

Outlook for the economy

Presentation to
The Melbourne Institute and The Australian
2003 Economic and Social Outlook Conference
'Pursuing Opportunity and Prosperity'

Saul Eslake
Chief Economist
ANZ Bank

Melbourne
13 November 2003

E-mail: eslakes@anz.com
or economics@anz.com

Internet: <http://www.anz.com/go/economics>

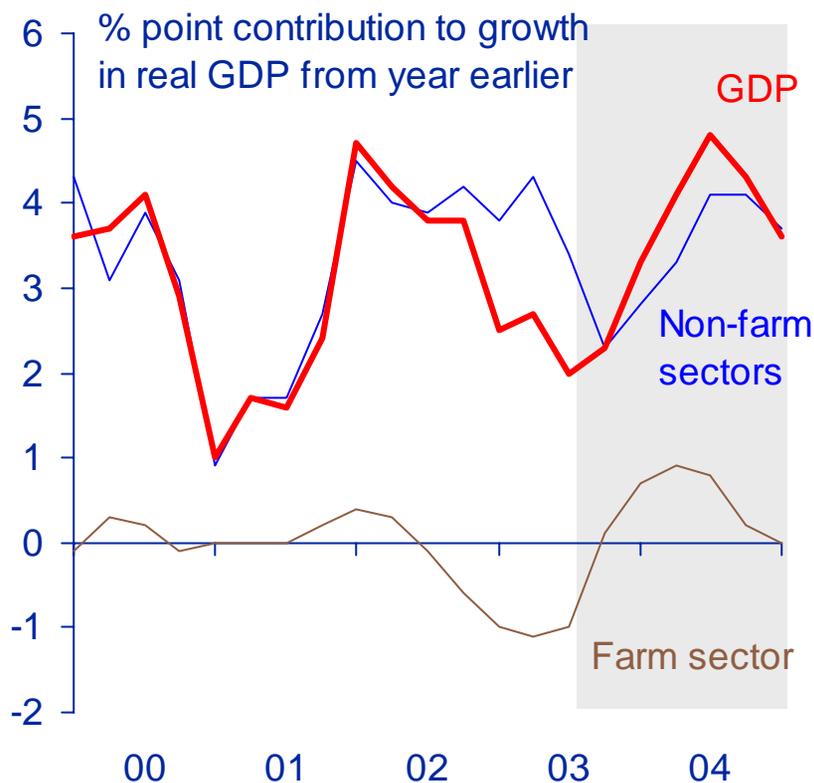
Summary of forecasts for the Australian economy

	2003	2004	2005
Real GDP (% change)	2½	4¼	3¼
Employment (% change)	2½	2½	1¾
Unemployment rate (% , Dec)	5¾	5¼	5½
Housing starts ('000)	163	168	153
Consumer prices (% change)	2	2	3¼
Current account deficit (\$bn)	-45	-39	-25
Official cash rate (% pa, Dec)	5¼	5½	4¾
10-year bond rate (% pa, Dec)	6¼	5¾	5½
Australian dollar (US¢, Dec)	72	69	65
A\$ TWI (May 1970 = 100, Dec)	62	59	57

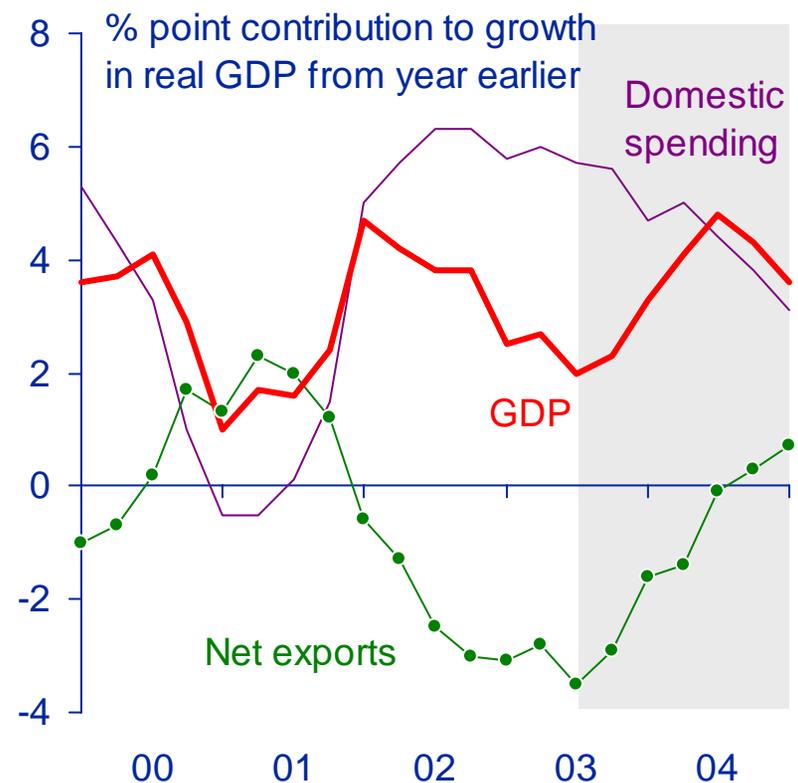
2002-03's growth detractors will turn into spurs – but domestic spending will slow

