

# ANZ Economic Outlook

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### Gross Domestic Product

% ch	2001	2002	2003(f)	2004(f)
North America	0.3	2.4	2½	3½
Western Europe	1.7	1.1	¾	1¾
Japan	0.4	0.2	2½	1¾
Australia	2.6	3.6	2½	4
New Zealand	2.6	4.4	3	2½
China	7.3	8.0	8	7½
Other East Asia	5.3	6.8	6½	6¾
South Asia	5.0	4.4	6¼	6
South America	0.8	-0.9	¾	3½
E.Europe & Russia	4.0	3.5	4¾	4¼
<b>World</b>	2.1	2.8	3¼	4

This publication was finalised on 6 October 2003

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## International outlook

### The world economy is starting to pick up

The recovery in the global economy is resuming after the setbacks of the second half of 2002 and the first half of this year, brought on by the protracted build-up to the war in Iraq and the SARS outbreak. These growth-dampening 'headwinds', together with the continuing effects of the collapse of the late 1990s equity bubble, have now receded sufficiently to allow the monetary and fiscal policy stimulus which central banks and governments have, to varying degrees, been stepping up over the past 30 months, to begin to work.

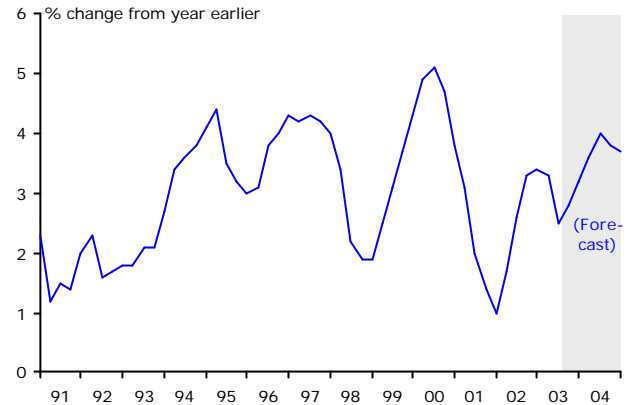
Evidence of strengthening economic activity is clearest in the United States – unsurprisingly, since policy settings have been much more expansionary in the US than anywhere else, and will remain so throughout at least the next 18 months. Aggressive cost cutting has restored corporate balance sheets and profitability to the point where investment spending is picking up once again. However weakness in employment growth is likely to dampen growth in consumer spending.

Economic activity has also been stronger than expected in Japan (even allowing for the suspicion that reported growth in the June quarter was overstated); moreover, the upturn in Japan is being driven largely by domestic demand, rather than exports. As in the US, business investment is picking up strongly, partly reflecting the extent of restructuring by large corporations.

China's economy was less affected by SARS than feared; the major concern for China now is of too much growth (of the wrong sort), rather than too little. The picture is mixed elsewhere in Asia. Recovery (from much sharper SARS-driven downturns) has been more tentative in Singapore and, especially, Hong Kong. Korea is still grappling with the aftermath of a credit crunch, labour unrest and continuing concerns over North Korea's nuclear ambitions. However other Asian economies have generally shown encouraging resilience. Most Asian economies stand to benefit from stronger growth in the US and Japan.

Economic growth in Europe has been more disappointing. The European Central Bank has been less aggressive in easing monetary policy than most other central banks, while the scope for fiscal stimulus has been somewhat constrained by the terms of the Maastricht Treaty. Even in Europe, however, business confidence appears to be improving. Recovery should be further assisted by tax cuts in Germany and progress in other structural reforms, and by improving prospects for exports.

### World GDP growth heading for 4%



The world economy now seems likely to grow by an average of 4% next year after an expected 3¼% in 2003. In each case these forecasts have been revised upwards by about ¼ pc point since the previous issue of *ANZ Economic Outlook*.

4% growth in 2004 would represent the best outcome for the world economy since 2000. It will make some inroads into the spare capacity which has been opened up by three years of below-trend global growth. It should therefore help to reduce the risk of deflation. Deflation has already ended (at the consumer level) in China. Consumer prices have declined at a slower pace in Japan this year, although that is partly due to increases in tobacco taxes and health insurance costs.

However it will take more than one year of above-trend growth before central banks in most countries (including the US) are convinced that deflation has become less of a risk than rising inflation. Hence, contrary to the conclusion which global bond markets initially leaped, most central banks are unlikely to begin raising interest rates from their current historically low levels until the second half of next year. Indeed it is possible that the European Central Bank could still have one more rate cut to go; while we do not expect the US Federal Reserve to lift its funds rate target until after the Presidential election in November next year.

The 'war on terrorism', the continuing US presence in Iraq, and North Korea's and Iran's nuclear programs will maintain geo-political tensions as a source of risk to the global outlook but, in the absence of major new developments, seem unlikely to derail the prospect of a global recovery. The greater longer-term threats to the health of the global economy stem more, in our view, from the 'unbalanced' pattern of global growth and possible reactions to it.

## Unbalanced growth

The period since the Asian financial crisis has seen the renewed emergence of substantial imbalances in the current accounts of the world's major regions. The US is now running a current account deficit in excess of US\$500bn (more than 5% of GDP); to which the main counterparts are the current account surpluses of six East Asian countries (Japan, China, Korea, Taiwan, Hong Kong and Singapore) totalling over US\$200bn (about 3¼% of their combined GDPs), the relatively smaller surpluses of other developing countries and of the EU, and the 'global current account discrepancy' which the IMF estimates to have been more than US\$100bn in each of the past four years.

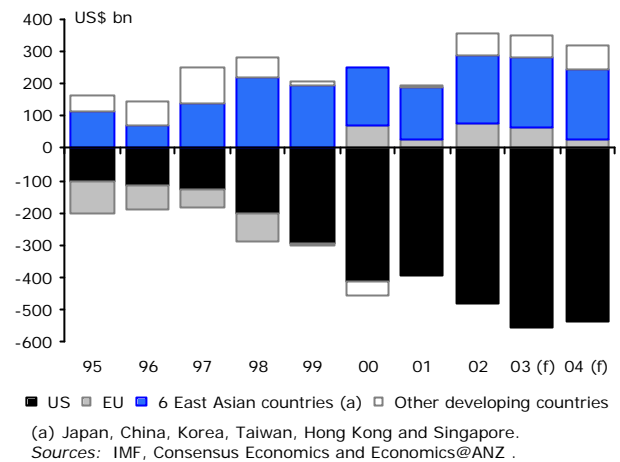
For the near term, at least, these imbalances are likely to become even larger. In dollar terms, US imports of goods and services are 50% larger than US exports. This means that exports have to grow half as fast again as imports merely to prevent the US trade deficit from widening further. Moreover, US imports are much more sensitive to changes in US domestic demand than US exports are to changes in demand from its major trading partners<sup>1</sup>. Thus, other economies would have to grow much faster than the US for a sustained period – something which has not happened for over a decade and seems unlikely in the foreseeable future – to achieve a 'painless' narrowing in the US current account deficit.

There is no *a priori* upper limit to the size of current account deficits, or the time for which they can be incurred; but in the past quarter-century few countries have sustained deficits of 5% of GDP or larger for more than two years.

In this respect, as in some others, the US may be subject to different 'rules': it can borrow in the world's reserve currency (its own), and its large and liquid financial markets have allowed it to attract relatively more capital than others with large deficits to finance have been consistently able to do. Moreover, it has suited Asian countries, in effect, to finance the purchase by US consumers of their own exports in order to sustain their preferred export-driven patterns of growth, avoid dependence on foreign capital and build up foreign exchange reserves as a 'buffer' against future financial crises. Up to half the US deficit is now being financed in this way; the remainder has to date not proved to be a major burden on the rest of the world.

<sup>1</sup> See, for example, Peter Hooper, Karen Johnson and Jaime Marquez, Trade Elasticities for the G7 Countries, *Princeton Studies in International Economics*, No. 87, August 2000, who find that a 1% increase in US domestic demand boosts US imports by 1.8%, but a 1% increase in foreign demand boosts US exports by only 0.8%.

## Major current account balances



By the end of 2002, the US had accumulated net international liabilities equivalent to 24.9% of GDP. While this represents a significant turnaround from the US' position as a net creditor up until 1988, it is not particularly high by the standards of other countries (Australia's net international liabilities, for example, amount to almost 60% of GDP). And the cost of servicing these liabilities is surprisingly low: indeed 2002 was the first year in which the US ran a deficit on investment income. While there must be some point at which the rest of the world's appetite for adding to its holdings of US investments becomes exhausted, it has not been reached yet.

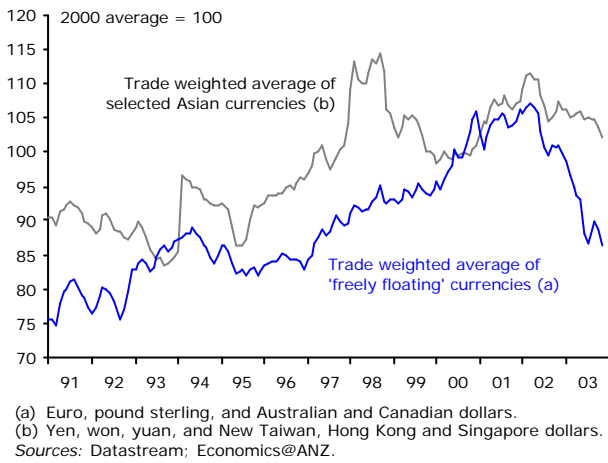
However the US may be approaching some kind of *political* limit to the size of the current account deficit which it can sustain. 2004 is a Presidential election year, and political attention is focussing on the net loss of over 2½mn jobs, nearly all of them from manufacturing, since the Bush Administration came to office. Both sides of American politics seem increasingly willing to blame job losses on Asian countries accused of 'artificially manipulating' their currencies so as to gain an 'unfair' competitive advantage. This is, of course, bad economics; but, sadly, bad economics all too often makes for good (short-term) politics.

In these circumstances the risk of an upsurge in protectionist sentiment is very real. There are already several pieces of protectionist legislation before Congress; and the failure of the WTO Ministerial talks at Cancún in September has further raised the risks of a retreat from trade liberalization.

## A further orderly fall in the US\$ will help

September's decision by G7 Finance Ministers to endorse 'more flexibility in exchange rates ... to promote smooth and widespread adjustments in the international financial system, based on market mechanisms', represents a serious attempt to head off the risk of a resort to protectionism.

### US dollar against other currencies



We interpret the statement as signalling an agreement that, first, the US dollar should fall some more; and second, that dollar should fall against Asian currencies as well as the euro and other 'freely floating' currencies (including the C\$ and the A\$) who have borne the brunt of the US\$'s decline since early last year.

As we argue elsewhere in this publication, given the fragility of its banking system China is unlikely to accede to US pressure to float the yuan any time soon. Nor does it seem willing to contemplate a one-time revaluation, despite the problems posed for domestic monetary management by capital inflows prompted by that possibility, which it is seeking to deal with in other ways.

However it does appear that Japan may have agreed to allow at least some appreciation of the yen – something which it is now in a better position to accommodate. It remains as yet unclear whether Japan intends to reduce the scale of its intervention in currency markets, or has merely shifted the level at which it intervenes.

The general consensus of formal studies is that a fall of at least 20% in the US\$'s trade-weighted value is required to bring the US current account deficit back to around 3-3% of GDP; some studies suggest the required decline could be as much as 40%. Since its peak in February last year the US dollar has fallen by about 19% against the Federal Reserve's index of major currencies (which includes only one Asian currency, the yen), but by less than 10% against a broader trade-weighted index.

We expect that the US\$ will fall to ¥105 and €1.20 during 2004. That is almost certainly not enough, on its own, to prompt a significant narrowing in the US current account deficit. But a quicker decline would likely prove more damaging to growth prospects outside the US, as well as putting upward pressure on longer-term US interest rates.

### US recovery unlikely to be a strong one

Most of the major US leading indicators are now signalling a fairly strong acceleration in economic activity. Households are spending most of the July tax cut; housing activity is still at close to record levels and is yet to be impacted by the rise in mortgage rates since late June; and business investment is beginning to recover from an unusually long and deep downturn.

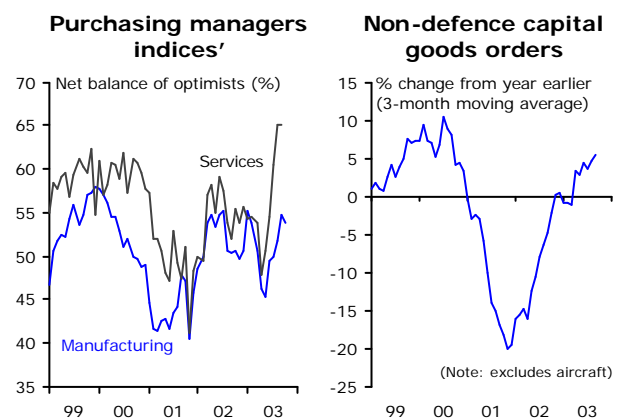
The recovery is being driven by a combination of substantial monetary and fiscal policy stimulus; an improvement in the financial position and profitability of the business sector as a result of several years of aggressive cost-cutting; and the partial reversal of some of the drags on growth of the past two years, including falling share prices, rising oil prices and global political tensions.

These influences, together with some rebuilding of inventories, should be sufficient to ensure real GDP growth of at least 4%, at an annualized rate, in the current half. However we doubt that this momentum will be maintained for as long as in previous recoveries; instead, we expect growth to ease back to an average of about 3½% in 2004.

This reflects what we see as three important constraints on the capacity of household spending to contribute as much as it usually does to growth at this stage of the cycle.

