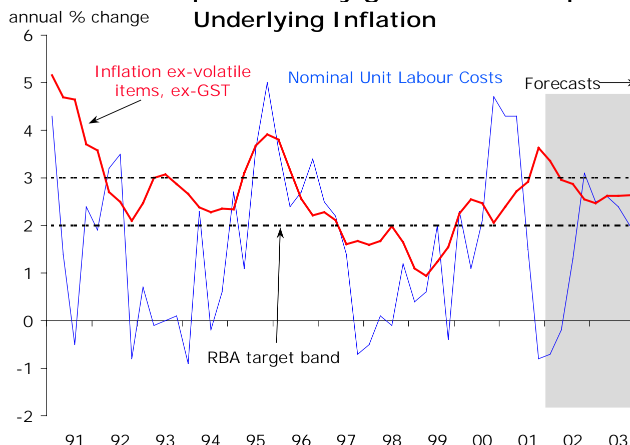
Conditions in the labour market are set to improve, with businesses now looking to hire workers as the recent period of uncertainty falls behind us. The underlying trend in ANZ job advertisements is consistent with continued growth in employment over the months immediately ahead, and a further decline in the unemployment rate. The pick-up in employment is likely to be more broadly based than seen previously, as external demand recovers. The participation rate remains near a historically high level, suggesting that upward pressure on the unemployment rate from discouraged workers entering the labour force will be limited. As a result, we expect the unemployment rate to fall to around 6¼% by December 2002.

Inflationary pressures remain subdued

The December quarter CPI was above expectations, rising by 0.9% (3.1%yy), with over half of the increase the result of sizeable increases in food prices, particularly meat and fruit and vegetables. The CPI excluding 'volatile items' (petrol and fruit and vegetables) also rose by 0.9% and has now increased by 3.6% over the past year - the largest increase (excluding the impact of the GST) since the March quarter 1996, and well above the upper end of the RBA's 2-3% target band. However the RBA's own estimate of underlying inflation is running at 3¼%, which whilst still above the target band, has more benign implications for monetary policy.

We expect underlying inflation's breach of the 2-3% target band to be temporary and we foresee a return to the target band by the second half of 2002. Industry rationalisation in the domestic air travel and insurance industries will exert upward price pressures in the medium-term, but these effects will be narrowly based and will be offset by disinflationary pressures elsewhere in the economy. Most of the import price pressures associated with the depreciation of the Australian currency in 2000, initially absorbed by business after the introduction of the GST, appear to have now worked their way through the Australian economy. A strong cyclical productivity upturn is also currently underway - the sluggish labour market has lagged the upturn in the Australian economy, acting to contain labour costs thus placing downward pressure on prices.

Solid labour productivity growth will help costs



Source: ABS Cat. No. 6401.0, Treasury and ANZ forecasts

Interest and exchange rate outlook

Global easing cycle ends

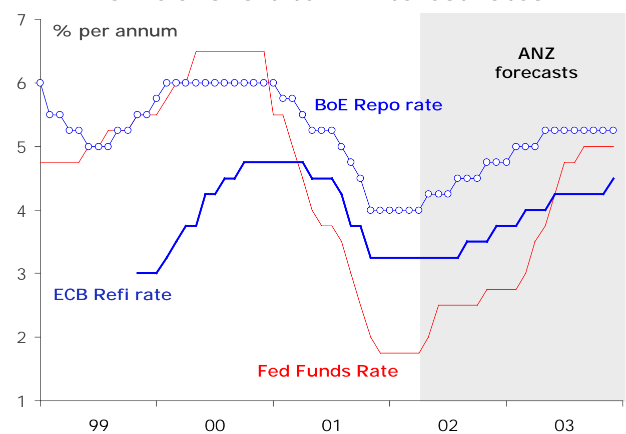
At its March 19 meeting, the Federal Reserve's Open Market Committee (FOMC) upgraded its outlook for US growth and inflation to a 'balanced' outlook from the weaker outlook that had been adopted and retained by the Fed since its December 2000 meeting[2]. Despite a much improved outlook, the FOMC has been in no apparent haste to lift rates back toward more normal levels. While the Committee recognised that the economy has been expanding at a significant pace so far this year, its members recognised that *'the degree of strengthening in final demand over coming quarters ...... is still uncertain'*. The FOMC left the funds rate unchanged at 1.75%.

Financial markets expect that the Fed will take back most of the 175 basis points (bps) in funds rate easings announced since September 11 last year and will then continue on with a program of lifting rates by a further 175-200 bps. By April, the market had priced in its expectation that the current Fed funds rate of 1.75% would thus be around 3.25-3.5% by the end of this year and would reach 5.25-5.5% at around the end of 2003. Underscoring the market's view that the global monetary easing cycle has clearly ended, two central banks - the Swedish Riksbank and the Reserve Bank of New Zealand - have recently increased their official interest rates by 25 bps[3].

ANZ expects that the Federal Reserve will soon commence to lift interest rates back towards a more sustainable level. A rise is predicted as early as the upcoming 7 May FOMC meeting. Signs of a US economic revival have been pervasive and come after what has been a modest economic downturn last year. In ANZ's view, it is likely that this year the Fed will commence unwinding the highly accommodative stance of monetary policy adopted last year as insurance against the heightened economic and financial uncertainty after September 11. The US economy managed to grow by an annualised rate of 1.7% in the December quarter and is likely to have accelerated to a 4.5% annualised pace in the March quarter. Such growth rates would indicate that the insurance put in place by the Fed to avert a sharp reduction in economic activity in the aftermath of September 11 will soon not be required.

After the expected rise in May, which could conceivably be held over until the June 26 meeting, further rises totalling 75 bps are expected for the remainder of this calendar year. By the end of 2003, ANZ expects that the Fed funds rate will be increased further to guard against the emergence of inflationary pressures in 2003 and 2004, when the economy's growth rate is expected to reach its potential of around 3½% per annum.

Official short-term interest rates



Source: Reuters, Economics@ANZ

Other major central banks are also expected to shift the stance of monetary policy to a less accommodative stance this year. The European Central Bank and the Bank of England are expected to lift their respective official interest rate targets by 50 and 75 bps respectively this year. The ECB is expected to begin lifting its targeted 'refi' rate in the September quarter while the BoE is forecast to begin lifting its 'repo' rate at its May monthly meeting. The earlier timing reflecting the stronger performance of the UK economy over the past year. No change in Japanese monetary policy is expected for some time, reflecting the well-below potential performance of the economy.

RBA to begin tightening soon

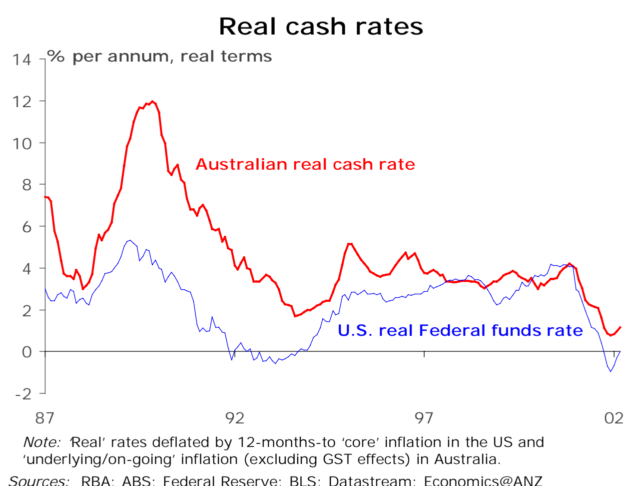
Just as the turnaround in the US economy has been much quicker than expected, the Australian economy finished 2001 in much stronger shape than might have been feared in the midst of the global slowdown. Further monetary policy easings now appear highly unlikely. There is a good case that the RBA will soon need to start taking back last year's special cuts, put into place to protect domestic confidence and spending which appeared

[2] At the December 2000 meeting, the Fed's policy outlook changed from strengthening economic conditions to weaker conditions in prospect.

[3] On 19 March, the Riksbank lifted its repo rate 25 basis points to 4%, pointing to "increasingly clear signs of an economic recovery, both internationally and in Sweden". Within hours, on 20 March, the Reserve Bank of New Zealand increased its Official Cash Rate, also by 25 basis points to 5%. RBNZ Governor Don Brash noted that the "increase in the OCR simply represents some withdrawal of monetary stimulus, much of which was put in place as insurance against risks which have now receded".

to be under threat from the global slowdown. But again the Australian economy has outperfomed expectations and fears of a backlash from the global economy. The domestic side of the Australian economy has been expanding well above what had been expected, led by the rapid rebound in dwelling construction activity and solid growth in consumer spending.

