

Open partnerships
Open possibilities

Economic outlook for 2008

February 2008

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Chief Economist

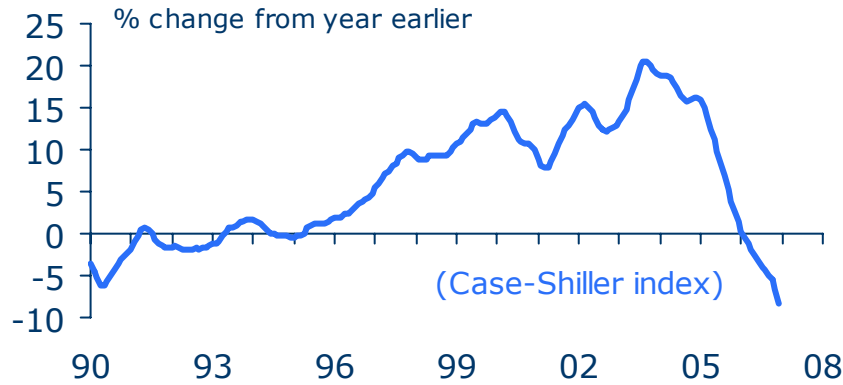
What's going on in the global financial system?

- 'Bubble' conditions in the first half of the decade ...
 - prompted by a combination of exceptionally easy monetary policy in advanced economies and rapid reserve accumulation (which creates liquidity) in developing economies
- ... dramatically lowered the 'price of risk' ...
- ... in turn leading to a significant increase in 'risk tolerance' ...
 - manifested in general lowering of credit standards (Exhibit A: the surge in sub-prime mortgage lending in the US)
- ... and widespread 'disintermediation'
 - explosive growth in off-balance sheet asset creation, derivatives etc (fuelled by efforts to engineer higher rates of return on capital)
- Last year, the price of risk rose dramatically, and risk tolerance slumped ...
 - prompted by tighter monetary conditions and a belated recognition that risk had been 'under-priced'
- Market forces (including customer demand) are now pushing strongly in the direction of 're-intermediation'
 - in circumstances where liquidity and capital are much more scarce
- The relationships between the price of risk and risk tolerance are non-linear on the way up, and on the way down

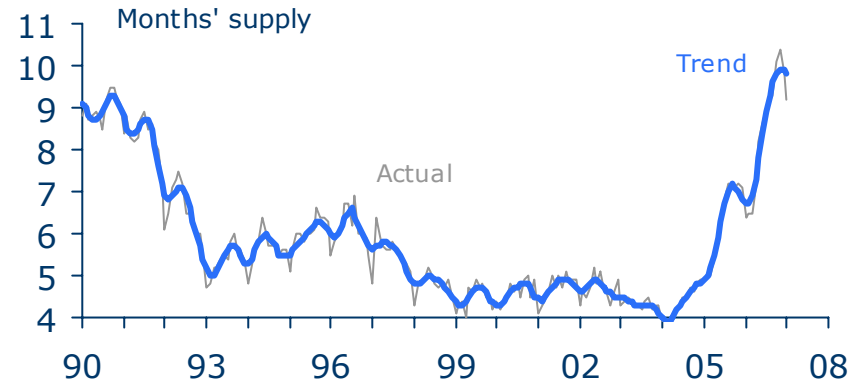
The US housing bubble has burst, like the equities bubble earlier this decade ³

US housing market

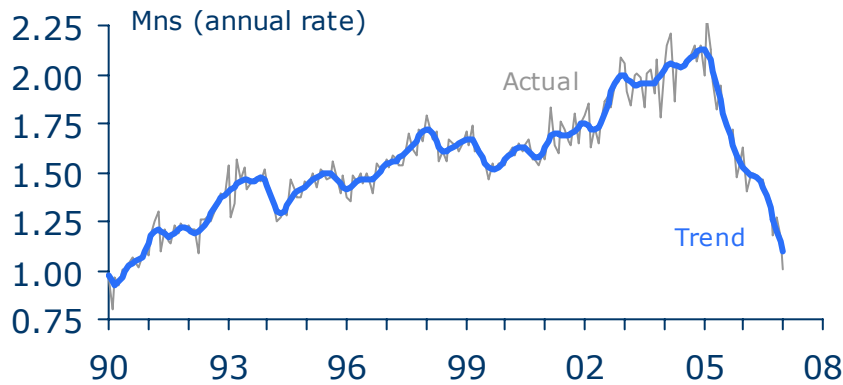
US house prices



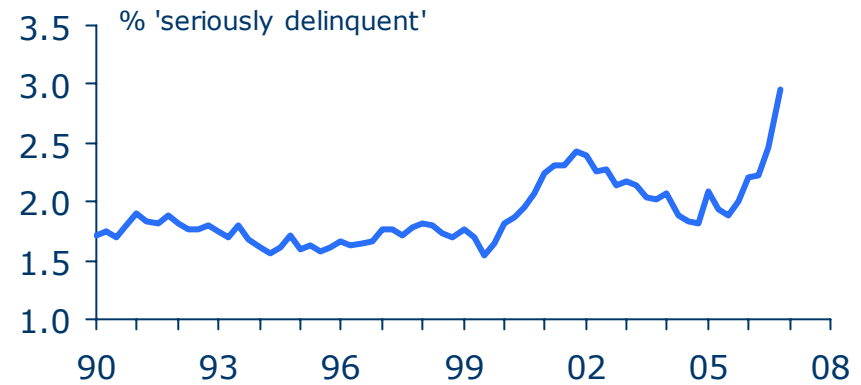
US unsold homes



US housing starts



US mortgage delinquencies

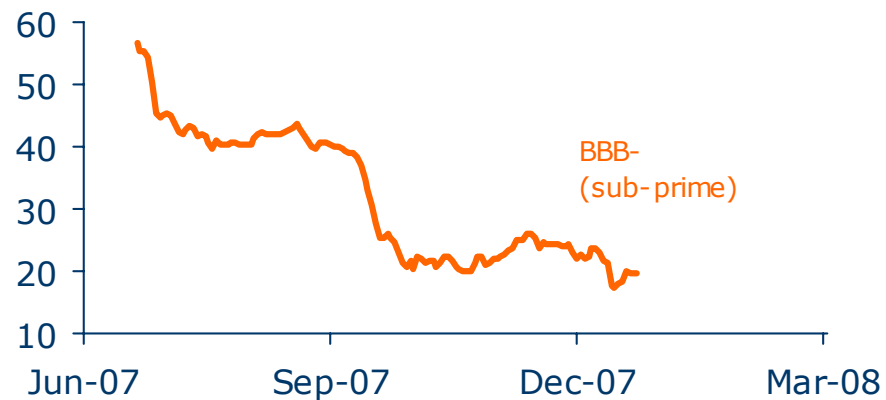
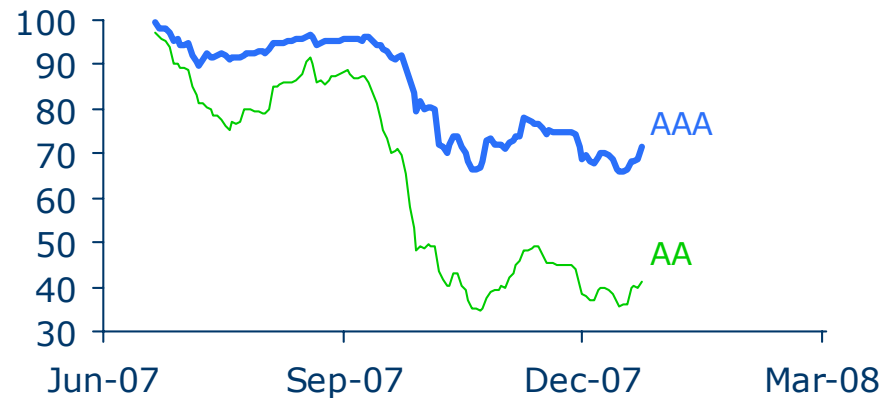


Sources: S&P; US Commerce Department; US National Association of Realtors; US Mortgage Bankers' Association.



Dramatic declines in the value of mortgage-backed securities have led to substantial losses incurred by big global banks

ABX index of prices of US mortgage-backed securities



Source: Bloomberg.

Losses announced by major banks since mid-2007

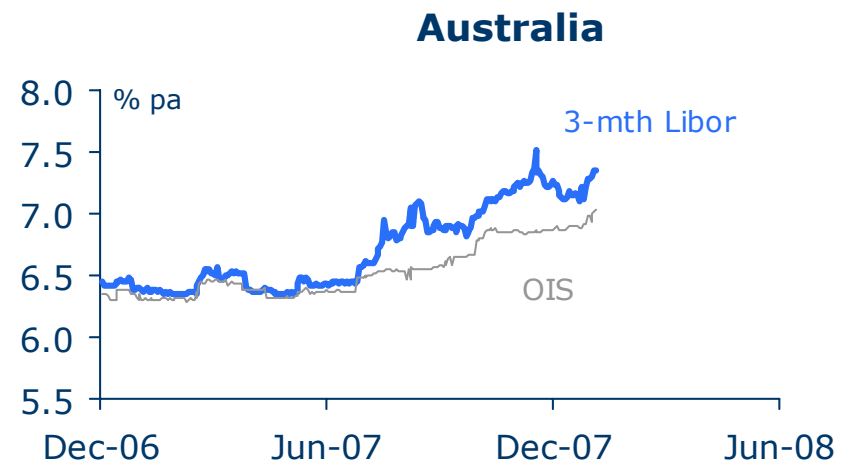
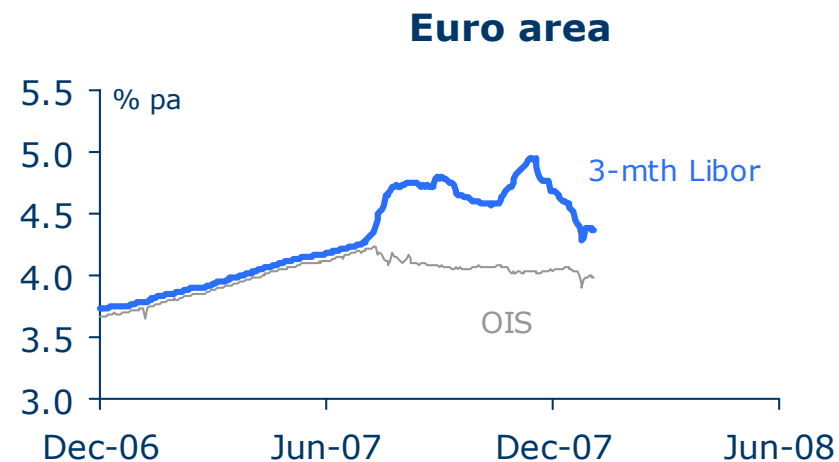
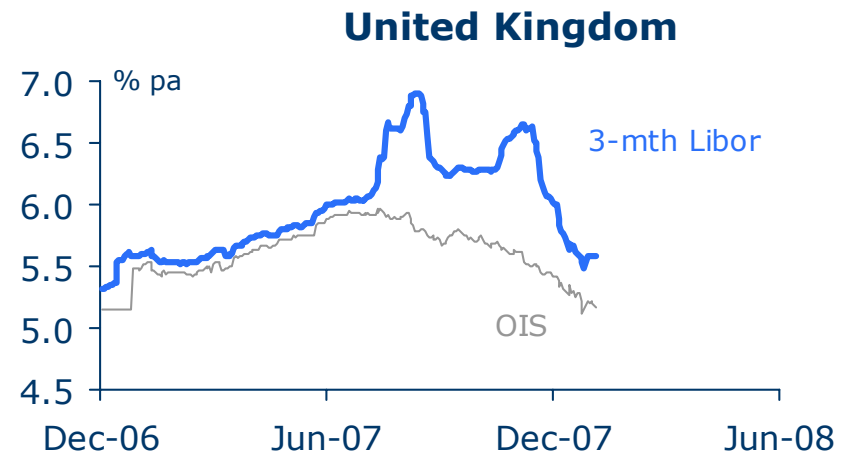
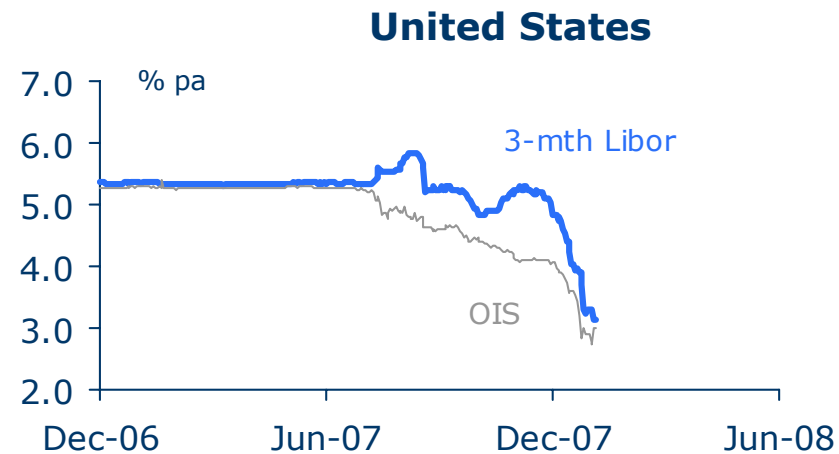
Bank	Total (US\$ bn)
Merrill Lynch	24.5
Citigroup	22.1
UBS	14.4
HSBC	10.7
Morgan Stanley	9.4
Bank of America	7.9
Washington Mutual	6.5
Credit Agricole	4.9
Wachovia	4.7
JPMorgan Chase	3.2
Canadian Imperial (CIBC)	3.2
Barclays	2.7
Bear Sterns	2.6
Royal Bank of Scotland	2.5
Deutsche Bank	2.3
Wells Fargo	1.7
TOTAL*	133.0

* incl. smaller banks not shown separately.



These losses (and fears of more to come) have made banks reluctant to lend to one another

Inter-bank borrowing rates and overnight index swap (OIS) rates

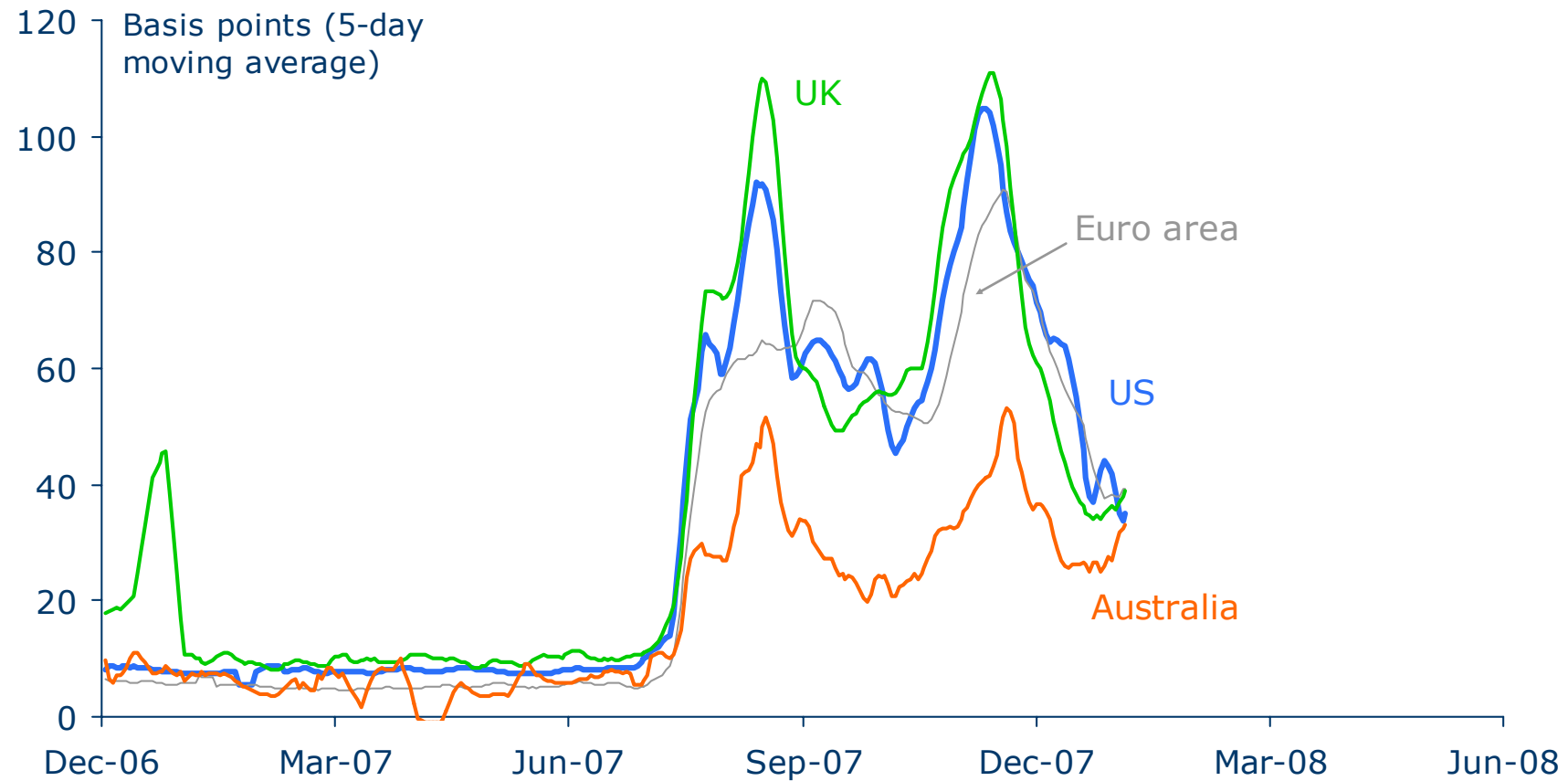


* The OIS is an indicator of market expectations of future movements in cash rates.
Sources: Thomson Financial; Bloomberg.



Banks' short-term funding margins have eased since year-end but remain much wider than 'normal'

Spreads between inter-bank borrowing rates and expected official cash rates

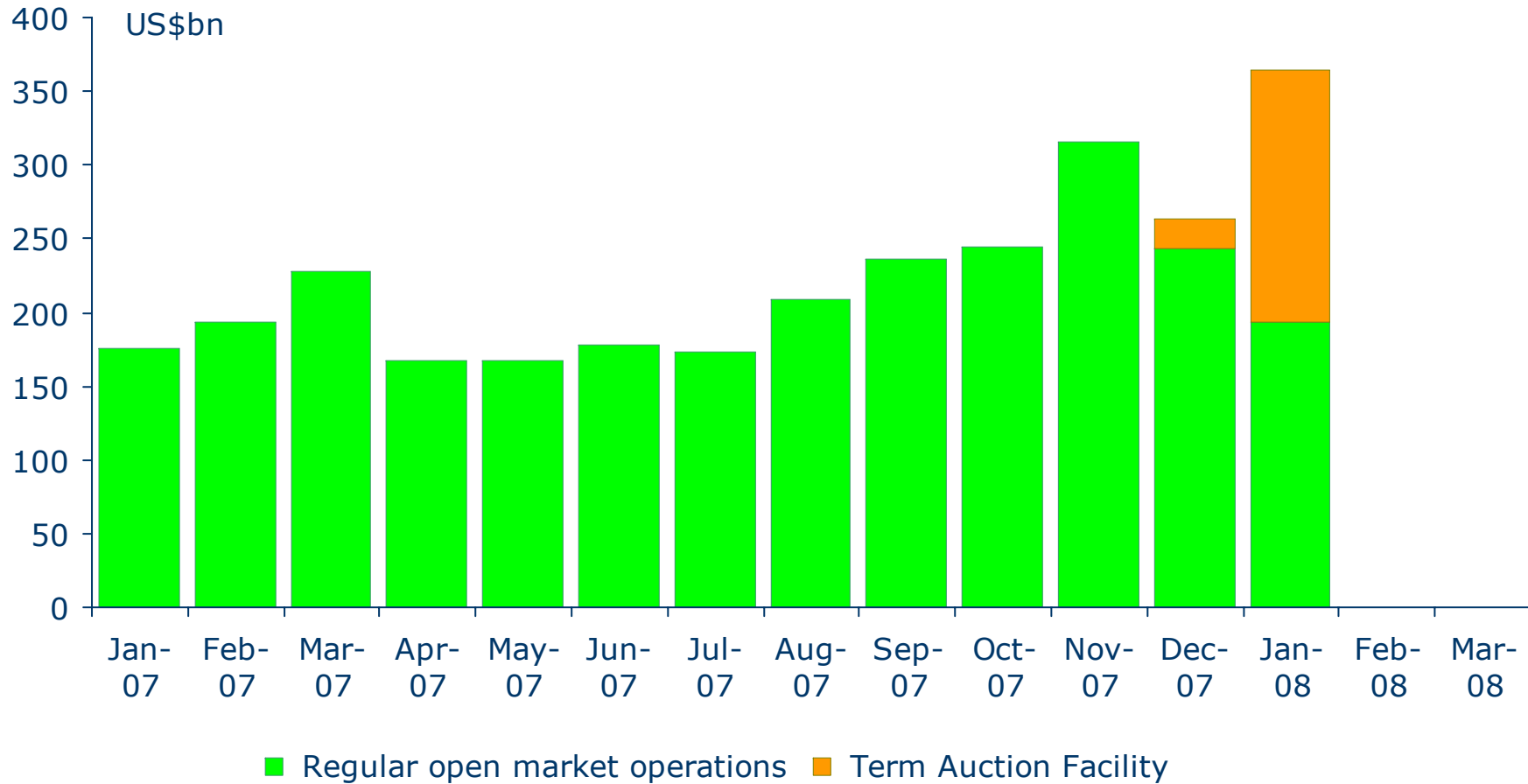


Sources: Thomson Financial; Bloomberg.