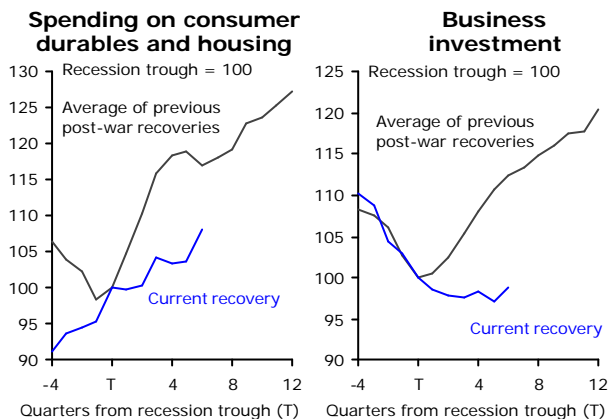
First, there is very little pent-up demand for consumer durables and housing which typically provides much of the momentum for rapid growth in the early stages of a recovery. In previous US recessions, these two components of spending have fallen by an average of nearly 15%, rebounding at an average annual rate of over 7% over the first two years of recovery, and contributing more than 1 pc point per annum to GDP growth.

### US leading indicators



Sources: Institute of Supply Management; US Commerce Department.

### This recovery will be different



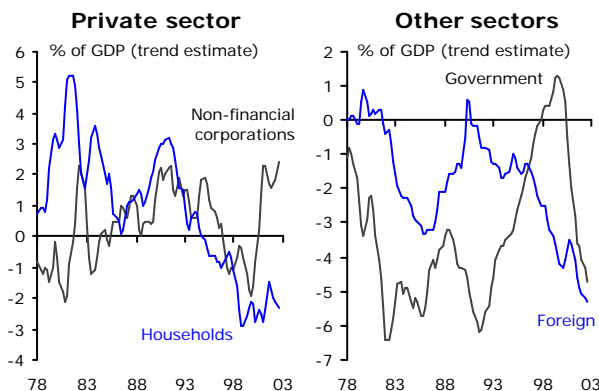
Source: US Bureau of Economic Analysis.

In the 2001 downturn, by contrast, the Fed's aggressive easing and the Administration's tax cuts succeeded in preventing any downturn in spending on consumer durables and housing; this was a major reason why the 2001 recession was so mild by historical standards. But for precisely the same reason, there is little basis for expecting these components of spending now to increase as strongly as they usually do.

Second, whereas the financial position of the corporate sector has been substantially improved over the past three years, that of the household sector has not. The corporate sector has eliminated its net financial deficit (the difference between saving and investment) and is now well placed to finance rising investment spending. By contrast – largely because spending on durable goods and housing did not fall during the 2001 recession or since – the household sector is still running a large financial deficit.

As a result, households are unlikely to be able to run down their saving rates as they typically do in the early stages of an economic recovery. Rather, saving rates are more likely to rise.

### Financial imbalances persist



Note: 'Financial balance' (or 'net lending') is the difference between saving and investment. Trend estimates calculated using ABS formulae. Sources: US Bureau of Economic Analysis; Economics@ANZ.

Finally, household income growth is likely to be weaker than in previous recoveries, as a result slower than usual growth in employment. According to the National Bureau of Economic Research, the last recession ended seven quarters ago, in the December quarter 2001. By this stage of the eight previous business cycles between 1945 and 1990, employment had risen by an average of 4.2% – equivalent to about 5½ million jobs in today's terms. Even in the so-called 'jobless recovery' from the 1990-91 recession, employment had by this stage risen by 0.4%, which scaled up today's labour market would be equivalent to over 130,000 jobs. Instead, employment has fallen by over 1mn since the 2001 recession officially ended.

This largely reflects the fact that overall economic growth has averaged 2.7% per annum since the last recession, less than half the average rate recorded over the same period of previous post-war business cycles, and below that typically required to generate net increases in employment. However the 'growth hurdle' required for sustainable job creation has also been raised by the elevated rate of productivity growth carried over from the late 1990s boom.

As a result, real wage and salary income has grown at a mere 0.1% annual rate since the 2001 recession officially ended. Tax cuts have thus far served to ameliorate the weakness in wage and salary income growth; but with the Federal Budget deficit now over 4% of GDP, the scope for repeating this strategy on the same scale looks fairly limited.

Given the expected acceleration in economic growth in the current half-year, employment growth is likely to turn positive soon (September's numbers may have marked a turning point); but the unemployment rate will come down only slowly and thus will continue to weigh on consumer confidence. As a result, the recovery which is now getting under way will be less reliant on household spending (which accounts for over 70% of GDP) than normal, and more reliant on business spending and exports (about 13% and 10% of GDP, respectively). It seems inevitable, therefore, that this recovery will be slower than implied by historical norms.

All of this implies that the Federal Reserve is right to insist that 'policy accommodation can be maintained for a considerable period'. Typically, the Fed does not initiate a monetary policy tightening cycle until the unemployment rate has clearly begun to fall, which is unlikely to be before the middle of next year. The Fed is also usually reluctant to change monetary policy settings during the formal stage of Presidential election campaigns, which begin in early September. US interest rates are thus likely to be 'on hold' until very late next year.

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## Several European countries in recession

Real GDP in the euro area fell by 0.1% between Q1 and Q2 with the annual increase declining to just 0.2%, the weakest since 1993. Fixed investment continued to decline and has fallen in seven of the past nine quarters with minute increases in the other two. Private consumption was up on the previous quarter by just 0.1%, while exports recorded their third successive decline with the impact of weak global demand exacerbated by the strength of the euro. Individual country results were even worse than the poor outcomes widely expected. Germany, Italy and the Netherlands are in recession with GDP in Q2 also contracting in France and Belgium. The only better-than-expected result was in Spain where a quarterly gain of 0.7% produced annual growth of 2.3%.

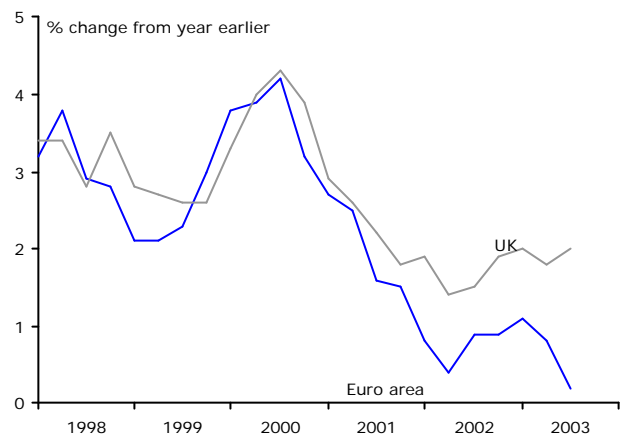
There is not yet any firm evidence that economic recovery in the euro area has begun, but business sentiment is becoming more positive. Both the 'overall climate' and 'future expectations' components of the German IFO survey rose each month from May to September. The Reuters Purchasing Managers' Index for manufacturing in the euro area has risen since June with the September reading signalling a small rise in output. The service sector PMI has been rising since April with business activity in September registering the fastest expansion since April 2002. Growing confidence that US recovery is under way is also bolstering hopes of economic recovery, but surveys of consumer confidence have been disappointing.

Interest rates in the euro area are expected to be held steady over coming months, but if there are no clear signs that improving sentiment is being reflected in activity levels by end-year then the prospect of a further cut in the ECB's official interest rates will increase. A further significant rise in the euro against the US dollar - the euro rose by 36% between its low in January 2002 and 1 October 2003 - would be detrimental to prospects of economic recovery and would also bolster the prospect of another interest rate reduction.

Tensions about the Stability and Growth Pact are mounting. The major economies are in breach of the pact and favour its revision so that it is not applied rigidly and fiscal policy can be used to boost GDP growth at times of economic weakness. Smaller EU countries consider this attitude to be irresponsible and are concerned about the detrimental impact on longer-term economic prospects of disregarding agreed rules and procedures. There is a further distinction between the positions that Germany and France have adopted. Both countries are expected to breach the 3% deficit ceiling for the third year in a row in 2004, but the German government says that it

respects the pact and is trying to get the deficit below 3% while France is more blatantly defying its provisions. As a result, the European Commission is expected to seek to censure France, but it is by no means certain that there will be sufficient support from other EU governments to approve such a recommendation. Some reform of the pact is likely eventually, but probably not until cyclical recovery eases some of the fiscal constraints that the major economies are currently up against; in the meantime continuing disagreement and bickering will further undermine the pact's credibility.

## Faster growth in the UK



Sources: Eurostat and UK Office for National Statistics

Revised UK figures show a quarterly GDP rise of 0.6% in Q2 following a weak 0.2% increase in Q1. The details are mixed. Construction output surged by 4.4% from the preceding quarter, which offset a slowdown in the service sector which grew by just 0.3%. GDP growth in 2003 is expected to be close to the bottom of the government's 2.0-2.5% forecast. GDP growth is expected to strengthen to above 2.5% in 2004, but the government's projection of 3.0-3.5% still looks too optimistic. The recent improvement in the growth outlook has reinforced expectations that the Bank of England will be the first major central bank to raise interest rates. ANZ expects a small 25bp rise in the Bank's repo rate, currently 3.50%, in early 2004. It is considered unlikely that the forthcoming switch to a new measure of inflation will delay an interest rate rise if economic recovery gains momentum. The government is expected to confirm in November that the new HICP inflation target is 2%, below the current RPIX target of 2.5%. If the unusually large gap between the RPIX and HICP measures - 2.9% and 1.4% respectively in August - persists then the government could allow some transitional flexibility to accompany the change.

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## Japanese economy surprises

The Japanese economy turned in an extraordinarily strong performance in the first half of 2003. GDP growth accelerated to a 3.9% annualised pace in the June quarter, the fastest of all of the G7 economies.

This strong number took everyone by surprise and indeed, may unfortunately turn out to be a little too good to be true. Japanese economic statistics are commonly subject to revision, and some Cabinet Office officials have reportedly confirmed that growth in the volume of capital spending has likely been overstated<sup>2</sup>. Another factor that contributed to Japan's strong GDP growth was a 1.6% decline in imports. This fall was at odds with strong domestic demand and indeed appears to have been a 'one-off' boost to growth from SARS, which discouraged international travel by Japanese residents. All of this suggests that the Japanese economy may not be travelling quite as strongly as the headline numbers imply.

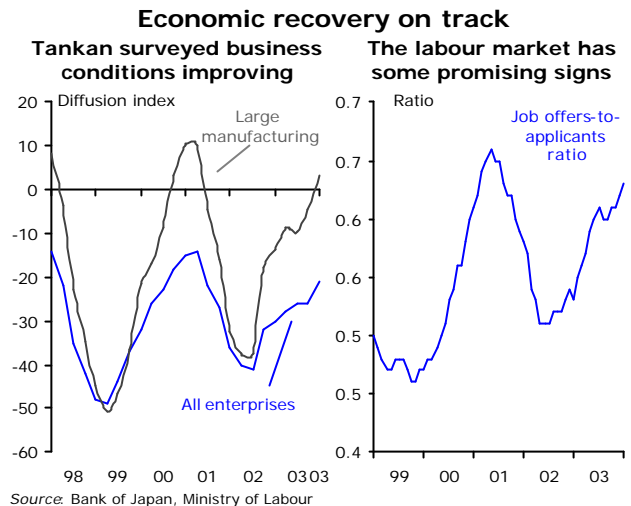
It is unlikely therefore that Japanese economic growth will be able to maintain its recent heady pace. Indeed, industrial production, a key leading indicator of growth, has eased back a touch in the last few months. GDP growth is now forecast to pick up to 2½% in 2003 before easing a little to 1¾% in 2004.

While growth is expected to moderate in the short-term, it does appear increasingly clear that the Japanese economy has made some significant steps towards the path of a sustainable recovery. Domestic demand has increased, led encouragingly by a pick up in business investment even allowing for some overstatement in the June quarter national accounts. Signs for this sector continue to improve. Ultra-easy monetary policy has eased corporate debt burdens and improved access to funds, as has the 22% rise in the Nikkei since the start of the year, which has no doubt also boosted confidence. In addition, the rate of corporate bankruptcies has fallen dramatically. In the face of all of these positive factors, the September quarter Bank of Japan (BoJ) Tankan survey showed a marked improvement in actual and forecast business conditions across all of the major sectors. Large manufacturers continued to fare the best, with business conditions in this sector turning positive for the first time in nearly three years.

Brighter prospects in the business sector have had positive implications for the economy more broadly. Employment growth has picked up markedly and

<sup>2</sup> The volume of capital spending in the June quarter has reportedly been overstated due to the use of an improbably low capital goods deflator, which was estimated to have fallen by 6.9%.

wage rates have also increased a little. Significantly, the pick up in demand has caused the rate of deflation to ease, even allowing for some recently administered price rises. Core consumer prices are now running at a -0.3% yearly rate, the smallest decline in close to 4 years.



An important contributor to the buoyant mood of firms and indeed the pick up in activity more generally is the aggressive policy agenda. Interest rates remain extremely expansionary with the BoJ continuing its quantitative easing policy to keep the overnight call rate at around zero. In addition, the BoJ has also spent ¥13.5tn (¥5.8tn more than the previous record in 1999) intervening in currency markets in an attempt to restrict the yen's appreciation. The BoJ's aggressive policy actions have been supported by Prime Minister Koizumi. After winning reappointment last month, the Prime Minister immediately introduced a new 'pro-reform' cabinet and pledged wide-ranging 'pro-growth' policy changes.