Sources of growth in the Australian economy

Farm vs non-farm



Domestic vs external



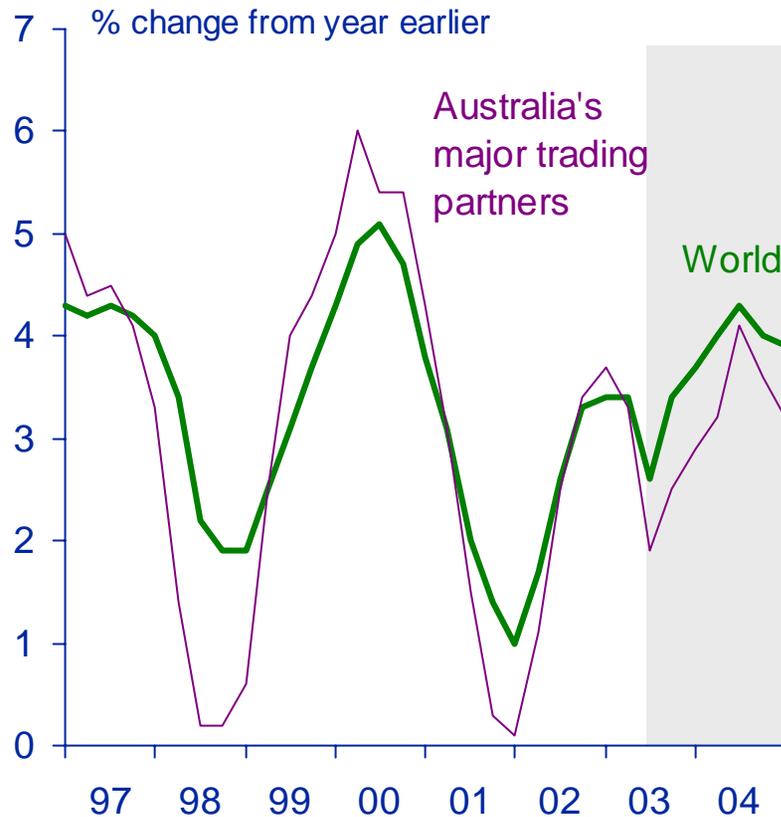
Sources: ABS; Economics@ANZ

Four major influences on the economic outlook

- **The international economic environment**
 - now clearly on the mend, but is the global recovery sustainable?
- **Tighter financial conditions**
 - no more ‘free ride’ from an undervalued exchange rate
 - rising interest rates – how far will they go?
- **The household debt/house prices issue**
 - is there really a ‘housing bubble’
 - if so how will it end?
 - what role if any should macro-economic policy play?
- **Capacity constraints**
 - how much spare capacity is there in the Australian economy?

The global economy has turned the corner, with 4% growth now a realistic prospect for 2004

Global economic growth



Sources: ABS; Economics@ANZ

Outlook for major economies

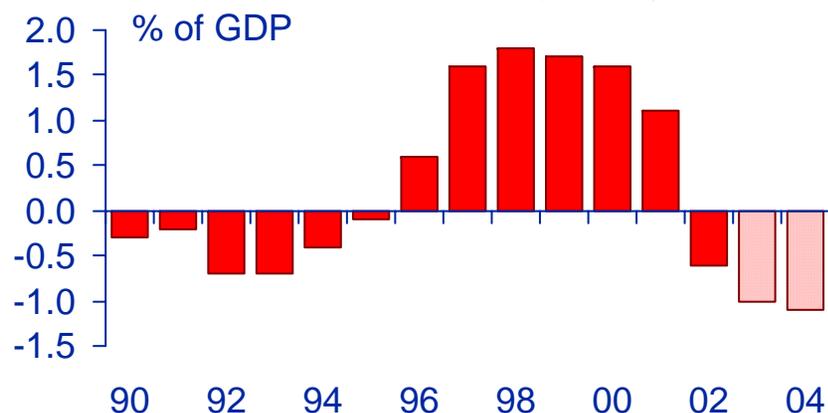
	Real GDP growth (%)		
	2002	2003	2004
US	2.4	3	4¼
EU	1.1	¾	2
Japan	0.2	2½	1¾
China	8.0	8	7½
Other East Asia	4.6	3½	5
World	2.8	3½	4