The RBA did not ease as much as the US Federal Reserve did after September 11[4], and so the RBA has some time on its hands to review the outlook before it need start to lift the cash rate. By the same token, the Australian economy is on track to record growth of 3½-4% over the course of the next year to 18 months, a growth rate that will require a less stimulatory stance of monetary policy.



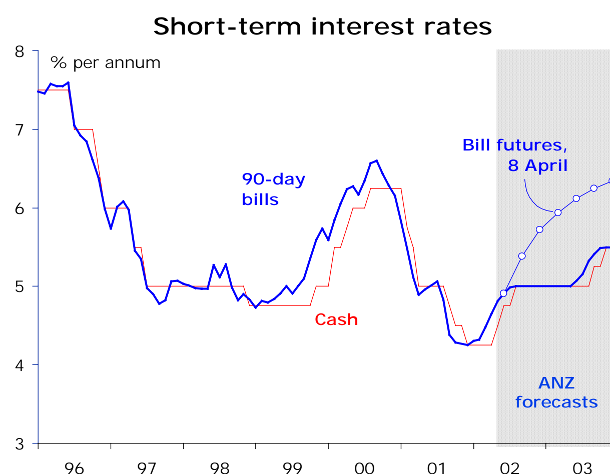
Note: 'Real' rates deflated by 12-months-to 'core' inflation in the US and 'underlying/on-going' inflation (excluding GST effects) in Australia.
Sources: RBA; ABS; Federal Reserve; BLS; Datastream; Economics@ANZ

One issue markets are now grappling with is an assessment of the current stance of monetary policy. To make that assessment, one measure is to compare current interest rates in real terms with past levels. In other words, to adjust say the RBA cash rate in actual or nominal terms to real terms, by subtracting a measure of inflation from the actual cash rate[5]. Over the past decade, the real cash rate has averaged around 3¼%. While such a measure is just one benchmark, this 'rule' might suggest that a sustainable cash rate that is neither unduly supporting or holding back growth might be around that level. Adding back an expected rate of inflation of around 2.5%, such a 'neutral' rate might well need to be 'five point something', a level of the cash rate that would neither hamper growth or risk igniting inflationary expectations.

Market factored in too many rises

As outlined in the *Australian Outlook* section of *AEO*, beginning on page 10, the economy's growth is expected to continue at a healthy rate over the next year or so, but then moderate somewhat from the robust rates of the second half of last year. Leading indicators of the dwelling construction sector already suggest that that industry's activity levels will peak in the middle of this calendar year. The growth outlook does not suggest that monetary policy needs to be shifted to a stance that will curtail growth; indeed a neutral to accommodative stance of monetary policy will be that most that is required in the quarters ahead.

With growth likely to pull back in coming quarters, monetary policy would then not need to be at a level that would constrain growth. A further - and related - consideration in the policy outlook is the outlook for inflation in coming quarters. ANZ forecasts that the annual rate of CPI will ease back from 3.1% over the year to the December quarter to 2.6% by the December quarter of this year. Over the next three quarters, the CPI is expected to grow at an annualised rate of between 2.4-2.8%, a rate that would be almost ideal from the point of view of the RBA.



Pushing up the rate of inflation in the near term will be recent increases in the world price of oil and increases in general and private health insurance premia. But not all influences on the inflation outlook are expected to be pushing up the CPI over coming quarters. In the final analysis, the medium term outlook for inflation will hinge on the productivity performance within the economy and expected growth in wage rates. The latest data on enterprise bargaining agreements and the wage cost index suggest that wages have been rising at annual rates of 3½-4% in the December quarter. Allowing for growth in non-farm labour productivity of up to 2% per annum, such wages growth is consistent with unit labour costs of up to 2%, a level that

[4] Including the 25 bps easing on September 5, the RBA reduced the cash rate by a total of 75bps between September and December. Over the same period, the Fed reduced its funds rate by 175 bps.

[5] To estimate the real RBA cash rate, ANZ has used the CPI excluding fruit, vegetables and petrol and making an allowance for the GST tax reforms, a measure that is akin to the 'CPI, excluding volatile items'.

would not threaten the RBA's medium-term inflation target.

Another factor that can influence Australia's inflation rate over a period of time is the Australian dollar and its impact on import prices. Recent rises in the value of the Australian dollar, both in trade-weighted terms and against the $US, suggest that the influence of the currency over inflation will be a neutral to moderating one over the period ahead. Already so far this year, the import-weighted $A - a measure more closely related to import prices over time - has risen by 2½% compared to its average of 2001 and by over 10% from its record lows reached in April and September last year.

Medium to longer-term rates nearing peak

Medium term interest rates depend on market expectations for growth, inflation, and monetary policy. How high will the cash rate need to rise? Will it need to rise as much as the peak in cash rates in the last cycle of 6.25%?

The 1994 tightening cycle ran from August through to December. The three year swap rate reached its peak late in that tightening cycle, when the market was expecting the cash rate to increase to over 10%, well in excess of the 7.5% eventual cash rate peak in that cycle. During the next tightening cycle, in 1999-00, medium term interest rates peaked much earlier and at less excessive levels. The peak cash rate in that cycle was 6.25%, while the peak in the three year swap rate was between the first and second tightenings at over 7%. The three year swap rate then persisted at around 6.5-7% through most of 2000.

This year, the three year swap rate had increased to over 6% by early April. Bank bill futures markets have recently been projecting a peak in the cash rate in this cycle of over 6%. ANZ does not expect the cash rate to exceed 6% in this cycle and thus some rally in medium to longer-term interest rates is likely in the period ahead.

Aussie dollar finding its legs

In January and February the Australian dollar appeared to be exhibiting some of the same early-year seasonal strength evident in the past two years. It looked very much like the 'early-year' rally in the Australian dollar had been and gone again. In 2000, the $A/$US rallied to its high for the year of 0.6677 on 13 January, only to succumb to selling as the year unfolded. The continued out-performance of the US economy relative to earlier expectations, talk of Australia as an 'old world economy' and the continued draw of investment capital to the United States all acted to support the $US and, in the process, unsettle the $A. The *Foreign Exchange Consensus Forecasts* survey conducted in January 2000 had a median forecast for the end of 2000 of 0.70. But after the Aussie's peak of 0.6677 at the start of the year, it was then one way traffic to lower levels.

Last year was almost a repeat. The peak in the Aussie was 0.5721, reached on 15 January. In the January 2001 *Foreign Exchange Consensus Forecasts* survey, the median market forecast for the end of the year was for a rebound in the $A, this time to 0.61, which again appeared eminently achievable given the volatility of the currency. But again, it was not to be. The haemorrhaging world economy and, what seemed to be a lacklustre performance of the Australian economy after the introduction of the GST the previous year, unseated the Australian dollar.

Markets have been less certain this year about prospects for the 'unpredictable' Aussie, but have again been expecting some appreciation, though modest. The Consensus forecast in January 2002 was 0.561 for the end of this year. And with the pattern of $A trading having an eerie resemblance to the 'early-year failed rally' of the past two years, markets might have had reason to become disenfranchised with the performance of the Australian dollar. But the earlier peak $A peak reached in January has since been surpassed, soothing some market concern that the Australian dollar would trend lower through this year.

Fundamentals coming back into vogue?

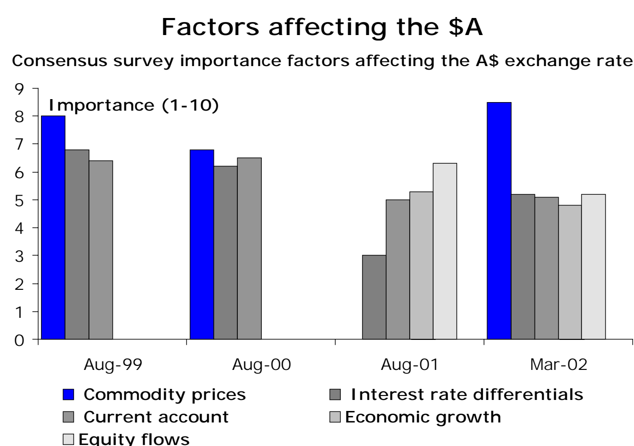
In years past, the Australian dollar has been most closely related to trends in commodity prices, the price and cost competitiveness of the Australian economy, the attractiveness of Australian interest rates relative to competing offshore rates and Australia's external indebtedness and current account deficit. In recent years, especially since the spectacular rise in the $US, Australia has had difficulty attracting sufficient investment capital even though the current account deficit has been declining. (The article *Capital Flows and Exchange Rates*, published in the March quarter 2001 issue of AEO canvassed some of the issues surrounding these developments.)