One potential risk to the economy is posed by the recent rapid appreciation of the Yen, which has risen to a 3-year high of just under US\$/JPY111 (see *Financial Markets* article, page 19). A sharp rise in the yen is unlikely to damage growth severely in the short-term, given that current momentum is being driven by the domestic economy, which makes up around 75% of the economy. A higher yen does however pose some risks over the longer-term, by reducing imported price pressures and potentially exacerbating deflation. As such, it seems likely that the BoJ will continue currency market intervention to keep the Yen from appreciating too sharply, although the desired 'competitive' rate is now probably a little higher than earlier this year, given Japan's recent better economic outcomes.

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## Asian outlook

### Second quarter growth tells a mixed story

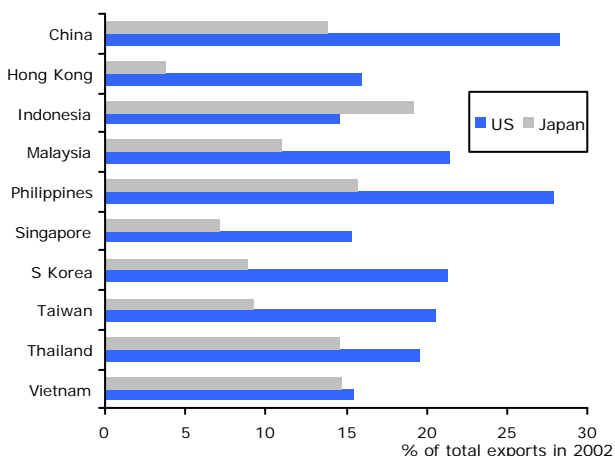
As anticipated, the SARS-hit economies of Singapore, Hong Kong and Taiwan experienced sharp declines in the second quarter. China's economy proved to be more resilient, slowing to 6.7% over the year to the June quarter, low by China's standards but the highest rate of growth among the major economies in East Asia. There are, however, concerns about potential overheating in China now that the SARS outbreak is over.

South Korea - a star performer in 2002 - drifted into recession in 2003, with real GDP declining by 0.7% in the June quarter after a 0.4% fall in Q1 2003. Domestic demand was dogged by tighter credit conditions, North-South tensions and a pick-up in strike action hampering industrial activity. The Philippine economy also declined in Q1, and grew at a lacklustre rate in the second quarter, weighed down by sluggish exports, weak government consumption and private fixed investment.

There were, however, a few stand-out economies. Malaysia and Thailand grew at impressive rates of 4.3% and 5.8% respectively in the year to Q2 2003 despite the adverse impact of SARS on the region. Economic growth in Indonesia also held up well, expanding by 3.7% over the year to the June quarter. These economies look set to gain momentum through the rest of 2003 and into 2004, riding on positive signs of a global recovery.

Overall, we remain optimistic over the growth prospects for the region, underpinned by a strengthening in external demand. Non-Japan Asia is forecast to expand by around 6½% in 2003 and 6¾% in 2004 supported by a stronger economic growth outlook for its major export markets of the US and Japan.

### Heavy export dependence on the US and Japan



Source: IMF, Direction of Trade Statistics

### Is China's economy overheating?

Since SARS subsided in June, two issues have dominated news and discussion about China, namely the value of the renminbi, and the question of economic overheating. The economy is not actually overheating, with inflation at just 0.4% over the year to August and a sizeable trade surplus. However, current rapid money supply growth, driven by official purchases of US dollars (in order to maintain the fixed exchange rate) as well as an unusually rapid expansion of bank lending, raises concerns about potential overheating in the future. Indeed, imports are growing faster than exports and the trade surplus is shrinking: In the eight months to August the surplus of US\$8.9bn was just half the amount in the corresponding period of 2002. It is thus quite possible that China's current account will move into deficit in the foreseeable future. The more immediate risk, given that a lot of the new bank credit has gone into housing, is of a bubble developing in certain sectors of the property market, notably luxury apartments in Shanghai. The authorities have responded by raising banks' reserve requirements and selling securities to mop up liquidity.

There has for some months been a clamour among some of China's trading partners for a revaluation of the RMB. However, revaluation is not in China's interests. It would add significantly to the pain of adjustment to the reforms required by WTO entry. Also, as mentioned above, surging imports could soon turn China's external surplus into a deficit in the not-too-distant future. Moreover, it is by no means clear that a stronger currency would achieve what critics want – a slowing of the expansion of China's global market share in manufactured goods.

On the wider question of the reform of China's exchange rate regime, a flexible, market-related currency will be to China's advantage, and is indeed a long-term objective. However, there are institutional pre-requisites, which will be difficult to achieve, such as a sound banking system, deep money and capital markets and the elimination of capital controls. An early move to a dirty float would probably be counter-productive, and the most sensible strategy is to press forward with these financial sector reforms.

### Hong Kong – mixed signs, post-SARS

The Hong Kong economy was severely hit by SARS, contracting by a seasonally adjusted 3.7% in the second quarter. Now the issue is how quickly and strongly the economy recovers. So far, the evidence is patchy. On the positive side, airlines



report a recovery in passenger numbers, and the Purchasing Managers' Index, a leading indicator of demand for goods, has now posted three consecutive monthly readings above 50, signifying economic expansion. Other indicators are less convincing. The value of retail sales in July was 2.7% below a year earlier and unemployment improved only marginally to 8.6% in the three months to August, compared to levels just above 7% recorded before the SARS outbreak.

The SARS epidemic boosted the budget deficit which, in the first five months of the fiscal year, has widened to HK\$60bn (7.5% larger than in the corresponding period of last year). The full-year target of HK\$68bn looks increasingly unattainable. To fund the deficit, the government is considering bond issues, rather than continuing to run down its fiscal reserves, which underpin the currency peg. While higher taxes and/or reduced spending are particularly unpalatable when the economy is weak and struggling with deflation, the structural component of the deficit will ultimately have to be addressed by broadening the tax base, probably by introducing a general sales tax or value-added tax.

### **Cautious optimism for Singapore**

The Singapore economy contracted by 1.3% in the first half of 2003 compared with the same period in 2002 as the effect of SARS and sluggish external demand brought the economy to a stand-still. However, the worst appears to be over. The Purchasing Managers' Index of manufacturing activity has remained above 50 over three successive months to August and business sentiment in both the manufacturing and services & commerce sectors have improved. In addition, the composite leading index, which foreshadows economic activity about three quarters ahead, rose by 2.9% in Q2 2003 after falling by 1.5% in the first quarter.

Efforts to reduce business costs through cuts to employers' contribution rate to the pension fund, a rebound in tourism-related industries, and an anticipated upturn in external demand are expected to help revive the economy. Real GDP is projected to expand by around 1% in 2003 and strengthen further in 2004, lifted by external demand. Contrary to earlier expectations, a rebound in exports is unlikely to be seen until later this year and into 2004. Exports in July and August have grown at a slower-than-expected pace.

### **Taiwan's recovery driven by exports**

Taiwan's economy shrank by a seasonally adjusted 2½% in the second quarter. This was worse than expected, but the government has raised its full year forecast from 2.9% to 3.1%, predicated on

strong external demand in the second half. There are a number of strong signals from recent partial indicators: exports were up 13% over the year to August; industrial production has rebounded, rising 7.5% over the 12 months to July; export orders rose 14.8% over the same period; and share prices and the composite index of leading indicators have both turned decisively upwards. Unemployment, however, remains stubbornly above 5%.

Economics@ANZ is forecasting growth of 2% this year. Next year should be stronger, with the world economy picking up momentum and the domestic economy boosted by a stimulatory budget, which has just been presented to the legislature. The next presidential election is due to be held in March next year.

### **South Korea eyes recovery**

The South Korean economy is facing its steepest downturn since the Asian crisis. Labour unrest and concerns over North Korea's nuclear ambitions remain lingering concerns impacting on consumer sentiment and foreign investment (FDI). FDI has fallen over recent years since a high of US\$15.5bn in 1999, with only US\$2.7bn in the first half of this year.

Domestic demand, the main driver of growth in late 2001 and 2002, has faltered. The more accommodative macroeconomic policy stance adopted should help to lift demand. The overnight call rate is at a record low of 3.75%. Proposed fiscal spending, estimated at around KRW3-4tn to repair the damage caused by powerful typhoon Maemi, in addition to extra-budget spending of KRW4.5tn approved in August, is expected to stimulate economic activity in the months ahead. A lot is also riding on further growth in exports as global growth strengthens. Real GDP is forecast to expand by around 2¾% in 2003, a sharp slowdown from 6.3% in 2002 but is projected to pick up to around 6% in 2004, supported by a recovery in domestic demand and an acceleration in exports.

A stronger won, to near 3-year highs against the US dollar, has raised concerns over its adverse impact on the economy particularly under the current climate. The won has appreciated by some 8.7% against the US dollar since lows recorded in late March and by around 3% against the yen, its main export competitor.

### **Thailand is on a strong growth track**

The Thai economy's robust growth of 5.8% in the year to Q2 2003 was helped by a strong rise in investment spending. This was particularly encouraging after several quarters of weak growth. With exports expected to perform strongly in the

second half, the government has raised its GDP growth target for 2003 to 5.8-6.2%. The target is realistic and, if met, the GDP rise would be the strongest since 1996, with only China and Vietnam in East Asia likely to do better in 2003. However, the official projection that economic growth will reach 6.5-8.5% in 2004 is ambitious and exceeds most other projections despite growing optimism about prospects for world economic recovery. The early repayment of debt due to the IMF in August 2003 underlines the significant economic progress achieved since the financial crisis in 1997, but several problems persist and cloud medium-term prospects. These include the high level of non-performing loans in the banking system and the failure to establish a legal framework that fully protects the rights of creditors of failed companies.

The authorities have introduced new measures to try to prevent the recent strong economic performance triggering a sharp rise of the baht against the depreciating US dollar that would be detrimental to export prospects. Banks have been banned from accepting short-term deposits of more than THB50mn from non-residents that are not trade or investment related. The baht has risen from THB43.1/US\$ at end-2002 to THB39.8/US\$ on 1 October and upward pressure is expected to persist. However, the central bank is likely to resort to more concerted intervention to try to prevent any move above THB39/US\$.

Thailand will host the APEC leaders meeting in October at which a free trade agreement with Australia is likely to be signed and framework plans for a free trade agreement with the US unveiled.

### **Medium term growth of 5% achievable for Malaysia**

Real GDP rose by almost 2% on the previous quarter following a disappointing first quarter result. However, the details of the latest GDP figures are not as impressive as the headline result. Investment spending continued to decline, albeit at a much slower pace than in the first quarter, and a strong contribution from net exports owed much to a sharp fall in imports. There were also mixed results on the production side; annual increases in agriculture and mining exceeded 10%, but growth of construction and services was sluggish. The manufacturing sector grew by 6.5%, a good result given the weak international environment and adverse impact of the Iraq war and SARS.

Prime Minister Mahathir, who is due to hand over power to Deputy Prime Minister Abdullah Ahmad Badawi at end-October, presented the 2004 budget in September. Its main economic objectives are to sustain growth while seeking to reduce the federal budget deficit from a projected 5.4% of GDP in 2003

(initially 4.0%) to 3.3% in 2004. The objective of a balanced budget is retained, but is now expected in 2006 rather than 2005. The corporate tax rate was unchanged at 28% and the budget builds on the pro-growth incentives unveiled in May that were directed towards small and medium-sized enterprises. The budget's emphasis on fiscal consolidation is welcome and there was no resort to populist measures to bolster support for the government ahead of the general election due by late 2004. Real GDP growth projections of 4.5% in 2003 and 5.5-6.0% in 2004 seem realistic. Economic stability has been restored and the prospects of sustaining annual economic growth around 5% over the medium-term are good despite strong export competition from China.

### **Vietnam's economy is growing strongly**

Vietnam achieved economic growth of 7.1% in the first 9 months of 2003, with manufacturing and construction output up by more than 10% from the year-earlier level. Strong economic growth is fuelling demand for imports and the trade deficit is expected to rise from less than US\$3bn in 2002 to around US\$4bn in 2003.

The IMF has suspended disbursement of its current facility until central bank accounting reforms are implemented. While the affected programme is small in financial terms - about US\$368mn of which US\$158mn has been disbursed - the decision indicates that regulatory and transparency issues continue to impede progress despite the firm commitment to economic reform. The IMF has reiterated that commercially-based decision-making in the state-owned enterprise and banking sectors is a key requirement to sustain solid economic growth. The US has called on Vietnam to accelerate its economic reform efforts in order to attain its objective of WTO membership by 2005. WTO membership would be particularly beneficial to the textile sector, with textile quotas for WTO members due to be lifted at end-2004, and would also have a major impact in boosting Vietnam's appeal to foreign investors.

### **Growth potential constrained in Indonesia**

Indonesia's financial markets weathered the shock of the Marriott hotel bombing, underscoring confidence in the domestic economy. Macroeconomic policy management over the past year and efforts to fight terrorism have helped to lift sentiment. After an initial dip, the stockmarket picked up, rising by over 20% since the bombing on 5 August and the rupiah has edged up slightly. Nevertheless, the incipient recovery in foreign direct investment (FDI) is likely to have been undermined. For the first eight months of 2003, FDI approvals rose to US\$5bn compared with US\$4.1bn for the

same period in 2002 but pales in comparison with an average of over US\$30bn per year between 1994 and 1997. Political uncertainty in the lead-up to parliamentary and presidential elections in 2004, security risks and pace of reform post-IMF are likely to limit long-term capital inflows.

Fiscal consolidation remains the main focus, particularly so for 2004 as the IMF ceases to provide financial support on expiry of its current agreement at the end of this year. The draft budget for 2004 projects a deficit of 1.2% of GDP from 1.9% for 2003. Inflation has been reduced to an average of 7.1% for the first eight months of 2003 compared with 11.9% in 2002 and interest rates have eased, with the one-month SBI rate at around 8.6% in late September 2003 compared with 12.9% at end-2002.