Global policy stimulus is 'kicking in' as growth-retarding 'headwinds' fade away

OECD monetary policy



OECD fiscal policy

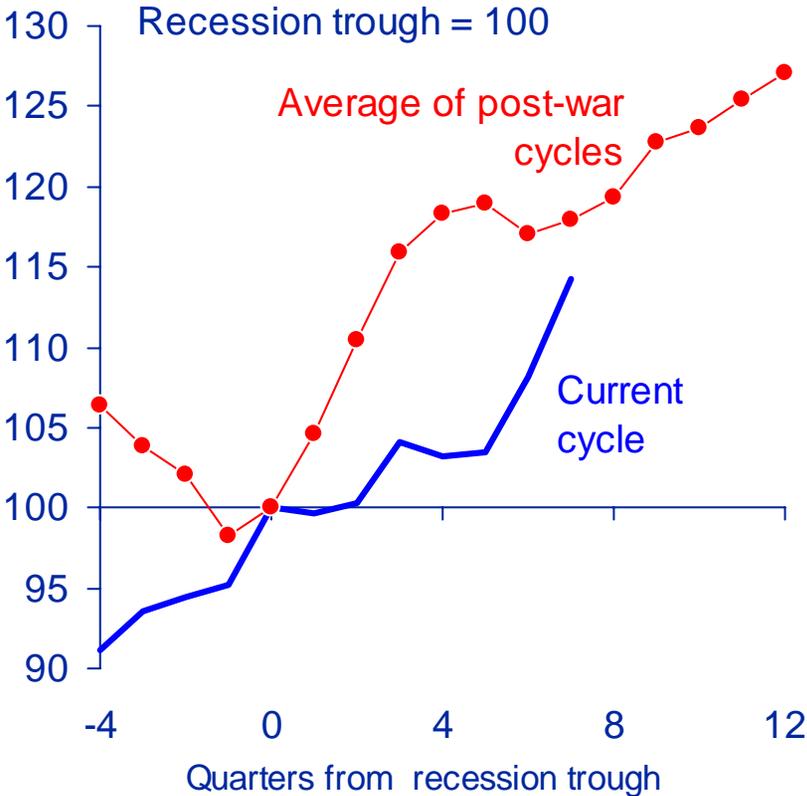


- Economic policy settings have for some time been much more stimulative than during the early 1990s global downturn
- For most of the past three years this stimulus has been blunted by a series of 'headwinds'
 - including geo-political tensions, falling share prices, high oil prices and SARS
 - additionally it has taken some time to purge excesses and imbalances built up during the 1990s boom
- Although they haven't gone away completely (and could flare up again), these headwinds have now eased enough to allow policy stimulus to come through

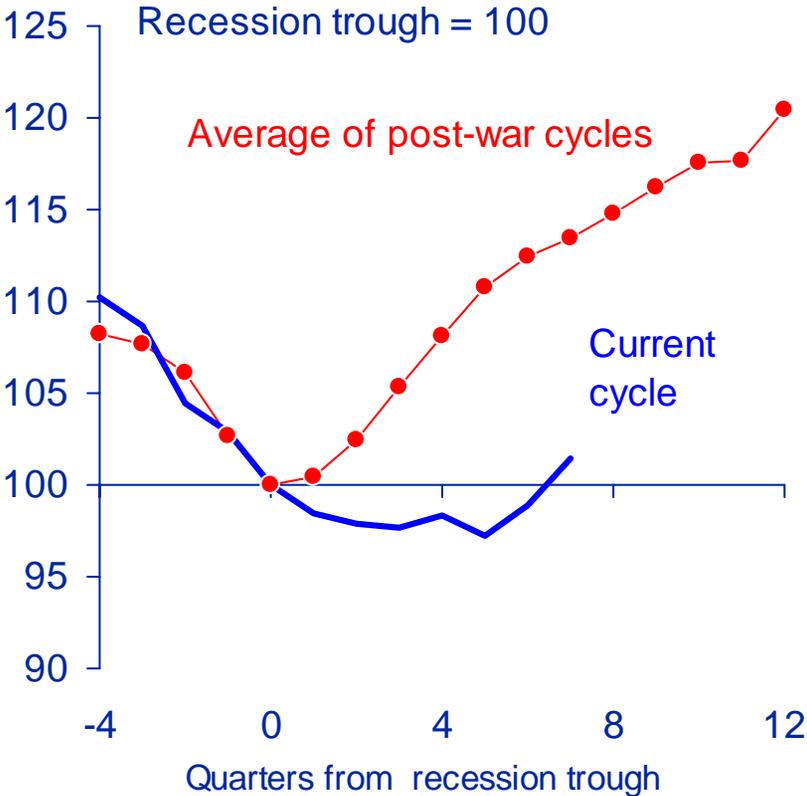
Note: 'Fiscal policy' measure is the cyclically-adjusted primary budget balance (ie excluding net interest payments). Sources: Datastream; OECD; Economics@ANZ.