The Australian dollar no longer seemed to have a continuing relationship with its long term fundamentals. Not only were commodity prices and the Australian dollar moving in opposite directions, but seemingly attractive Australian interest rates were doing little to attract offshore investment interest. International investors were taking little notice of the improvement in Australia's current account deficit, which had declined from 5.9% of GDP in 1999 to 2.6% of GDP in 2001.

Instead, what took the attention of international investors were equity flows into $US investments, prospects for the continued out-performance of the US economy and how well macroeconomic policy was supporting these expectations. It was evident that commodity prices - which had hitherto been a reliable guide to $A prospects over the medium term - were no longer featuring in surveys as a factor that $A watchers were most attuned to.

But economic fundamentals now appear to be re-emerging and exerting some influence on the direction of the Australian dollar this year. The Australian dollar now appears to be showing some sensitivity to commodity prices. In the March 2002 survey of 'Factors Affecting Exchange Rates'[6], commodity prices have re-appeared as the key driver of the Aussie after having not been on the radar screen of $A watchers for some time. In fact, in the latest survey, scoring an importance rating of 8.5 out of 10, commodity prices are now regarded by analysts as important as they have been for many years, including before the onset of the Asia crisis.

Factors affecting the $A



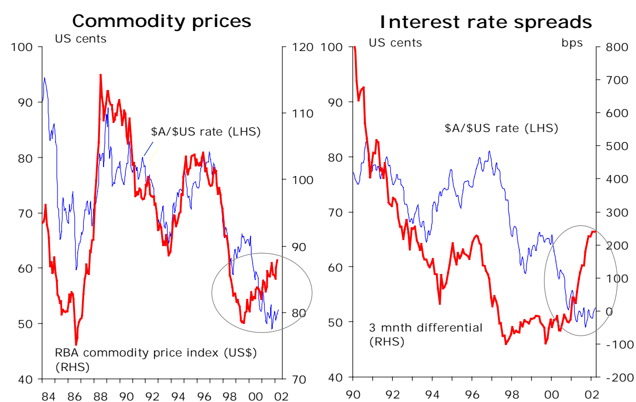
Source: Consensus Economics, Inc.

So far this year, commodity prices have been rising. The RBA's Australian export commodity price index has risen 3% above recent lows of October 2001. Other major commodity price indexes have also been rising in recent months along with improving expectations for the global economy. For example, the CRB futures commodity price index has been rising from its lows of late September 2001, while the Metallgesellschaft base metals index has been increasing in anticipation of a resurgence in global manufacturing activity this year.

More attractive Australian interest rates have also added to the allure of the $A. At the end of August 2001, the Fed funds rate was 3.5% and the RBA cash rate was 5%, with the differential 1.5 pct points in favour of Australian investment. By mid December, that differential had grown by a further 1 pct point, with the Fed cutting its funds rate by a further 175 bps and the RBA reducing its cash rate by 75 bps.

While this spread has been most prominent at the short end of the yield curve, there has also been an increase in the spread of Australian Government bond yields over US Treasuries. The spread of 10 year Australian government bonds over corresponding US Treasuries has increased from around 80 bps in early September to 90-110 bps in recent months. ANZ expects that the attractive spread of Australian interest rates over US rates will be maintained for most of this year, but will diminish as the Fed pushes rates up a little more this year than the forecast increase in the RBA cash rate.

Traditional 'drivers' have been under stress



Source: ABS

The $A/$US has reached a peak so far this year of 0.5359, paving the way for further gains as the year unfolds. ANZ forecasts that the $A/$US will make some further net gains by the end of the year to an end year projected levels of just over 0.55. After the initial growth spurt of the US economy in the first part of the year, ANZ expects that the growth rate of the US economy will ease as the year unfolds, hosing down to some extent ever increasing expectations of global growth and commodity prices and limiting the attraction of the Australian dollar as a play on global growth and commodity prices.

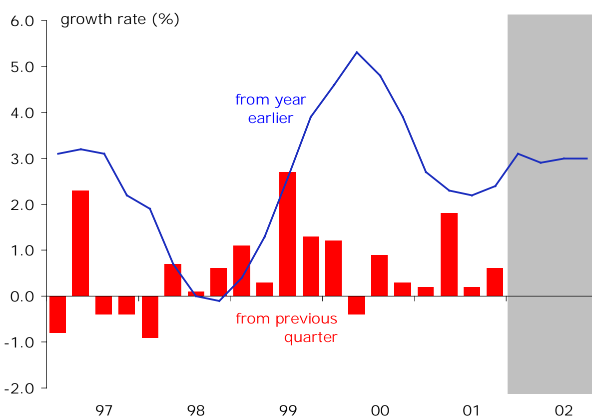
[6] See *Foreign Exchange Consensus Forecasts*, A Digest of Financial Forecasts, March 11 2002, Consensus Economics Inc., London, United Kingdom.

New Zealand Outlook

Like Australia, the New Zealand economy remained relatively robust during 2001 in the face of a global recession. GDP growth of 2.4% was posted over the 2001 calendar year. While New Zealand is on track for GDP growth of 2½-3% this year, the domestic rather than the external sector will be the engine of growth.

Moderate growth expected in 2003

Real GDP



Sources: Statistics NZ; NZEconomics@ANZ

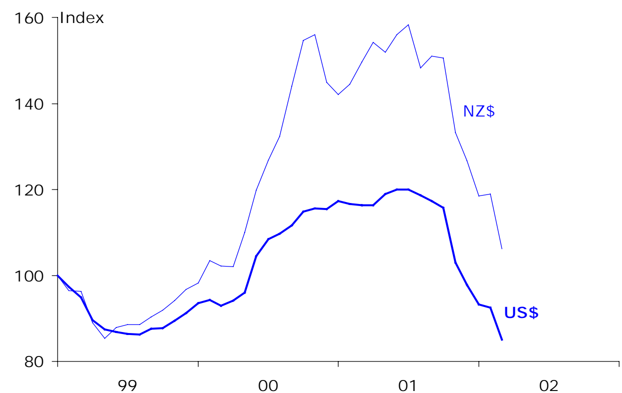
External sector to remain under pressure

The external sector is feeling the fallout from a weak world economy in 2001 and is likely to continue to do so for some time yet. During the past couple of years the export sector enjoyed the combined benefits of favourable agricultural production conditions, a weak $NZ and strong world prices for many of New Zealand's key agricultural commodities. Supply factors, such as lingering pressures associated with the foot and mouth disease outbreak in Europe, continued to underpin important markets through much of 2001. However, these factors were finally overwhelmed by weakening demand and prices started to fall sharply late last year. Dairy products, which account for a third of New Zealand's commodity exports, have been hit particularly hard and prices are down around 30% on their peak in mid 2001. In this case, the effect of weakening demand has been compounded by a series of increases in export subsidies paid to producers in the EU and US.

Against this background, export growth stalled in late 2001. Even so, the fact that the external sector has managed (to date) to retain most of the 40% increase in merchandise export revenue achieved over 2000-01 is a laudable achievement. But key commodity prices are likely to weaken further. Although many world industrial commodity prices have stabilised and started to recover in line with the global economy, New Zealand's predominantly agricultural commodity markets (as a whole) are likely to remain under pressure for some time yet. Competition from synthetic fibres and cotton will put pressure on wool prices, increasing stocks of butter and milkpowders in Europe and the US will hamper dairy markets and a sharp increase in Australian beef production will compete directly with NZ beef in many markets. This suggests that recovery in the NZ export sector is likely to lag that of Australia, for which industrial commodities (such as metals and minerals) comprise a relatively greater proportion of the export basket.

Dairy prices have plunged

World dairy prices



Source: ANZ Commodity Price Index

While commodity exports are likely to remain under pressure for some time yet, manufacturers are continuing to enjoy the benefits of a relatively robust Australian domestic economy – particularly the strength of residential construction. Moreover, tourism has bounced back in early 2002 after coming under considerable pressure in the aftermath of the September 11 terrorist attacks in the US. Yet given the overwhelming dominance of agricultural products in New Zealand's export basket, the external sector overall is likely to contribute little to growth during 2002.