Nevertheless, a tighter budget together with the lack of a strong pipeline of investment will make it difficult to put the economy on a sustainable growth path exceeding 6% - a rate needed to make serious inroads in reducing unemployment. Real GDP has been growing at a 3½-4% pace in year-on-year terms, over the past four quarters. The economy is forecast to expand by around 4% in 2003 and 4¼% in 2004.

### Modest pick-up in the Philippines

After recovering early in 2002, exports from the Philippines have been sluggish for over a year now. In the first seven months of 2003, exports in US dollar terms were up by only 3.3% on the corresponding period of 2002. A pick-up remains dependent on stronger demand in the major export market, the US. Real GDP declined in the first quarter and was flat in the second. Even factoring in some pick-up in the second half, the economy is likely to grow at an anaemic rate of 2.4% in 2003.

**Philippines peso reflects many woes**



In contrast to other Asian currencies which have tended stronger against the weakening US dollar, the peso has been quite soft in recent months. This underperformance reflects a deterioration of investor confidence due to a confluence of negative factors including violent incidents involving armed rebel groups, the brief army mutiny in late-July, the disputed suspension in mid-August of the central bank governor by the Court of Appeals (since reversed) as well as the lacklustre performance of the economy. The budget deficit, long a source of investor concern, does not appear to have been a factor in the recent peso weakness. In fact, it appears that this year, at last, some progress is being made, with a cumulative deficit in the eight months to August of P113bn, well below the figure of P144bn recorded in the same period of last year. It would appear that the government is well on track to achieving a full-year deficit below its target of P202bn (4.7% of GDP).

Following the US rate cut in June, official interest rates were cut by 25 points in early July, the first cut in a year. With the overnight borrowing rate at 6.75% and inflation at 3%, the wholesale cost of money is high in real terms, reflecting the central bank's tendency use interest rates to support the peso.

### Economic growth in Asia

% ch.	2002	2003 (f)	2004 (f)
China	8.0	8	7½
Hong Kong	2¼	1¼	3¼
Indonesia	3.6	4	4¼
Malaysia	4.1	4¼	5½
Philippines	4.4	2½	3
Singapore	2.2	1	6
South Korea	6.3	2¾	6
Taiwan	3.5	2	3¾
Thailand	5.2	5¾	5¾
Vietnam	7.0	7	7½
<b>East Asia*</b>	<b>6.8</b>	<b>6½</b>	<b>6¾</b>
<b>(ex China)</b>	<b>4.6</b>	<b>3½</b>	<b>5</b>

\* weighted GDP at PPP exchange rates

As the northern winter approaches, the region will be bracing itself for a possible resurgence of the SARS virus. While the virus may not have as devastating an impact this time due to the level of preparedness of the region, services-related industries would again be exposed to a period of uncertainty. However, unlike the first of half of this year, exports are expected to accelerate on the back of an anticipated pick-up in external demand, which will help to cushion any possible negative fall-out.

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# Australian outlook

## The Australian economy is back on track

Australian economic growth slowed to just 2% over the year to the June quarter 2003, the weakest performance in two years. However the overall slowdown masked markedly different experiences between the domestic and external sectors of the economy. Domestic demand remained extraordinarily robust, growing by 5.8% in 2002-03, the best performance in 8 years. This spurred strong imports, which grew by a monster 14%. In contrast, the drought and moribund global demand saw Australian export volumes fall. The combination of weak exports and strong imports saw Australia's trade deficit widen sharply, causing net exports to subtract 3¼ percentage points from economic growth over 2002-03, the worst result in 20 years.

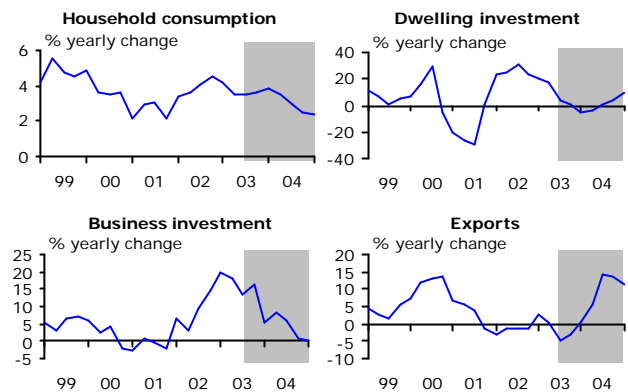
Recent indicators have all pointed to a renewed upturn in Australian economic conditions in the second half of 2003. Retail sales and motor vehicle sales have surged in the last few months, consumer and business confidence is high and the unemployment rate has fallen to 5.8%, its lowest level in 13 years. Perhaps even more importantly, the battered export sector is starting to show signs of a turnaround.

After slowing to 2¾% in 2002-03, Australian economic growth looks set to rebound to around 3½% in 2003-04, accelerating further to 3¾% in 2004-05. As economic growth improves, it is also expected to become more balanced, with the sources of growth becoming more broadly based.

A pick up in global demand and a rebound in farm product should see exports rebound solidly over the next two years to become one of the main drivers of growth. This will take some of the pressure off domestic demand, which is expected to remain firm, but to grow at less vigorous pace than in the last couple of years as all of the main components of domestic spending come off the boil. The business investment boom, a significant driver of Australia's recent resilience, now appears to have passed its peak. Many large projects, particularly in the manufacturing and transportation sectors, are at or near-completion while aircraft purchases, which made up nearly 40% of total new equipment investment in 2002-03, are also expected to be substantially lower. Building approvals suggest that housing investment is set for a moderate downturn over the coming period while household consumption is also likely to ease back a touch as household wealth gains moderate.

## Drivers of economic growth to change

### Sources of economic (GDP) growth



Source: ABS and Economics@ANZ

A pick up in overall economic growth should see employment growth gain momentum. The recent rises in the ANZ job ads series suggests that labour demand is already accelerating. This will put further downward pressure on the unemployment rate, which, even accounting for a likely rise in the participation rate, is expected to maintain its current sub-6% level, to be 5¾% at June 2004. Indeed, the current low level of the participation rate suggests that, despite the low unemployment rate, spare capacity persists in the labour market. This should limit wage growth, which, together with the higher A\$ and solid productivity growth, should keep inflationary pressures contained. Overall, the inflation rate is expected to ease to around 2% by the June quarter 2004, the bottom of the Reserve Bank's (RBA) target band. By the June quarter 2005, further falls in the unemployment rate and a slightly softer A\$ is likely to see inflation to pick up to around 3%, the top of the RBA's target band.

## Can a rebound in exports be assured?

With domestic demand expected to moderate, a rebound in export growth is the key to ensuring that Australian economic growth remains on track. Exports have declined for the last two consecutive years, the first time this has occurred in the 40-year history of the data. At a number of stages in the past two years, exports have made the first steps towards recovery, only to be blindsided by some unexpected and unavoidable shock, including the worst drought in a century, the weakest global economy in a decade and the SARS virus crisis.

The most recent data implies that the tide is beginning to turn with export values increasing by a brisk 4.7% in August. Continued recovery in the global economy should underpin a solid pick up in Australian exports of manufactures and services in

the coming period. Indeed, tourism service exports have already improved following the containment of SARS and will receive a further boost in the December quarter of this year from the Rugby World Cup. All of this suggests that the trough in Australia's trade deficit is behind us. However given recent experience, it is important to ask whether there are special factors that will stop this recovery from being more than just another false start?

The distinguishing feature this time lies in Australia's commodity sectors. The first factor that should ensure some resilience in Australian export growth in the coming year is the breaking of the drought. Low rainfall saw rural export volumes drop 13% in 2002-03, stripping 2½ percentage points from total export growth. While there is no such thing as a certainty when it comes to the weather, current seasonal conditions suggest that a pick up in farm production, and as such, rural exports over 2003-04 is almost assured. Rainfall deficiencies have eased drastically over most of Australia in the last 6 months and the Bureau of Meteorology advises that the short-term outlook for future widespread rainfall is good.

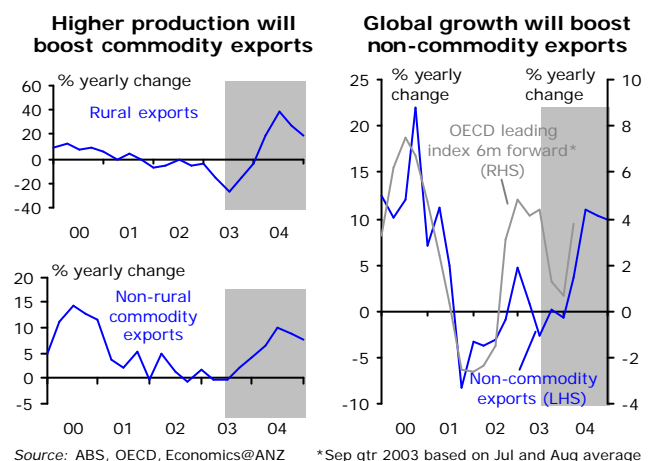
Higher rainfall will underpin a strong rebound in broadacre crops, particularly wheat and barley. Crop production is now expected to more than double in 2003-04, boosting grain exports in the order of around 20%. Nevertheless, not all of the rural sector will recover as strongly. Growers of some of the smaller, irrigation-dependent crops still face tough times due to low dam water levels. Meanwhile Australia's relatively large livestock sector faces a drawn-out recovery period. Higher stock turnoff during the drought has seen livestock numbers fall to low levels. While a better season will facilitate herd rebuilding, this is a long process, unlikely to contribute to production and exports of either meat or related products for a couple of years to come. The expected rebound in total rural exports is therefore unlikely to fully recover all of the losses of 2002-03. For 2004-05, a year of average rainfall, which is the standard forecasting assumption, would see farm production continue to improve across most of the major rural commodities, in turn leading to a further increase in the pace of rural export growth.

The second factor that should allow Australian exports to be a little more resilient in the next few years is a likely step-up in production by Australia's resources sector. Non-rural commodity export volumes have already proven relatively resilient over the past few years, underpinned by increased production of some commodities, more recently gold and iron ore, as well as still strong demand from the increasingly important market of China. These exports are set for considerably stronger growth in the coming two years as Australia's recent mining

investment boom significantly boosts domestic production of a large range of commodities, including coal, alumina, nickel and LNG. The majority of this increased supply should be pushed straight onto the export market, with demand picking up in line with stronger global industrial production.

Once higher capacity comes on stream, it will be hard to derail the forward momentum in these mineral and energy commodity exports. The high quality of most Australian mineral commodities means that these exports can be diversified into other markets, should the recovery in some export markets prove fragile. High quality also usually ensures that the majority of Australia's mineral and energy production intended for exports are indeed sold, with commodity markets adjusting to changes in either global supply or demand via price.

### Conditions in place for an export recovery



Source: ABS, OECD, Economics@ANZ \*Sep qtr 2003 based on Jul and Aug average

One risk that may threaten Australia's burgeoning export recovery is a sharper than expected appreciation of the currency. The A\$/US\$ has risen by 22% since January 2003, mainly as a result of the structural decline in the US\$ and is expected to continue this upward climb, peaking at around US70¢ (see *Financial Markets* article on page 19). At this level, the A\$/US\$ would be around its long-run average while in real terms (on a trade weighted and export weighted basis), the A\$ would be less than 5% above its long-run average. At these levels, the A\$ should pose only minimal threat to the competitiveness of most Australian exporters.

As with recent currency movements, a sharper than expected rise in the A\$ would most likely reflect US\$ weakness, as opposed to A\$ strength. As a result, the A\$ would be unlikely to gain as much ground against many of the other major currencies, and indeed could even lose some ground, dampening the flow through to Australia's real trade weighted exchange rate. This will take the edge off the loss of competitiveness from a sharp currency appreciation.

Furthermore, loss of price competitiveness will mainly affect Australia's manufactured and services exports, which make up about 40% of total volumes. RBA modelling suggests that a 10% appreciation in the TWI would lead to an 8% reduction in manufactured exports in the long-run. Assuming the same impact on service exports, the overall effect on export growth would only be in the order of 4% over the long-term. The short-term impact, given that exchange rate pass through to prices is generally lagged, would likely be smaller.

While a sharper than expected rise in the A\$ will see local commodity producers take a hit on incomes, these export volumes, which make up more than half of the nation's total exports, tend to be supply driven and are unlikely to be significantly disrupted. The likely resilience of Australia's commodity exports should therefore not only return total export growth into positive territory, but will also reduce the overall export sector's vulnerability to other unexpected shocks.

### Could domestic demand keep running hot?

The backbone of Australia's resilient economic performance in recent times, domestic demand is expected to ease to a more moderate pace over the next two years. However, many of the underlying fundamentals of spending remain highly supportive. Employment growth is set to remain solid, inflation is low, household wealth is high and with interest rates unlikely to rise sharply and the Government's recently delivered tax cuts, policy is supportive. Could these factors see domestic demand continue to run hot?

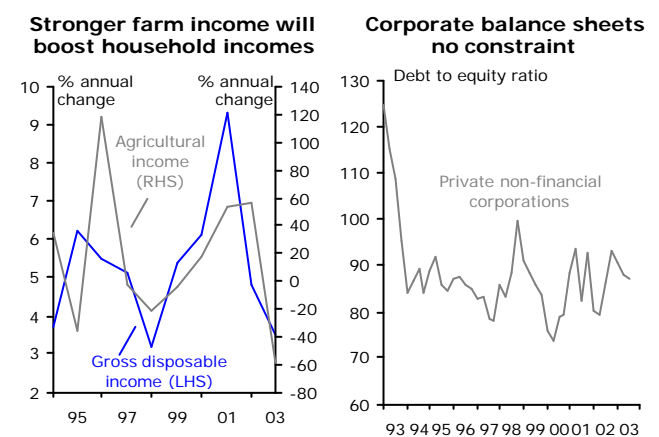
Household consumption, which makes up around 60% of the economy, has been one of the main drivers of Australia's resilience in recent years. One reason behind this strength is that, in contrast to many overseas economies, household wealth in Australia has continued to rise over the last couple of years. Furthermore, households have become better at extracting this wealth, mainly through increasing their borrowing. Household credit growth is currently running at a 20% yearly pace, to be around a 14 year high. This has allowed household consumption to grow faster than household income, which in turn, has seen household saving become negative.