The US recovery won't be as strong as suggested by the September quarter numbers

Consumer durables spending plus housing



Business investment

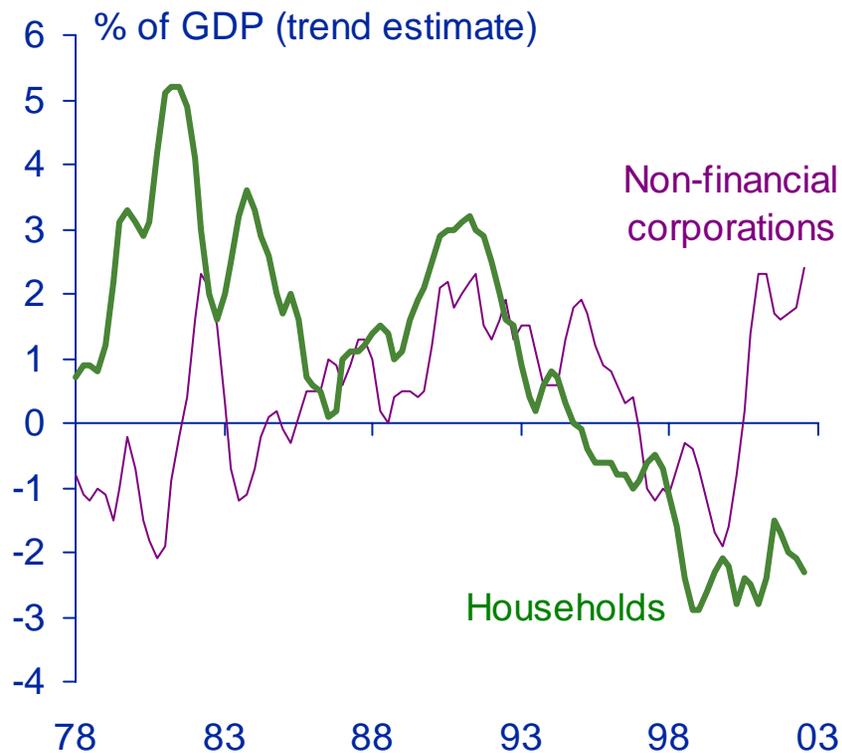


Note: recession troughs as dated by the National Bureau of Economic Research (eg., November 2001).
 Sources: US Bureau of Economic Analysis; Economics@ANZ.

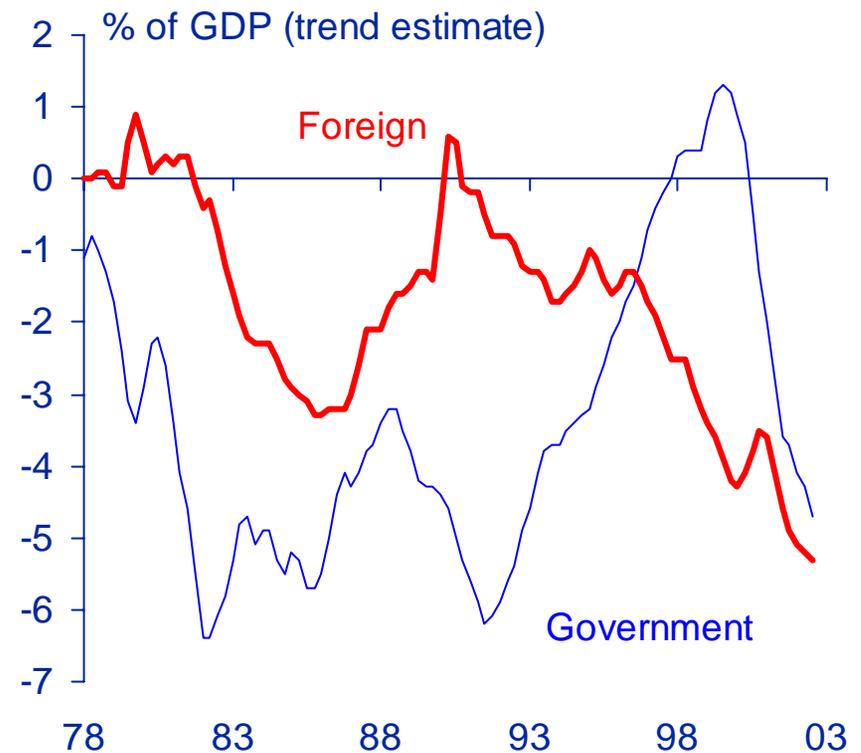
Large financial imbalances also argue against a strong recovery in US household spending

