Economics@ANZ

ANZ Australian Economics Weekly

Strong inflation seals case for rate hike

25 January 2008

Inside:

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Economic wrap

- Consumer price inflation for the December quarter exceeded market expectations.
- This will prompt the RBA to hike interest rates.

Market matters

- Australian equities suffered their biggest one-day fall in 18 years.
- High inflation has the market more convinced about interest rate rises.
- The A$ is holding up remarkably well at US$0.88.

Economy in focus — It never rains, it pours

Our spotlight on key issues and developments in the Australian economy.

- Heavy rainfall has caused flooding in central Queensland.
- The damage bill could be as high as $1bn.
- The flooding will hit the agricultural industry hardest.
- Beyond the floods, rain has improved water storages, soil moisture levels and the agricultural outlook.

New publications from Economics@ANZ

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- *ANZ Liquidity Monitor*
- *ANZ Commodity Weekly*
- *ANZ International Economics Monthly – February 2008*

Dr Alex Joiner
Economist, Australia

Economic wrap

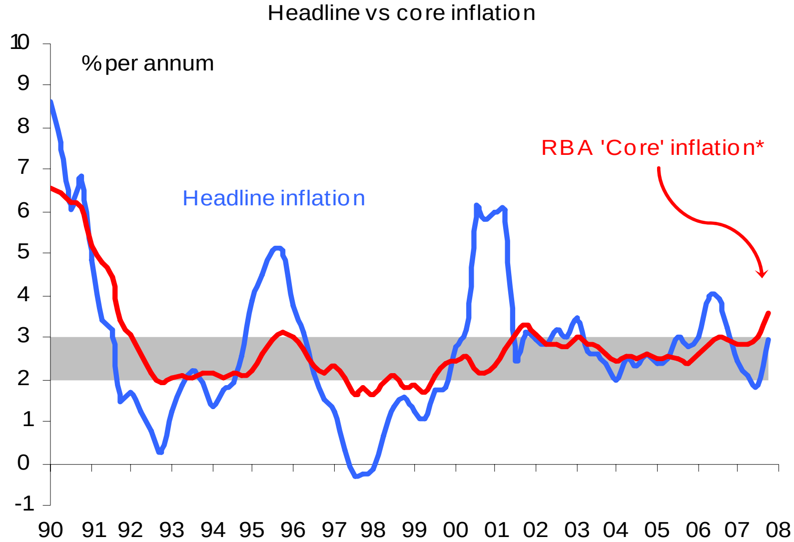
Accelerating inflation points to higher interest rates…

Consumer price inflation for the December quarter exceeded market expectations

The focus was firmly on the turmoil in global and Australian equities markets early in the week. However, this focus shifted on Wednesday to the all important inflation data release and subsequently the outlook for domestic interest rates. A relatively benign read on producer prices on Monday (up +0.6% in the quarter) gave little indication as to the potential movement of consumer prices and left market expectations unchanged leading up the release. As it turned out, the inflation figures exceeded expectations across both of the RBA's statistical 'core' measures. The pressing need to tackle inflation now means it is unlikely the RBA will be able to sit on the sidelines as it did at the December meeting. We believe the inflation figures give the RBA no choice but to raise interest rates by 25bps at their February meeting, a hike that most likely will not be the last in this tightening cycle.

The RBA's statistical measures of core inflation averaged 1.05% in the quarter and 3.6% over the year. Within this, the trimmed mean increased by 1.0% in the quarter and 3.4% over the year and the weighted median increased by 1.1% in the quarter and 3.8% over the year. Averaging these two measures, puts the annual rate of core inflation at its highest point since 1991, before the RBA adopted inflation targeting and at a time when inflation was decelerating due to a recession.

Core inflation at an inflation targeting period high



*Average of RBA weighted median and trimmed mean inflation measures
Source: Australian Bureau of Statistics

Core inflation has been in or above the top half of the RBA's target band for almost 6 years. The chief driver of this inflation has been persistently strong economic growth. Over the past half decade or so, this has reflected the boost to national income from the global commodities boom, but even prior to that the Australian economy was on a solid growth path.