As widely detailed in previous publications, the large increase in Australian household wealth, and subsequently borrowing, mainly reflects an increase in housing related wealth. This has been driven by rapid increases in house prices. This, amongst other things, has simply been the logical outcome of the large increase in the debt servicing capacity of Australian households as a result of the structural

decline in interest rates over the last decade. However, as the structural decline in interest rates is now largely complete, household's debt servicing capabilities are also likely to be near their peak. This implies that further increases in house prices above the rate of growth in average incomes are not sustainable.

The forecast slowing in the pace of household consumption growth over the medium term is therefore predicated on the basis that recent strong increases in housing wealth will begin to ease and that, in the face of this, household spending will also ease to be in line with household income, or perhaps a little lower if households seek to consolidate their overextended balance sheets. However, as this process takes place, a number of other influences could see either household wealth or incomes increase by faster than expected. One is that household's financial wealth, which accounts for around 30% of net household wealth, could easily reverse recent losses and rise strongly, should the pick up in the global economy stimulate a rebound in global equity markets. Also the expected recovery in farm production will provide a solid boost to farm incomes, which will flow directly through to the household sector, helping to restore balance sheets. The higher A\$ which, all other things equal, increases the purchasing power of households is another source of support for consumer spending. The Commonwealth's larger than expected \$7.5bn budget surplus for 2002-03 could also provide a surprise boost to household consumption, should the Government use these funds to offer tax cuts prior to next year's election.

### Conditions still supportive of spending



Source: ABS

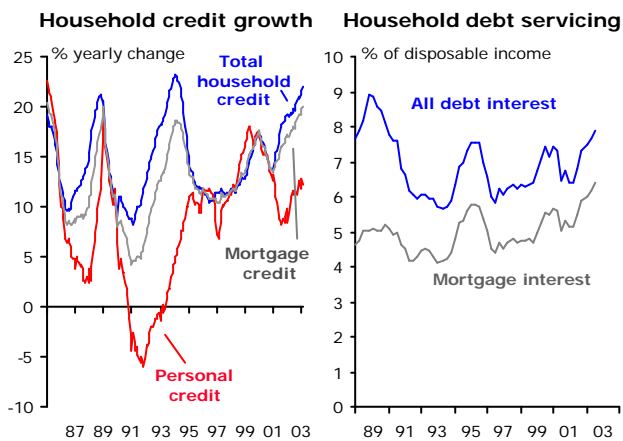
As foreshadowed in last quarter's *ANZ Economic Outlook*, there is also potential for business investment to surprise a little on the upside. Private non-financial corporate balance sheets remain healthy, with the aggregate debt to equity ratio maintaining a low level despite some corporate profits having been adversely affected by the higher

A\$. Firms do not appear to be facing any internal liquidity constraints while external access to funds will be facilitated by continued low real interest rates and improved sentiment in equity markets. In addition, brighter global economic prospects has seen business confidence surge in recent months. In these conditions, it would not be a surprise to see the business investment cycle run a little further.

### A hot domestic economy comes with risks

Strong domestic demand is usually good news. However, in present circumstances it can also give rise to some downside risks to growth in the medium-term, given that some of this spending is being fuelled by borrowing rather than income growth. Strong credit growth has seen the household debt-to-income ratio almost double in the last five years to 133%. While manageable in the goods times, a higher level of indebtedness has increased household's vulnerability to adverse changes in financial and economic conditions, including interest rates, asset prices or the unemployment rate.

#### Households sensitive to financial conditions



With this in mind, a significant risk to the Australian economy is posed by strong growth in borrowing for investor housing. 45% of all lending for property over the past year has been to investors and commercial borrowers, rather than to owner-occupiers. This borrowing continues to run at a 30% annual pace, despite emerging signs of oversupply in this market, as signalled by falling rental yields and rising vacancy rates. Continued strong demand for property by investors, in spite of these unsupportive fundamentals, increases the risk that prices in this market could overshoot. If this occurs, prices will eventually need to correct, by way of either a sharp slowing in the rate of price growth or possibly even in some markets a decline in prices.

Given that households are now more highly leveraged and thus more sensitive to changes in asset prices, such a correction will exert a more destabilising impact on household balance sheets. As detailed in the accompanying article *Housing wealth and consumer spending* (page 23), the hit to balance sheets would in turn likely flow through and hit household consumption, given that home-owners now appear to be using the equity in their houses to directly fund expenditure. In addition to this, investors have also introduced greater volatility into the housing market, given their sensitivity to changes in vacancy rates and rental yields, factors that aren't an issue for owner-occupiers. Heightened volatility in one sector contributes to the volatility of overall activity, reducing the ability of the economy to withstand adverse shocks, in both the short and longer-term.

### Monetary policy set to tighten

It appears then that just as the sources of economic growth are set to change over the medium-term, so have the risks facing the Australian economy. Over the past few years the main risk confronting the RBA in its monetary policy deliberations related to heightened uncertainty over the direction of the global economy and the potential impact this would impart on Australian economic circumstances. Interest rates, while unchanged, appeared to be on an easing bias.

Now, the picture is quite different. The global economy appears to have turned the corner and furthermore, even if world growth did suffer another setback, an upturn in local commodity production should see exports better placed to see off such an event compared with earlier years. With local conditions still supportive of growth, the main risks confronting the Australian economy are now domestic-oriented. Continued strong rates of household credit growth and borrowing for investor housing will put the household sector in a considerably more vulnerable position in the face of adverse shocks. This poses a real risk to household consumption and overall economic growth, should something unexpectedly go awry.

All of this suggests that interest rates are likely to be moved back to a less expansionary setting. Our view is that the official cash rate will rise twice, by 25 basis points a piece, in the first half of 2004, remaining unchanged at 5¼% in the second half of the year (during which a Federal election is likely to be held). In 2005 stronger economic growth and higher inflation will see the RBA continue to raise interest rates back towards the 5½-6% 'neutral' range.

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# New Zealand outlook

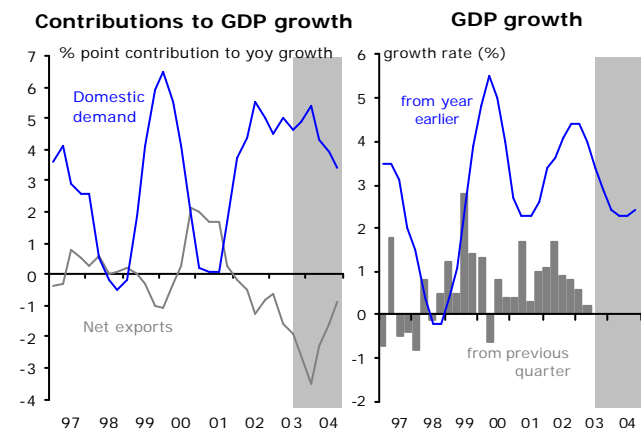
## Growth slowing; soft landing in prospect

The New Zealand economy has proved encouragingly resilient through a difficult period. The uncertainty and high oil prices that preceded the Iraq war, the consequences of dry conditions in parts of the country for agricultural production, the impact of the SARS outbreak on tourism and trade, and electricity problems all took their toll on activity and sentiment during the second quarter of the year in particular. But initial market and RBNZ fears that these factors could have caused economic activity to contract over the period proved unfounded, with GDP inching up by 0.2% in the June quarter.

The direct impact of reduced value added in the electricity, water and gas sector as a consequence of an unseasonably heavily reliance on relatively expensive thermal electricity generation given low hydro lake levels reduced GDP by 0.2 pc points during the quarter – compounded by the negative impact of high electricity prices on manufacturing production. Similarly, we estimate that the impact of the SARS outbreak in Asia on tourism and trade also reduced GDP by 0.2 pc points during the quarter. In the face of these negative developments, the positive GDP result is testament to the strength of the domestic economy.

With these problems now behind us, the recovery that is already occurring in affected sectors will provide some support to growth over the second half of 2003. Yet growth is likely to continue to slow from the peak of near 4½% in the March 2003 year. The impact of rapid gains in the Kiwi dollar on export incomes is expected to increasingly impinge on economic activity. But ongoing domestic strength (particularly in housing), albeit gradually moderating, is likely to prevent a ‘hard landing’ and growth of 2½% is expected over the year ahead.

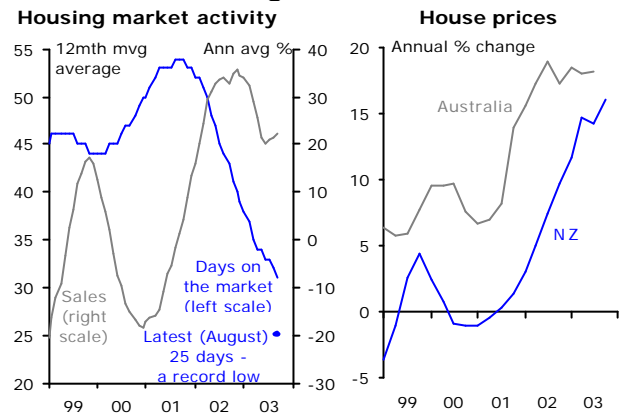
## Growth is slowing



## Domestic activity to underpin growth

Domestic economic activity continues to be underpinned by a red hot housing market. Spurred on by a third 25 basis point rate cut in July, house sales growth has gained a second wind in recent months. House sales in the past 12 months have exceeded the peak of the last boom in the mid 1990s by 20% and the number of days that properties are spending on the market has fallen to a record low of 25 days from a high of 64 days in January 2001. With prices up 16% on the same time last year, NZ house price inflation is fast catching up with that of Australia.

## The housing market is red hot



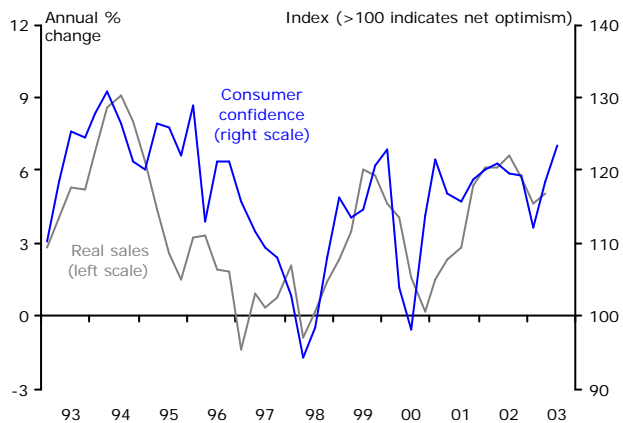
Furthermore, not only has residential construction activity been exceptionally strong over the past year, but building consents – which are up more than 28% over the past 12 months – point to a very strong pipeline for the next 6-12 months. The repercussions of fervent house sales and construction activity for expenditure on furniture, floor coverings and appliances continue to support retail spending growth.

Consumer spending growth has slowed relative to the highs seen during 2002, particularly in the provinces where the impact of lower export incomes has been most keenly felt. Generally, however, the outlook for consumer spending remains reasonably well supported by household income growth on the back of a strong labour market. Solid employment growth has continued and the unemployment rate has fallen to a 16 year low of 4.7%. Surveyed hiring intentions and the ANZ Job Ads series suggest employment growth will continue, although at a slower rate than seen over the past couple of years. Moreover, with skill shortages remaining intense throughout the economy, a tight labour market is generating stronger wage increases. And, no doubt



supported by increased wealth perceptions associated with house price gains, a sharp rise in consumer confidence to seven year highs after a soft patch during the first half of the year sets the scene for a resurgence in spending growth.

### Consumer confidence is at seven year highs

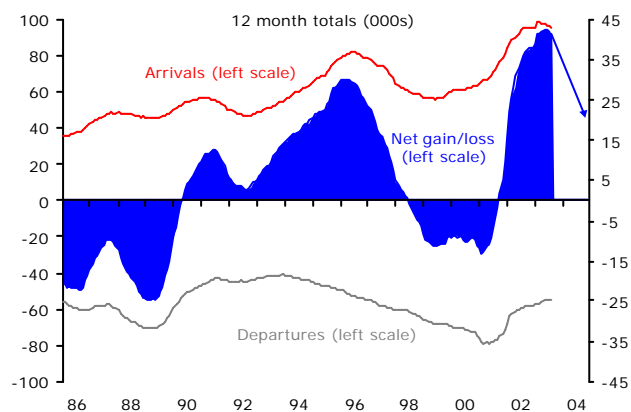


Sources: Statistics NZ; Westpac McDermott Miller

But while this is likely to ensure continued strong growth in domestic economic activity in the near term, momentum is expected to eventually ease over the next 12 months. Slower population growth as a consequence of waning net immigration flows will eventually take some of the heat out of housing market activity and retail spending growth.

Net immigration, which contributed more than 60% of New Zealand's population growth over the past 12 months, is now slowing in response to a tightening of entry criteria. Seasonally adjusted monthly net inflows have eased to around 2,500 from an average of close to 3,500 per month over the second half of 2002 and the first half of 2003. This equates to the annual rate slowing from unprecedented levels in excess of 40,000 to around 30,000. Regardless, this would still be in line with the peak of the last immigration boom in the mid 1990s.