The narrowing in money-market spreads largely reflects central bank efforts to inject additional liquidity

Net cash injections to the US banking system by the Federal Reserve



Source: US Federal Reserve.



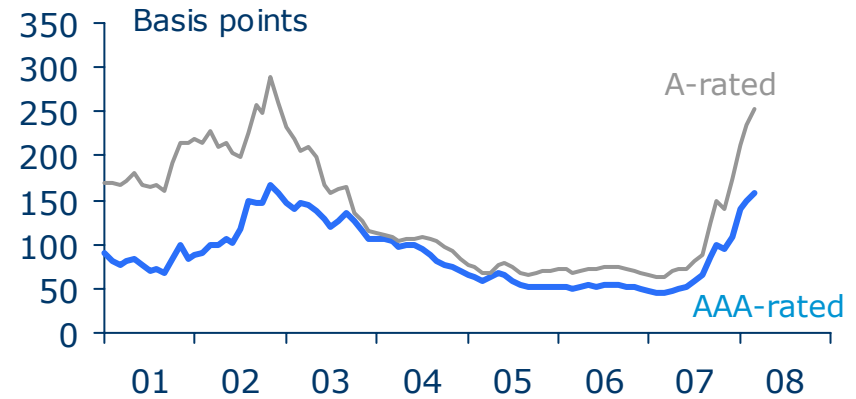
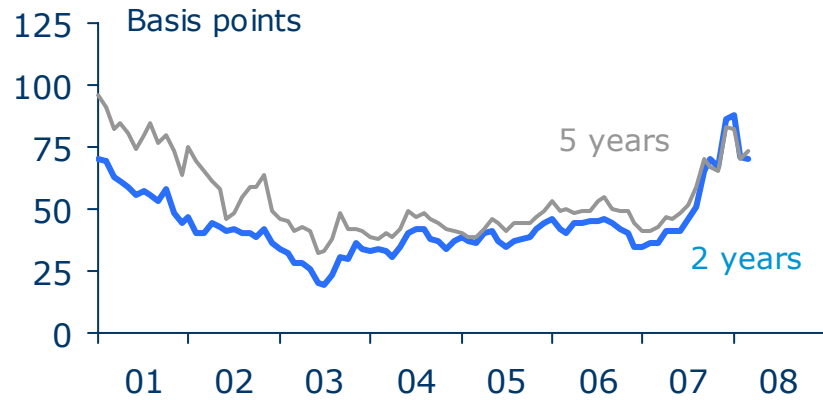
However longer-term borrowing spreads for both banks and corporates remain wide by historical standards

Swap spreads

Corporate bond yield spreads

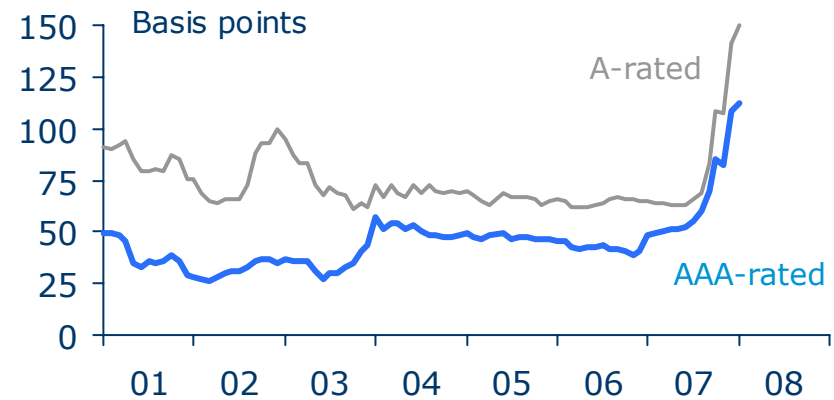
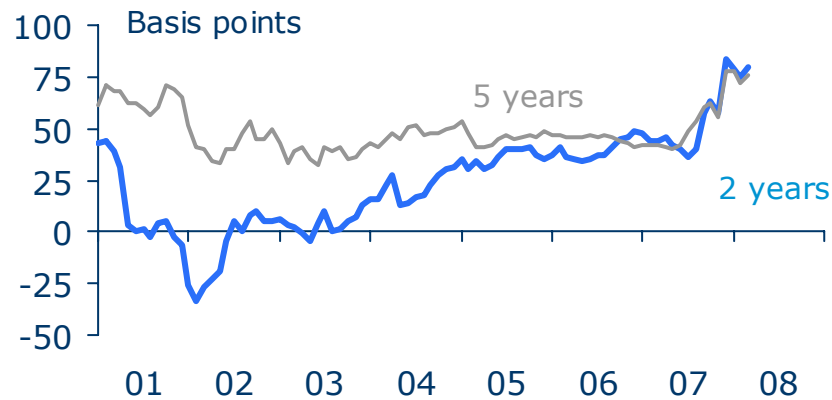
United States

United States



Australia

Australia

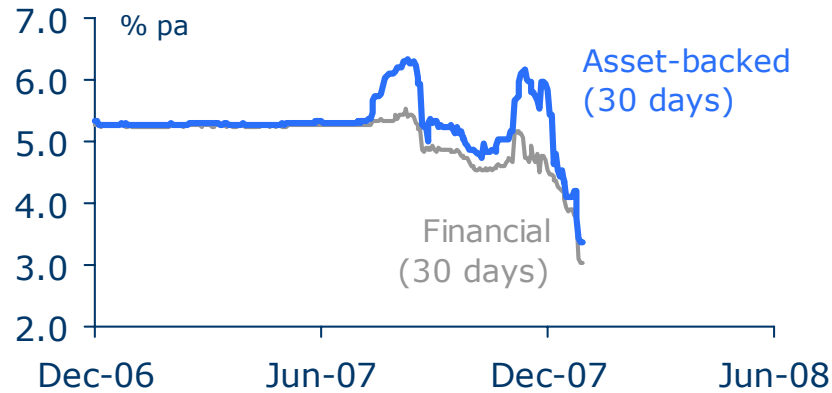


Note: spreads are to government bond yields of comparable maturities.
Sources: Thomson Financial; Bloomberg; Reserve Bank of Australia.

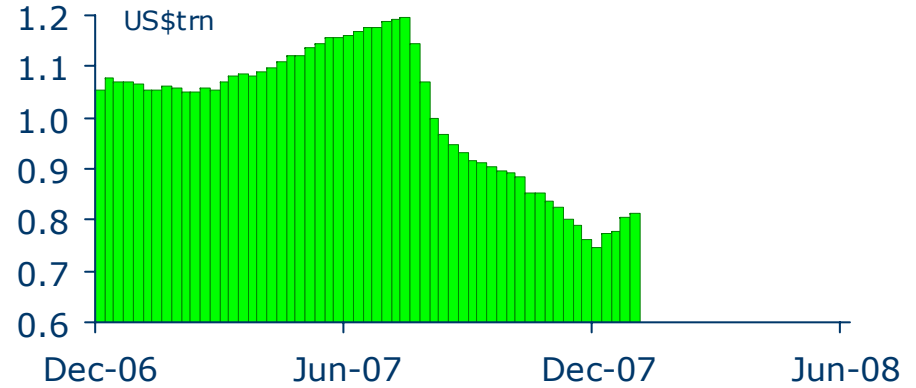


The commercial paper market was severely disrupted, although some stability seems now to be returning

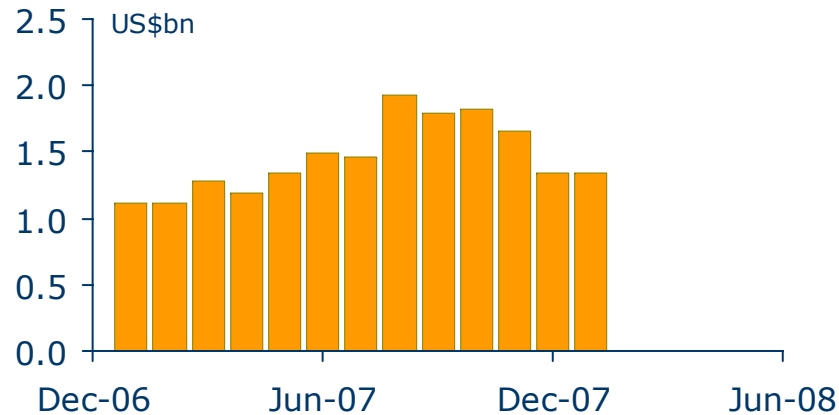
US commercial paper yields



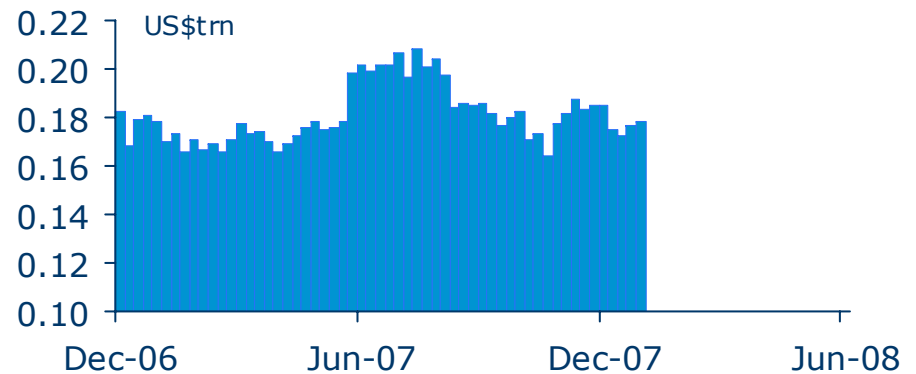
Asset-backed CP outstanding



Asset-backed CP issuance



Non-financial CP outstanding

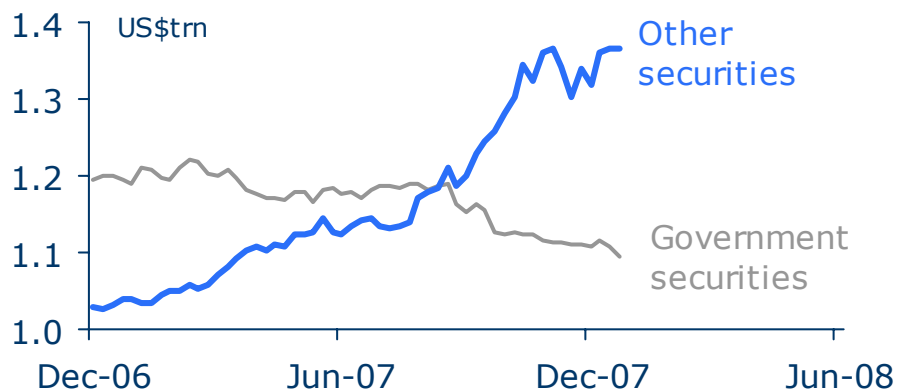


Sources: US Federal Reserve; Bloomberg.

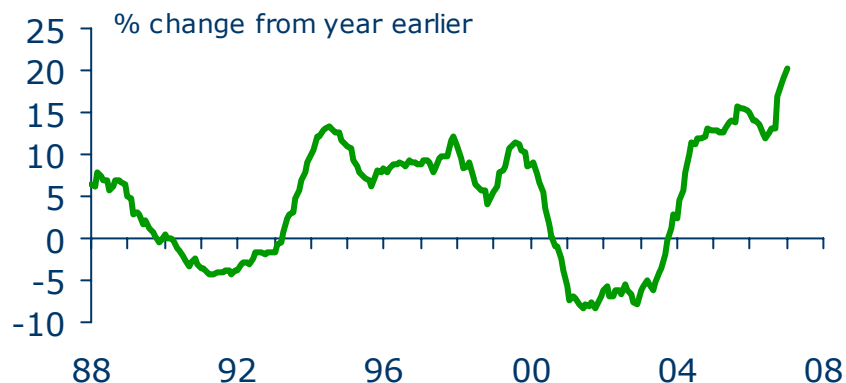


Sharply diminished investor appetite for securities has forced banks to take large volumes of assets onto their balance sheets

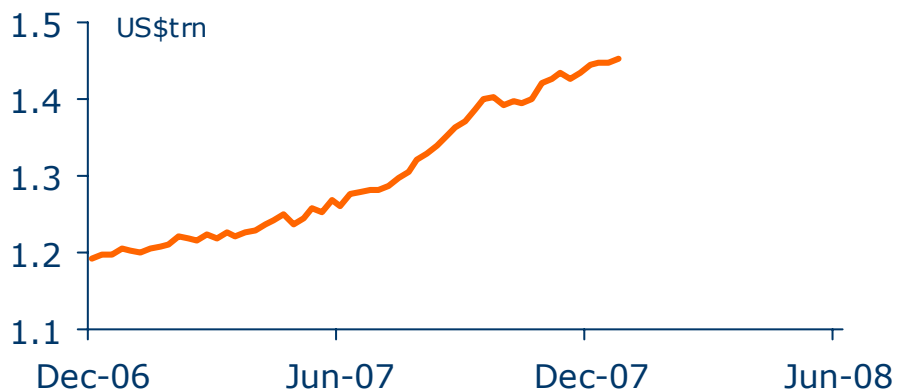
US banks' securities holdings



US banks' business lending



US banks' commercial & industrial loans



Australian financial intermediaries' business lending

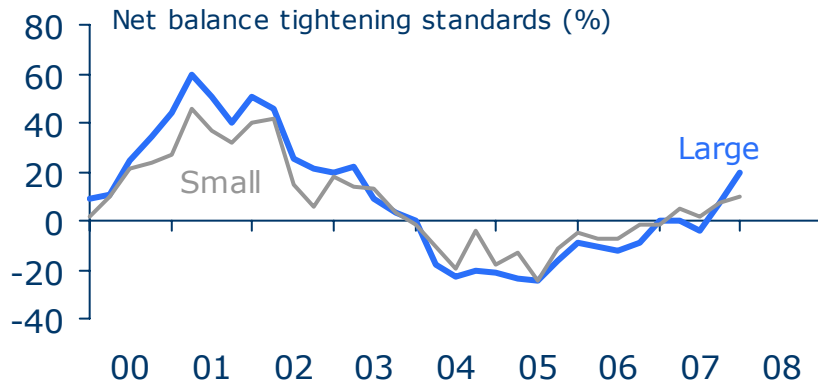


Sources: US Federal Reserve; Reserve Bank of Australia.

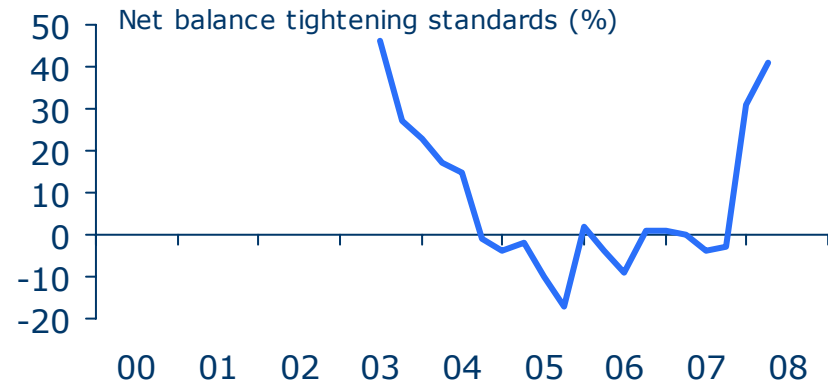


Banks in the US and the euro area are tightening credit standards

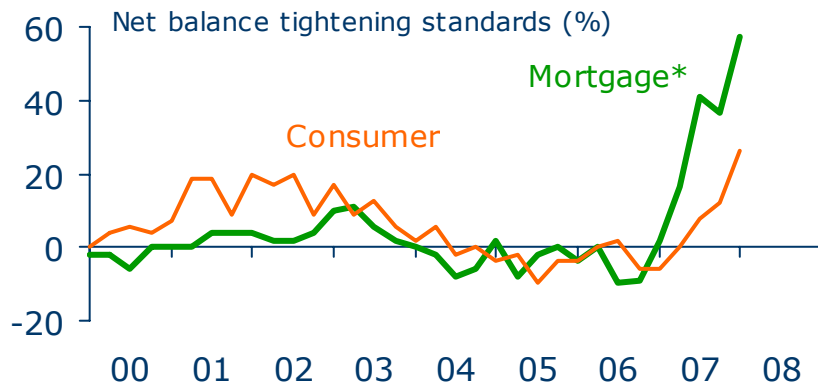
US banks Commercial & industrial loans



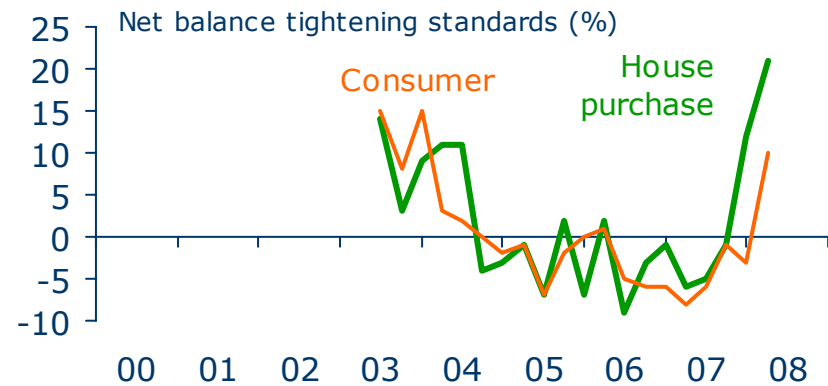
Euro area banks Loans to enterprises



Mortgage and consumer loans



Mortgage and consumer loans



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

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

It's too soon to be confident that the financial system is 'out of the woods'

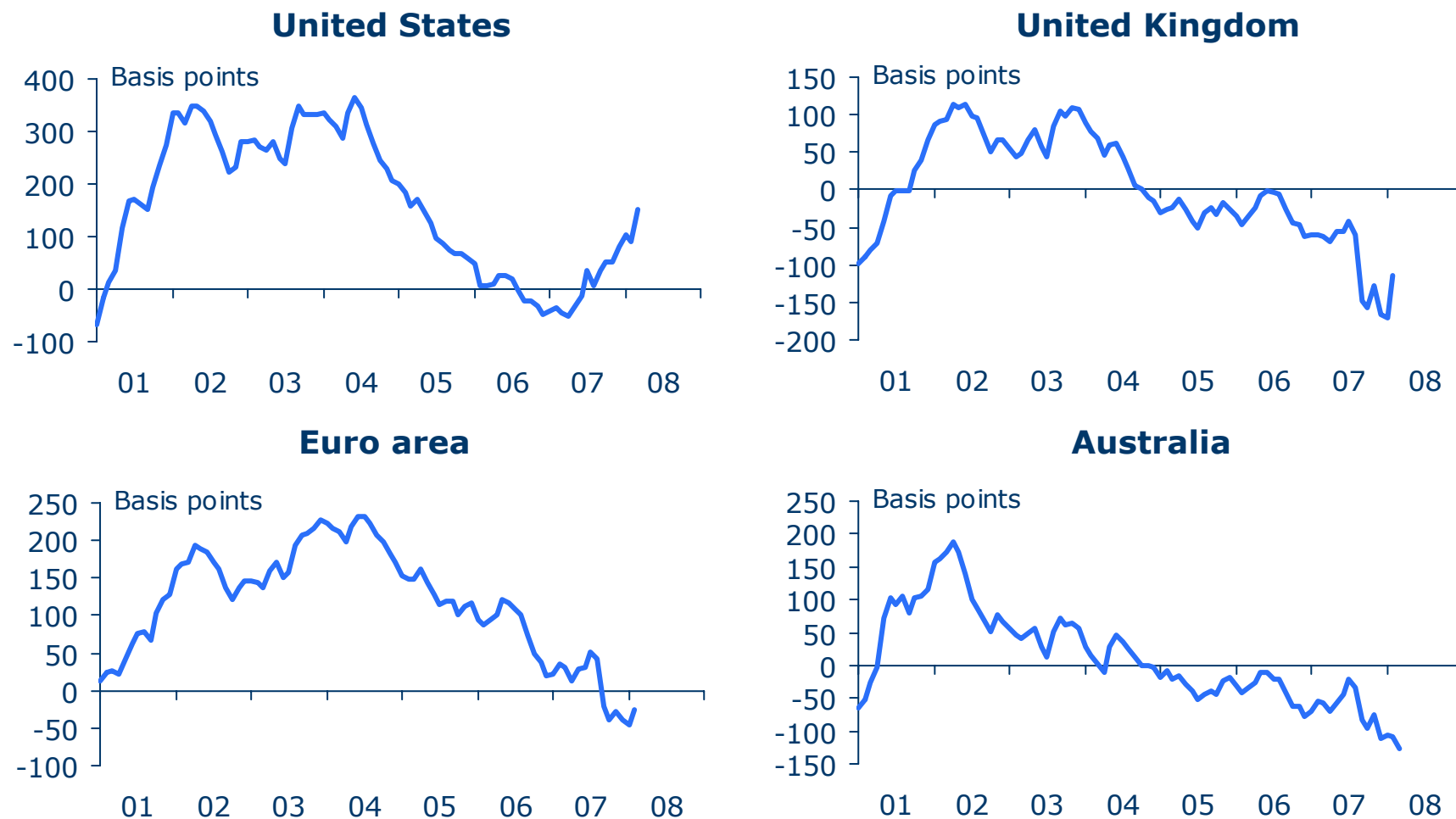
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Risks still facing the financial system