There is an additional problem in that much of the recent acceleration in inflation has been due to factors not directly related to domestic demand. Fuel prices rose 7.3% in the quarter on the back of a Tapis oil prices that touched just over $A100 in the quarter. Milk and bread prices were up 4.5% and 2.1% in the quarter respectively due to domestic drought conditions and higher global soft commodity prices. Housing rents increased 1.6% in the quarter, prompted by ongoing tightness in the housing market and rental vacancy rates approaching record lows. Indexed prices for utilities have also added to inflation, rising 5.4% over the past twelve months.

The RBA tightening cycle which began in May 2002 has been quite gentle and protracted. Rates have increased by 250 bps over the past 5¾ years. This is in stark contrast to the last two tightening cycles which were relatively short and sharp. For example in the mid-1990's, interest rates were raised by 275bps in less than six months. It may be argued (with the considerable benefit of hindsight) that the RBA could have been more aggressive earlier in this cycle to head off the current inflation problem, having the comfort of the stimulus from global growth as a safety net to maintain domestic economic prosperity.

... which will prompt the RBA to hike interest rates

As it stands the RBA would seem to be behind the curve on inflation. Core inflation has breeched the upper limit of the RBA's target band and is likely to stay above the band well into 2008. The recent global financial market volatility and a potential slowdown in global growth will again be taken into account by the Reserve Bank. Our assessment is that it is doubtful that these factors will significantly moderate the prognosis for medium term inflation and are unlikely to remove the need for an immediate policy tightening in February. It is anticipated that this rise will be followed by another hike, the specific timing of which will be determined by the data flow, most likely around May this year.

Key points to note from this week's economic data releases are:

- The number of **new motor vehicle sales** rose by 1.1% in December to be 11.6% higher over the year according to the ABS.
- The final commodities **producer price index** increased by 0.6% in the December quarter, following a 1.1% rise in the September quarter. The intermediate price index rose by 1.1% in the quarter and the preliminary price index posted an increase of 1.5% in the quarter.
- The **consumer price index** rose by 0.9% in the December quarter giving an annual rate of 3.0%. The RBA's statistical measures of underlying inflation – the trimmed mean and weighted median – increased to 1.05% in the quarter. The annual rate of underlying inflation accelerated to 3.86% (3.4% for the trimmed mean and 3.8% for the weighted median).

Data preview

Alex Joiner
Economist, Australia

31st January: RBA Private Sector Credit (Dec)

ANZ forecast: +1.3% MoM, +16.7% YoY, Last: +1.7% MoM, +16.2% YoY

A robust rate of credit growth will continue to be supported by the strength of business credit expansion in December. Business credit expanded 2.9% in November to reach 23.6% over the past twelve months, the fastest rate of growth since the heady days of the late 1980's. The business sector has seemingly been impervious to consistent interest rate hikes over the past few years and continues to increase levels of debt unabated. Further, growth is continuing to be fuelled by the ongoing trend towards re-intermediation with global credit markets remaining tight and making access to offshore funding difficult and more expensive. Housing credit is expected to run at just under 1% for the month with overall housing finance approvals so far remaining relatively buoyant. Housing credit may soften in coming months following the interest rate hikes in August and November, and the expectation of another rise in February, impacting on borrowers.

Market matters

Katie Dean
Senior Economist, Markets

Hold on!