### Net immigration is slowing



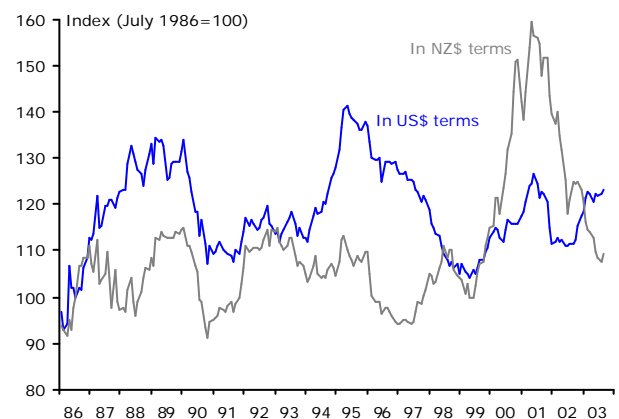
Sources: Statistics NZ; Economics@ANZ

We expect net immigration to slow further over the next 12-18 months, as a recovering world economy attracts potential migrants and New Zealanders to other countries. However, stronger global growth is likely to take some time to translate into more favourable labour market conditions in the world's major economies. For the time being, New Zealand's relatively strong labour market is likely to continue underpin net immigration flows. As a consequence, we forecast net inflows to slow to an annual rate of 20,000 by the end of 2004 – a still very healthy level by historic standards. As such, population growth is likely to be sufficient to support solid, albeit slower, growth in domestic economic activity. Within this, the prospects for housing during the next 6-12 months remain particularly favourable. With the increase in housing requirements (as a consequence of strong population growth) having significantly outstripped completions of new dwellings over the past two years, the resulting housing shortage will take some time to clear even if population growth is slowing.

### Benefit of world recovery may be limited

Indeed, the domestic economy is likely to remain sufficiently robust to cushion what might have otherwise been a rather hard landing for the NZ economy as a consequence of the 30% fall in export prices that has occurred over the past two years. This is yet to be fully reflected in export incomes, given the extent to which marketing and hedging activities have muted and delayed the impact. Compounded by recent further gains in the Kiwi dollar (particularly against the US\$), some further weakness in export revenue is likely over the next few months.

### Commodity export prices hit by NZ\$ strength



Source: Economics@ANZ

Recent signs of a more concerted recovery in the world economy should benefit the export outlook. However, given the composition of New Zealand's export basket, some caution is warranted with regards to how quickly and to what extent stronger

world growth will flow through into stronger market conditions for NZ exporters. The dominance of rural products, which make up close to 45% of NZ exports of goods and services (compared to around 20% in the case of Australia), can have an important bearing in this regard. In the case of basic foodstuffs – with demand relatively insensitive to changes in incomes – supply and regulatory factors can tend to dominate market developments. For example, the Australian drought, which has limited production from a key group of competitors, has underpinned prices for meat and (to some extent) dairy products despite a weak world economy. But by the same token, a recovery in world economic growth will not necessarily translate into stronger market conditions for these products. Certainly manufactured goods stand to benefit (although Australia, their dominant export market, has remained relatively strong in recent years), as should forestry products (however these account for less than 10% of total exports).

We do expect some recovery in exports during the year ahead. But the recovery may not be as strong as the recent improvement in prospect for the world economy might suggest – certainly relative to Australia, where minerals (commodities that tend to be more sensitive to global industrial production) make up more than a third of exports of goods and services as opposed to just 2% in NZ.

### Rates to remain on hold for now

The RBNZ remains mindful of the pressure on the export sector from a strong NZ\$ – pressure that prompted three rate cuts totalling 75 basis points between April and July. But the disinflationary influence of currency strength and slowing growth generally is increasingly being offset by the inflationary risks from a strong housing market. As a consequence, the September Monetary Policy Statement saw the RBNZ abandon the easing bias that it had maintained since the beginning of the year – instead describing the risks to inflation as ‘balanced’.

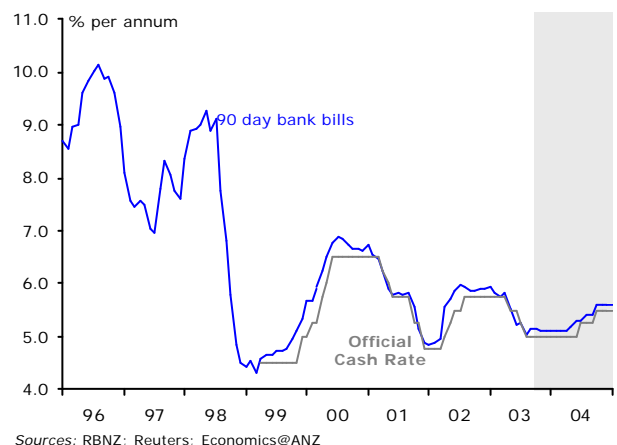
Annual CPI inflation likely bottomed out at 1.5% in the June 2003 year, as one-off factors (such as falling petrol prices in the aftermath of the Iraq war) and the direct effect of NZ\$ gains on import prices reduced tradeable sector prices. However, inflation is expected to gradually rise towards the top end of the RBNZ’s 1-3% medium term target band over the year ahead as these influences wane and as domestic inflation pressures continue to build. With resource pressures – high capacity utilisation and a tight labour market – remaining intense despite slowing growth, there are upside risks in this regard.

Even so, while the next move for rates is likely to be up, we believe that it will be some time before the RBNZ begins to return the OCR to higher levels. Not only does the current inflation rate mean that the RBNZ has significant headroom within the target band, the medium term nature of the target may provide for a more gradual approach than has been taken in the past. As the RBNZ suggested soon after Alan Bollard was appointed as Governor and the change had been made from the previous target of maintaining 0-3% continuously, ‘the changes provide a little more flexibility for monetary policy in some circumstances. In some cases, this may mean that the Bank can be more gradual in its monetary policy responses’.

A key caveat to this was the suggestion that more prompt action might be necessary in the case of an ‘unsustainable boom’ developing – the concerns recently expressed by the RBNZ regarding the housing market in this context suggest some risk of an early move. But, for the time being, this risk is balanced by the potential for further Kiwi dollar strength driven by ongoing US\$ weakness. However, on a trade weighted basis (TWI), we expect that further gains in the NZ\$/US\$ will be at least partly offset by further retracement against the A\$ as the growth rates of the two countries converge during 2003-04 after New Zealand outperformed Australia over the past year.

If future TWI gains are relatively moderate and a recovery in the world economy continues, we believe that inflation pressures will become sufficiently compelling to prompt the RBNZ to start raising the OCR from mid 2004.

**The OCR is likely to be raised from mid 2004**



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## Financial markets

After having eased monetary policy this year to support the uncertain growth outlook, most major central banks now foresee an improving economic outlook. Global interest rates have most likely bottomed. While official short-term interest rates are set to remain unchanged for a year or more, the emerging economic recovery is set to increase bond yields over the next year or so. After making a recovery during July and August, US\$ selling re-emerged in September. The A\$/US\$ appreciated as a result, benefiting also from higher commodity prices and still attractive Australian interest rates. The A\$/US\$ is forecast to break through 0.70 in the months ahead.

### Supportive US monetary policy to remain

As always, a major barometer of global interest rates will continue to be trends in the United States economy. Most commentators accept that the economic recovery is occurring. Nevertheless, worries persist that not only is inflation very low but that it might fall further. Add to that worries about the absence of a pick up in employment and those concerns are likely to underwrite the continued stance of very accommodative Federal Reserve monetary policy for some time. Conceivably, the Fed funds rate is set to remain at its current extremely low level through most, if not all, of 2004.

The degree of under-utilised capacity across the US economy is set to hold inflation down to lower than desirable levels, if not push the measured inflation rate lower. With the US unemployment rate above its long term average, the growth in spending by US consumers and business could be permitted to grow at a faster than normal rate for a period of time without pressuring the Federal Reserve's Open Market Committee into raising its funds rate from 1%.

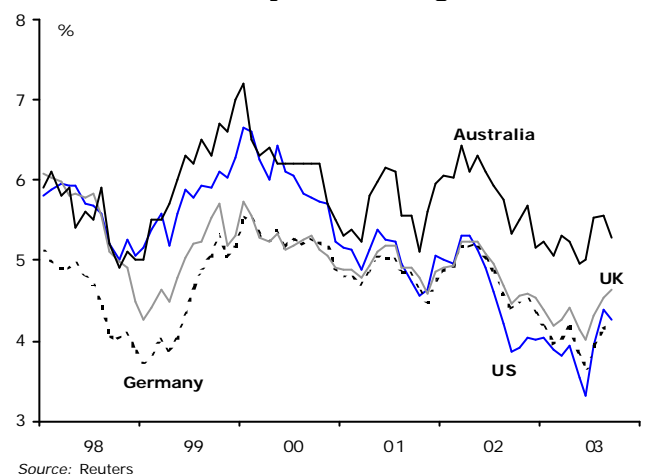
Even though the economy has been growing continuously since the December quarter of 2001, employment levels have continued to fall and the unemployment rate has risen. Indicators to this point of a lift in labour demand have been scant at best. Corporations have continued to concentrate their efforts on lowering unit costs, including on labour and not adding new employees to payrolls.

There is clearly a limit to the ability of businesses to continue to increase production to satisfy rising demand through such higher levels of productivity. But those limits have not apparently been reached yet. Most recently, the US Commerce Department reported an upward revision to June quarter 2003 non-farm productivity growth from an initially reported 5.7% (at a seasonally adjusted annualised

rate) to 6.8%, a truly startling figure. Indeed, over the past eighteen months, productivity has grown at an average annualised rate of 4.4%, up from average growth of 2.6% over the past decade. Companies have been doing their level best – and succeeding in keeping their unit costs down, supporting bottom lines in an economy that to now has been growing less than its long term average.

ANZ expects that the Fed funds rate will remain at its current 1% level until late in 2004. US bond yields however are expected to push higher, underwritten by continued growth in the economy, a stabilisation in the unemployment rate at just over 6% together with an increase in employment from later this year. From its level of around 4% in early October, the US 10 year bond yield is forecast to reach 4½-4¾% by the end of this year.

**Global bond yields finding a base**



### RBA more concerned about current rates

Australian wholesale interest rates such as government bond yields and swap yields often follow US trends in the short term. This is evident at times in overnight SYCOM movements in bank bill and bond futures that might respond to developments in US Treasury bond yields and in short term US interest rate markets such as Eurodollar and Fed funds futures markets. However, over periods beyond the very short term, Australian wholesale interest rates are following trends in and the prospects for the Australian economic cycle that has become much less correlated with the US economic cycle.

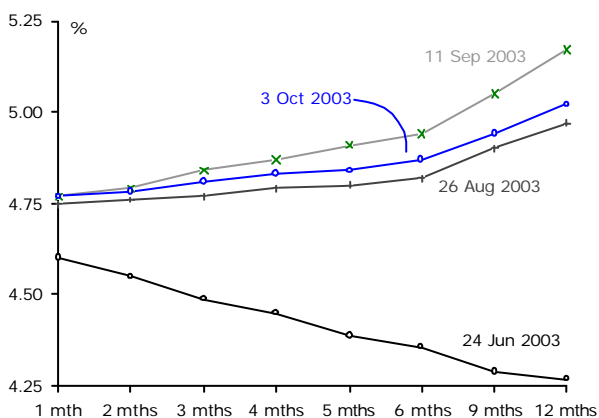
As a result, the difference between US interest rates and Australian interest rates can and does vary significantly both in terms of level and often direction. This has been evident again this year with the Federal Reserve reducing its funds rate

further – as many offshore central banks have – whereas the Reserve Bank has left its targeted cash rate steady at 4.75%. At the longer end of the yield curve, the spread between Australian 10 year government bond yields and the counterpart US Treasury yield has varied from Australian yields being 100-170 basis points above the US rate. The difference is now toward the lower end of that range.

With the global economic outlook improving, financial market pricing is now questioning the Reserve Bank's expectation outlined as recently as in their August 2003 Quarterly Statement on Monetary Policy that 'the pace of growth of the non-farm economy is likely to ease during the remainder of 2003'. Most recently, it has become apparent from speeches of RBA Deputy Governor Glenn Stevens and Federal Treasury Secretary Ken Henry that the global outlook is fast becoming less of a hindrance to returning the cash rate to a less expansionary setting.

The RBA Board will likely be questioning, in a serious manner, the appropriateness of the current expansionary stance of monetary policy. While it would be reasonable for the Board to allow the passage of several more months to be more assured that the world economy is truly turning the corner toward recovery, nearly all of the economic signs are pointing in that direction. Financial markets are increasingly pricing toward recovery, analysts expect it, and leading economic indicators confirm that it is not far away.

**Markets expect Australian rate rises next year**  
Overnight indexed swaps, implied cash rates

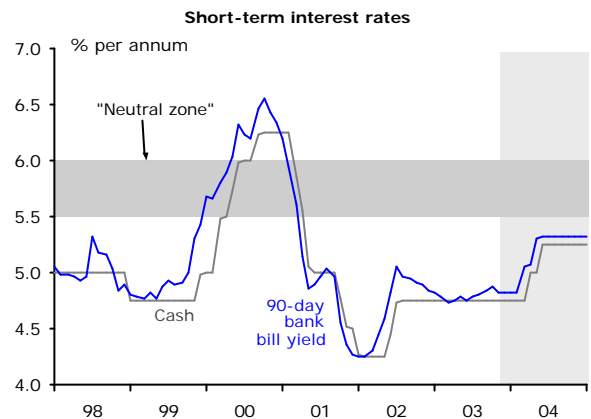


**Rates: on the way up, next year**

ANZ's view is that it is more likely than not that the RBA will need to remove some monetary stimulus in the first half of 2004. Our expectation is that in the first quarter of next year, the RBA will re-commence its program of moving its targeted cash rate back toward a 'neutral' level. An improving world

economy removes one key major element of economic uncertainty that has, until recently been weighing down on economic prospects. Add to that the breaking of the drought and a repairing labour market and the still hectic rates of household debt accumulation come well and truly back into focus. The Board, we expect, will come to the view that maintenance of the existing expansionary stance of monetary policy risks the creation of an imbalance in the housing market that might become unmanageable.