Domestic economy to drive growth

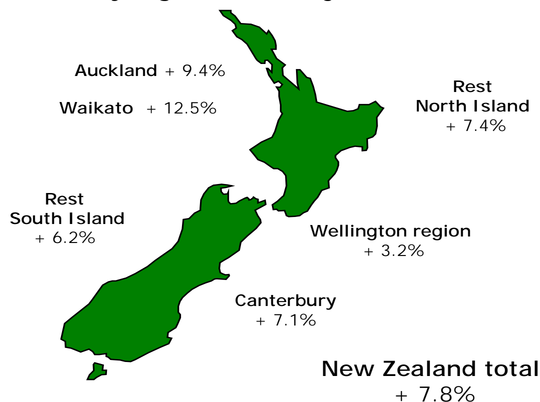
Instead, domestic sectors have become the primary driver of growth. Initial strength in the domestic economy during the past year was seen in the provincial areas, which benefited most directly from higher rural incomes associated with the agricultural export boom over 2000-01. But this strength has now become more widespread.

Retail spending rose a further 0.5% in January, on top of gains of 1.8% and 0.6% in November and December (respectively), to be more than 9% ahead of the same time last year. Regional data suggests that sales growth in the main urban centres

(particularly Auckland) is catching up with the strong growth enjoyed by the provincial areas over the past year. Housing market activity and construction has also surged, with house sales in February up 41% on the same time last year and building consents up 25% over the same period. A sharp increase in housing market activity and construction intentions in Auckland in recent months has accounted for a disproportionately large two-thirds of the nationwide growth in these indicators over the past year.

Retail spending growth has strengthened

Retail sales by region Ann % chg - three months to Jan



Sources: Statistics NZ, NZEconomics@ANZ

Behind this recent strength in the domestic economy has been solid growth in household incomes. Around 80,000 new jobs have been added over the past two years and the unemployment rate at 5.4% remains close to 13 year lows. Moreover, average earnings growth has accelerated from an annual rate of around 1½% to above 3% during the past eighteen months. Until recently, falling interest rates and petrol prices had also been providing an additional boost.

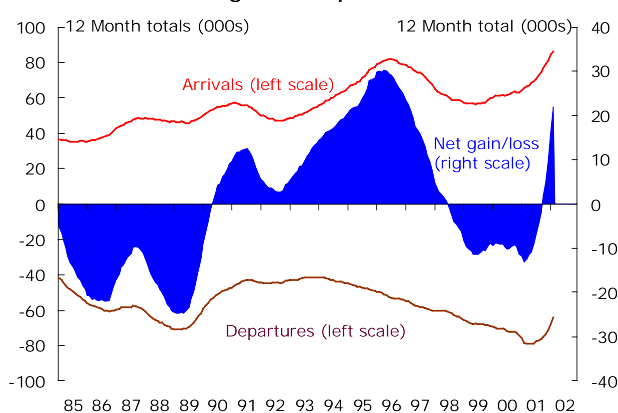
Household income growth is likely to be more moderate over the year ahead. Rural income growth will be impacted by the recent weakness in agricultural commodity prices. More generally, with ANZ job advertisements softening over the past six months (albeit with a modest bounceback in February), employment growth is unlikely to continue at its recent pace. Petrol prices have risen sharply since the beginning of the year and the RBNZ has begun to increase interest rates (as discussed below).

Yet this is still likely to be sufficient to provide the basis for further gains in domestic economic activity over the year ahead. Moreover, the sharp turnaround in net migration inflows over the past year is providing a significant boost to domestic demand. A net gain of more than 22,000 people was recorded in the twelve months to February 2002, compared with a net loss of 13,000 during the same period last year.

There appear to be a number of factors behind this rebound. A weak world economy has limited business and employment opportunities for New Zealanders offshore (combined with heightened fear and uncertainty in the wake of September 11), prompting many to either return home or not to leave. Changes to social welfare entitlements in Australia, whereby New Zealanders now have a two year stand-down period before they can access benefits, has removed an important 'safety net'. New migrant numbers have been boosted by an influx of international students over the past year, particularly from Asia.

Net migration flows have turned sharply

Permanent/long-term departures and arrivals



Source: Statistics NZ.

As was the case during the last migration boom in the mid 1990s, this has been of particular benefit to the Auckland region where most migrants tend to settle - going some way to explain the disproportionately large gains in activity in this major urban centre in recent months.

Yet by the same token, the significant turnaround in migration flows has raised the spectre of a repeat of the mid 1990s, when a migration-fuelled Auckland housing boom prompted a sharp rise in inflation pressures. However, with the composition of migrants more heavily weighted towards students than the wealthy families which dominated inflows in the mid 1990s, it is not immediately apparent that the current migration upturn will generate such strong demand pressures. Indeed, the increase in the working age population growth associated with increased net migration appears to have reduced pressure on the labour market and eased wage inflation risks.

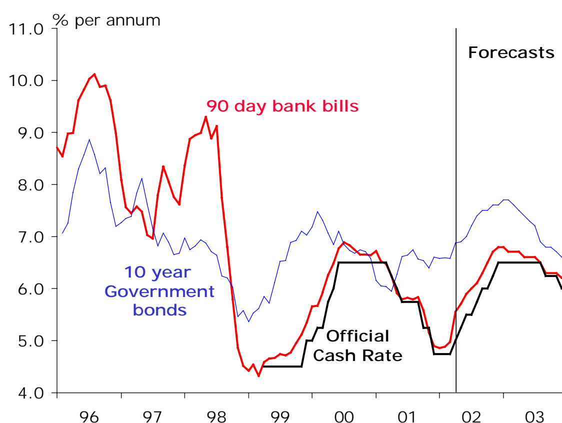
Interest rates heading higher

Nevertheless, potential inflation risks associated with these migration trends, along with recent strength in the domestic economy and signs that the world economy is stabilising, were cited by the RBNZ when in March it became one of the first central banks in the world to raise rates in 2002. The Official Cash Rate (OCR) was increased by 25 basis points (bps) to 5%. The RBNZ rationalised the increase as removal of some of the 100 bps of rate cuts undertaken as 'insurance' in late 2001 during the period of extreme uncertainty that followed September 11.

The March Monetary Policy Statement clearly signalled that the RBNZ intends to continue raising the OCR over the months ahead, given projections of above potential growth and inflation close to the top of the 0-3% target band over the next eighteen months. Subject to the domestic economy remaining strong and the world economy gradually recovering, we expect the RBNZ to raise the OCR to a peak of 6.5% by the end of 2002.

Interest rates have started to rise

Interest Rate Forecasts



Sources: Reuters, NZ Economics@ANZ

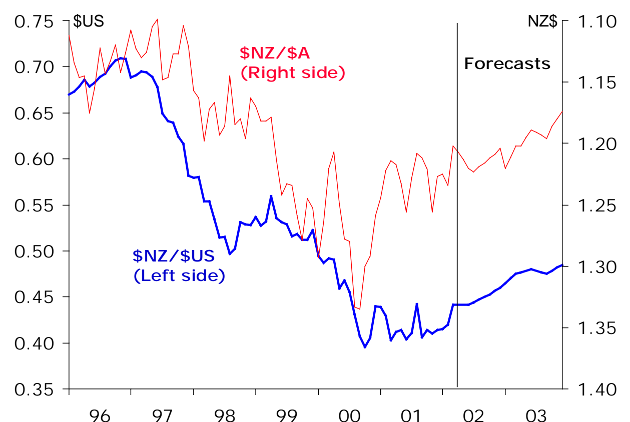
Longer term interest rates are also on the rise, with 10 year government bond yields expected to peak above 7½% in late 2002 (from current levels around 6¾%). This is largely expected to reflect rising yields in global markets as a recovering world economy reawakens inflation expectations. However, NZ long bond yields are likely to rise to an even greater extent. A significant increase in government bond issuance over the year ahead, a reflection of the pressures that contributions to the Government's new superannuation fund are putting on fiscal cash flows, will prove difficult for the market to absorb and is likely to put added upward pressure on yields.