Australian equities suffered their biggest one-day fall in 18 years …

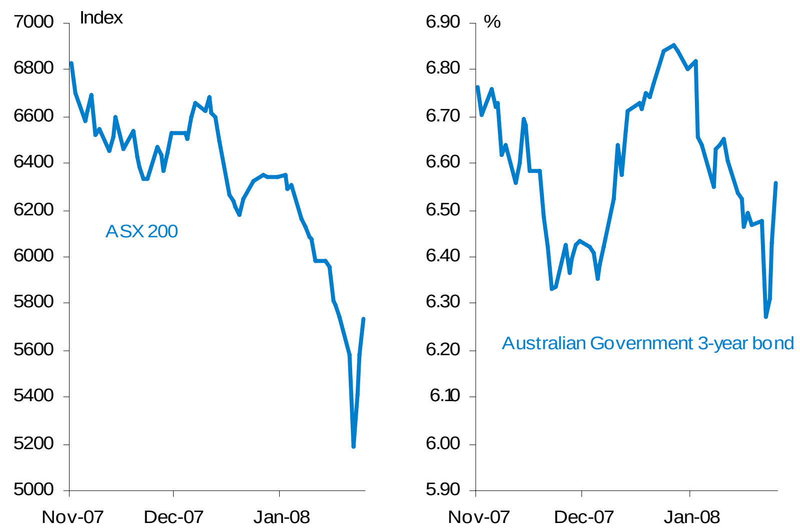
Who said the US didn't matter? Global investors changed their mind on the whole 'desynchronisation' story this week and decided that the sharply weakening US economy was going to hit the rest of the world after all. The result was a global equity rout, the likes of which have not been seen since the tech-wreck at the start of this decade. Heightened concerns about Asian prospects saw Australian markets hit particularly hard. Local equities posted 12 consecutive daily falls, the longest losing stretch since 1982 and in the process wiped off all of last year's gains and then some. Panic reached a crescendo on 'Black Tuesday', when the ASX 200 fell 7%, the biggest one-day fall in 18 years.

… before staging a late-week recovery.

The Federal Reserve's circuit-breaker – in the form of the surprise 75bp cut in the US Fed funds rate on Tuesday night – has restored some sense of calm. Also helping sentiment is further clarification on the US government's fiscal stimulus package as well as the proposed rescue plan for US bond insurers. Nerves on this side of the Pacific have also been calmed by this week's very strong Chinese data, which confirmed that the economy was still travelling at an 11% annual clip in the December quarter. News that Societe-General has suffered a US$7.2 billion trading loss, the largest in banking history, on fraudulent trades, had the potential to re-ignite market turmoil overnight, but so far the fall out in equities appears to be contained. The ASX 200 has been able to claw back some of this week's early losses and at the time of writing was 9% above this week's low. While now officially back out of our 'bear market', local equities do remain 10% lower than the start of the year and 15% below November's stock market peak.

Next week's FOMC meeting is shaping up as the key directive for Australian equities in the week ahead. We expect the Fed to deliver a further 50bp cut at its November 30 meeting. Anything less than additional aggressive easing will likely give the bears more reason to sell offshore equities. The actions of the last week show that Australia will have little immunity to swings in the global investor mood.

A recovery in equities has markets more convinced of higher rates



Source: Bloomberg and Economics@ANZ

Rates re-focus on inflation

High inflation has the market more convinced about interest rate rises

Global equity market turmoil provided plenty of volatility across local bond markets this week, but the key event was the Q4 CPI result. The much stronger than expected outcome, which showed underlying inflation had shot up to a 16-year high, saw Australian government bonds sell off. The sell-off was a little more concentrated in the short end with the 3-year bond yield rising to 6.56% and the 3s10s curve flattening slightly to -0.45 percentage points.

Prior to the CPI, and battered by the tanking equity market, the local market was pricing in less than a 20% chance of a 25 bps rate rise at the February RBA board meeting. After the CPI, and with equity markets calming, this pricing has increased to around 60%. We think the market is still underestimating the chance of the RBA raising rates, and indeed believe that if the global markets had been better behaved the board would seriously be considering a 50bp rate rise. As such we think there is further scope for short-end yields to rise and the curve to invert further in the lead up to the RBA's February board meeting.

Aussie battler lives up to its name

The A$ is holding up remarkably well

While volatile, in the wash up the A$ has performed well in this wild week. While the free fall in shares of course saw the A$ quickly lose ground, we were impressed that it did not breach the US$0.85c level, let alone try to re-test US$0.80c. In the event, US$0.8513 proved the low for the week. The rebound in stock markets and the good news on the Chinese economy has seen the A$ stage an impressive come back in the last 48 hours to be back above US$0.88c at the time of writing.