**RBA expected to lift rates from 2004**



Sources: Reuters; Economics@ANZ.

We expect that the Bank will use the occasion of the coming November and February Monetary Policy Statements to lay the ground work for a rate rise, to prepare markets and the community. Our call is that by the middle of next year, the RBA cash rate will have been increased to 5.25%, with one 25 bp rise in each of the March and the June quarters.

**Implications for the A\$ swap curve**

The market is currently priced for a peak in the cash rate at around 5¼-5½%, a cumulative rise of up to 75 basis points from the current cash rate. We would not take substantial issue with that view and current market pricing. But we would not at all be surprised to foresee that the yield curve will steepen in coming months as the market gets closer to the likely time of the first tightening and adjusts its pricing in response to the views espoused in the Bank's coming Monetary Policy Statements and speeches. Any sell off in US bond markets through the December quarter would further support the trend to high domestic medium to long term interest rates.

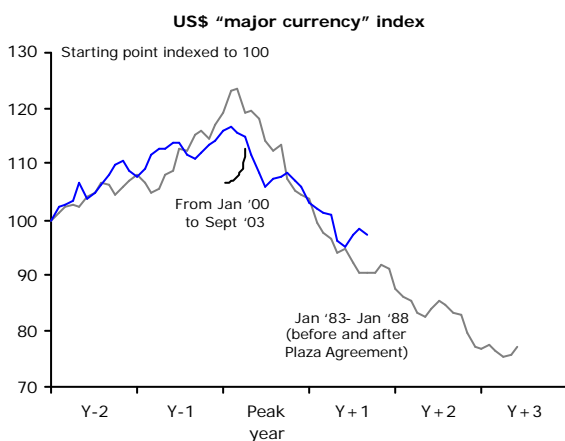
In each of the past three tightening cycles the three year swap yield has increased by up to 100 basis points from three months before the first tightening in the cycle to the day of the first tightening. The three year swap – a good barometer of the market's policy change expectations – did not peak until up to

five months after the first tightening. (A shorter interval was evident last year when the market quickly responded to fear that the US would fall back into recession after Enron, World Com and related corporate governance issues.) In each case, the market overshoot the extent of eventual tightening:

- On 2 February 2000 when the three year swap yield peaked in that tightening cycle at 7.3%, the cash rate had just been raised to 5.5% (it was subsequently raised to 6.25%), but at the time the market expected the cash rate to get to 7.5-7.75%;
- Last year, on the day of the second tightening in June raising the cash rate to 4.75%, the market was priced for a peak cash rate of 6.5% with a three year swap yield at the time of 6.2%.

We do not yet know how sensitive household borrowing and spending will be in this tightening cycle. It would be reasonable to expect an increasingly sensitive household sector, including to the wide press coverage that changes in monetary policy attract. In the event that the RBA is more aggressive than our forecasts envisage, the downside in yields will no doubt be more pronounced when it comes, probably in late 2005 when the global interest rate cycle is in tightening phase, continuing the disconnect between the Australian and global business cycle seen now for several years.

### US\$ decline mostly complete?



### US\$ still falling .....

The G7 Dubai communiqué of 20 September outlined an agreed view that major global currencies should be more flexibly determined: 'We reaffirm that exchange rates should reflect economic fundamentals. We continue to monitor exchange markets closely and co-operate as appropriate. In this context, we emphasise that more flexibility in

exchange rates is desirable for major countries economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."<sup>3</sup>

The key phrases in this paragraph are 'more flexibility in exchange rates' and 'based on market mechanisms', interpreted by the market as an agreed view that the Japanese yen be permitted by the Japanese authorities to appreciate rather than artificially held down by intervention to buy the US\$ against the yen.

With the US facing severe external and internal imbalances, not to mention a still tenuous labour market ahead of next year's Presidential election, it is not surprising that the US authorities have been pushing the Japanese authorities to adopt a more hands off approach to management of the yen. While the Japanese authorities have most recently recognised that the tone of their economic data has been improving and that the yen has less tendency to appreciate, they remain sensitive to any rapid appreciation of the yen.

The Japanese Ministry of Finance is unlikely to take their hands off the currency intervention lever altogether. Since the Dubai meeting, acting through the Federal Reserve as its agent, the Bank of Japan reported that it had in September sold a record monthly ¥4.46tn (\$US40bn) to support the US\$ and limit yen appreciation. Ending deflation remains their number one priority and very accommodative monetary policy conditions with a more than ample supply of yen and a competitive currency is an important component of that policy. ANZ forecasts that the US\$/JPY will trade in a recent 110-115 range between now and the end of this year. By next June, a US\$/JPY of 108 is in prospect.

To early October, the trade weighted index of the US\$ has fallen by 20% from its peak at the end of January 2002. As we have outlined previously, when economies have run abnormal current account deficits at around 5% of GDP, their currencies have typically declined by at least 20% to aid the adjustment of the deficit to more sustainable levels. With the US\$ having already declined by around 20%, declines from these levels are less assured. ANZ forecasts that the US\$ will decline by another 5% over the next year or so, for a cumulative decline of around 25% from its peak.

### A\$ also grasps improving global prospects

In addition to benefiting from the decline in the US\$, the A\$ has also been supported by its 'traditional drivers'; attractive Australian interest rates relative

<sup>3</sup> Statement of G7 Finance Ministers and Central Bank Governors, Dubai, 20 September 2003.

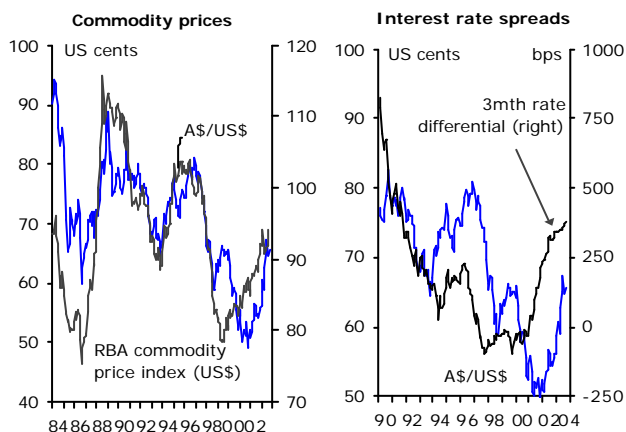
to most offshore rates together with a rise in world commodity prices.

On the commodity price front, encouraging economic prospects among the world's major economies and among Australia's major Asian export markets have brightened in recent months. An improvement in Australian export market growth will contribute, over time, to an improvement in Australia's trade balance and provide support to the Australian dollar.

After being revised down in each month since August 2002, Consensus Economics forecasts for Australia's major trading partner (MTP) growth were revised up marginally in August and more decisively in the September survey. Growth forecasts for MTP growth for 2003 are now back to April 2003 levels, with Japan recording the largest upgrade in the past two months, with the market consensus forecast increasing from an expectation of subdued 0.9% growth as recently as July, to 1.9% by September.

The September survey was conducted before the release of upwardly revised June quarter Japanese GDP, although the more upbeat capital expenditure data on which the GDP revisions were based was already released. As we have outlined in the international section of *ANZ Economic Outlook*, ANZ's expectation is that the Japanese economy will record growth this year of 2½%, with an expectation of another good year next year with the expansion continuing at a 1¾% rate.

#### A\$/US\$: traditional drivers positive now



#### Commodities on the move again

Improving world economic prospects will provide a base of support to world commodity prices. It has been evident that even prices of some of the 'old world' commodity prices such as thermal coal are rising. This reflects the improving economic prospects in Japan but more specifically increased reliance on thermal coal power generation by Japanese utilities as a substitute for nuclear power

generation which has been curtailed for maintenance checks.

While the relationship between world commodity prices and the Aussie over recent years has been questionable, base metal prices – a barometer of global industrial demand – are beginning to rise again. The RBA's base metals index expressed in neutral Special Drawing Rights terms have been rising since April and in September were 6.6% above average levels in 2002-03.

Leading indicators of the global manufacturing industry such as the various purchasing managers indexes are rising, consistent with the lift evident in demand that is being priced in by metal markets. ANZ's estimate of a 'global' manufacturing purchasing manager's index<sup>4</sup> for September has risen to 52.6, the highest level since June 2002 and a sign of emerging growth in industrial activity. All of the indexes are now above the 50 growth threshold level, a pointer to a lift in demand for commodities in the months ahead. In the United States for example, recent levels of the PMI indicate that the economy is set to record growth in the region of 3-4% over the period ahead.

ANZ continues to forecast that the A\$/US\$ has some further upside over the next year or so. The A\$/US\$ is forecast to reach its post float average of just over 70 US cents in the months ahead, before finding a peak during 2004. With ANZ expecting that the RBA will be one of the first central banks to increase interest rates during 2004, the attractive yield story will likely be neutral to positive in the first part of 2004. Beyond the middle of 2004, how much further the A\$/US\$ rises will be dependent on the outlook for the US\$ as much as A\$-specific factors. At that time, ANZ foresees that the decline in the US\$ will have run its course and that markets will be focusing on the probability that major central banks such as the Federal Reserve will need to adjust interest rates to higher levels.

Such prospects would suggest that the A\$/US\$ then has less upside above US 70 cents. Moreover, if the rate of Australian domestic economic growth slows through 2004-05 in response to forecast RBA interest rate rises in the first half of 2004, then the A\$/US\$ will lose some of its yield shine. 2005 might yet be a year when the RBA will be giving consideration to easing the stance of monetary policy at a time when most offshore central banks are lifting interest rates, a negative for the A\$/US\$ over the medium to longer term.

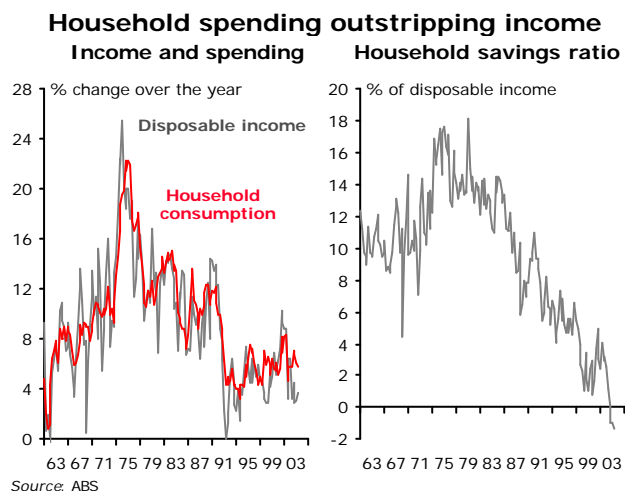
**David de Garis, Senior Treasury Economist  
(03) 9273 1995**

<sup>4</sup> Based on the manufacturing purchasing manager indexes of US, the Euro-zone, UK, Canada, Singapore, Hong Kong, and Australia.

## Housing wealth and consumer spending

Australia's domestic economy has performed well compared with its overseas counterparts over the last few years. This is partly attributable to a fall in interest rates to low levels by Australian standards, which has fuelled an increase in borrowing and, coupled with increased investor interest in property, has underpinned a marked rise in property prices. This increase in wealth has boosted consumer spending in two distinct ways. First, it has indirectly underpinned higher and more resilient levels of consumer confidence. Secondly, households have become increasingly willing and able to use unrealised capital gains to support spending more directly. This note explores the role that house prices and the withdrawal of housing equity have played in supporting private consumption in Australia, and how sustainable that may be.

Private consumption has risen strongly in the last two years, up by 6% per annum on average, compared with more modest growth in disposable incomes of 4¼% per annum. As a result, the household savings ratio has fallen dramatically and has been negative for the last three quarters.



So what has been the source of funds for consumption? The alternatives are borrowing and/or the disposal of assets. Data on financial assets suggests that over the last year, households have instead *accumulated* \$30bn of financial assets<sup>5</sup>, which is more than accounted for by the accumulation of liquid assets such as currency and deposits. Net flows into equities have fallen slightly over the past year, reflecting the liquidation of corporate and bank stocks following the weakness of the share market and has been only partly offset by the accumulation of stocks issued by 'financial

<sup>5</sup> Includes currency and deposits, holdings of bonds, bills of exchange, commercial paper, loans and placements borrowed by financial intermediaries and equities

institutions nec' (which includes unit trusts). A similar pattern and amount of financial assets were accumulated in 2001-02, clearly suggesting that funds for private consumption over the last two years has come from elsewhere.

Borrowing to fund private consumption can occur via a number of avenues, the first being consumer credit or unsecured borrowing. The latest data suggests that this has grown strongly in recent years, up by 11.8% over the year to the June quarter. Borrowing to fund purchases of consumption goods via fixed loans has risen particularly strongly over the last year, with commitments for new motor vehicles, household goods, boats and caravans and travel and holidays up by 9.1% over the year to the June quarter. In contrast net credit card spending appears to have slowed, with some evidence of an easing in the value of new purchases. Thus households unsecured borrowing is likely as usual to have supported growth in private consumption but is unlikely to have played a special role in supporting growth recently.

The other borrowing option for households that could be used to underpin private consumption and the purchase of financial assets is through secured borrowing. Innovations in the provision of housing finance means that households are now increasingly able to access the equity in their homes to finance private consumption at generally low interest rates. This, along with the disposal of housing assets to finance non-housing purchases, is captured in a measure known as housing equity withdrawal which is a relatively new phenomenon in Australia.