Moreover, a recovery in the New Zealand dollar – if it continues to rise at its recent pace – has the potential to become a source of concern for exporters already faced with a difficult international environment. The $NZ has risen above $US0.44 for the first time since August last year and the $NZ trade weighted index (TWI) has gained more than 5% since the beginning of the year. However, there have been a number of periods of short-lived strength over the past 18 months since the all-time low of $US0.3895 in October 2000 and there is no guarantee that recent strength will not prove similarly transient. We cannot be confident that the $NZ has indeed turned the corner until the long term downtrend that has been in place since the highs in late 1996 has been broken and this would require a sustained move above $US0.45. While recent strength – particularly in the TWI – appears to have been driven by 'hot money' attracted to NZ's relatively high interest rates, a sustained move higher (sooner or later) is likely to be part of a global trend towards a weaker $US.

The $A/$NZ cross rate has also moved lower, at one stage falling below 1.20. This may reflect expectations that interest rates in New Zealand will rise faster and to a greater extent than in Australia. However, looking forward this is likely to be balanced by the likelihood of a relatively stronger growth performance by Australia, given the Australian economy's relatively higher 'speed limit' or potential non-inflationary growth rate. Moreover, Australia's export commodity prices, which are relatively more heavily weighted towards industrial products such as metals and minerals than NZ's primarily agricultural export commodities, will benefit more directly from a recovering world economy. Given these offsetting factors, we expect the cross rate to remain in the low 1.20 region during 2002.

The NZ dollar to rise moderately

Exchange Rate Forecasts



Sources: Reuters, NZ Economics@ANZ

Australian manufacturing: winners and losers

Manufacturing relatively sluggish

The manufacturing sector's contribution to the overall economy has contracted over time and, while its growth rate has improved in recent years, the differential between the two has narrowed only marginally. The table below shows relative real growth rates of industry gross value added (GVA - broadly the value of goods and services produced by industry, less the cost of goods and services used in the production process) for the manufacturing sector, compared with output growth for the economy as a whole over the 25 years to 2000-01.

Manufacturing GVA		Gross Domestic Product	
Period	Avg % pa	Period	Avg % pa
Past 25 yrs	1.8	Past 25 yrs	3.2
Past 15 yrs	1.9	Past 15 yrs	3.4
Past 10 yrs	2.0	Past 10 yrs	3.6
Past 5 yrs	2.4	Past 5 yrs	3.9

Based on ABS chain-weighted data, 1999-00

However, the sluggishness in manufacturing activity has not been 'across-the-board' and there has been a substantial improvement in a few key sectors.

There are nine sectors or, more accurately, sub-divisions of manufacturing under the Australian and New Zealand Standard Industrial Classification (ANZSIC) system used by the Australian Bureau of Statistics. The relative importance of most of these sub-divisions to overall manufacturing output has changed significantly over time.

Trend growth in value added in manufacturing sub-divisions, such as food, beverages and tobacco; printing and publishing; and petroleum, coal and chemical products has been particularly strong, while that for the textiles, clothing, footwear and leather industries has weakened steadily. In nearly all industries trend growth was noticeably weakened by cyclical economic downturns in the early years of the 1980s and 1990s. Some industry sectors, such as metal manufactures and petroleum, coal and chemical products seem to have been moderately affected, while the food, beverages and tobacco sector experienced barely a hesitation in growth.

Features of manufacturing sub-divisions

Food, beverages and tobacco (turnover in 1999-00, $51,237 mn) is the largest sub-division within manufacturing industry. GVA in this 'recession-proof' sector has grown on average by 2.5% a year since 1977-78 and over the past five years it has expanded by over 6% a year, making it the fastest growing sub-division in manufacturing.

The food, beverages and tobacco sector is a significant exporter, accounting for some 24% of the total export sales of manufacturing industries in 2000-01. Imports were less significant, at 6% of total manufacturing imports. Exports as a proportion of production are expected to decline over the three years to 2003-04. At the same time the trend in import penetration is expected to ease.

In terms of factors influencing the outlook, the availability and price of inputs (such as beef, dairy, sugar etc) and the state of private consumption activity in particular, will be the major influences on the level of production and domestic sales.

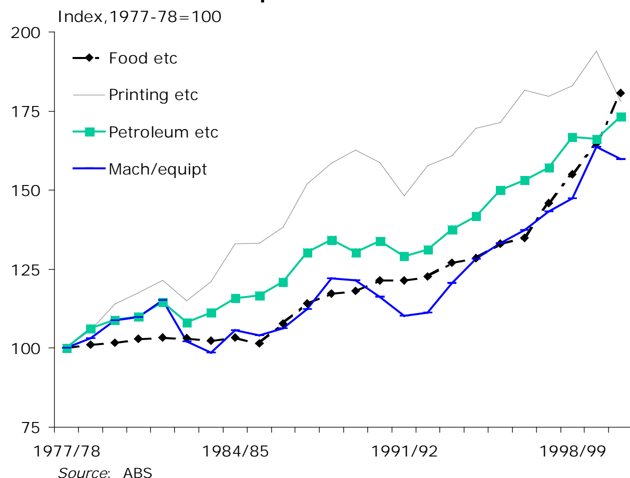
Economic forecasting and analysis group Econtech produces forecasts for Australian industries based on their macro-industry model, the Murphy Model 2. Growth expectations for the various ANZSIC sub-divisions used here are drawn from these forecasts. For the food, beverages and tobacco sector, Econtech has forecast output growth in line with GDP growth for the three years to 2003-04.

The **textiles, clothing, footwear and leather** (TCFL) sub-division (turnover in 1999-00, $9,161 mn) is the smallest, after 'other manufacturing', with a 4% share of manufacturing GVA. It has been a sector in decline, with GVA decreasing by an average 0.1% a year since 1977-78 and by more than 2% a year for the five years to 2000-01.

In September 1997 the government announced a freeze on tariffs for TCFL industries. The freeze was followed by a government package of measures designed to strengthen the competitive position of the industry.

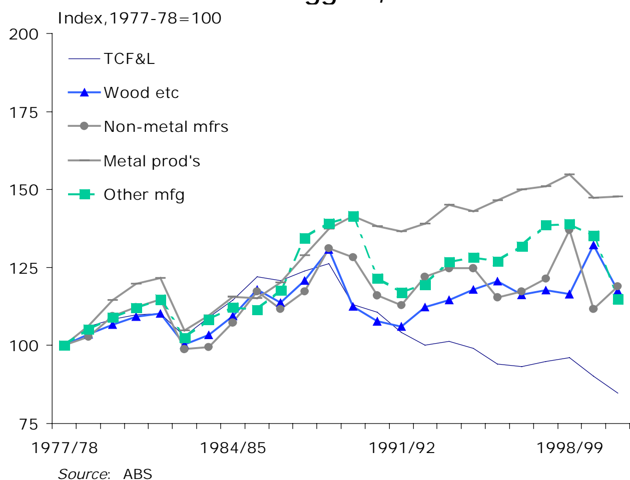
The sector is highly exposed to import competition, with imports taking half of domestic sales. Exports are also significant, accounting for 28% of the turnover of domestic enterprises in 1999-00. A small average annual decline in output from this sector is expected over the next three years, based on a weak export picture and a trend increase in import penetration.

Some sectors have performed well...



Source: ABS

...others have been sluggish, or worse



Source: ABS

The **wood and paper products industry** (turnover, $13,635 mn) has also not been a strong performer. GVA growth has averaged only 0.7% a year since 1977-78 and in the five years to 2000-01 it has fallen by 0.5% a year. The sector holds roughly a 6% share of manufacturing GVA.

This sub-division has two main areas of activity: log saw-milling, timber dressing and the manufacture of other wood products (60% of production); and the manufacture of paper and paper products (40%). Exports have increased at a solid pace in recent years and are equivalent to over 10% of sector turnover. Imports account for about 22% of this sector's domestic sales.

Activity in this sector is strongly influenced by demand in the residential building industry (for saw-milling and wood products) and the printing industry (for paper and paper products). Output from the sawmill and other wood products industries is expected to grow moderately to 2003-04, consistent with the building industry cycle. This is expected to be largely offset by a decline in production of paper and paper products. Import penetration is forecast to ease over this period.

The **printing, publishing and recorded media** sub-division (turnover in 1999-00, $17,212 mn) has broadly a 9% share of GVA in Australian manufacturing. This has been a strong growth sector over the years (although one particularly sensitive to economic downturns). However, the economy's sharp slowing 2000-01 pulled the latest five-year average annual growth rate under 0.8%.

The vast bulk of this sub-division is printing and publishing (over 95% of turnover). The industry is driven by domestic economic conditions. Exports form a small part of the turnover of local producers, influenced by the high cost of paper in Australia. Imports by this sub-division are more substantial, but have declined during the past two years.