Now that global waters are calmer, it seems that yield is once again winning the tug of war with risk aversion. With little local data out in the next week, and Australia on holiday on Monday, the A$ will be turning to offshore events for direction next week. The FOMC decision and US GDP will be the main risk events. While this points to another possible volatile week ahead, the likelihood of impending rate rises from the RBA should prevent the US$0.85c level from being breached on the downside.

Wain Yuen
Economist, Australia

Economy in focus — It never rains, it pours

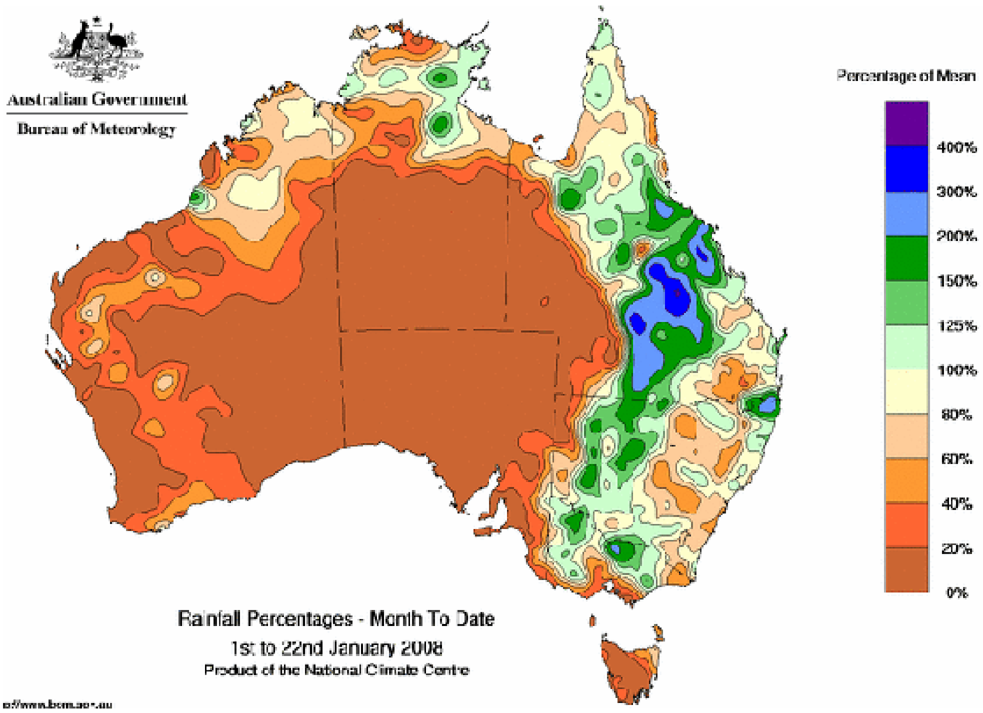
This week, we look at the impact of the recent floods in central Queensland.

State of play

The heaviest rainfall has been in central Queensland

Following years of drought, a veritable deluge has covered much of eastern Australia over the past week. The heaviest rainfall has been in central Queensland with weather stations recording over 400mm of weekly rainfall around the Belyando and Nogoa River Valleys, almost 4 times more than normal. As a result, towns such as Emerald and Charlesville have been inundated while parts of Rockhampton have received flood warnings.

Drenching rain over the eastern states



Source: Bureau of Meteorology

The damage bill could be as high as $1bn

At the time of writing, Queensland's Emergency Services Minister, Neil Roberts, had approved 61 shires, representing about 72% of the state, for natural disaster relief. And although the full toll of the flooding is yet to be determined, Queensland Premier, Anna Bligh, has suggested that the damage bill might reach $1bn.[1]

Effects on local industries

Few of central Queensland's industries have been spared. Flooding has caused the closure of mines such as the Burton, Blair Atoll and Kestrel sites. And agriculture, which accounts for 28.7% of the region's economy (encompassing are area from Emerald to Rockhampton), has been subject to crop, livestock and machinery losses. Some estimates suggest that up to 100,000 cattle have been lost and the use of up to 20,000 hectares of high production farmland has been temporarily disrupted.[2]