- Further write-downs in the value of mortgage-backed securities as a result of on-going defaults and falling house prices
 - estimates of eventual total losses are in the range US\$200-500bn (cf. \$133bn written off to date)
- Write-downs in the value of other securities triggered (eg) by ratings downgrade of 'monoline' bond insurers
 - these institutions have 'guaranteed' US\$2.4trn of municipal and consumer debt (of which \$900bn is structured finance debt (CDOs etc))
- Rising defaults by corporate borrowers, prompting losses on credit default swaps (CDSs)
 - total CDS outstanding estimated at US\$45trn, potential losses in the event of 'normal' corporate insolvency rate estimated of the order of US\$250bn
- On-going pressure on banks' capital from having to expand balance sheets to meet needs of customers unable to debt issue securities, and from further write-downs
 - which could eventually lead to banks being unable to extend further credit
- Regulatory backlash and civil lawsuits

Cutting short-term rates sufficiently to restore a positive yield curve would help financial system stability

10-year / 3 mth yield curves



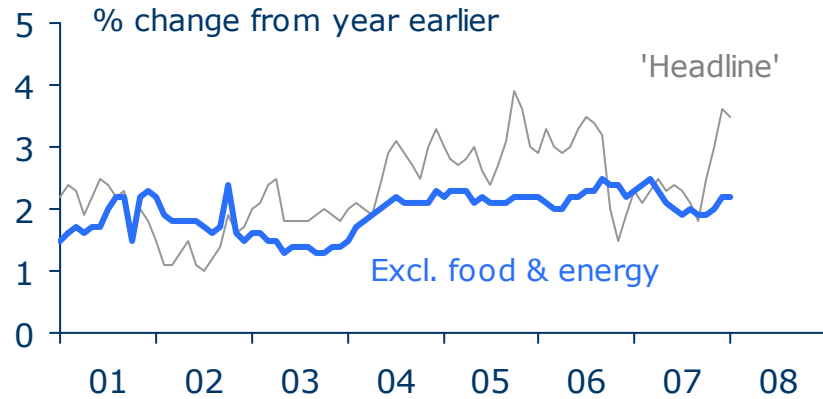
Source: Thomson Financial.



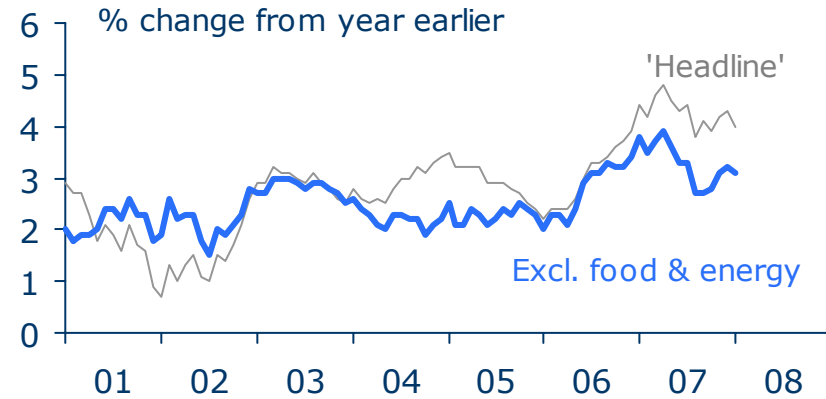
But that poses a dilemma for central banks in countries where inflation remains uncomfortably high

Consumer price inflation

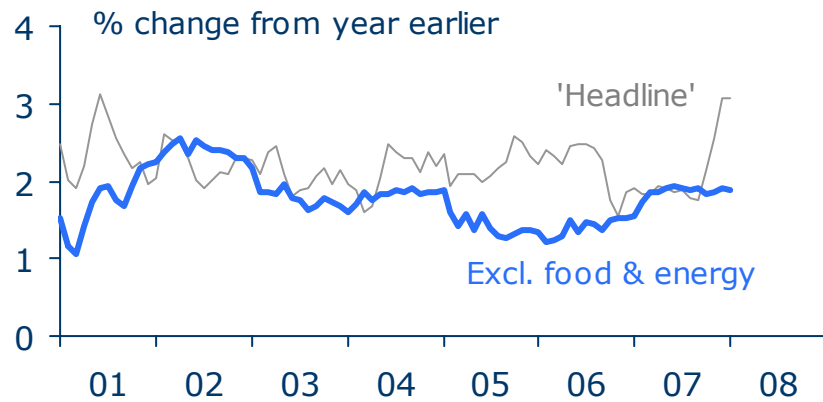
United States*



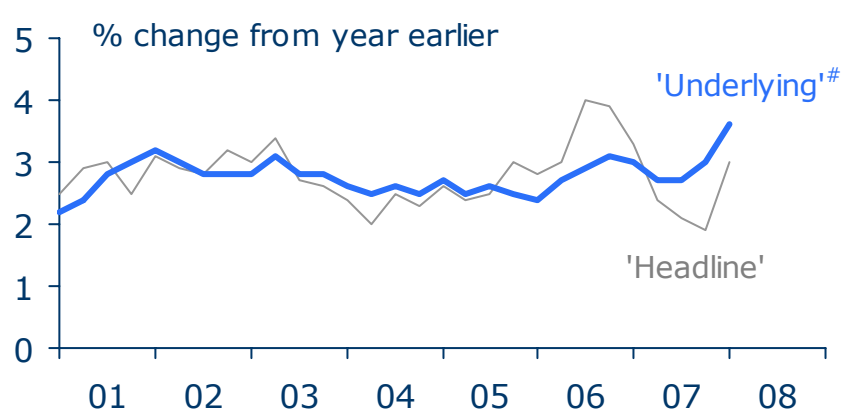
United Kingdom



Euro area



Australia[†]



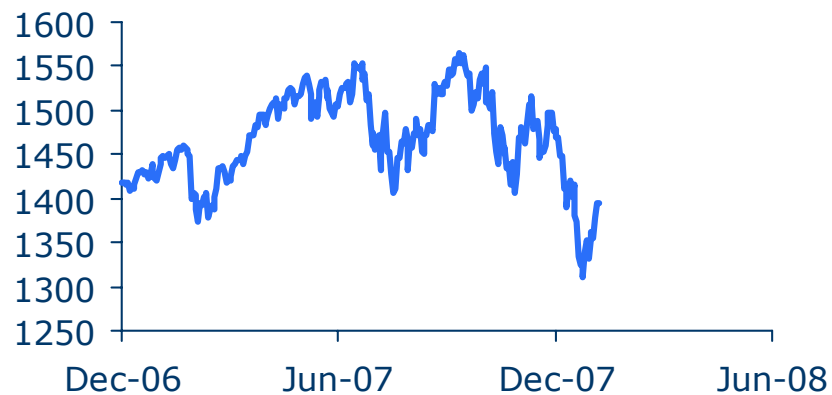
* Personal consumption expenditure deflator. † excludes GST impact in 2001. # Average of RBA's two preferred measures. Sources: US Bureau of Economic Analysis; Eurostat; UK Office of National Statistics; ABS; RBA.



Equity markets have fallen sharply since mid-2007 – it's as yet unclear whether mid-January marked the bottom

Equity markets

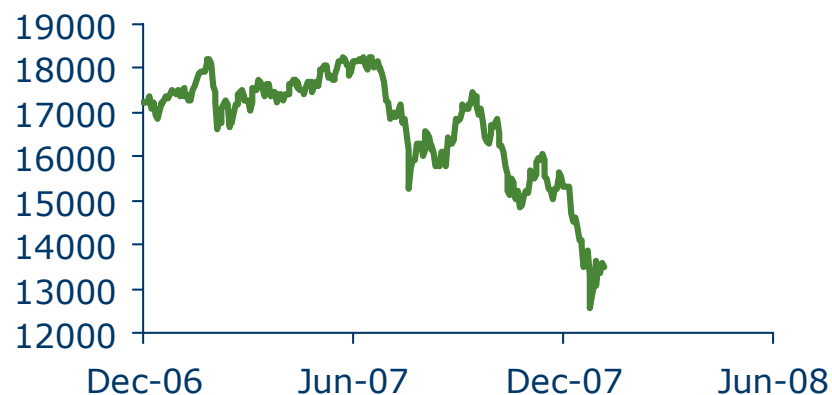
US – S&P 500



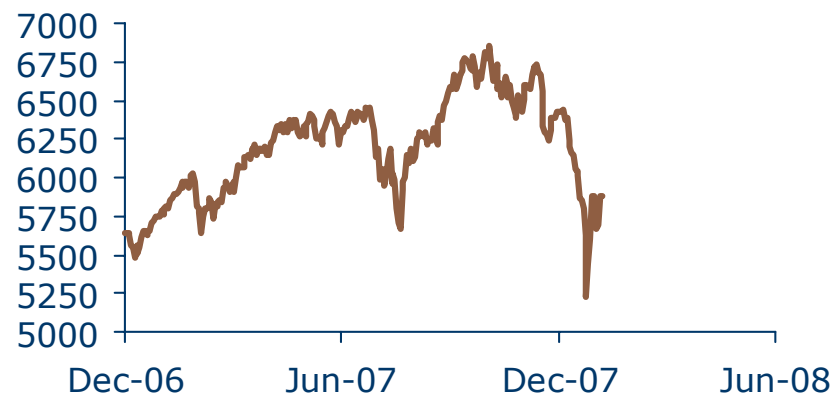
UK – FTSE 100



Japan - Nikkei



Australia – ASX All Ords



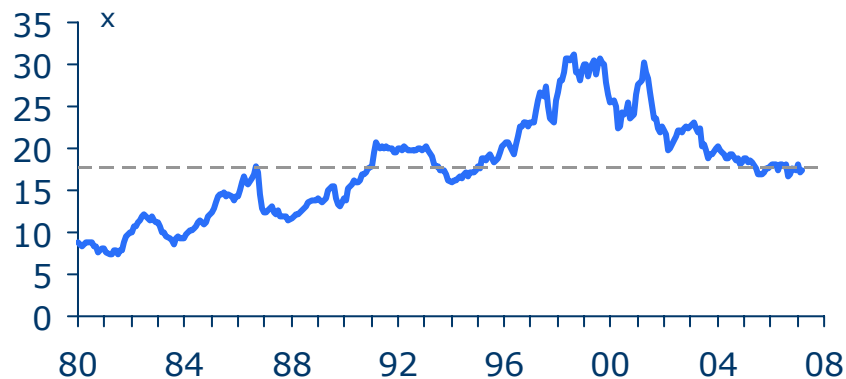
Source: Thomson Financial.



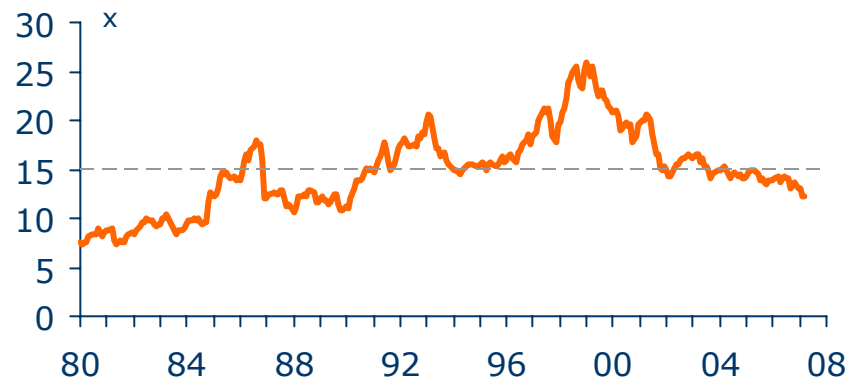
Share market investors are more concerned about the risk of earnings downgrades than about stretched valuations

Price-earnings ratios compared with long-term averages

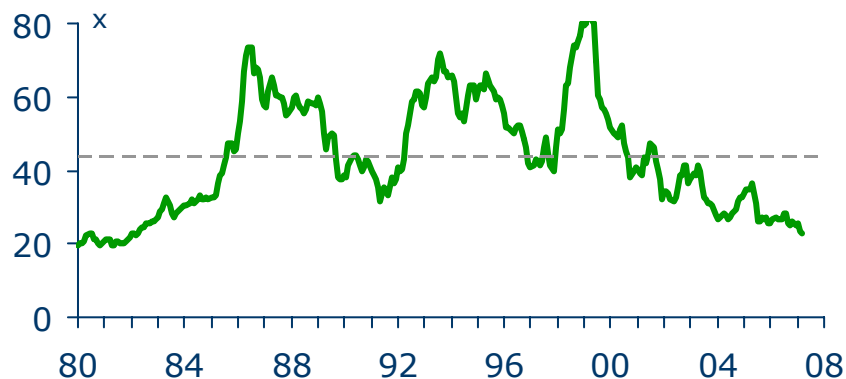
United States



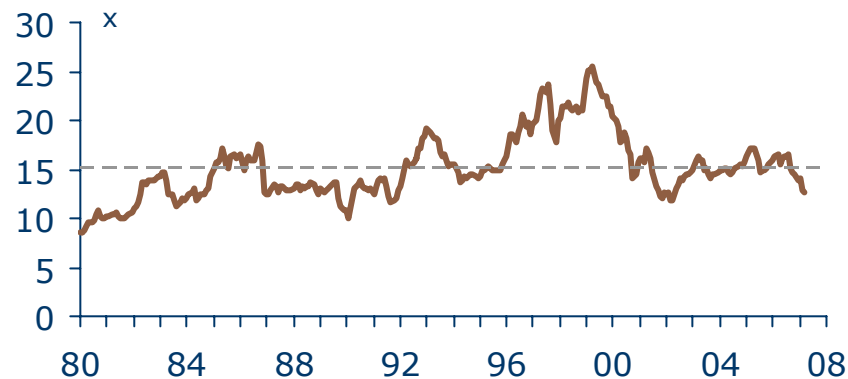
United Kingdom



Japan



Australia

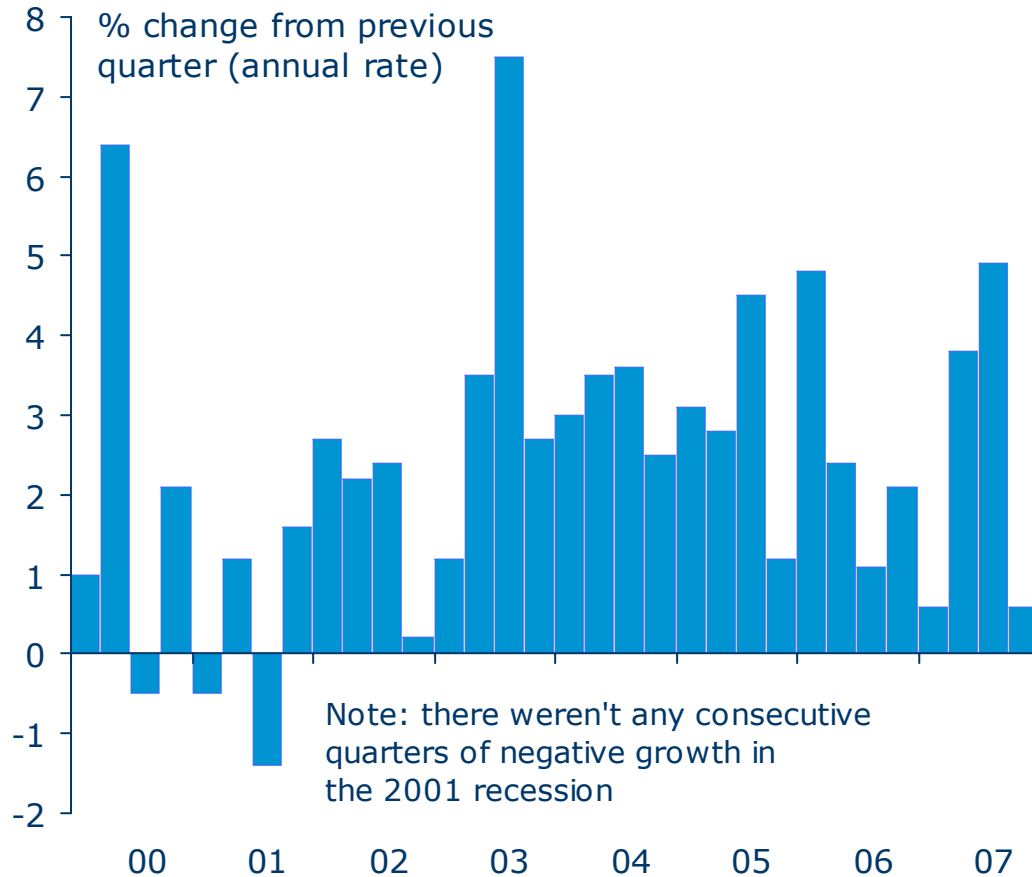


Source: Thomson Financial; ANZ.

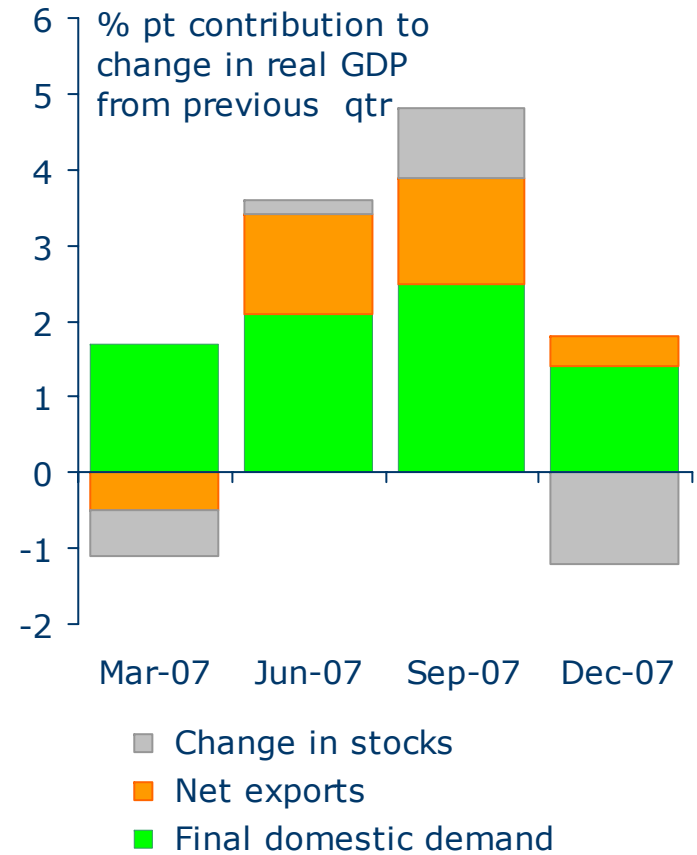


US real GDP growth slowed sharply in the final quarter of last year – but that doesn't mean the US is already in recession

US real gross domestic product



Composition of GDP growth



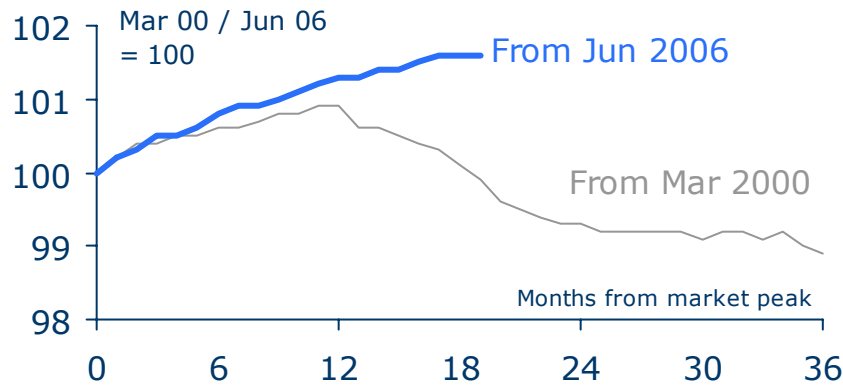
Source: US Bureau of Economic Analysis.