Financial balances

Private sector



Other sectors



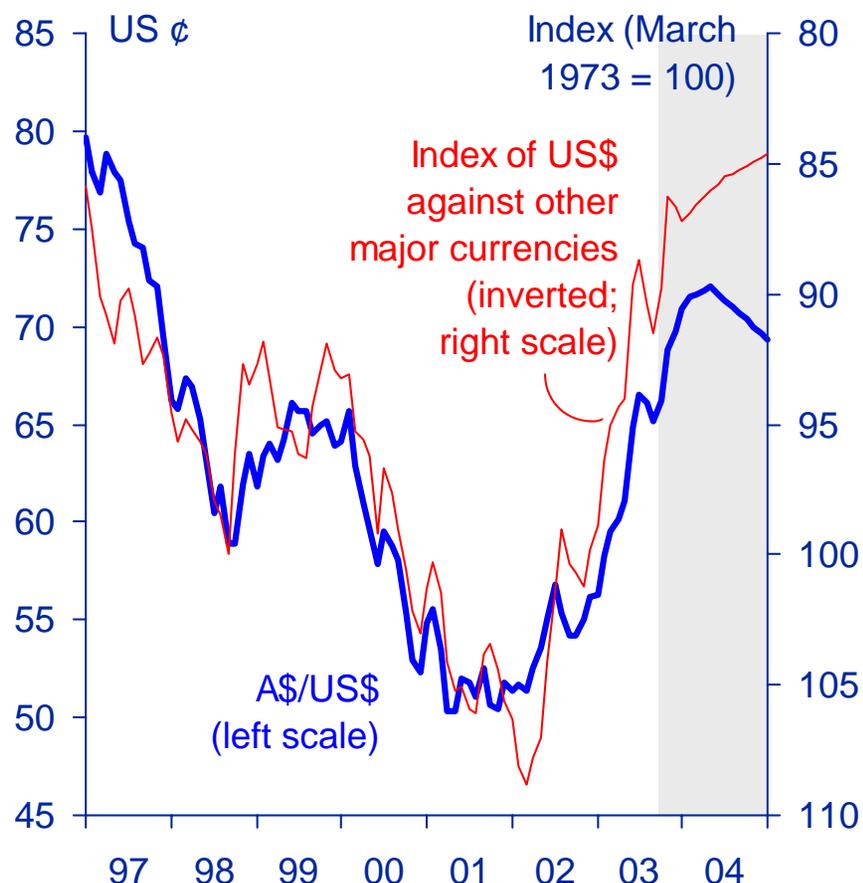
Note: Financial balances (or 'net lending') defined as saving minus investment; 'trend estimates' calculated using ABS formulae. Sources: US Bureau of Economic Analysis; Economics@ANZ.

Other medium-term risk issues in the global economy

- **How sustainable is the Japanese upturn?**
 - Japan is potentially a source of further ‘positive surprise’ near-term, but reforms to date have been piecemeal and half-hearted
- **Is China headed for a bust?**
 - China’s economy is beginning to show some signs of ‘over-heating’
 - efforts to dampen down ‘bubbles’ with administrative measures may not be successful
- **Will Europe ever assume its rightful role in the global economy?**
 - Germany and (to a lesser extent) France are attempting to implement far-reaching reforms
 - if these efforts fail Europe may continue to be a long-term drag on global economic growth
- **Can the Doha Round of trade negotiations be revived?**
 - or will protectionist pressures continue to build?
- **How much further will the US\$ fall?**
 - could a more rapid decline in the US\$ snuff out recovery in the US, Japan and Europe