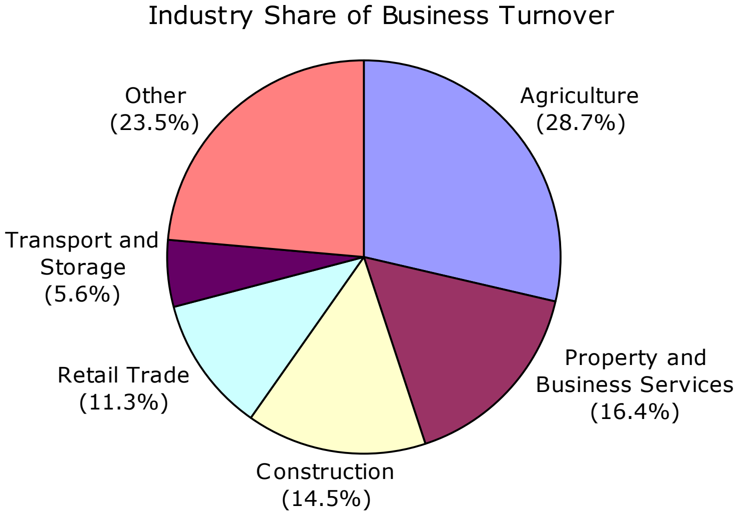
The impact of the flooding will hit hardest on agriculture

The region is a major contributor to Australia's agricultural production. It produces around 10% of the country's cattle, 15% of Australia's sunflowers, 20% of Australia's sorghum and 25% of the country's mung and other field beans. Many farmers hoping to cash in on high commodity prices for sorghum and other crops have seen their plantings destroyed. The region is also a significant producer of fruit, accounting for 13% of Australia's watermelons and 21% of its pineapples.

[1] ABC Radio, 23 January 2008

[2] ABC News Online "Flood damage could reach $1 billion", 24 January 2008

Agriculture dominates central Queensland's economy



Sources: Australian Bureau of Statistics and Economics@ANZ

Government assistance

The Queensland Government is offering immediate flood assistance covering:

- food, clothing, accommodation and medical supplies for those caught in the immediate aftermath of the floods;
- the replacement and repair of uninsured essential household contents damaged or destroyed by the cyclone; and
- assistance to return owner-occupied, uninsured premises damaged by the disaster to a safe, habitable and secure state.[3]

In addition, the state and commonwealth governments have announced jointly-funded grants of up to $25,000 for small businesses and farmers, and one-off payments of $1,000 for adults and $400 for children.

Beyond the floods, the rains are welcome

Although the rains have caused devastating flooding, they have not been entirely unwelcome with water storages filling up. Queensland's second largest storage, Fairbain Dam, is now at levels not seen in years. As a result, water allocations for irrigators should remain well supported for the next two years.

In addition, regions beyond the vicinity of the flooding such as the Callide Valley have benefited from ideal soaking rains which will boost prospects of summer crop production.

Beyond the floods, rain has improved water storages, soil moisture levels and the agricultural outlook

Further afield, rain in the eastern states is generating important flows in the Murray and Darling catchments, with falls of up to 100mm last weekend. In Victoria, the rain was welcomed by everyone from dairy farmers in the Goulburn Valley to crop farmers in the Mallee. And in New South Wales, flooding rains since late December have resulted in "the best figures in the past 18 months with the drought declared areas of New South Wales down to 52 per cent, last year at this time it was up at 93 per cent," according to NSW Primary Industries Minister Ian Macdonald.[4]

With dams filling up, soil moisture levels improving and pasture sprouting in some areas, hopes are high that 2008 could mark the start of the recovery from drought.