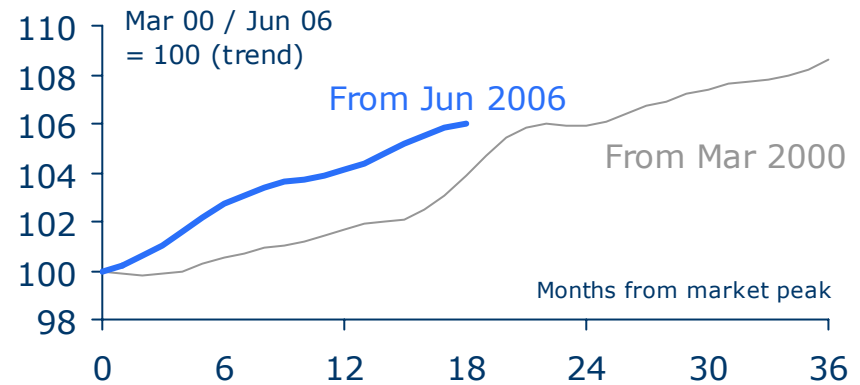
So far, the US economy has held up better since the peak of the housing bubble than it did after the equities peak in 2000 ¹⁸

US economic indicators after the peaks of two most recent 'bubbles'

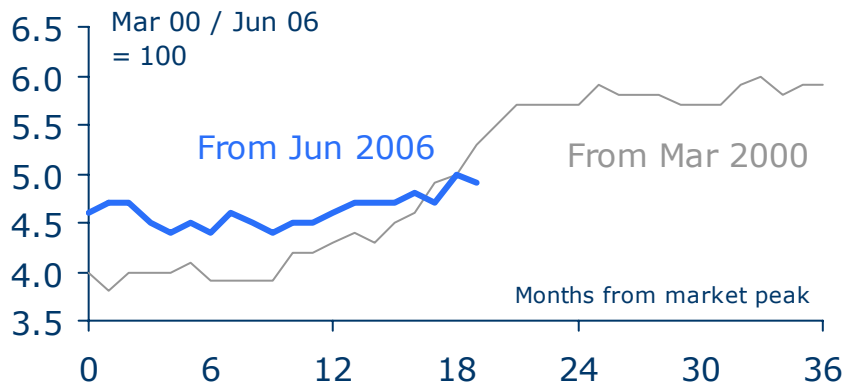
Non-farm payroll employment



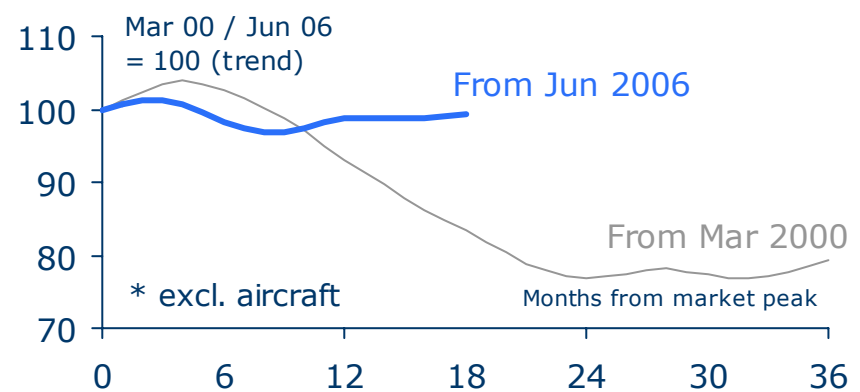
Real retail sales



Unemployment rate



Non-defence capital goods orders*



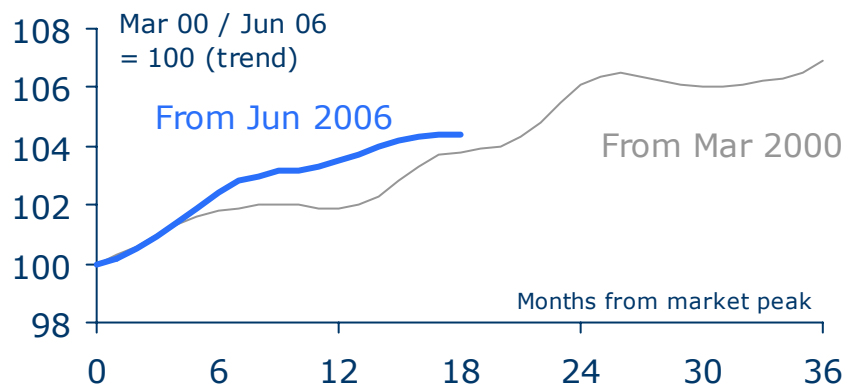
Sources: US Bureau of Labor Statistics; US Commerce Department; ANZ.



Both the household and corporate sectors are in a stronger financial position than they were ahead of the 2001 recession

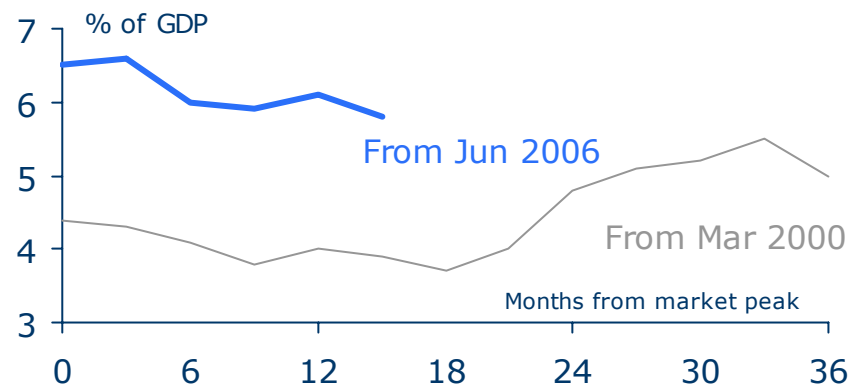
US household sector

Real personal disposable income

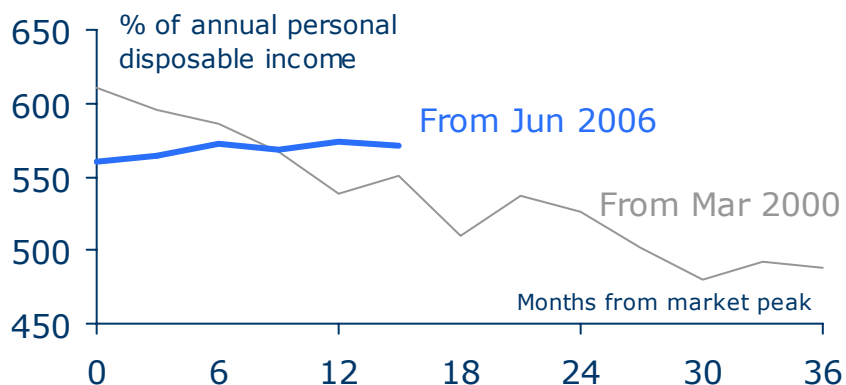


US non-financial corporate sector

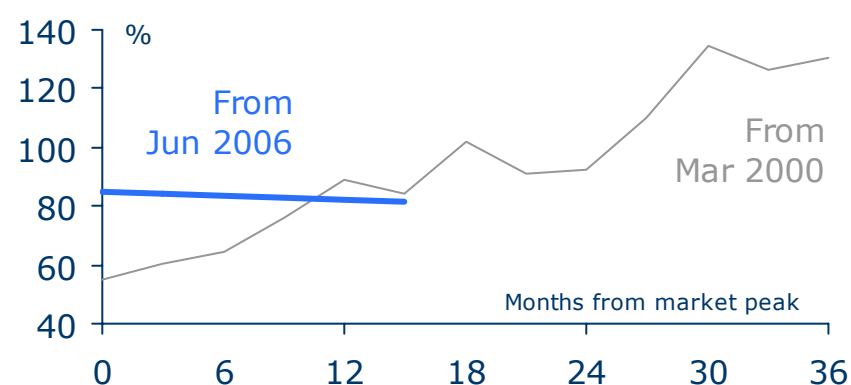
After-tax corporate profits



Personal net worth



Debt-equity ratio



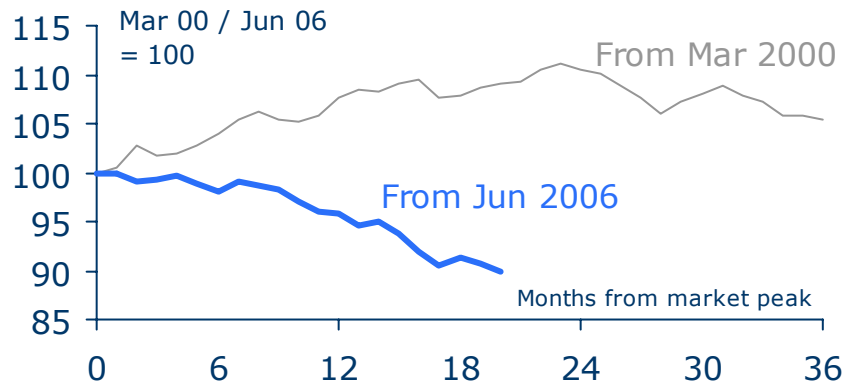
Sources: US Bureau of Economic Analysis; Federal Reserve; ANZ.



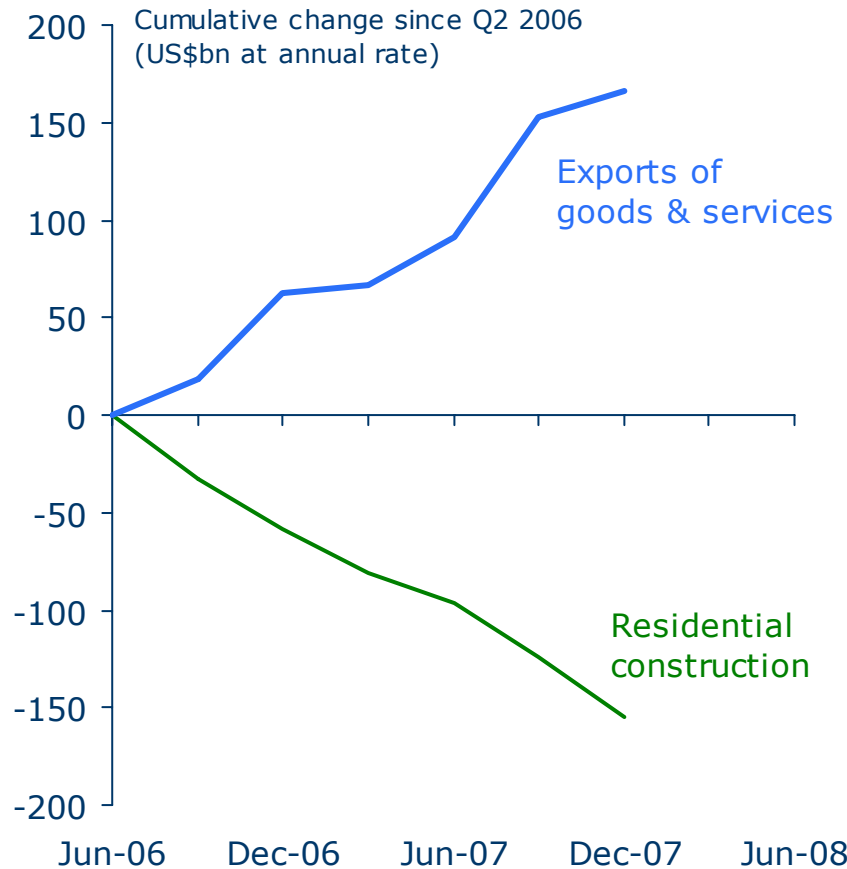
Rising exports, aided by a weaker US\$, have more than offset the impact on GDP growth of falling housing construction

US dollar, exports and housing

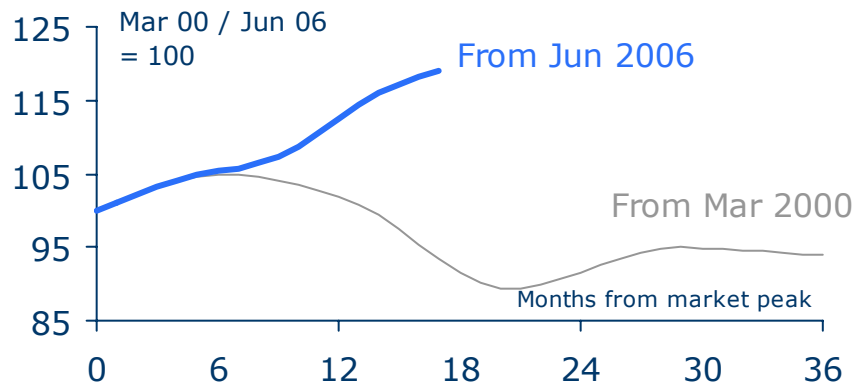
Trade-weighted value of US\$



Exports and housing



Real exports of goods and services



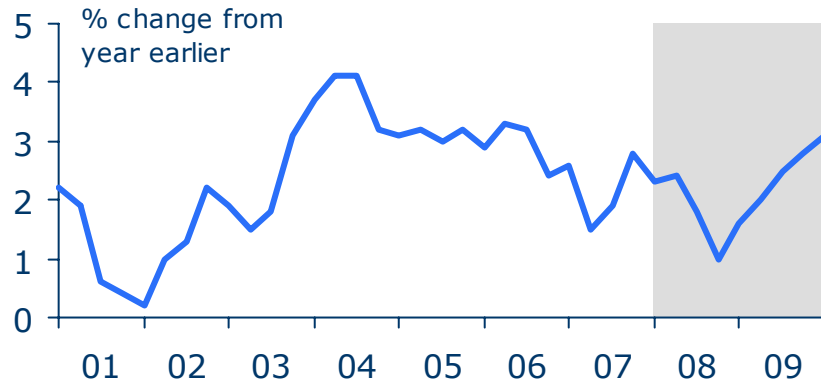
Sources: Thomson Financial; US Bureau of Economic Analysis; ANZ.



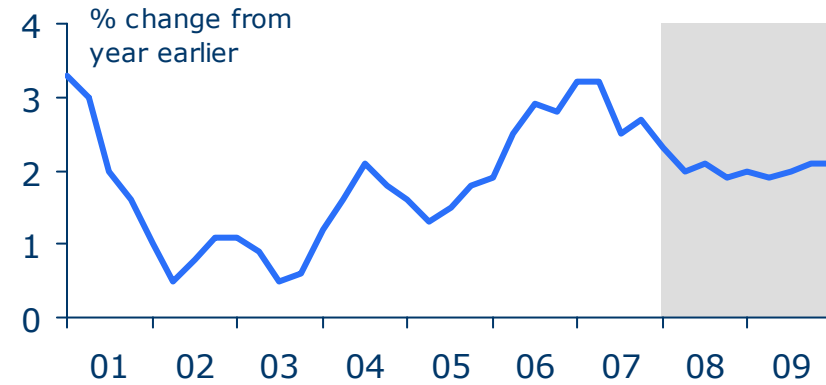
All of the world's major advanced economies will experience slower growth in 2008

Major advanced economies – real GDP growth

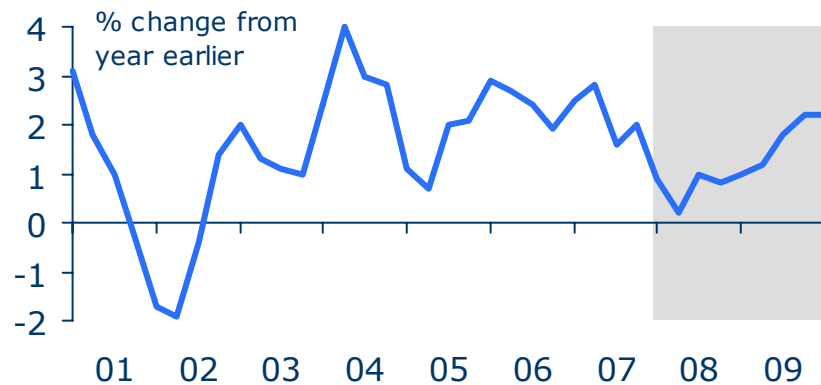
United States



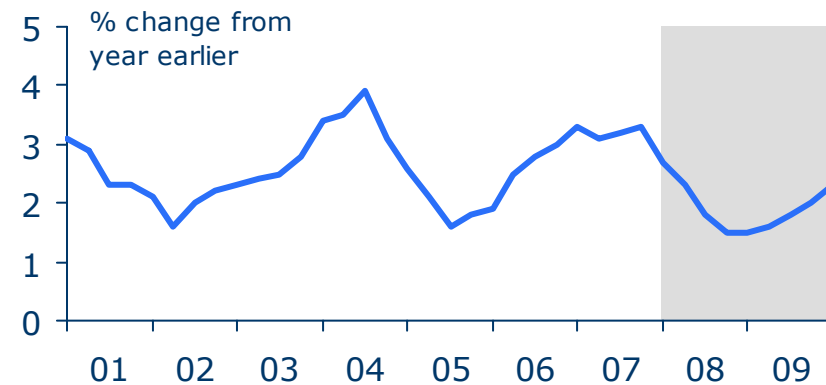
Euro zone



Japan



United Kingdom

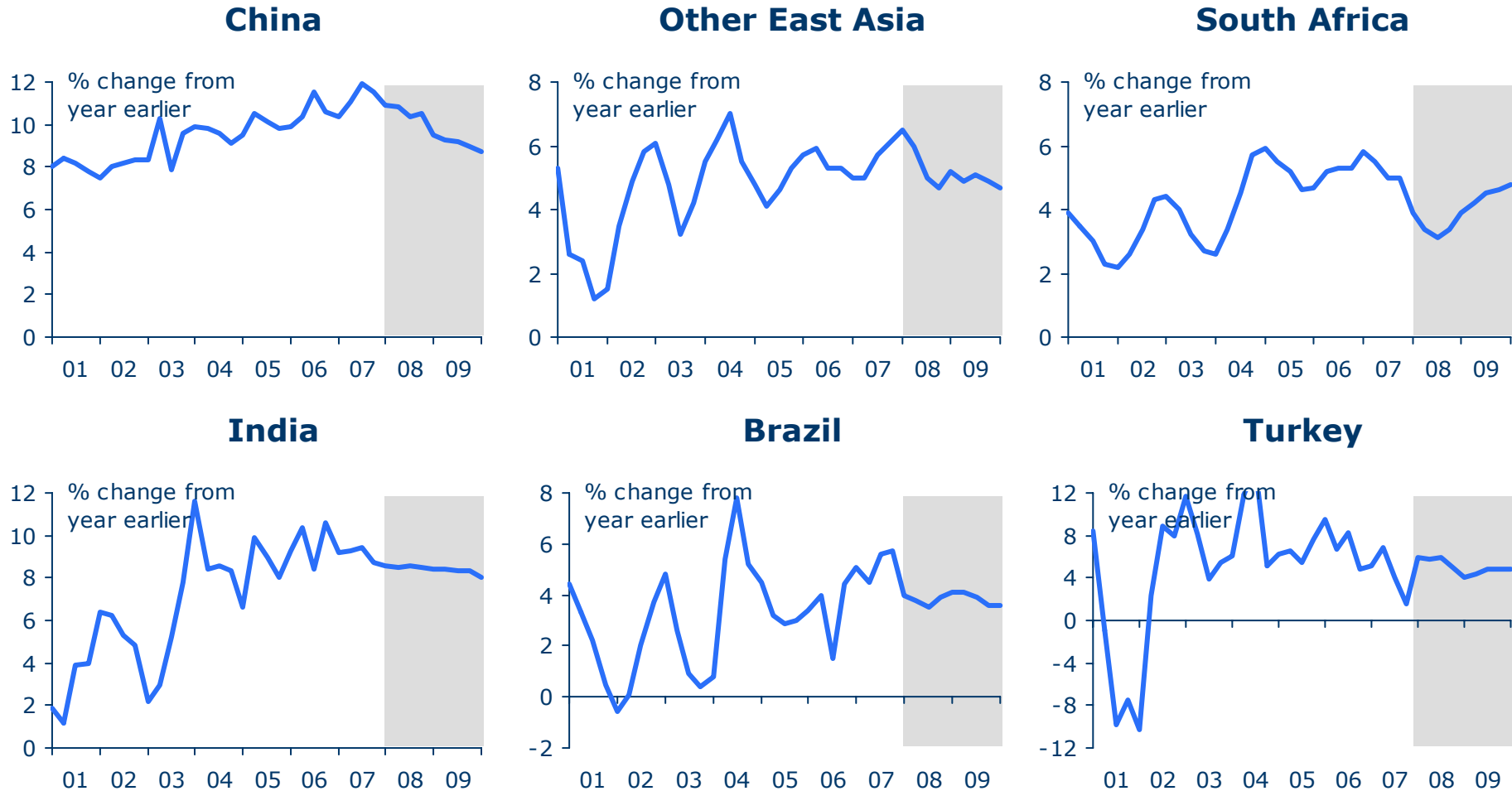


Sources: national statistical agencies; ANZ.