A\$ strength is largely though not totally a function of US\$ weakness

A\$ vs US\$

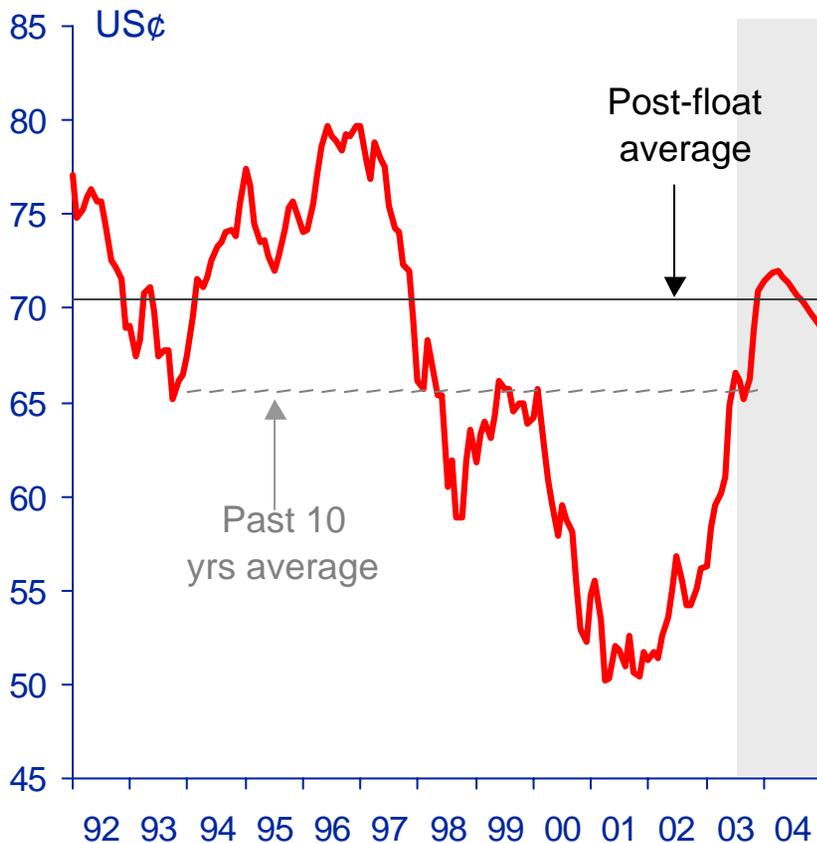


Sources: Datastream; Economics@ANZ

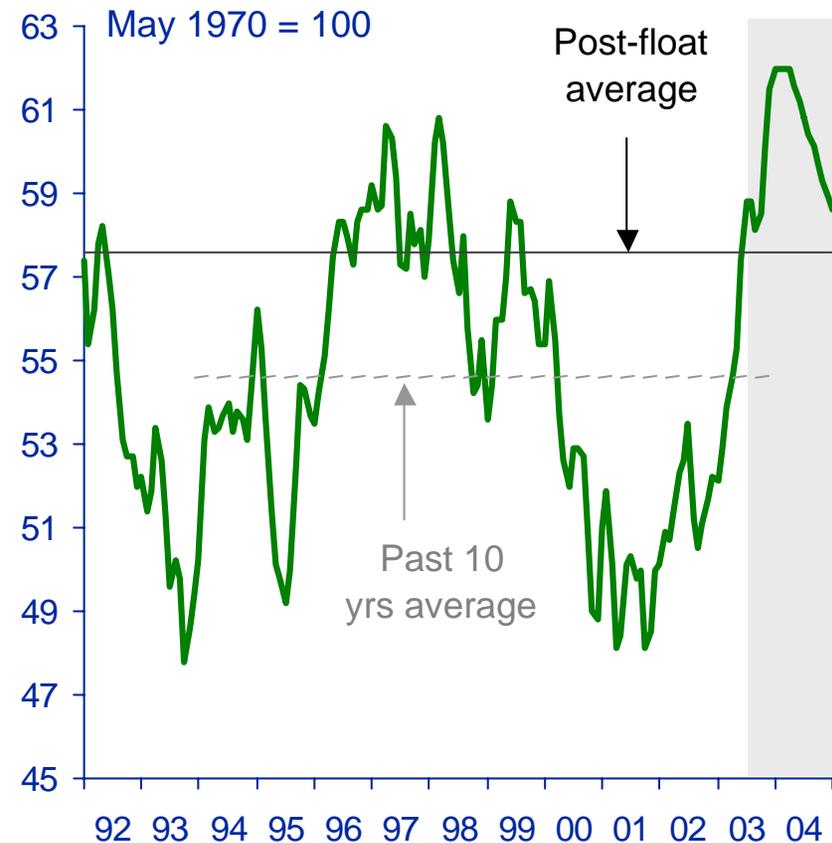
- The rise in the A\$ since mid-2001 largely reflects the 18% decline in the US\$ (against major currencies) over this period ...
- ... re-inforced by rising commodity prices and a widening spread between Australian and offshore interest rates
- We expect the A\$ to peak around US72-73¢ in Q2 2004, and then to ease back as offshore interest rates begin rising, and commodity prices 'top out'
- However if the US\$ continued to fall sharply, say to ¥100 and €1.25, the A\$ could easily surpass US75¢

The Australian economy will no longer be getting any 'wind assistance' from an undervalued A\$