There is a government/industry Action Agenda in place for the printing and publishing industry. The outlook for this sub-division is closely related to the prospects for growth in the economy overall. Production is expected to post modest growth over the next three years on the back of reasonable prospects for the publishing industry and a continued strengthening in recorded media. Import penetration is expected to ease.

The **petroleum, coal, chemical and associated products** sub-division (1999-00 turnover of $35,958 mn) accounts for some 15% of manufacturing GVA. It has shown consistent, moderate growth, averaging 2.2% a year since 1977-78, but in the five years to 2000-01 it rose by an average 2.9% a year.

Of sub-division output, petroleum refining accounts for around 17%, chemical and chemical product manufacture (including pharmaceuticals) 54% and plastic products a further 20%. Overseas trade is a major part of this sector's activity. Exports, notably kerosene and LPG, make up about 20% of domestic producers' turnover. At the same time imports account for some 37% of total domestic sales.

Moderate growth in production is expected to continue over the three years to 2003-04, driven mainly by activity in chemicals and plastics.

Non-metallic mineral products manufacturing (turnover in 1999-00, $10,484 mn) is one of the smaller manufacturing sub-divisions, with a 6.1% share of the division's total GVA. It has a history of modest growth, averaging 0.7% a year in GVA since 1977-78. Ready-mixed concrete, together with cement, lime and plaster, account for well over 50% of output, with the glass and ceramics industry groups each at 15%-20% of output and other non-metallic mineral products at less than 10%. The output of this sub-division is mainly for use in the construction industry and production is especially sensitive to the residential building cycle.

Reflecting the nature of the products, this sector is not strongly oriented to international trade.

Modest growth in production is expected of about 1% a year on average over the next three years. At the same time, the proportion of exports to total production is not expected to change, but import penetration is forecast to decline.

Metal product manufacturing (1999-00 turnover, $40,596 mn) is one of the largest manufacturing sub-divisions, with a 15.4% share of the sector's GVA, little changed from its share in 1977-78. It has grown by only 0.2% a year over the past five years, probably due in part to a rise in import penetration.

This sector encompasses the basic processes involved in the manufacture of iron and steel and non-ferrous metals (56% of output), production of structural and sheet metal (29%) and fabricated metal manufacturing (15%). A substantial proportion of the sector's output goes to the construction area, as well as to the motor vehicle and other transport industries.

The sub-division has a strong overseas trade orientation, with exports making up about 45% of domestic producers' turnover in 1999-00 and 30% of Australia's manufactured exports. Imports accounted for 26% of domestic sales in this period.

Value added has been weak over the past two years but modest growth of 2% a year over the three years to 2003-04 is forecast. This reflects, in part, an anticipated pick-up in the heavy industry section of manufacturing. Growth in exports is expected to be lower over the three years to 2003-04.

The **machinery and equipment manufacturing** sub-division (turnover of $43,784 mn in 1999-00) covers a range of diverse industries, including: motor vehicles and parts (39.8% of turnover); other transport equipment (11.5%); electronic equipment (11.9%); electrical equipment/appliances (13.8%); industrial machinery/equipment (17.7%) and photographic/scientific equipment (5.1%). The sector has grown by under 2% a year since 1977-78, but by 3.7% over the past five years which is nearly as fast as the economy as a whole.

This sector is heavily exposed to international trade, with the value of imports equivalent to nearly two-thirds of domestic sales of machinery. The value of exports is approaching one-third of the turnover of domestic producers in this sub-division.

While the overall state of the economy strongly influences demand, periods of rapid growth are associated with strong business investment.

A slowing in the trend growth of output from this sector is expected over the three years to 2003-04 (although recent stronger-than-expected business investment should mitigate this). At the same time, both the proportion of output exported and the extent of import penetration are expected to ease slightly from current levels.

The **other manufacturing** sub-division (1999-00 turnover, $6,884 mn) contains three industry groups: furniture manufacturing (70% of production); prefabricated building manufacturing (10%); and miscellaneous manufacturing, eg, jewellery, toys and sporting goods (20%).

This sector's share of total manufacturing GVA is only 3%. It has declined across all groups, by an average 2% a year, during the past five years, with the furniture industry hit hard by the sharp downturn in residential building in 2000-01.

'Other manufacturing' is oriented toward consumer sales. Imports took more than a third of domestic sales in 1999-00 - mainly miscellaneous manufactures and furniture. Exports made up only 11% of domestic producers' turnover at that time.

Production is forecast to be flat over the three years to 2003-04, although recent housing industry strength and a more buoyant economy generally suggest furniture manufacturers are likely to do better than initially expected.

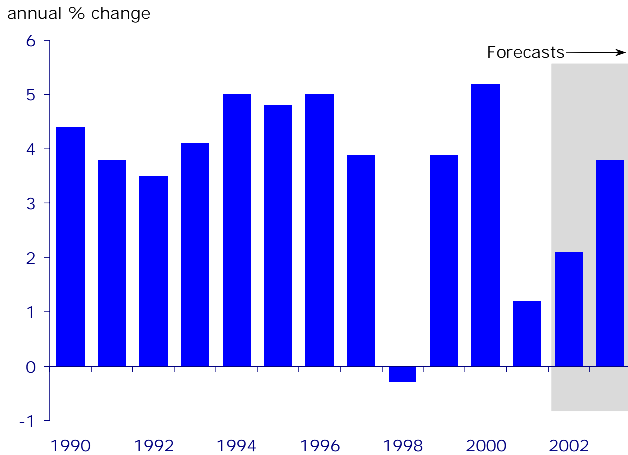
Winners and losers

The best performing sectors of Australian manufacturing have been: food, beverages and tobacco; petroleum, coal, chemical and associated products; machinery and equipment; and printing, publishing and recorded media. These sectors are quite diverse and common characteristics are not immediately apparent. An important factor seems to be a significant proportion of exports in total turnover and/or a relative insulation from imports. Another contributing feature is the ability to leverage off a natural advantage (eg agricultural base, petroleum etc) or skills (machinery and equipment manufacture). In the case of the textile, clothing, footwear and leather subdivision, the opposite features are apparent; relatively low skill level requirements and high vulnerability to imports.

It is to be expected that these same factors will be influential in the future performance of Australia's manufacturing industries. While natural advantages are unlikely to change significantly, the extent of exposure to imports (via changes in tariffs, cost structure, etc.) and the propensity to export are likely to change, making overseas trade orientation an important consideration when evaluating the potential for future growth.

Economic Chartbook

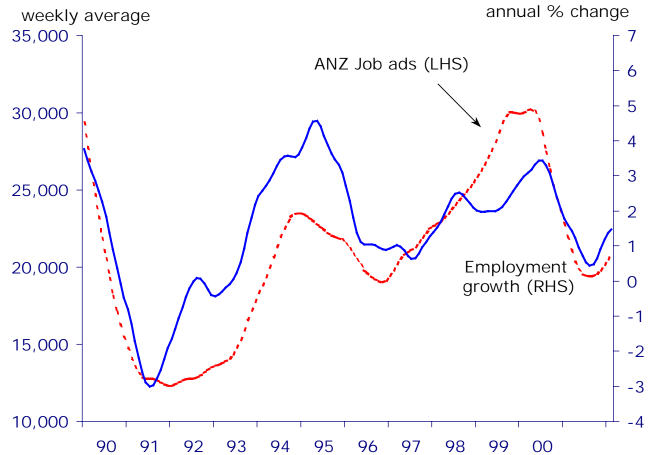
Major trading partners growth



Source: ANZ forecasts

Growth in Australia's major trading partners (MTP) slowed sharply from 5.2% in 2000 to just 1.3% in 2001, reflecting one of the sharpest decelerations in world growth in recent history. Prospects for 2002 have improved however, as recovery in the US and Non-Japan Asia appears now to be taking hold. Unfortunately Australia's largest export market, Japan, burdened by a fragile financial sector, is likely to remain stagnant for some time. Economics@ANZ expects MTP growth of 2.2% in 2002.