There'll be some slowing in major developing economies too, though more due to domestic policies than to weaker exports

Major developing economies – real GDP growth



Sources: national statistical agencies; ANZ.



Asian economies will feel the effects of a US slowdown, though not by as much as suggested by simple exports/GDP ratios

Asian economies' exposure to a downturn in the US economy

Country	Exports as a % of GDP	Exports to US as a % of total*	Total export value-added as a % of GDP	US export value-added as a % of GDP	GDP impact of a 10%pt US import slowdown
China	34.1	21.4	12.6	2.7	-0.3
Hong Kong	197.9	15.2	42.6	6.5	-0.6
India	22.9	16.3	10.5	1.7	-0.2
Indonesia	33.5	11.8	13.9	1.6	-0.2
Japan	14.3	24.2	6.8	1.6	-0.2
Korea	42.5	15.0	19.8	3.0	-0.3
Malaysia	123.4	21.2	36.1	7.7	-0.8
Philippines	47.3	21.4	14.4	3.1	-0.3
Singapore	243.0	10.8	44.3	4.8	-0.5
Taiwan	65.9	20.8	25.7	5.3	-0.5
Thailand	73.6	16.4	28.8	4.7	-0.5
Vietnam	67.3	19.2	26.2	5.0	-0.5

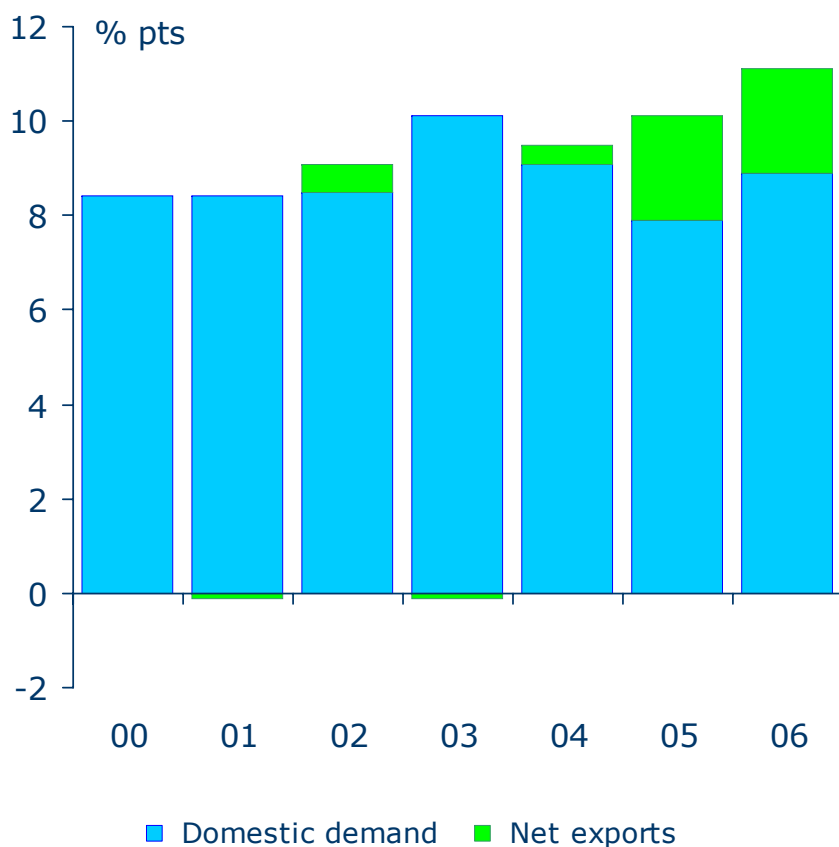
* Includes indirect exposure through China.

Source: Jonathan Anderson (UBS, September 2006)

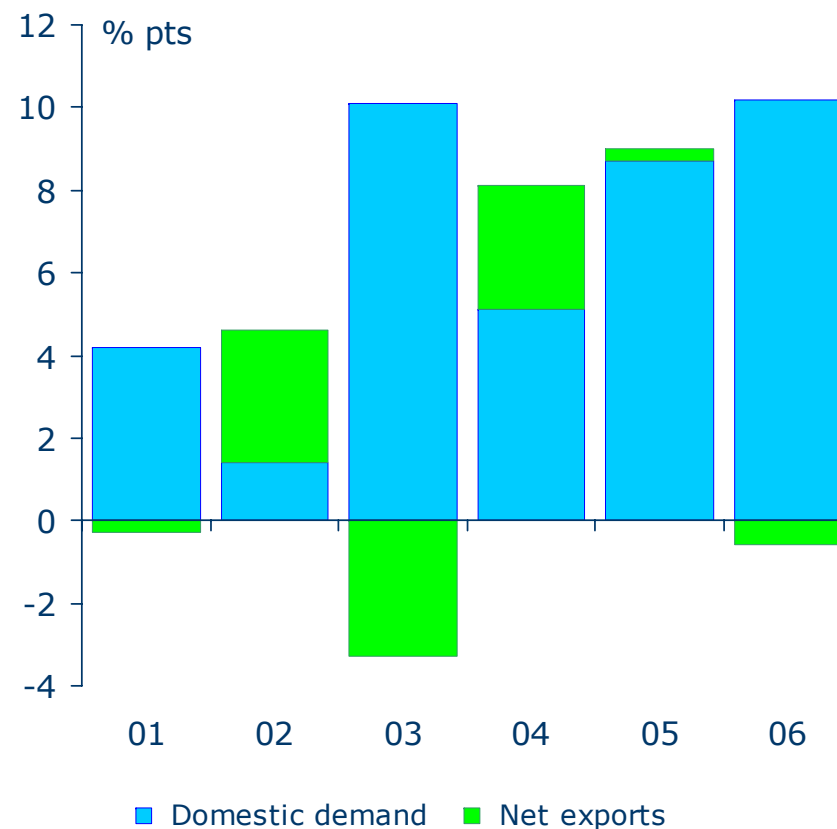


China's and India's growth has been predominantly driven by domestic demand, not by net exports

**Contributions to
China's real GDP growth**



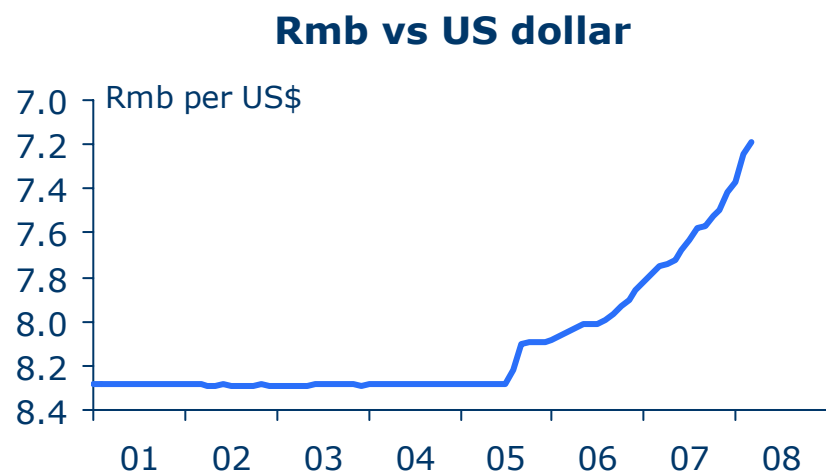
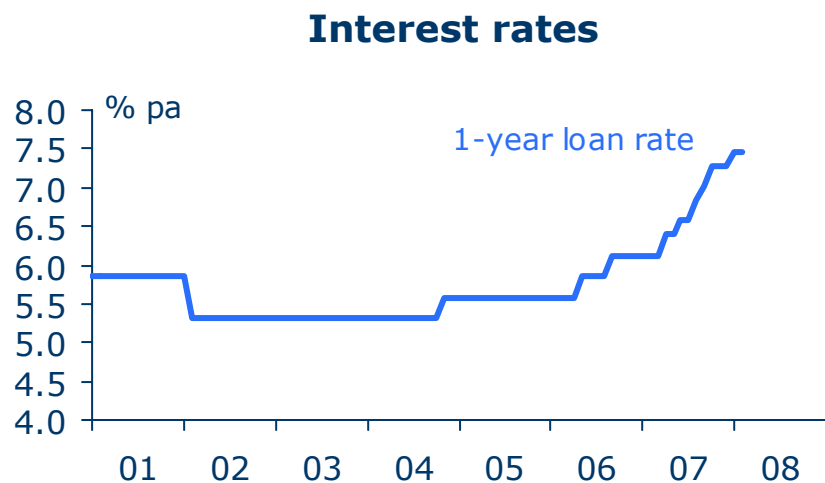
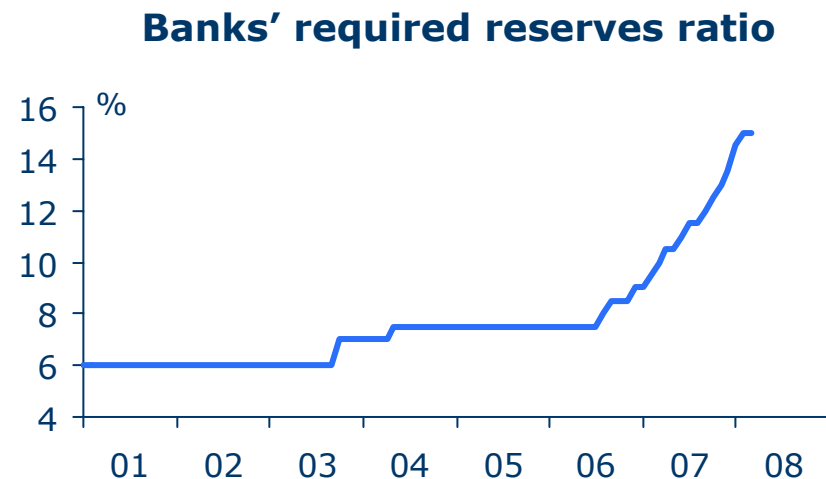
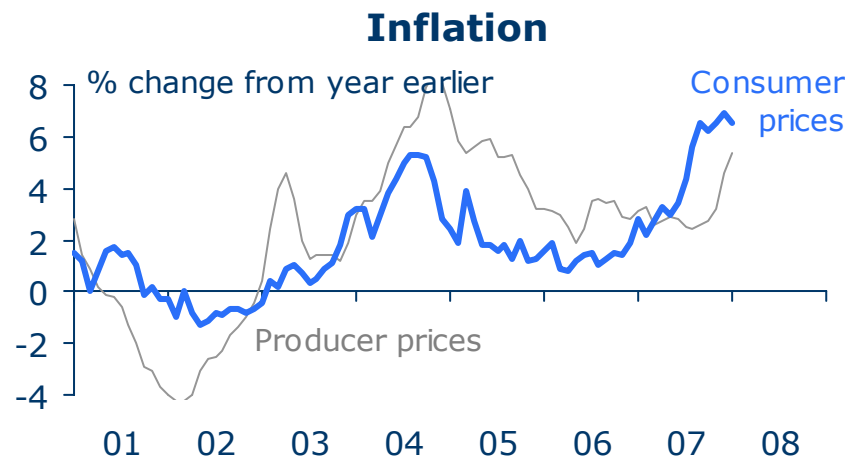
**Contributions to
India's real GDP growth**



Source: China National Bureau of Statistics, CEIC.

Chinese authorities have been tightening monetary policy and using other instruments to dampen inflation pressures

China - inflation and monetary conditions

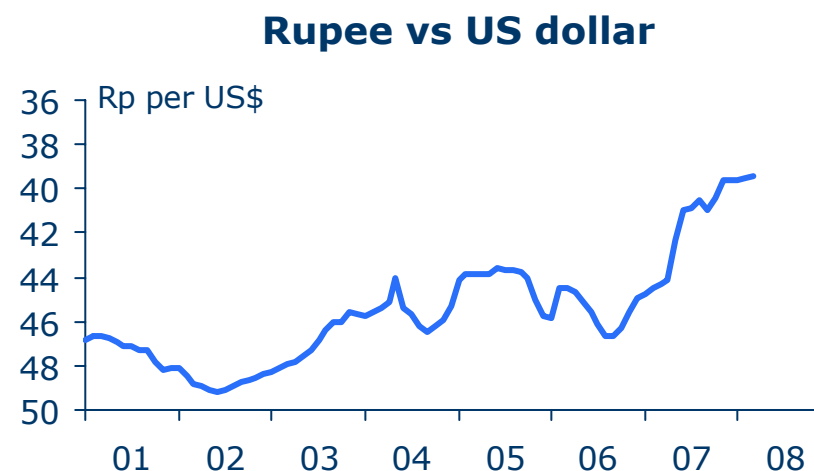
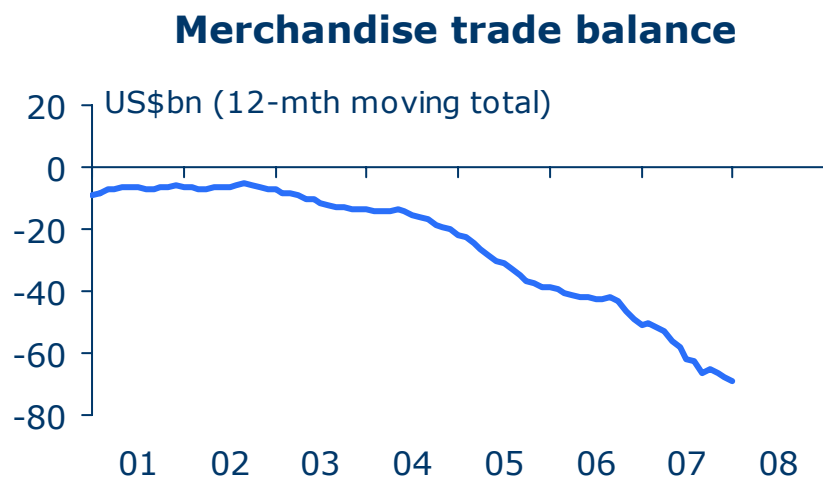
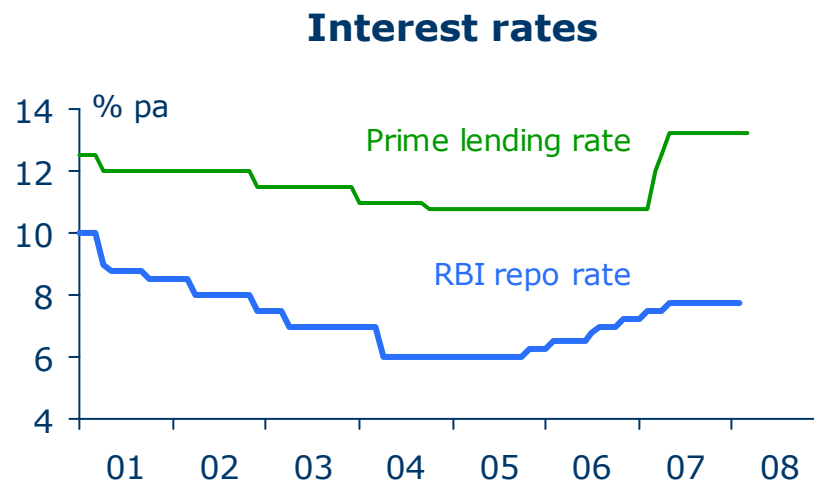
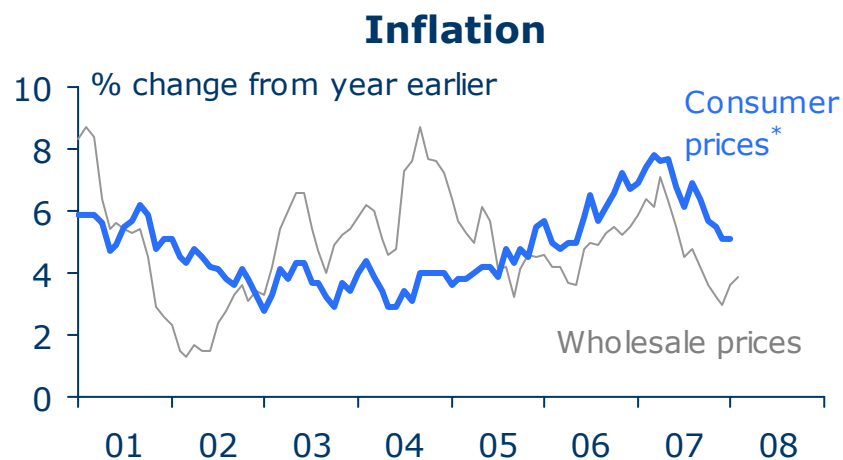


Sources: China National Bureau of Statistics; People's Bank of China; Thomson Financial.



India has also been seeking (with some success) to reduce inflationary pressures

India - inflation, trade balance and monetary conditions

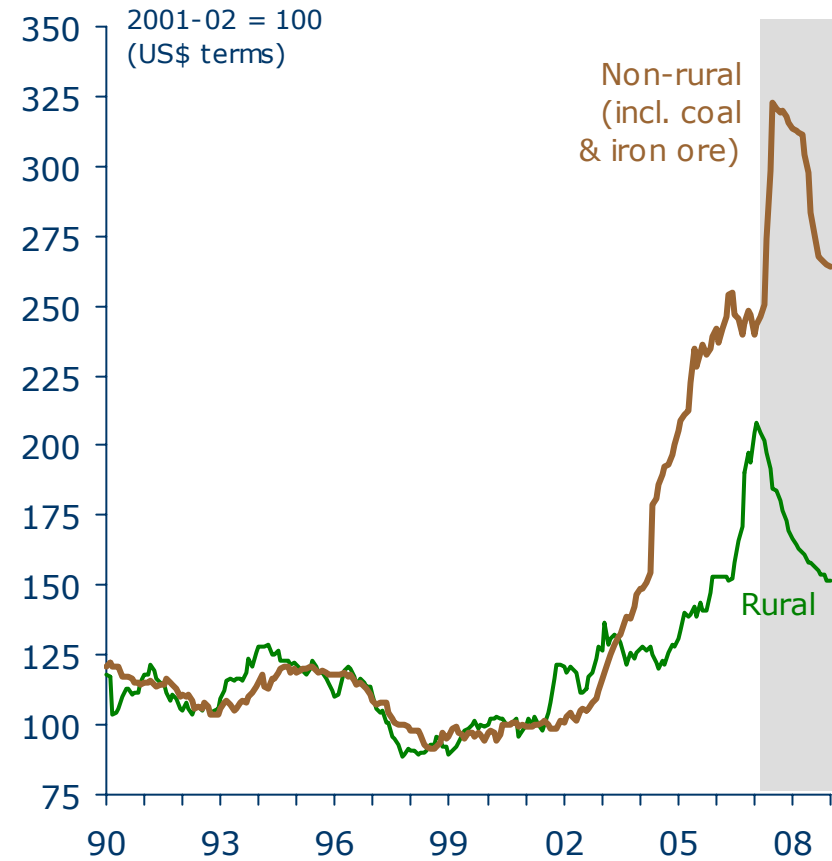
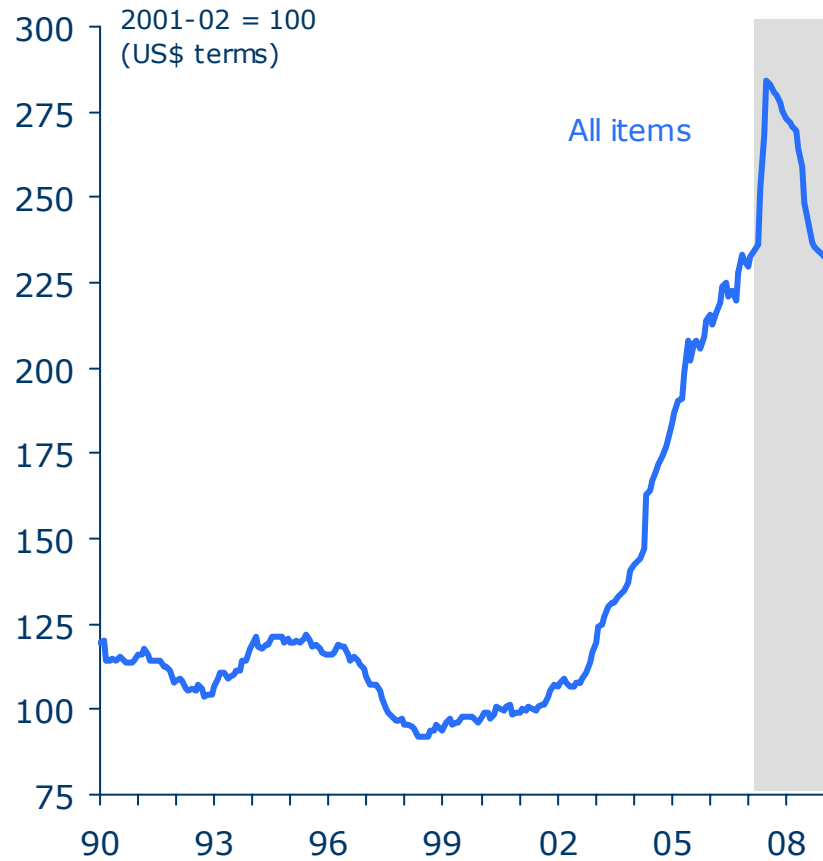


* CPI for urban non-manual workers. Sources: India Department of Statistics; CEIC; Thomson Financial.