Housing equity withdrawal (HEW) essentially represents the amount of secured borrowing over and above the amount of new spending on housing assets. Traditionally Australian households have injected equity into their houses (that is, paid down their mortgages and 'saved' the unrealised capital gains in their homes) but for the last two and a half years, Australians have been withdrawing equity from their homes.

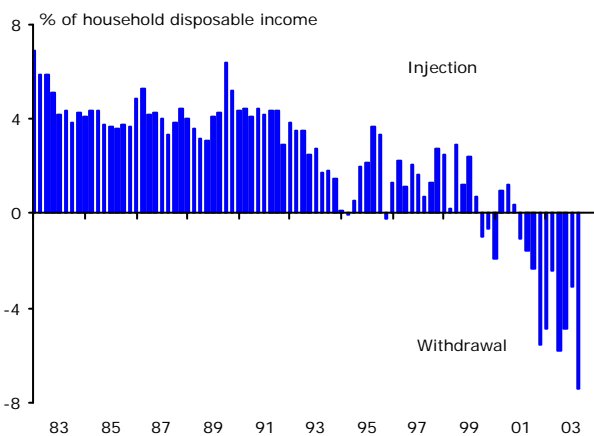
There are different ways that households can withdraw equity<sup>6</sup>, including by refinancing or through products such as home equity loans which do not require moving. Other ways that households can withdraw equity are through housing turnover such as when moving to a more expensive house and the mortgage that is taken out is greater than the difference in price between the old and the new home or through trading down, when a seller

<sup>6</sup> See Housing Equity Withdrawal, RBA Bulletin February 2003 for further details

purchases a cheaper property but does not reduce the mortgage by the same amount of the house sale. Data from other countries suggests that there is a close link between housing equity withdrawal and housing market transactions. This makes sense as the fixed costs involved in arranging a mortgage may mean that it is convenient for households to withdraw equity when they are already involved in a housing transaction.

It is important to note that rising house prices and transactions in existing properties do not by themselves have any housing equity withdrawal implications. Such developments (ie, price rises, housing turnover) can however unleash net equity changes in either direction depending on the equity positions of buyers and sellers. Housing equity withdrawal reached a record \$9.4bn in the June quarter and has totalled \$26bn over the last year. In other words, households borrowed \$26bn against their houses over the last year which was not invested in the housing stock, which is more than 5% of annual income.

### Housing equity withdrawal/injection



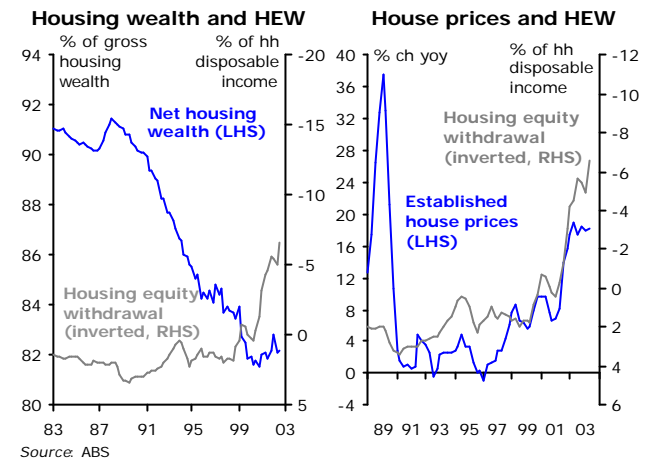
Source: RBA

One factor that is likely to have been particularly important in determining housing equity withdrawal is the extent to which households have positive equity in their houses. Obviously if households do not have positive equity, defined as the market value of the dwellings (including land) minus the debt secured on them, then they are unable to borrow against it. In Australia, net housing wealth as a percentage of gross housing wealth declined for much of the 1990s as growth in liabilities outstripped increases in the value of the gross housing stock. Since September 2001 however, net housing wealth has increased relative to gross housing wealth, as sharp rises in house prices have outpaced rising debt.

Another way of looking at this metric is via a gearing ratio (housing liabilities to gross housing wealth) which has fallen in recent quarters. In the

UK in particular there seems to be a strong relationship between rising house prices and housing equity withdrawal. Thus it would seem plausible to suggest that as house prices and equity rise that households withdraw equity in their homes, either by trading down or through the use of products such as home equity loans or re-financing, to unlock the equity in their homes. It is equally plausible that rising house prices would be associated with falling savings rates, as households reach their desired levels of wealth through asset price appreciation rather than saving out of income.

### Housing and equity withdrawal



So how have households been withdrawing equity in their homes? Data on the gross flows of withdrawals and injections that would enable the calculation of a microeconomic measure of housing equity withdrawal is difficult to come by in Australia. There are however a few sources that may provide us with some indication of these trends. Home equity loans are one such area and data suggests that such products have grown in popularity to account for around 14% of credit secured against housing. While the amount of funds drawn down has eased since the peak in 2000, net flows are still roughly in excess of \$2bn per quarter. Some of these funds are likely to be directed towards housing (and thus not counted as HEW) but some would be available for other purposes.

Housing turnover is another channel to withdraw (or inject) equity and while no such data exists for Australia, a rough estimate can be calculated using Residex data for New South Wales, Victoria and Queensland. This reveals that the number of housing transactions in these three States rose strongly to peak at 352,600 in the year ended June 2002 before dropping back to a still high level of 342,800 in the year ended June 2003. Not surprisingly though, due to rising house prices, the value of sales in these three States continued to increase strongly in the year ended June 2003. Despite this, the (loan) advancements to sales ratio has actually dropped back to below the ten year



average in the last two years. While it is difficult to be certain, on face value this suggests some *injection* of equity by households through housing market transactions. This could reflect a combination of increased first time buyers (in 2001-02) and higher deposits as a result of the First Home Owners Grant, or households selling their homes and increasing the mortgage by less than the difference in the prices of the old and the new home. This theory gains further support from evidence that suggests that mortgage repayment rates have stepped up in the last few years, i.e. households have injected equity.

While this only tells us half of the story it still could suggest that housing equity withdrawal evident in Australia of late has more to do with innovations in finance and the spread of products (such as home equity loans and the use of refinancing to access equity) than it does with housing transactions. While we cannot measure the extent of funds withdrawn from refinancing (as we need to know the amount of debt paid off *vis a vis* the new debt taken on), ABS survey data<sup>7</sup> suggests that more than 20% of borrowers refinancing home loans over the period 1997-99 used some of the proceeds to fund purchases such as holidays and cars. The same survey suggested that in 1999, more than 10% of households with a mortgage were using their homes as security for a motor vehicle purchase. As a rough indication the numbers involved would account for around one half of total passenger motor vehicle sales each year.

Since there may be a relationship between house prices and housing equity withdrawal, and between housing equity withdrawal and private consumption, it is worth exploring the main drivers of private consumption of late. It is important to note that an increase in housing equity withdrawal may not lead to higher spending; instead it could be a substitute for other forms of funds and thus not lead to any net increase in spending. Also, housing equity withdrawal may also be used to pay down other forms of debt or to purchase financial assets (or used for business purposes).

The table below provides a broad indication of the sources and uses of household funds. Housing equity withdrawal has been split into its component parts of housing secured credit and housing grants (sources) and private dwelling investment and ownership transfer costs (uses). It would appear from the table that while secured housing credit has obviously been directed towards investment in the housing stock, the residual (housing equity withdrawal) would appear to have played a role in driving consumer spending, with flows much larger than for personal borrowing. It is less likely to have

been an important factor in the acquisition of financial assets, given that this has remained steady as a share of income. Personal borrowing is still likely to explain some of the resilience of consumer spending, as unsecured borrowing for financial asset purchases would only comprise a small proportion. However that personal borrowing has not picked up as strongly as could be expected could reflect changes in the value of both new purchases and repayments. Indeed, the recent trends evident in credit card transactions could suggest that there has been a minor switch towards the use of secured facilities to fund consumption and also to repay relatively more expensive forms of debt.

**Sources and uses of household funds**

\$bn	2000-01	2001-02	2002-03
<b>Sources</b>			
Income	457	479	495
Ch in housing secured credit*	40	66	84
Ch in personal borrowing	8	6	10
<b>Sum</b>	<b>505</b>	<b>551</b>	<b>588</b>
<b>Uses</b>			
Private consumption	404	427	454
Dwelling investment	39	48	58
Acquisition of financial assets	28	25	30
Other invest**	17	18	19
<b>Discrepancy</b>	<b>15</b>	<b>33</b>	<b>28</b>
<b>Sum</b>	<b>505</b>	<b>551</b>	<b>588</b>

\*Includes housing grants \*\*Gross fixed capital expenditure and change in inventories less dwelling investment and ownership transfer costs

Given the link between house price and housing equity withdrawal, it would appear that private consumption is now inexorably linked to the housing market through the housing equity withdrawal channel. This introduces some new risks to the Australian economy that have not been present before and from the experience of the UK in the early 1990s could prove to be particularly debilitating should the housing market turn. In such circumstances, negative housing equity would shut down the option to access housing wealth to fund consumption, forcing households to restrain spending to more in line or below the level of incomes to restore balance sheets. While such an experience is not expected in Australia given that much of the increase in wealth reflects a one-off shift in the level of house prices due to structurally lower interest rates, private consumption will be now more sensitive to the fortunes of the housing market than ever before.

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<sup>7</sup> ABS Australian Social Trends 2001

## Financial markets forecast table

	End period					End period			
	Jun-2003	Sep-2003	Dec-2003	Mar-2004	Jun-2004	2001/02	2002/03	2003/04	2004/05
	← actual		forecast	→		← actual		forecast	→
<b>Interest rates</b>									
<i>Australia</i>									
90 day bank bills (%p.a.)	4.7	4.9	4.9	5.2	5.3	5.1	4.7	5.3	4.8
10 year bond rate (%p.a.)	5.0	5.3	5.6	5.6	5.6	6.1	5.0	5.6	5.5
<i>United States</i>									
3 month LIBOR (%p.a.)	1.1	1.2	1.1	1.1	1.1	1.9	1.1	1.1	2.8
10 year bond rate (%p.a.)	3.6	3.9	4.6	4.8	5.1	4.8	3.6	5.1	5.5
<i>Euro area</i>									
3 month LIBOR (%p.a.)	2.1	2.1	1.8	2.0	2.2	3.4	2.1	2.2	3.5
<i>New Zealand</i>									
90 day bank bills (%p.a.)	5.3	5.2	5.1	5.1	5.3	6.1	5.3	5.3	5.6
<b>Exchange rates</b>									
AUD/USD	0.67	0.68	0.69	0.70	0.70	0.56	0.67	0.70	0.67
NZD/USD	0.59	0.59	0.60	0.61	0.61	0.49	0.59	0.61	0.57
AUD/JPY	80.6	75.4	77.3	76.5	75.8	67.0	80.6	75.8	72.0
AUD/EUR	0.58	0.58	0.60	0.60	0.59	0.56	0.58	0.59	0.58
AUD/GBP	0.41	0.41	0.42	0.42	0.42	0.37	0.41	0.42	0.41
AUD/NZD	1.15	1.14	1.15	1.15	1.15	1.15	1.15	1.15	1.18
USD/JPY	119.7	110.9	112.0	110.0	108.3	119.4	119.7	108.3	107.5
EUR/USD	1.15	1.16	1.15	1.16	1.18	1.00	1.15	1.18	1.17
A\$ Trade weighted index	59.3	59.1	60.2	60.2	60.1	52.3	59.3	60.1	57.8

## Economic forecast table

	Quarterly % change					Annual % change			
	Jun-2003	Sep-2003	Dec-2003	Mar-2004	Jun-2004	2001/02	2002/03	2003/04	2004/05
	actual	forecast*	—————▶			←————	actual	forecast*	————▶
<b>Australia</b>									
GDP	0.1	1.0	1.3	1.4	0.9	3.8	2.7	3.4	3.8
- Final demand	1.2	1.3	0.7	0.6	0.5	4.6	5.8	3.8	2.8
- Stocks	0.2	-0.4	0.1	-0.1	0.0	-0.1	0.2	0.2	-0.2
- Net exports	-1.5	-0.3	0.5	0.9	0.6	-0.8	-3.1	-0.8	1.3
CPI	0.0	0.8	0.3	0.4	0.5	2.9	3.1	2.2	2.6
Wages	0.6	1.0	0.7	1.0	0.7	3.3	3.5	3.3	3.5
Employment	-0.4	0.3	0.5	0.5	0.5	1.1	2.5	1.6	2.1
Unemployment rate (%)	6.1	5.9	5.9	5.9	5.9	6.7	6.1	5.9	5.6
Current account deficit (\$b)	-12.7	-11.7	-9.9	-8.1	-6.9	-22.0	-42.3	-36.6	-24.2
- % GDP	-6.7	-6.0	-5.0	-4.0	-3.4	-3.1	-5.6	-4.6	-2.9
<b>New Zealand</b>									
GDP	0.2	0.8	0.6	0.3	0.7	3.6	4.0	2.3	2.6
CPI	0.0	0.9	0.8	0.5	0.5	2.4	2.3	2.3	2.7
Wages	1.5	1.2	0.5	0.8	1.6	2.7	3.1	3.7	3.3
Employment	0.8	0.2	0.1	0.1	0.4	2.8	2.2	1.4	1.2
Unemployment rate (%)	4.7	4.9	5.0	5.2	5.2	5.3	5.0	5.1	5.4
Current account deficit (\$b)	-1.4	-3.1	-2.9	-0.1	-1.2	-3.2	-5.8	-7.4	-7.9
- % GDP	-4.5	-4.7	-5.4	-5.8	-5.5	-2.6	-4.5	-5.5	-5.5



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