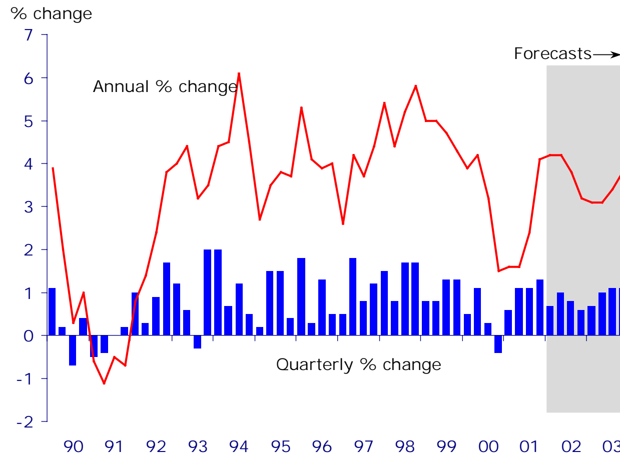
The labour market



Source: ABS Cat. No. 6202.0 and ANZ

ANZ's job ads series has now risen in trend terms for seven consecutive months, notwithstanding a 9.0% fall in March, which was due to the unusual timing of Easter this year. This bodes well for a labour market that until recently has remained sluggish, despite strong economic growth over 2001. The recovery in employment growth now underway means that the peak in the unemployment rate is likely to have already passed and we expect the unemployment rate to be under 6¼% by year's end.

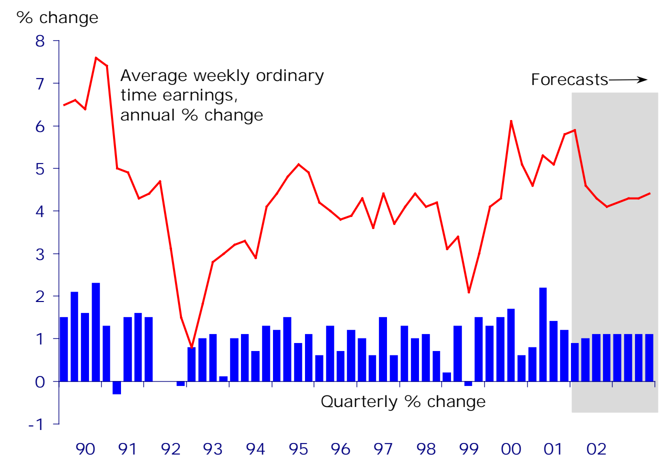
Australian economic growth



Source: ABS Cat. No. 5206.0 and ANZ forecasts

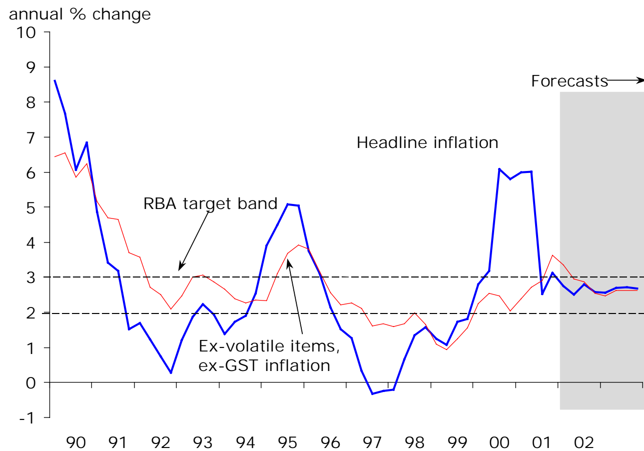
The Australian economy has bounded onwards despite the downdraft from the weak world economy, growing by 1.3% in the December quarter and 4.1% over the year, making Australia one of the fastest growing industrialised countries in 2001. Continued strength in housing and a pick-up in business investment offset a sharp detraction from net exports in the quarter. Robust growth will be maintained this year as a surge in business investment and an improving global environment offset weaker housing.

Average wage growth

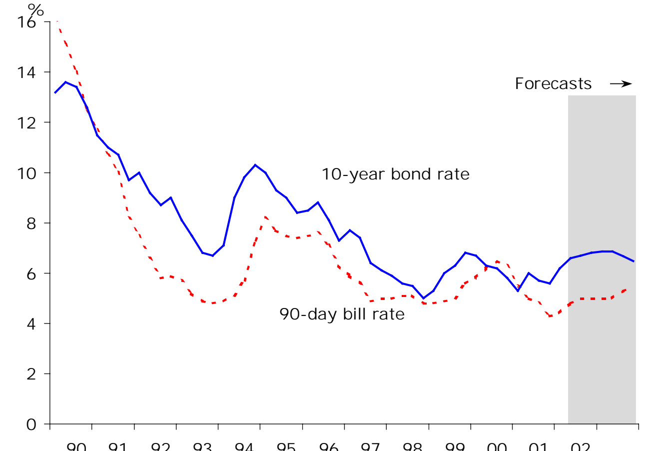


Source: ABS Cat. No. 6302.0 and ANZ forecasts

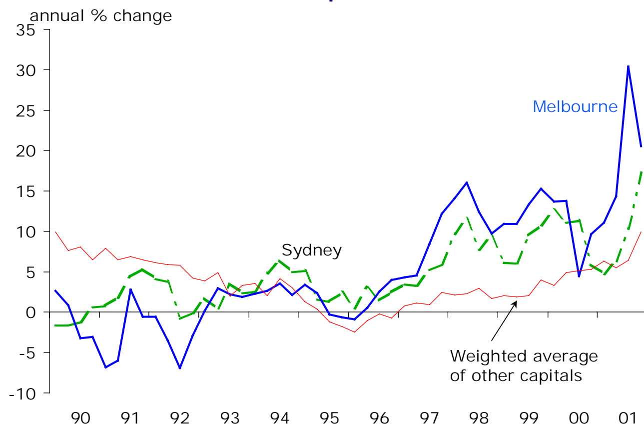
The two main measures of Australian wages growth are currently sending divergent messages on wage inflation. Growth in average weekly ordinary time earnings accelerated through 2001 and is up 5.8% in the year to December 2001, while growth in the wage cost index was more consistent with weaker conditions, easing to 3.4% in the year. Tighter labour market conditions should reassert themselves as the economy continues to grow, however slowing price inflation should moderate wage demands.



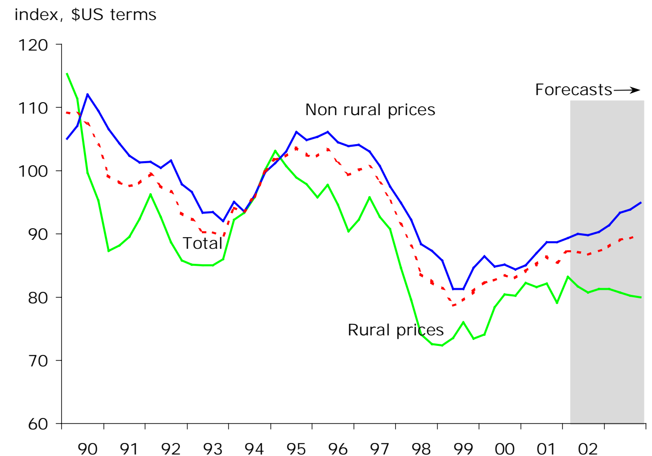
December quarter CPI was above expectations, rising by 0.9% (3.1%yy), with over half of the increase the result of sizeable increases in food prices, particularly meat, fruit and vegetables. CPI excluding 'volatile items' also rose by 0.9% and has now increased by 3.6%yy - the strongest rate of growth (excluding the impact of the GST) since the March quarter of 1996 and well above the upper end of the RBA's 2-3% target band. This breach will be temporary however, as a reduction in unit labour costs should constrain prices in the medium-term.



With the Australian economy evading the worst of the global recession which itself appears to be milder than previously envisaged, the current cash rate of 4.25% looks unusually accommodative. Given the robust state of the Australian economy we expect the RBA to begin reversing last year's post-September 11 'insurance' cuts in May, and provided core inflation returns to the RBA's 2-3% target band, we expect rates to peak at around 5.5% by the end of 2003.

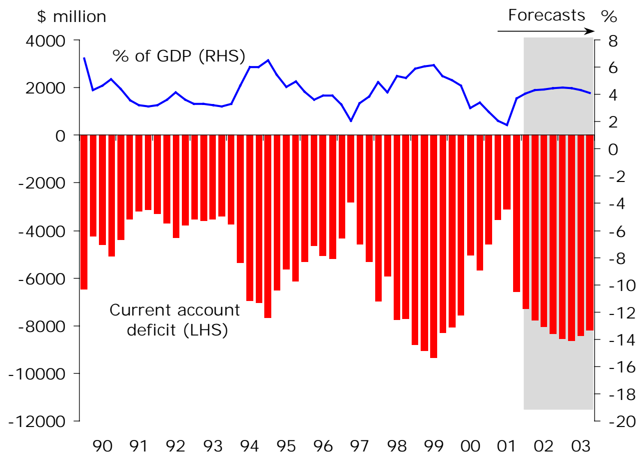


Thirty-year lows in home loan interest rates are continuing to spur house prices forward at rates not seen since the late 1980's. Established house prices rose by 3.8% in the December quarter and are now up 15.5%yy. While stellar returns were initially contained to Melbourne and to a lesser extent Sydney, the property boom has now become more broadly based, with all capital cities enjoying healthy capital gains. Expectations of imminent interest rate rises do not bode well for the property market though and prices will moderate over the medium-term.