Apart from coal and iron ore, Australian export commodity prices will ease in 2008 and 2009

Australian export commodity prices



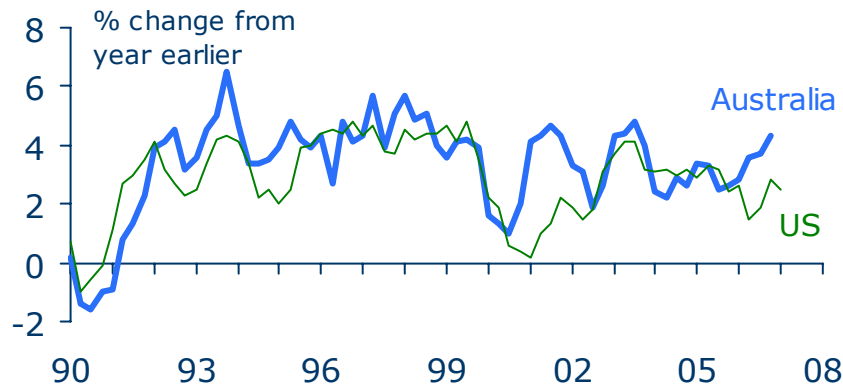
Sources: Reserve Bank of Australia; ANZ.



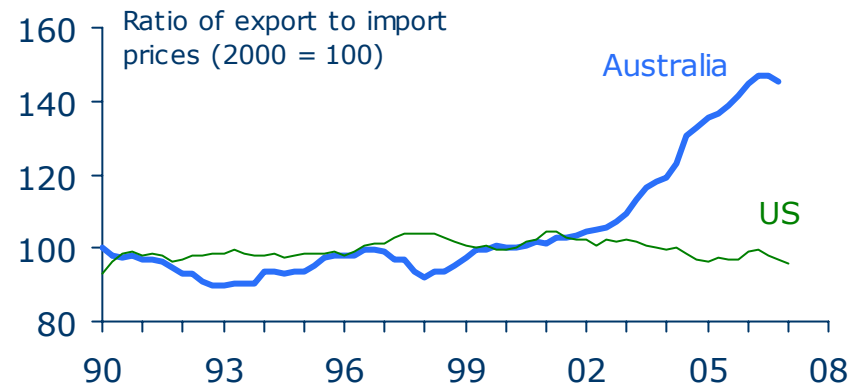
Australian and US economic cycles have not been closely correlated this decade, and are diverging further now

Australian and US economic indicators

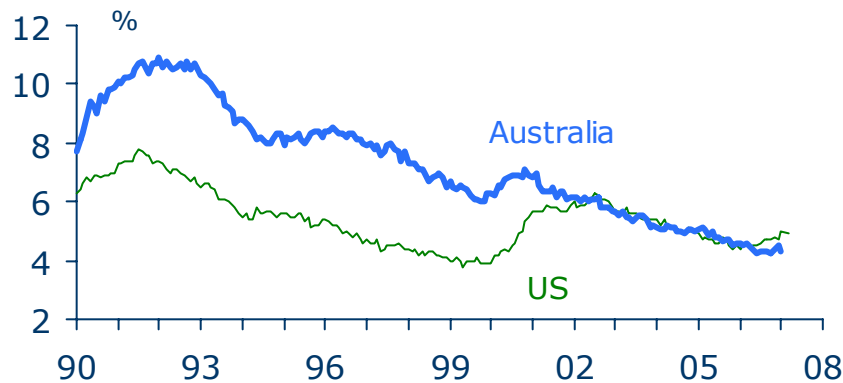
Real GDP growth



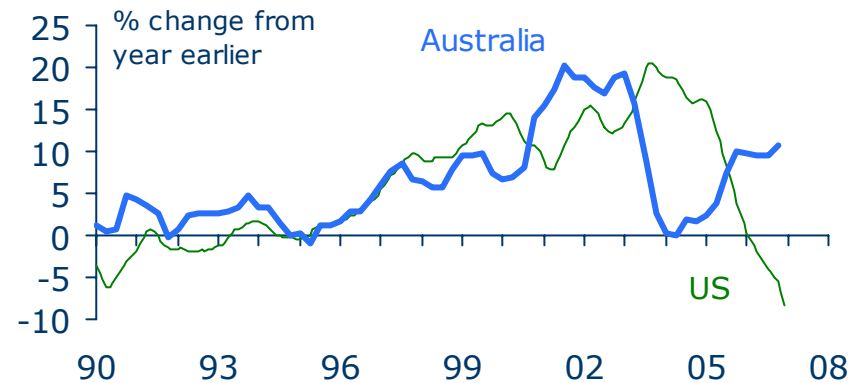
Terms of trade



Unemployment



House prices



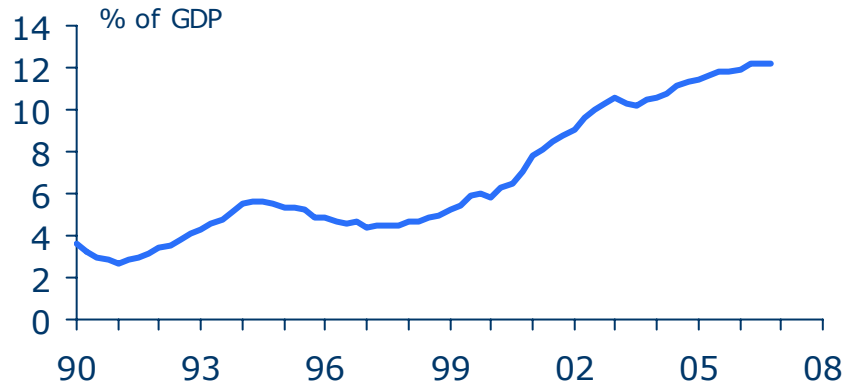
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; US Bureau of Labor Statistics; S&P.



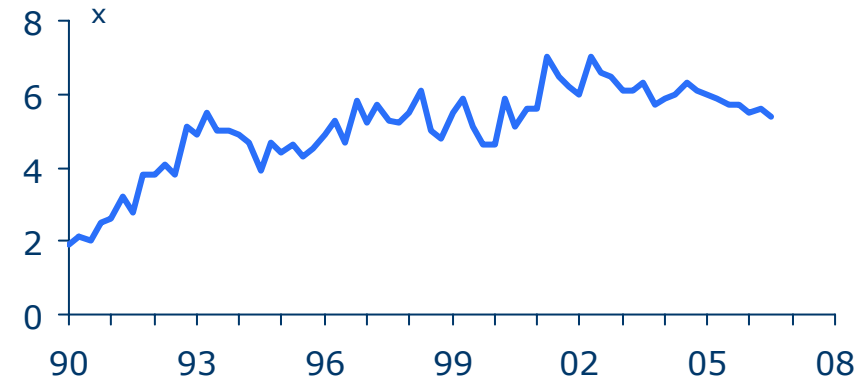
Australian corporate sector profits and balance sheets are (in aggregate) very strong

Australian corporate sector income, balance sheet and sentiment

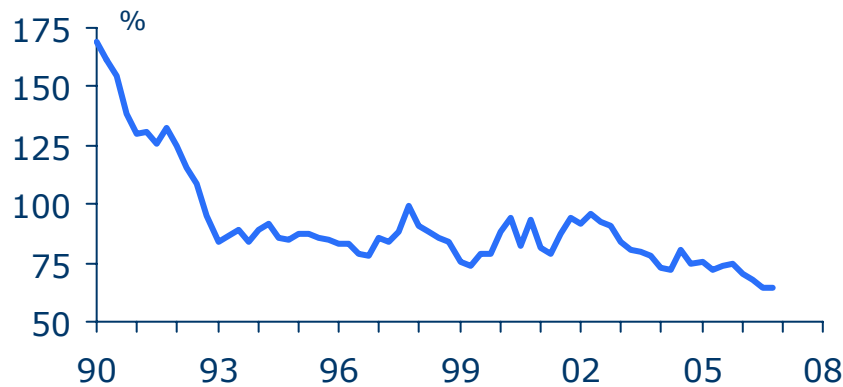
Non-financial sector profits



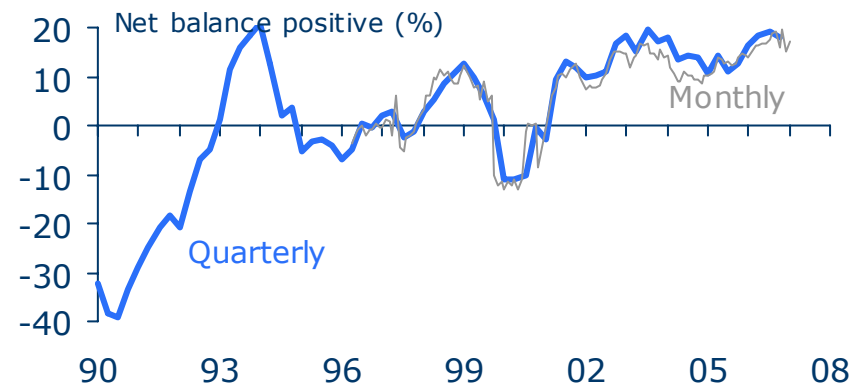
Interest cover ratio



Debt-equity ratio



'Business conditions'

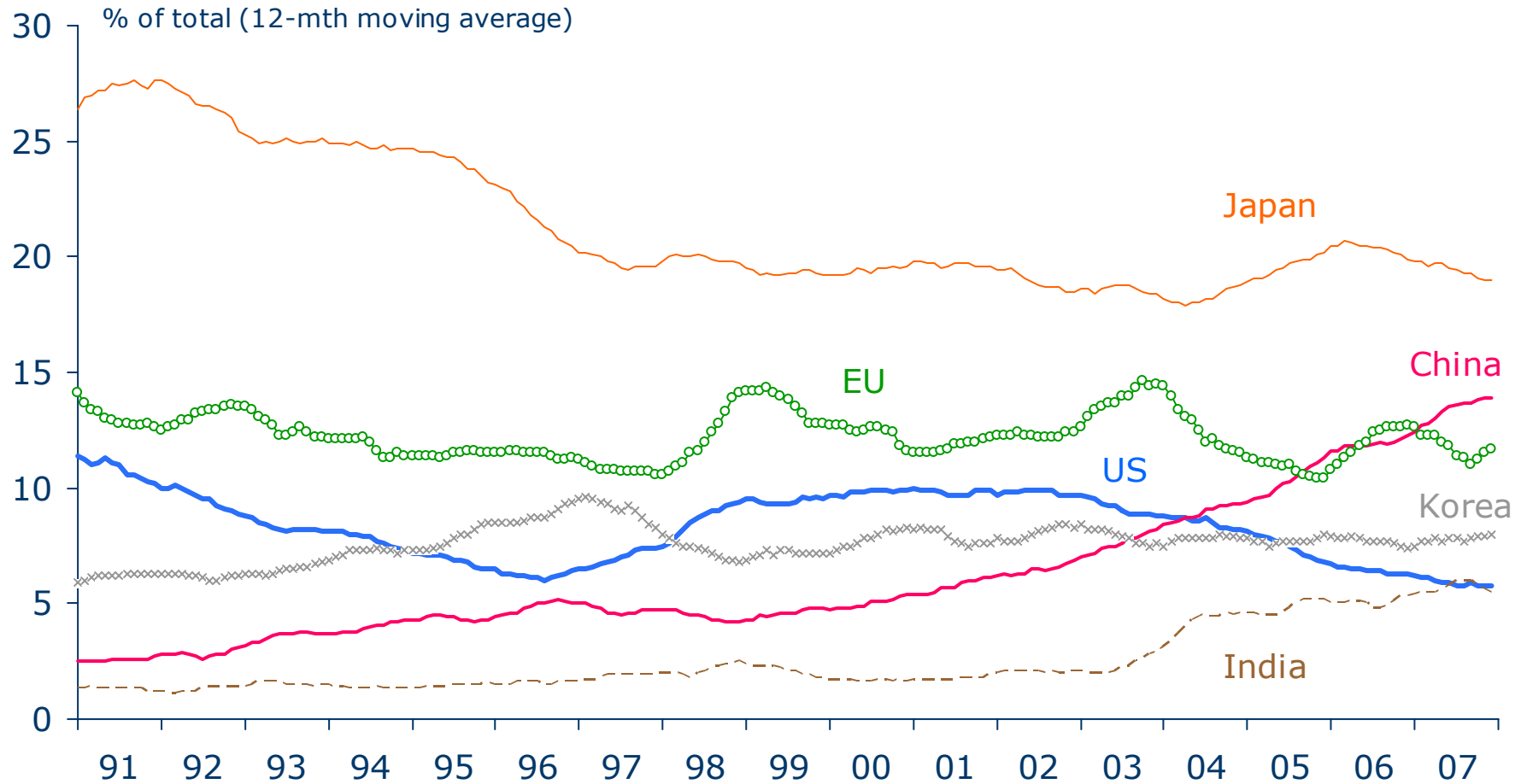


Sources: Australian Bureau of Statistics; ANZ; nab.



The US now accounts for less than 6% of Australia's exports – less than China, Korea or even India

Australia's major export markets

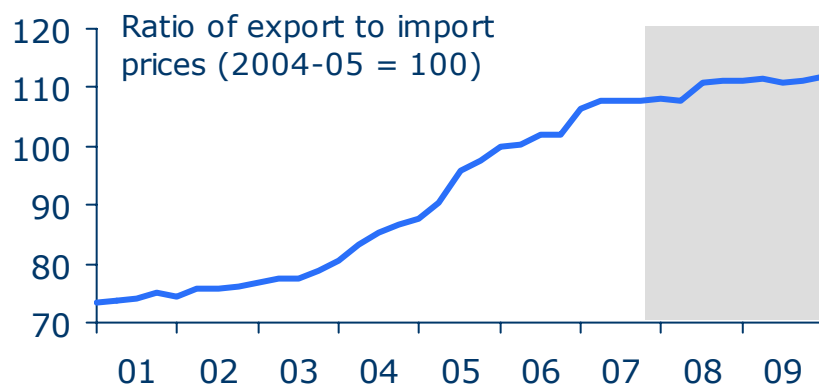


Sources: Australian Bureau of Statistics.

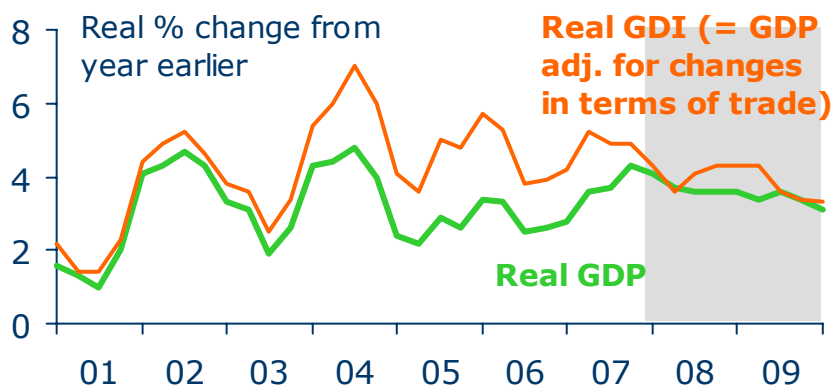


Higher commodity prices and other 'terms of trade' gains have boosted Australia's income by over 1% per annum

Australia's "terms of trade"



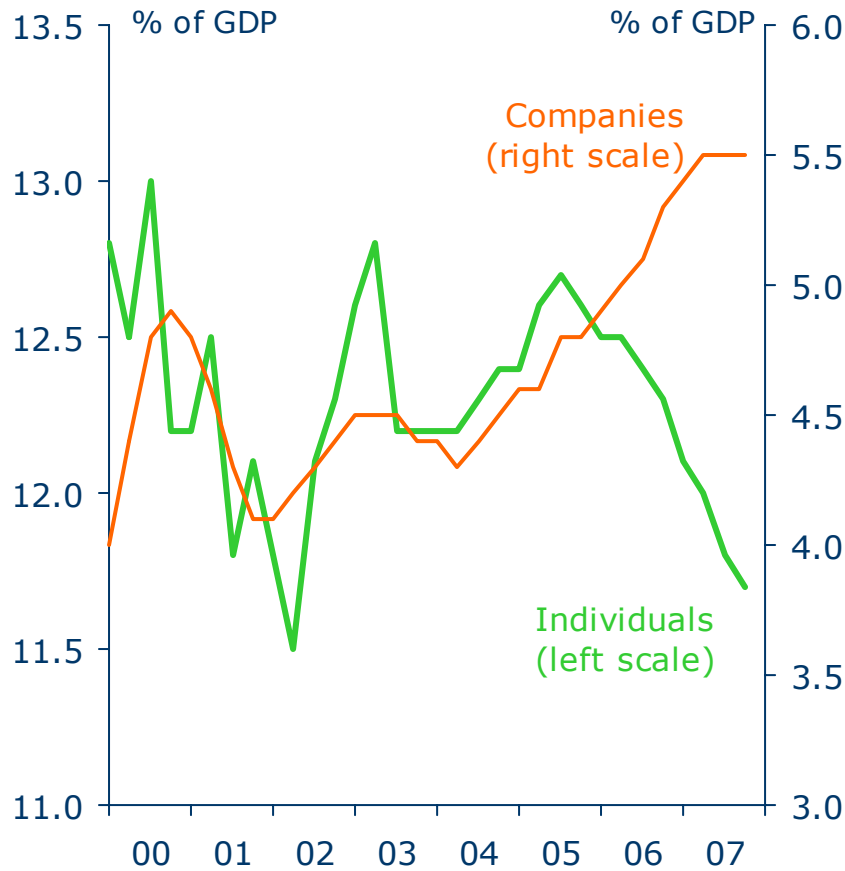
Australia's gross domestic product and income



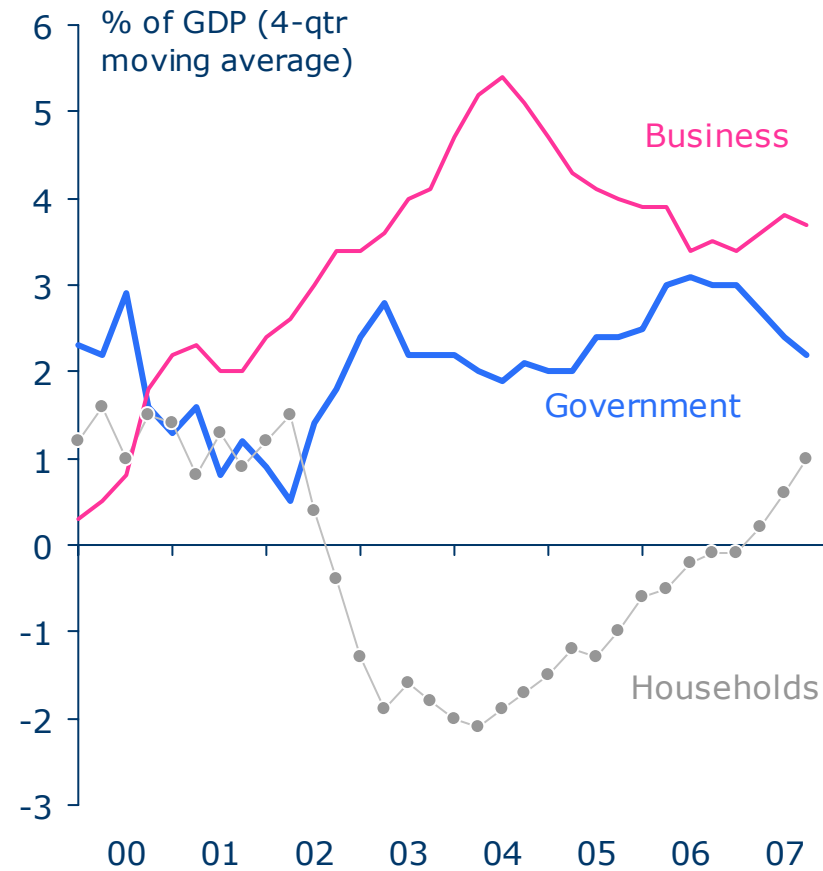
- Australia's 'terms of trade' have improved by over 50% so far this decade, boosting income relative to output by over 1% pa (or by 11% in total)
- 'Terms of trade' gains have been spread broadly across the Australian community through repeated rounds of personal income tax cuts (financed in part by higher tax revenues from mining companies) – which have in turn boosted household spending (and largely offset the impact of rising interest rates)
- This boost to Australian incomes is likely to peak in mid-2008 but seems unlikely to unwind substantially before the end of the decade

Personal tax cuts financed by windfall business tax revenues have boosted overall spending

Australian income tax collections



Net saving by sectors of the Australian economy



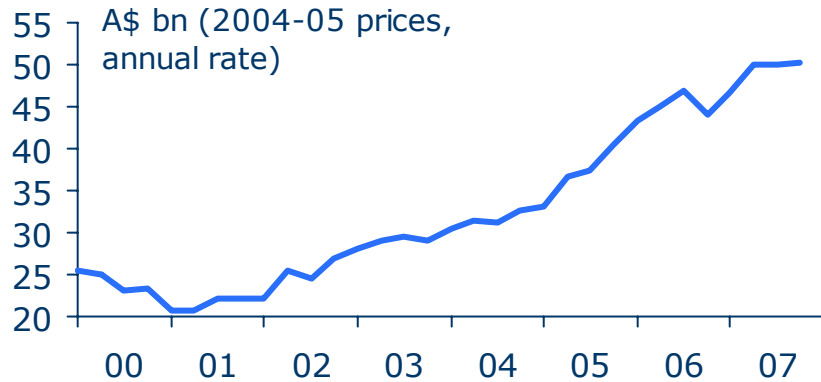
Sources: Australian Bureau of Statistics; ANZ.