A\$ vs US\$



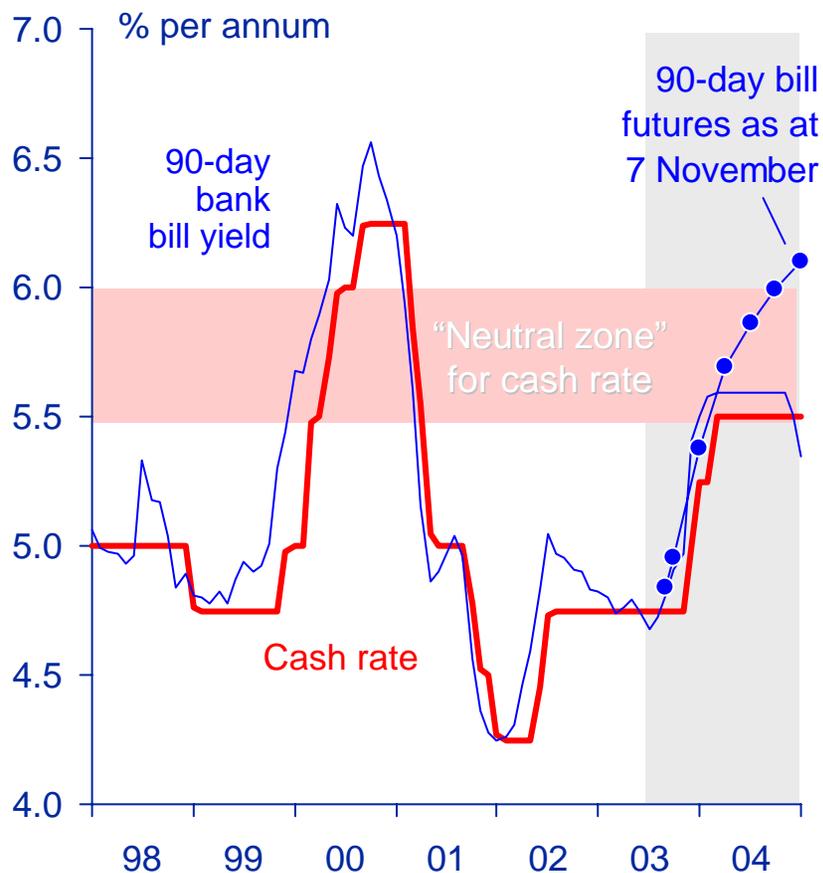
Trade-weighted value of A\$



Sources: Reserve Bank of Australia; Economics@ANZ.

Monetary policy is moving back to 'neutral' – so no 'wind assistance' from interest rates either

Short-term interest rates

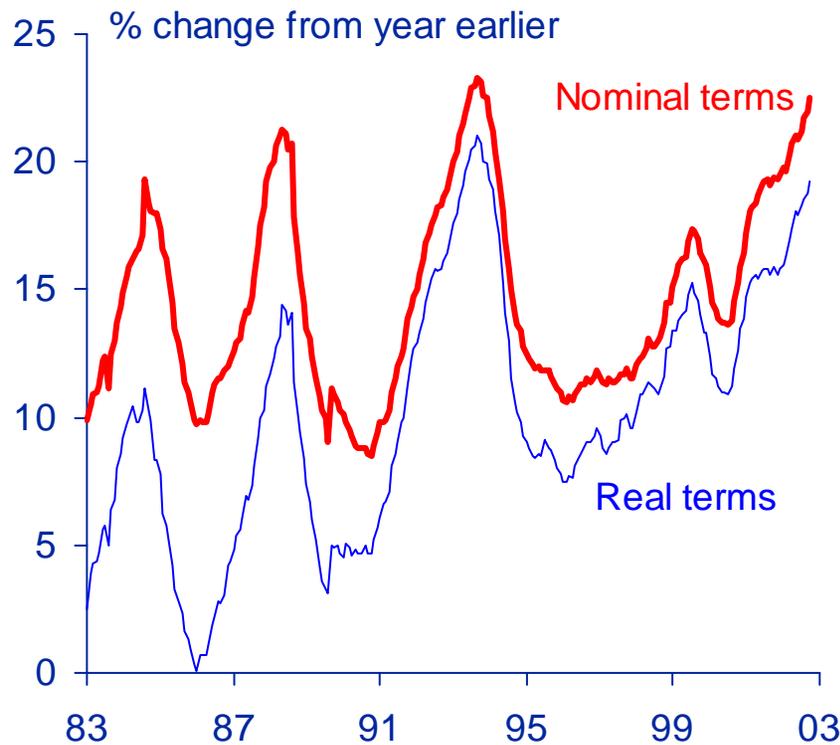


Sources: Reuters; Economics@ANZ.