[3] http://www.communities.qld.gov.au/community/disaster/flood-assistance
[4] "Drought over for almost half of NSW" ABC News, 23 January 2008

Economic and financial market forecasts

Australian economic indicators		2006	2007f	2008f	2009f
Economic activity (annual % change)					
Private final demand		3.5	5.4	3.7	3.5
Household consumption		2.8	4.0	3.6	3.2
Dwelling investment		-2.6	4.5	2.4	6.3
Business investment		8.6	11.1	4.8	2.9
Public demand		3.7	3.6	5.1	4.2
Domestic final demand		3.6	5.0	4.0	3.6
Inventories (contribution to GDP)		-0.7	0.7	0.0	0.0
Gross National Expenditure (GNE)		3.1	5.7	4.0	3.6
Exports		3.3	4.2	6.3	6.7
Imports		7.3	10.2	7.6	6.3
Net Exports (contribution to GDP)		-0.9	-1.4	-0.5	-0.1
Gross Domestic Product (GDP)		2.8	3.9	3.7	3.3
Prices and wages (annual % change)					
Inflation:	Headline CPI	3.5	2.3	3.3	2.8
	Underlying*	2.8	3.1	3.4	2.8
Wages		4.0	4.1	4.2	4.2
Labour market					
Employment (annual % change)		2.1	2.8	2.6	1.9
Unemployment rate (%)		4.8	4.4	4.1	4.0
External sector					
Current account balance:	A$ bn	-55.0	-62.6	-65.1	-66.7
	% of GDP	-5.5	-5.8	-5.6	-5.4

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Mar 08f	Jun 08f	Sep 08f	Dec 08f	Mar 09f
RBA cash rate	6.75	6.75	7.00	7.25	7.25	7.25
90 day bill	7.28	7.24	7.25	7.45	7.45	7.45
3 year bond	6.62	6.89	6.95	6.50	6.15	5.30
10 year bond	6.11	6.33	6.25	6.00	5.75	5.00
3s10s yield curve	-0.51	-0.56	-0.70	-0.50	-0.40	-0.30
3 year swap	7.28	7.53	7.60	7.15	6.70	5.75
10 year swap	6.95	7.25	6.95	6.70	6.45	5.55
International interest rates						
RBNZ cash rate	8.25	8.25	8.25	8.25	8.00	7.50
NZ 90 day bill	8.75	8.88	8.70	8.55	8.03	7.53
US Fed funds note	3.50	4.25	2.75	2.25	2.00	2.00
US 2 year note	2.31	3.05	2.00	1.75	2.25	2.50
US 10 year note	3.70	4.02	3.75	3.75	3.75	3.50
Japan call rate	0.5	0.46	0.50	0.50	0.75	1.00
ECB refinance rate	4.00	4.00	4.00	4.00	4.00	4.00
UK repo rate	5.50	5.50	5.00	4.75	4.75	4.75

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Mar 08f	Jun 08f	Sep 08f	Dec 08f	Mar 09f
Australia and NZ exchange rates						
A$/US$	0.8823	0.91	0.90	0.88	0.86	0.84
NZ$/US$	0.7745	0.76	0.74	0.71	0.68	0.66
A$/¥	94.53	100.1	97.2	93.3	89.4	88.2
A$/€	0.5976	0.61	0.60	0.60	0.61	0.61
A$/£	0.4465	0.46	0.46	0.46	0.45	0.45
A$/NZ$	1.139	1.20	1.22	1.24	1.26	1.27
A$/CA$	0.8856	0.89	0.90	0.91	0.91	0.91
A$/CHF	0.9596	1.00	0.98	0.99	1.00	1.01
A$/CNY	6.372	6.36	6.06	5.85	5.73	5.63
A$ Trade weighted index	68.10	70.4	68.9	67.6	66.5	65.6
International cross rates						
US$/¥	107.1	110	108	106	104	105
€/US$	1.476	1.49	1.50	1.46	1.42	1.38
€/¥	158.2	164	162	155	148	145
£/US$	1.976	1.97	1.95	1.93	1.90	1.88
€/£	0.7471	0.76	0.77	0.76	0.75	0.73
US$/CA$	1.004	0.98	1.00	1.03	1.06	1.08
US$/CHF	1.088	1.10	1.09	1.12	1.16	1.20
US$ index	75.69	75.4	75.2	76.7	78.3	80.1
Asia exchange rates						
US$/CNY	7.220	6.99	6.73	6.65	6.66	6.70
US$/HKD	7.807	7.80	7.80	7.79	7.80	7.79
US$/IDR	9350	9500	9400	9450	9500	9550
US$/INR	39.47	39.0	38.8	38.9	39.0	39.1
US$/KRW	946.2	940	920	925	930	935
US$/MYR	3.27275	3.27	3.25	3.30	3.32	3.35
US$/PHP	40.98	40.5	40.3	40.8	41.5	42.0
US$/SGD	1.427	1.42	1.40	1.39	1.38	1.39
US$/THB	31.14	32.9	32.8	33.1	33.4	33.6
US$/TWD	32.34	32.50	32.80	33.00	33.00	33.30
US$/VND	15981	15794	15500	15423	15345	15383
Pacific exchange rates						
PGK/US$	0.339	0.39	0.40	0.38	0.36	0.35
FJD/US$	0.626	0.65	0.64	0.63	0.62	0.62