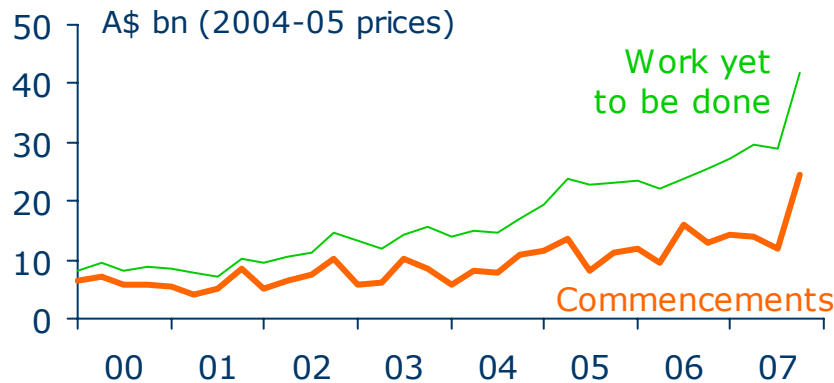
The mining boom and efforts to alleviate infrastructure bottlenecks have prompted a surge in non-residential construction

Engineering construction

Real value of work done

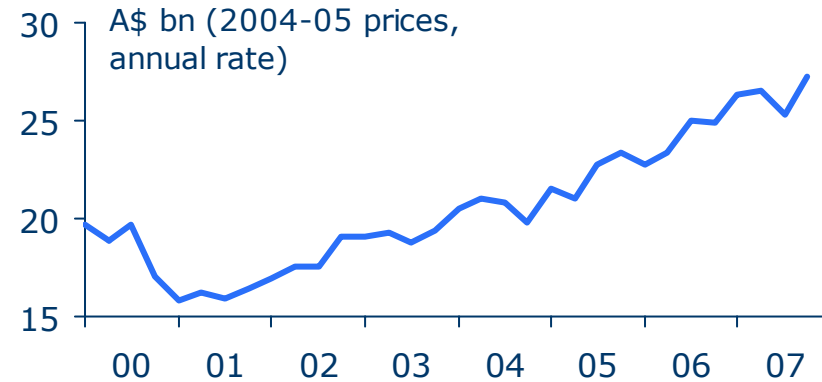


Commencements and backlog of work yet to be done

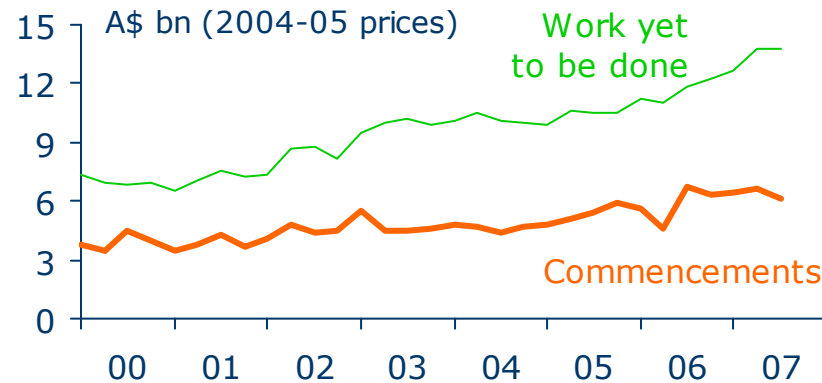


Non-residential building

Real value of work done



Commencements and backlog of work yet to be done



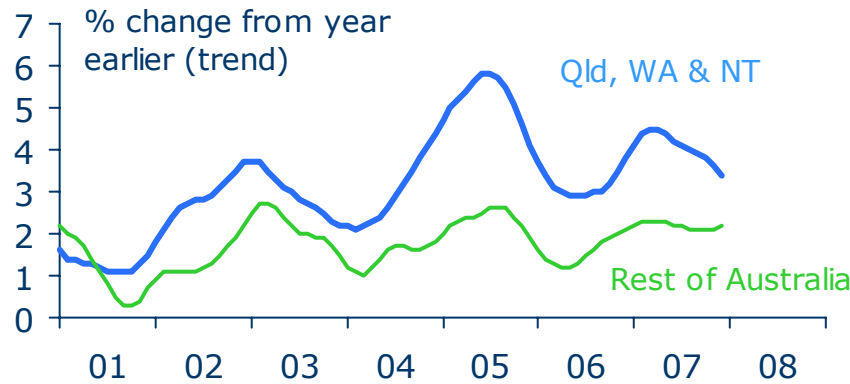
Sources: Australian Bureau of Statistics; ANZ.



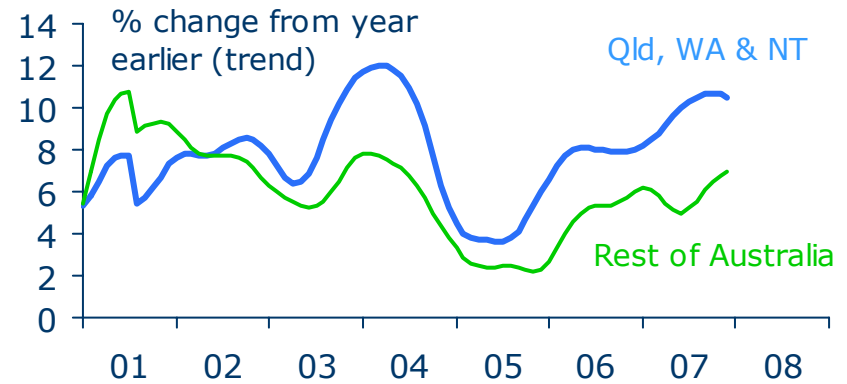
The mining boom continues to benefit Queensland, WA and the Northern Territory more than the south-eastern States

Resource-rich vs other States and Territories

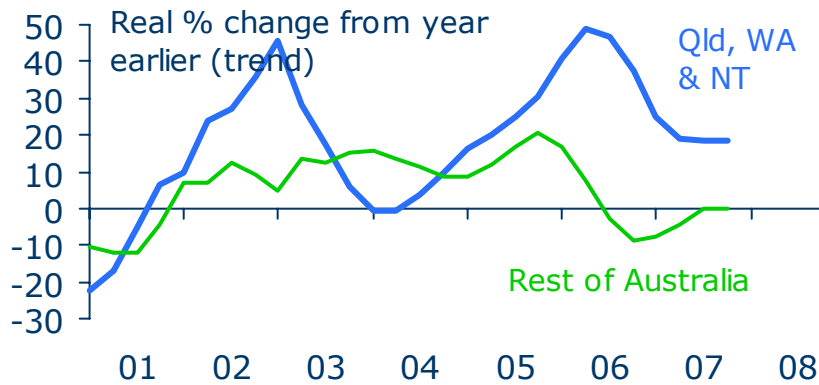
Employment



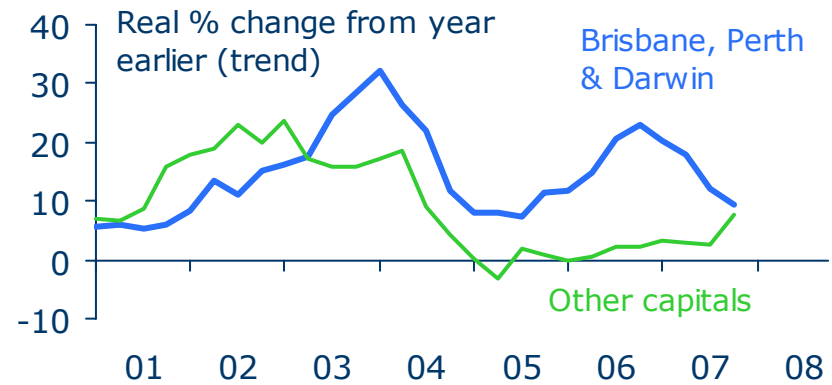
Retail sales



Engineering construction work



House prices



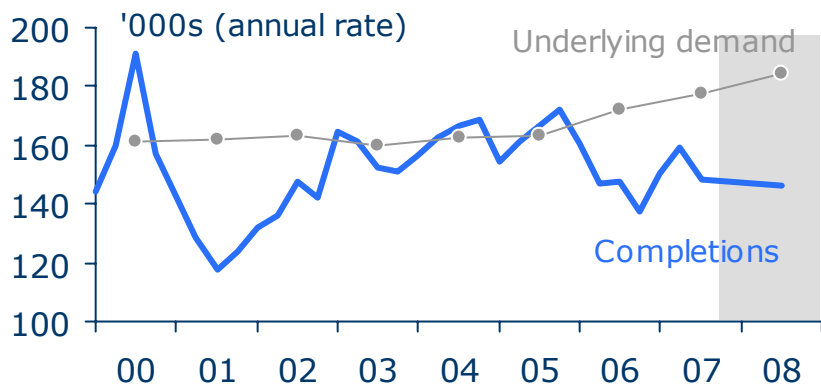
Sources: Australian Bureau of Statistics; ANZ.



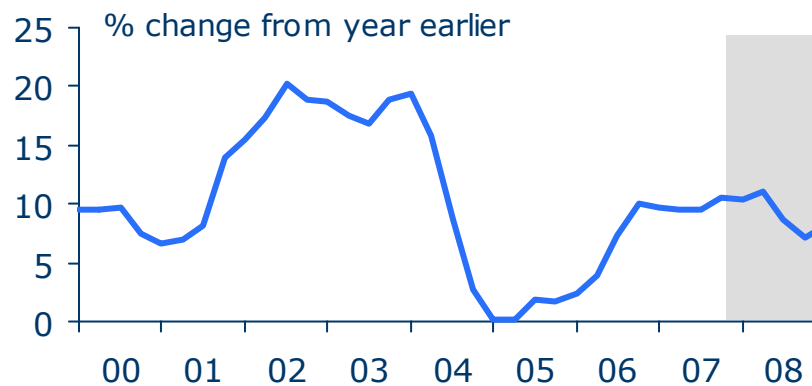
Housing is also in short supply, putting upward pressure on prices and rents

Australian housing market fundamentals

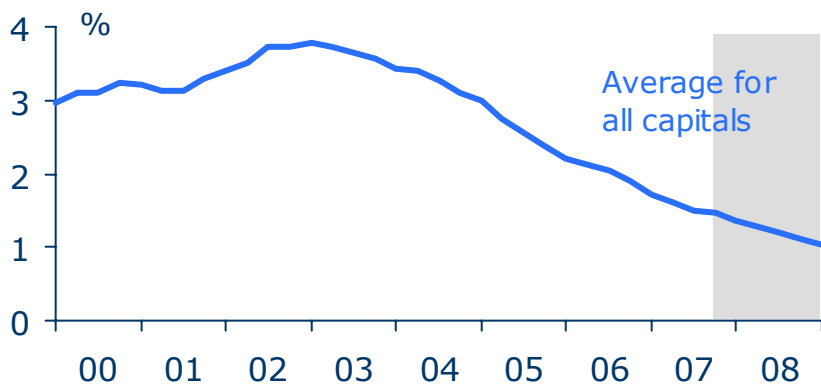
Housing supply and demand



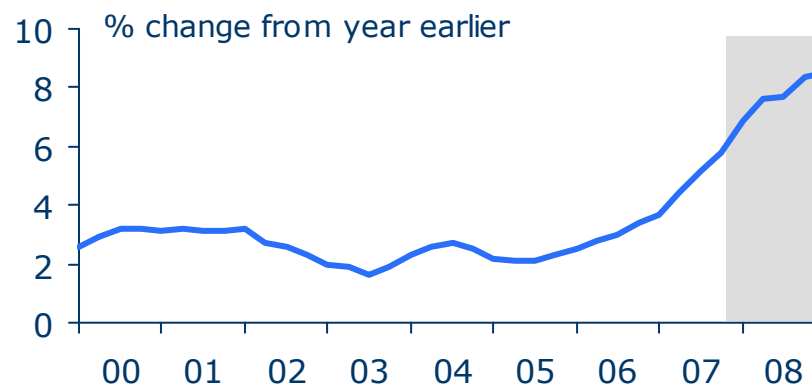
Capital city house prices



Rental vacancy rates



Capital city dwelling rents



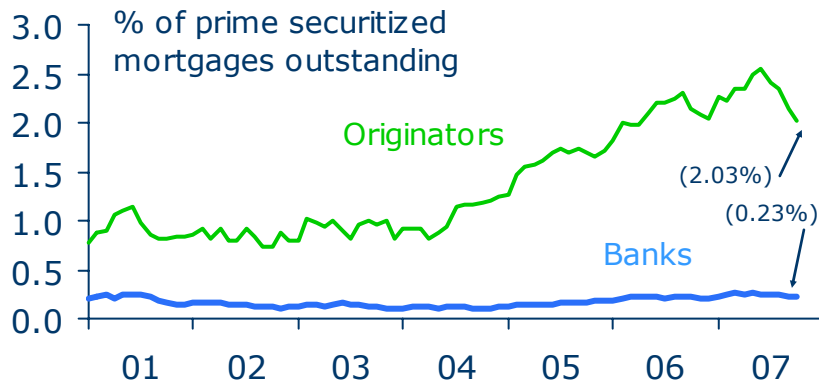
Sources: Australian Bureau of Statistics; Real Estate Institute of Australia; ANZ.



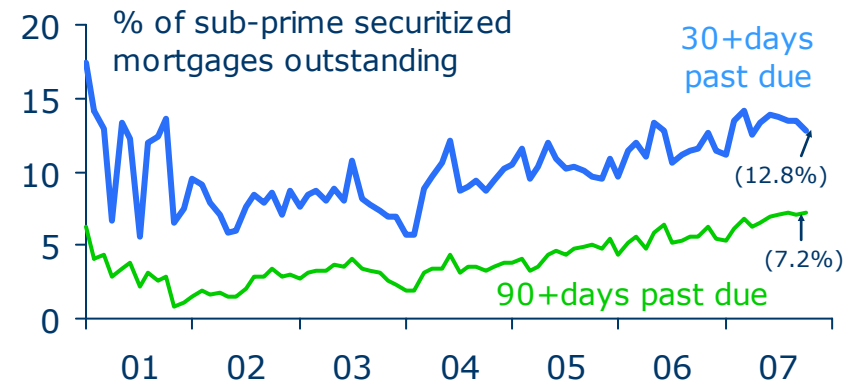
Although mortgage delinquencies have been rising, they remain very low by international standards 36

Mortgage delinquency rates

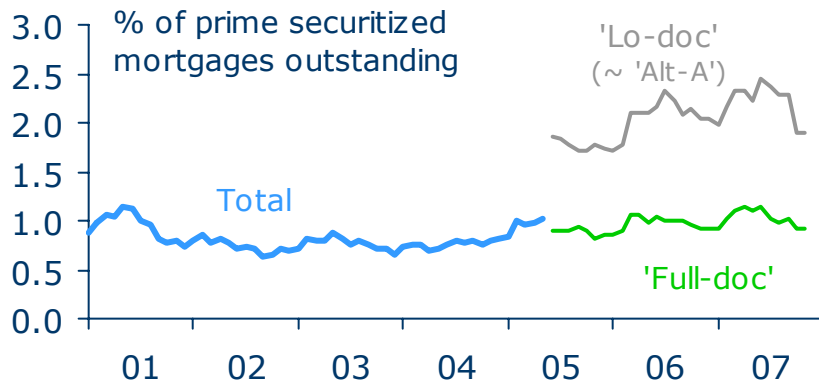
**Prime securitized mortgages
30 days + past due, by lender**



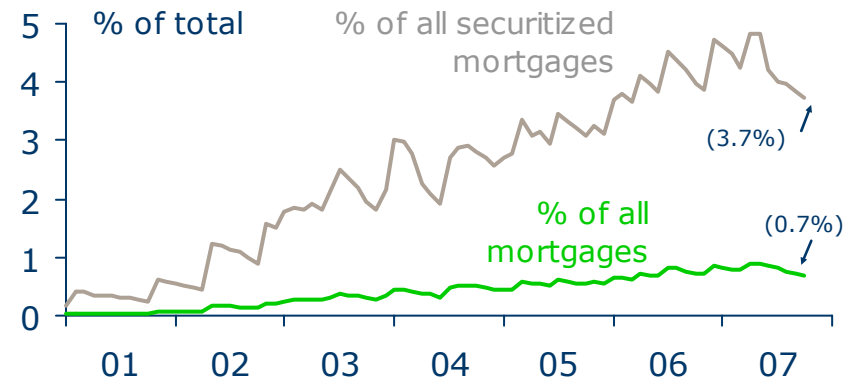
**Sub-prime securitized mortgages
30 days + past due**



**Prime securitized mortgages
30 days + past due, by type of loan**



Sub-prime mortgages as a pc of total mortgages



Sources: S&P.