Unlike previous economic cycles, the synchronised slowdown in global economic growth did not negatively affect major Australian commodity prices, which grew by 3.8% in $US terms in 2001. In contrast, while 2002 will be characterised by a rebounding global economy, growth in Australian commodity prices in $US terms will be more subdued at 0.6% over the year. Bulk contract negotiations currently underway for coal and iron ore are unlikely to be as generous as last year, given the parlous state of Japanese industry, while gold is unlikely to rally from current levels.

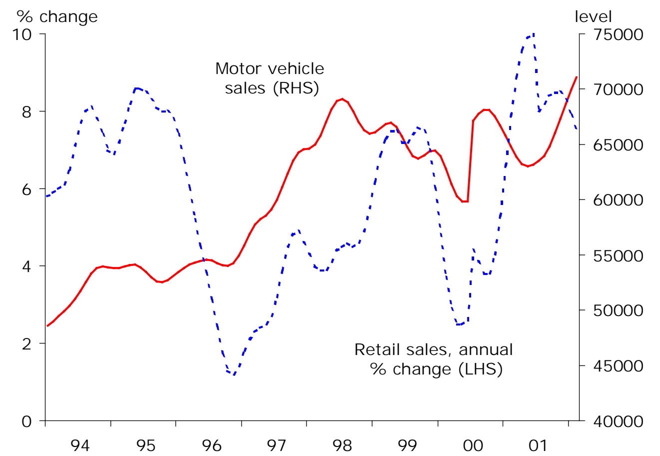
Current account



Source: ABS Cat. No. 5206.0 and ANZ forecasts

Net exports imparted a massive 1.5 pc point detraction from Australian GDP growth in the December quarter, due to the combined effect of an import intensive surge in investment and an export sector that has been badly effected by the sharp slowing in the world economy. Having deteriorated from the September quarter peak of -1.8% of GDP, Australia's current account performance is likely to weaken further, with the import demand of a robust Australian economy likely to outstrip more moderate export growth, despite the global recovery.

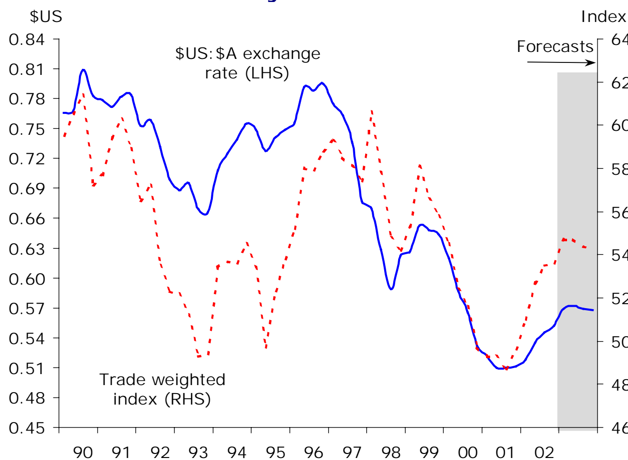
Retail sales and motor vehicle registrations



Source: ABS Cat. No. 9314.0 and 8501.0

Historically low interest rates and rebounding consumer confidence have buoyed the consumer sector over the last year. Real retail sales have grown by 4.8%yy to the December quarter, and evidence suggests that first quarter sales are also strong, while sales of new motor vehicles have grown by 10.9% in the year to February and are now at record levels in trend terms. Rising interest rates and the risk of higher petrol prices will broadly offset the improving labour market, and private consumption should remain firm in the medium term.

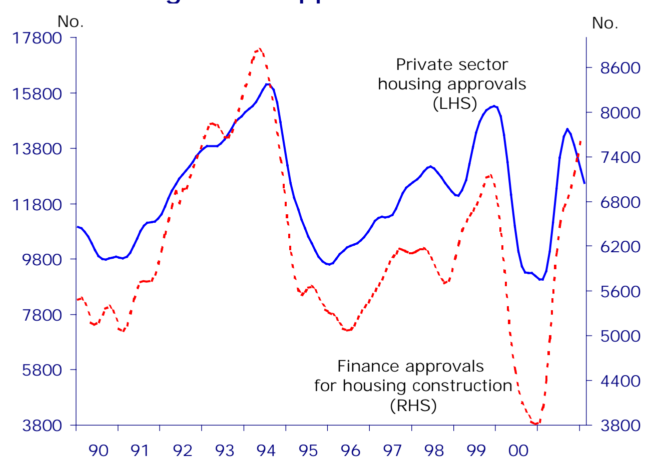
Currency movements



Source: Reuters and ANZ forecasts

The AUD has taken on a more positive tone of late, firmly knocking against the upper limit of its $US0.50-0.53 range of the last several months. Aussie bulls have repeatedly had their fingers burnt over recent years, nevertheless fundamentals look extremely supportive. With markets now anticipating the recovery in global production there is a growing appetite for risk and commodity prices already appear to have bottomed. The Australian economy should also continue to outperform and as such large positive interest rate differentials are likely to persist for some time.

Housing sector approvals and finance



Source: ABS Cat. No. 8731.0 & 5609.0

New private dwelling approvals are now well down from their August peak and will continue to retreat from what were unsustainable levels, as the gradual phase-down of the First Home Builder Grant continues and the interest rate tightening cycle commences. Nevertheless the amount of dwelling construction in the pipeline should see dwelling investment continue to contribute to Australian economic growth in the first half of 2002. Reduced dwelling investment will then detract from otherwise solid economic growth in the second half of 2002 and throughout 2003.

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Forecast table

	Quarterly % change						Annual % change				
	Sep-2001	Dec-2001	Mar-2002	Jun-2002	Sep-2002	Dec-2002	1998/99	1999/00	2000/01	2001/02	2002/03
	← data		forecast →				← actual			forecast →	
GDP	1.1	1.3	0.8	0.9	0.8	0.7	5.3	4.3	1.9	3.7	3.4
- Final demand	1.7	2.1	1.6	1.1	0.9	0.7	5.1	5.2	-0.2	4.8	4.3
- Stocks	-0.5	0.6	-0.2	0.3	0.2	0.0	0.8	-0.1	-0.3	-0.2	0.4
- Net exports	-0.1	-1.5	-0.5	-0.3	-0.4	0.0	-0.6	-0.8	1.7	-1.0	-1.4
CPI	0.3	0.9	0.7	0.6	0.6	0.7	1.3	2.4	6.0	2.7	2.7
Wages (ordinary time earnings)	1.4	1.2	0.9	1.0	1.1	1.1	3.7	3.3	5.3	5.3	4.2
Employment	0.1	0.3	0.9	0.3	0.4	0.4	2.2	2.7	2.1	1.3	1.8
Unemployment rate (%)	6.8	6.8	6.6	6.5	6.3	6.3	7.4	6.6	6.4	6.7	6.2
Current account deficit ($b)	-3.1	-6.6	-7.4	-7.9	-8.1	-8.1	-33.4	-33.3	-18.8	-25.0	-32.1
- % GDP	-1.8	-3.7	-4.1	-4.3	-4.4	-4.3	-5.6	-5.3	-2.8	-3.5	-4.3
90 day bank bills (%p.a.)	4.8	4.3	4.4	4.8	5.0	5.0	4.9	5.7	5.8	4.5	5.0
10 year bond rate (%p.a.)	5.7	5.6	6.2	6.6	6.7	6.8	5.5	6.5	5.8	6.0	6.8
US$/A$	0.51	0.51	0.52	0.54	0.55	0.55	0.62	0.62	0.53	0.52	0.56
Trade weighted index	48.7	49.6	51.0	52.7	53.5	53.6	55.6	54.8	50.0	50.5	54.1
World GDP **							3.4	4.6	2.3	2.7	3.9
Trading partners' GDP **							-0.3	3.9	5.2	1.1	2.1
(**calendar years)							(1998)	(1999)	(2000)	(2001)	(2002)