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*.

What to watch — 4 weeks from Monday 28 January 2008

Mon 28 January	Tues 29 January	Wed 30 January	Thur 31 January	Fri 1 February
Australia Day public holiday *Markets Closed*	11:30 NAB Monthly Business Survey (Dec)	11:00 DEWR, Skilled Vacancy Survey (Jan)	**11:30 RBA, Private Sector Credit (Dec)** *ANZ forecast: +1.3% mom; +16.7% yoy* *Last: +1.7% mom; +16.2% yoy* HIA, New Home Sales (Dec)	9:30 AiG-PWC Performance of Manufacturing Index (Jan) 11:30 NAB Business Confidence Index (Dec) 16:30 RBA, Index of Commodity Prices (Jan)
Mon 4 February	**Tues 5 February**	**Wed 6 February**	**Thur 7 February**	**Fri 8 February**
10:30 TD Securities Inflation Gauge (Jan) **11:30 ABS, International Trade in Goods and Services (Dec)** 11:30 ABS, House Price Indexes (Dec Qtr) 11:30 NAB Quarterly Business Survey (Dec Qtr)	**RBA Board Meeting** 9:30 AiG-CBA Performance of Services Index (Jan) **11:30 ABS, Retail Trade (Dec)** **11:30 ABS, Building Approvals (Dec)** **14:30 RBA Cash Rate Decision Announced** VFACTS, New Vehicle Sales (Jan) ACCI Business Expectations Survey	11:30 NAB SME Survey (Dec Qtr)	9:30 AiG-HIA Performance of Construction Index (Jan) 11:30 NAB Agribusiness Survey (Dec Qtr) 16:30 RBA, Foreign Reserves (Jan)	
Mon 11 February	**Tues 12 February**	**Wed 13 February**	**Thur 14 February**	**Fri 15 February**
11:30 RBA Quarterly Monetary Policy Statement **11:30 ANZ Job Advertisements (Jan)** **11:30 ABS, Housing Finance (Dec)**	11:30 NAB Monthly Business Survey (Jan) AOFM Bond Issuance ($400mn)	10:30 Westpac Consumer Confidence Survey (Feb) **11:30 ABS, Lending Finance (Dec)**	10:30 Consumer Inflation Expectations (Feb) **11:30 ABS, Labour Force (Dec)**	
Mon 18 February	**Tues 19 February**	**Wed 20 February**	**Thur 21 February**	**Fri 22 February**
	8:00 ABARE, Australian Crop Report (March Qtr) **11:30 RBA, monetary policy minutes** 11:30 ABS, Merchandise Imports (Jan) ACCI Small Business Survey	10:30 Westpac Leading Index (Dec) 11:00 DEWR, Skilled Vacancy Survey (Feb) **11:30: ABS, Labour Price Index (Dec Qtr)** **RBA, Payments System Board Meeting**	**11:30 ABS, Average Weekly Earnings (Nov)** 11:30 ABS, Sales of New Motor Vehicles (Jan) **11:30 RBA Bulletin (Feb)**	

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