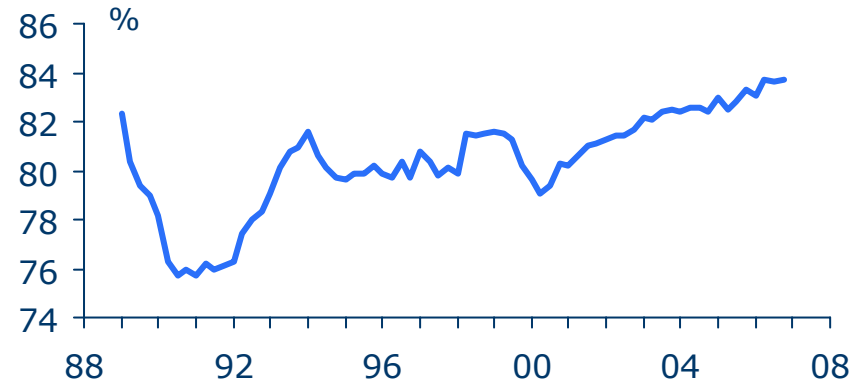
After more than 16 years of continuous economic growth, Australia's economy has run into serious capacity constraints

Indicators of 'spare capacity' in the Australian economy

Unemployed persons per job vacancy



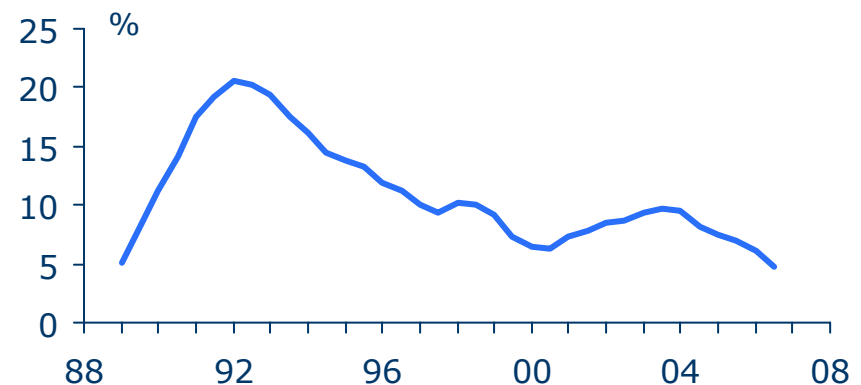
Capacity utilization rate



Businesses reporting labour shortages



Office vacancy rates

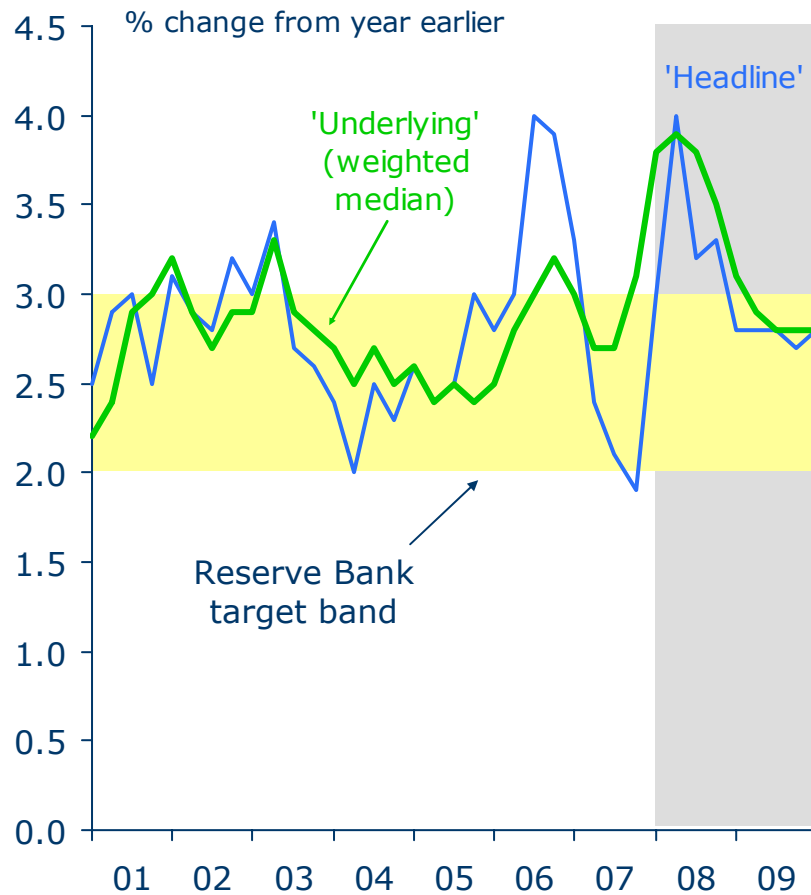


Sources: Australian Bureau of Statistics; nab; Property Council of Australia.

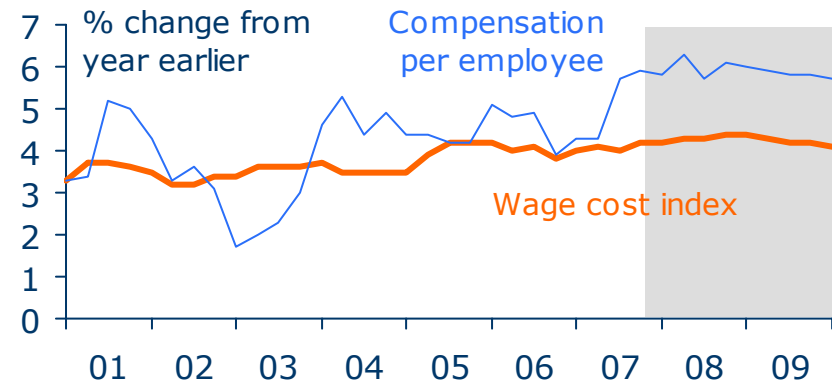


Rising inflation (reflecting demand growth in excess of supply potential as well as global factors) is the major macro concern

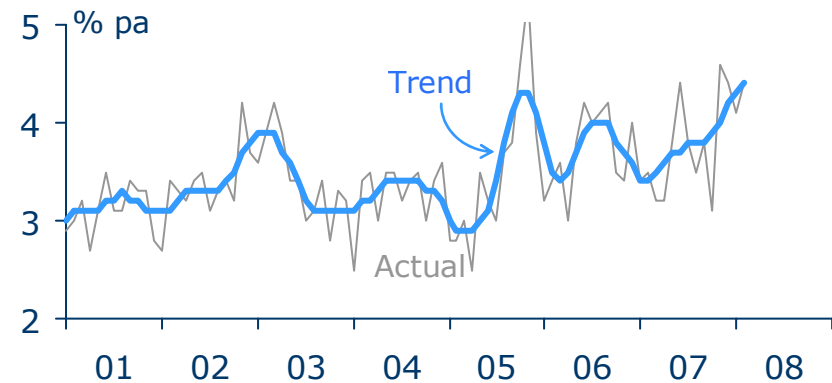
Consumer prices



Measures of labour costs



Household inflation expectations



Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Westpac-Melbourne Institute; ANZ.



By contrast with the 1990s, Australian productivity growth during the current decade has been very poor

Labour productivity growth



Australian labour productivity as a p.c. of US level

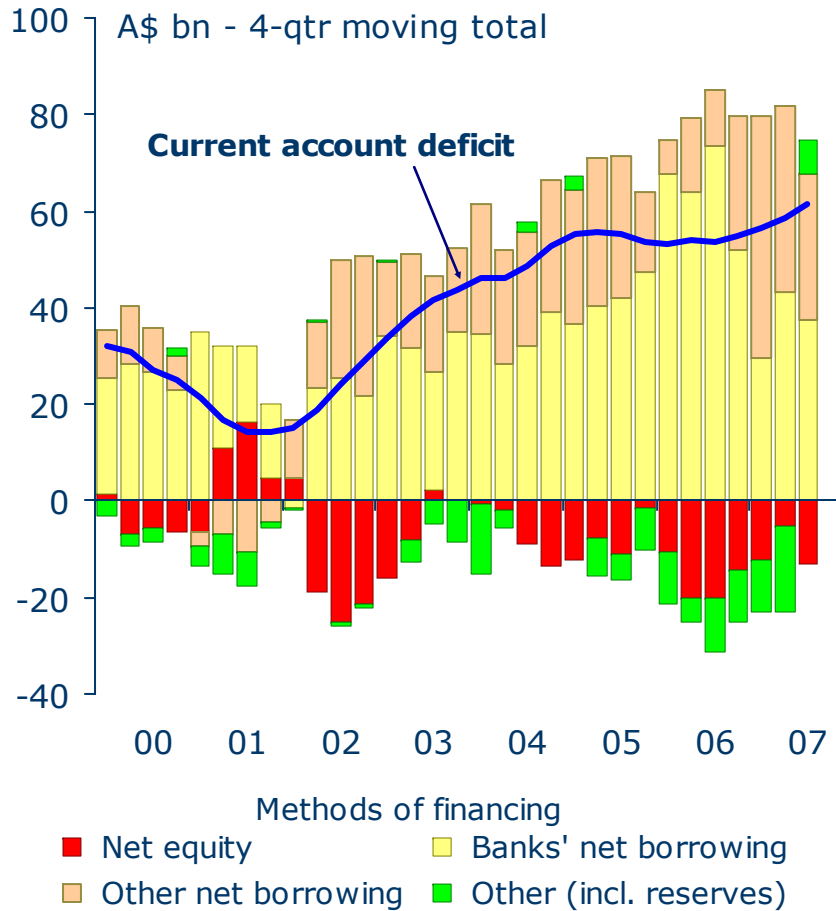


Sources: Australian Bureau of Statistics; The Conference Board and Groningen Growth & Development Centre Total Economy Database January 2008.

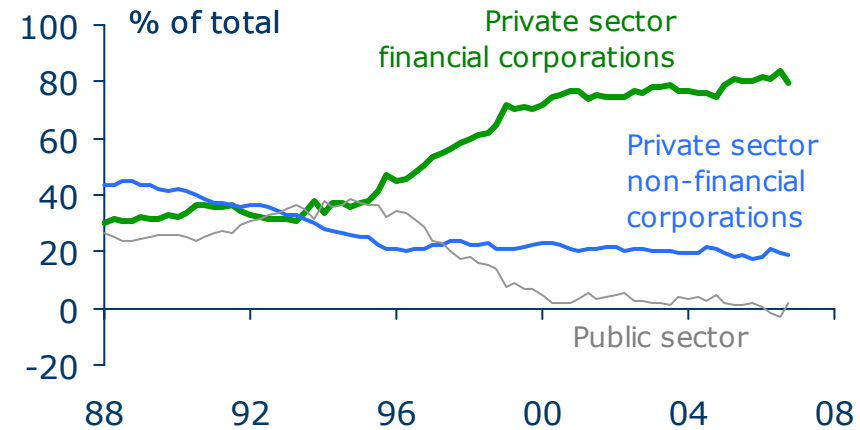


Reliance on banks' overseas borrowings to finance the deficit leaves Australia exposed to abrupt shifts in global markets

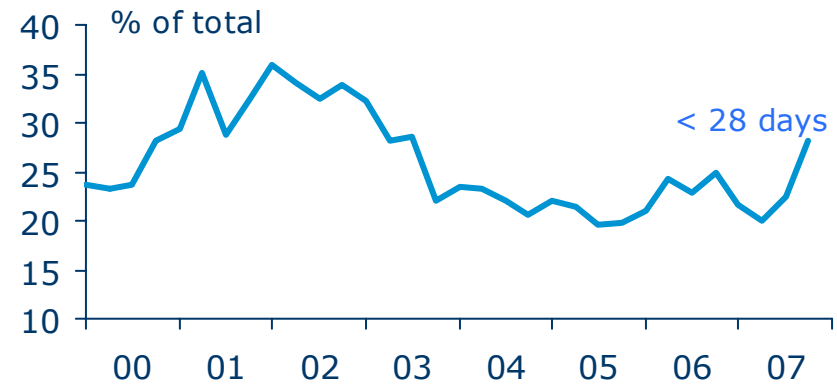
Financing Australia's current account deficit



Net foreign debt, by borrower



Maturity structure of net foreign debt

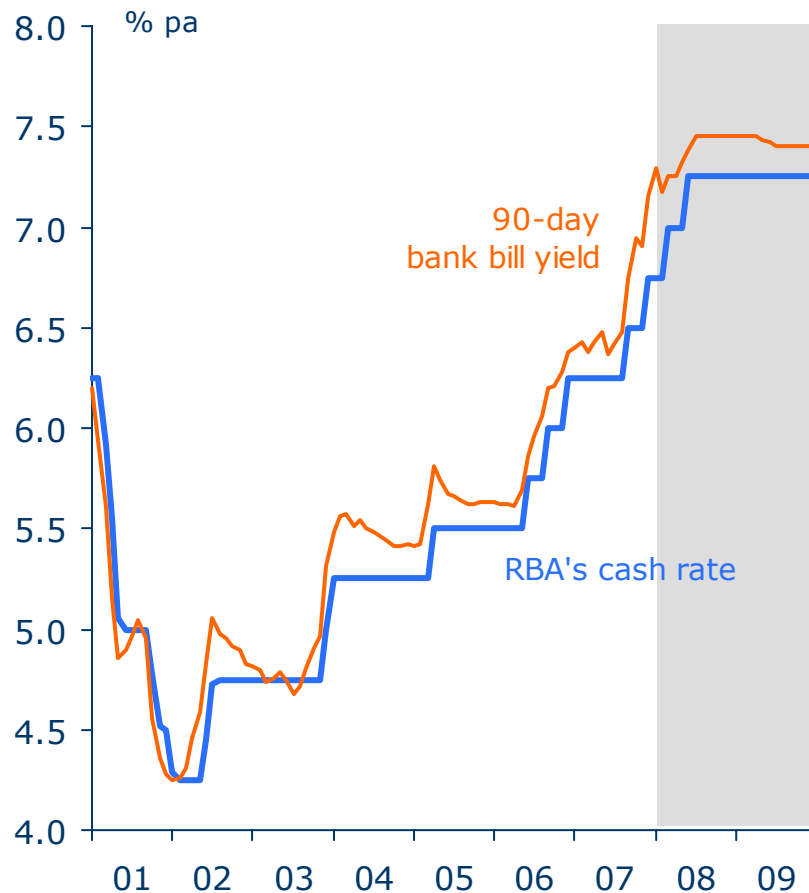


Sources: Australian Bureau of Statistics; ANZ.



Reserve Bank will likely need to tighten monetary policy further in order to ensure inflation returns to the 2-3% band 41

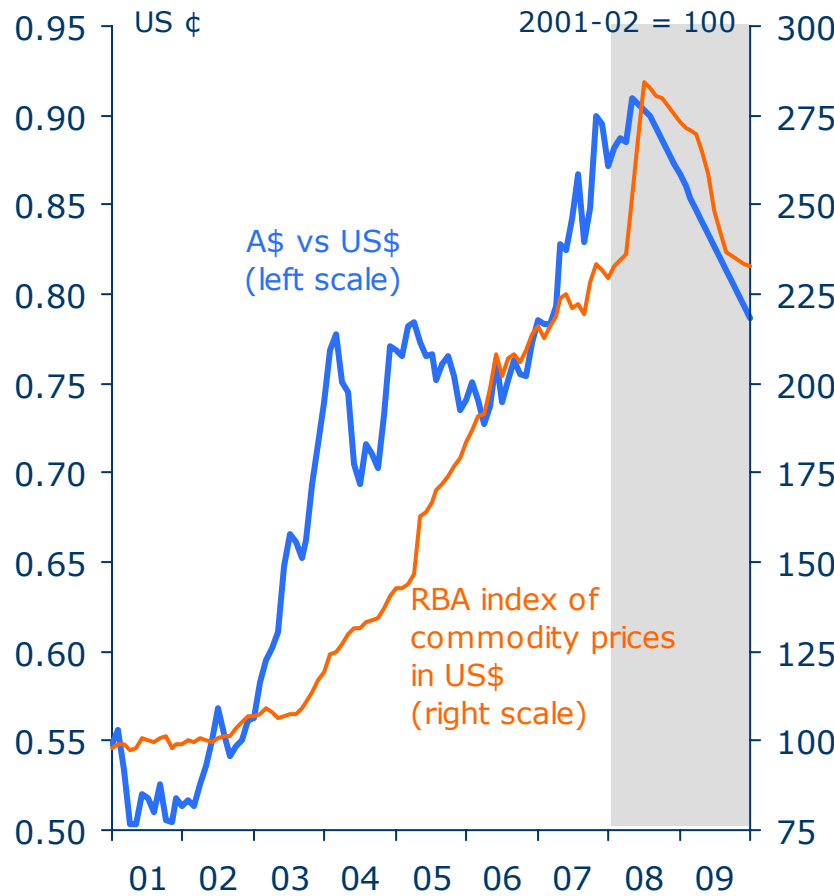
Short-term interest rates



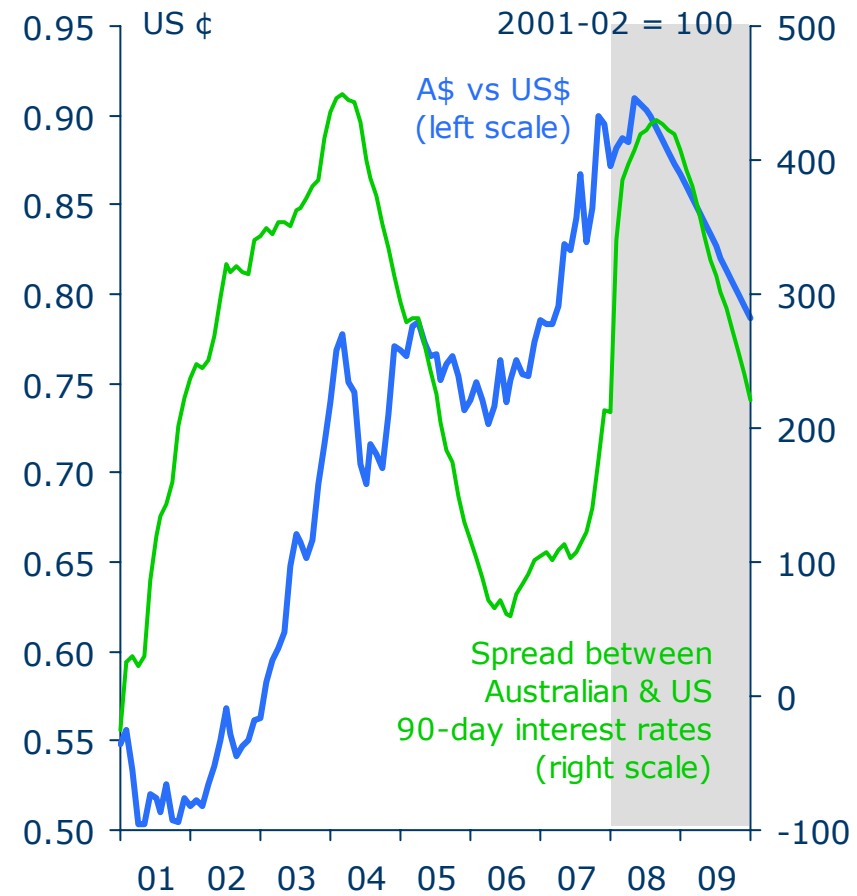
- 10 interest rate increases since mid-2002 have had little lasting impact in restraining growth in domestic demand – largely because they've been offset by commodity-related income gains, repeated rounds of tax cuts etc.
- The RBA does not appear to be greatly concerned about near-term downside risks to Australian growth from higher borrowing costs as a result of global financial turmoil, global effects of weaker US growth or intangible confidence effects
- Although the new Government has committed to running a tighter fiscal policy than its predecessor, that will make little difference in the short term to deliberations over monetary policy

Commodity prices and interest rate spreads likely to continue supporting the A\$ until mid-2008

A\$ and commodity prices



A\$ and interest rate spreads



Sources: Thomson Financial; Reserve Bank of Australia; ANZ.



The new Government has made a promising start although there are lot of policy details to be filled in

What the new Government has already done

- Further strengthened the independence of the Reserve Bank (by reducing the scope for political interference in appointment of Board members and termination of senior executives)
- Foreshadowed a Budget surplus target of 1½% of GDP, up from the previous Government's 1% (though that was usually exceeded)
- Foreshadowed longer-term strategies to address skilled labour shortages and infrastructure bottlenecks
- Ratified the Kyoto Protocol

What is still to come

- Detail of proposed industrial relations changes (abolishing statutory individual contracts, re-introducing 'unfair dismissals' laws but retaining much of the remainder of the previous Government's reforms)
- Specific measures to attain the Budget surplus objective
- Detail of policies to 'foster a culture of savings'
- Specific targets for greenhouse gas emission reductions and strategies for achieving them
- Reviews of specific industry policies (eg innovation, coastal shipping) - Productivity Commission excluded

Australian forecast summary

	Economic forecasts				
	2006	2007e	2008f	2009f	
Real GDP growth (%)	2.8	4	4	3½	
Unemployment rate (year-end, %)	4.6	4.4	4	4	
'Underlying' inflation (year-end, %)	3.0	3.6	3	2¾	
Housing starts ('000)	153	150	145	155	
Current account deficit (\$bn)	54.2	55	63	67	
	Financial market forecasts				
	Dec 07	Jun 08	Dec 08	Jun 09	Dec 09
US Fed funds rate (% pa)	4.25	2.25	2.00	3.25	4.25
RBA cash rate (% pa)	6.75	7.25	7.25	7.25	7.25
90-day bill yield (% pa)	7.25	7.50	7.50	7.40	7.40
10-year bond yield (% pa)	6.33	6.00	5.25	5.00	5.50
A\$-US\$	0.88	0.90	0.87	0.82	0.79
A\$-¥	98	98	91	89	88
A\$-€	0.60	0.60	0.61	0.61	0.62
Gold price (US\$ / oz)	807	920	780	710	670
Oil price (US\$ / barrel, WTI)	92	82	75	79	80