- The Reserve Bank began moving monetary policy back to 'neutral' (cash rate of 5½-6%) in mid-2002 ...
- ... but was forced to shelve that intention by the renewed global downturn and the drought
- With both of those constraints now easing, the Bank is reverting to 'Plan A' – which means a cash rate of 5½% by Q2 2004 unless another economic shock intervenes
- The Reserve Bank is not targeting house prices, nor is it trying to slow the economy down
- Rather, it is seeking to prolong the expansion by minimizing (as far as it can with the tools available) the risks associated with unsustainably rapid credit growth

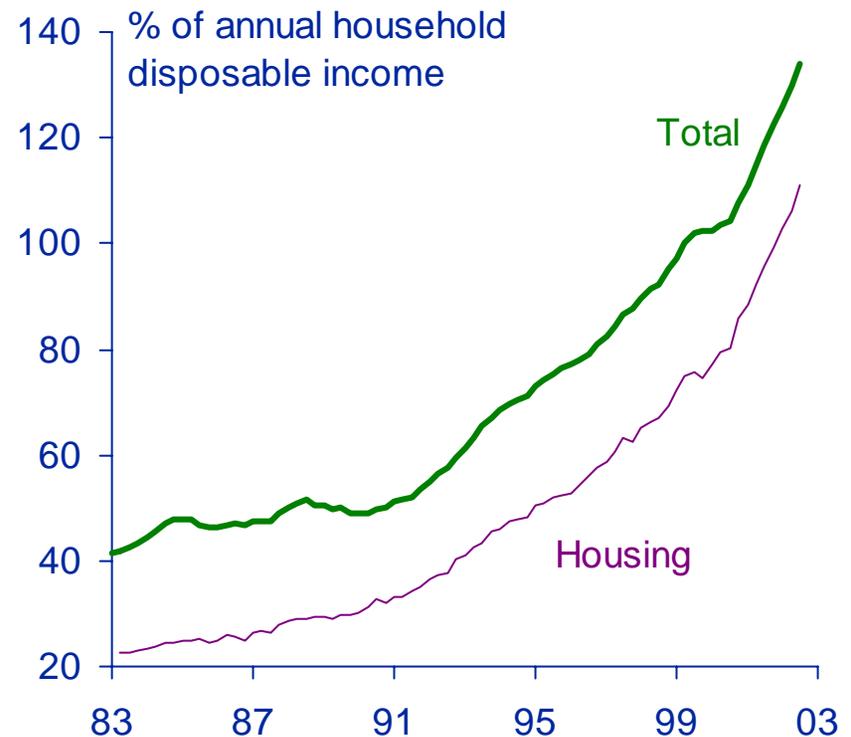
Household borrowing has grown very rapidly – but does that mean the level of debt is unsustainable?

Borrowing by individuals for housing



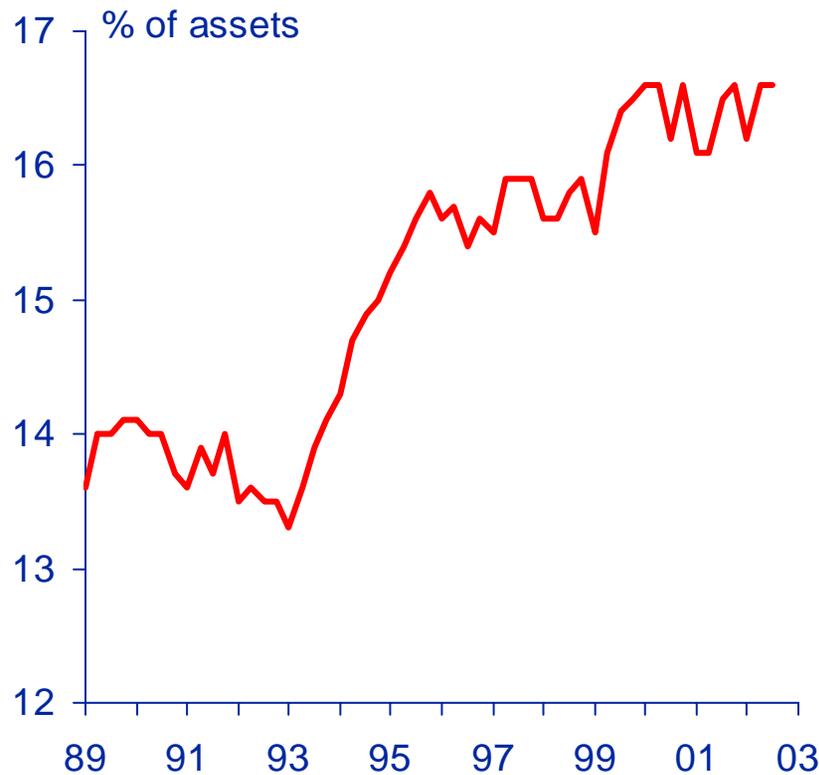
Source: RBA.

Household debt as a p.c. of disposable income



Judged by gearing or debt servicing ratios, it's not clear that the level of debt is unsustainable

Household debt as a p.c. of household assets



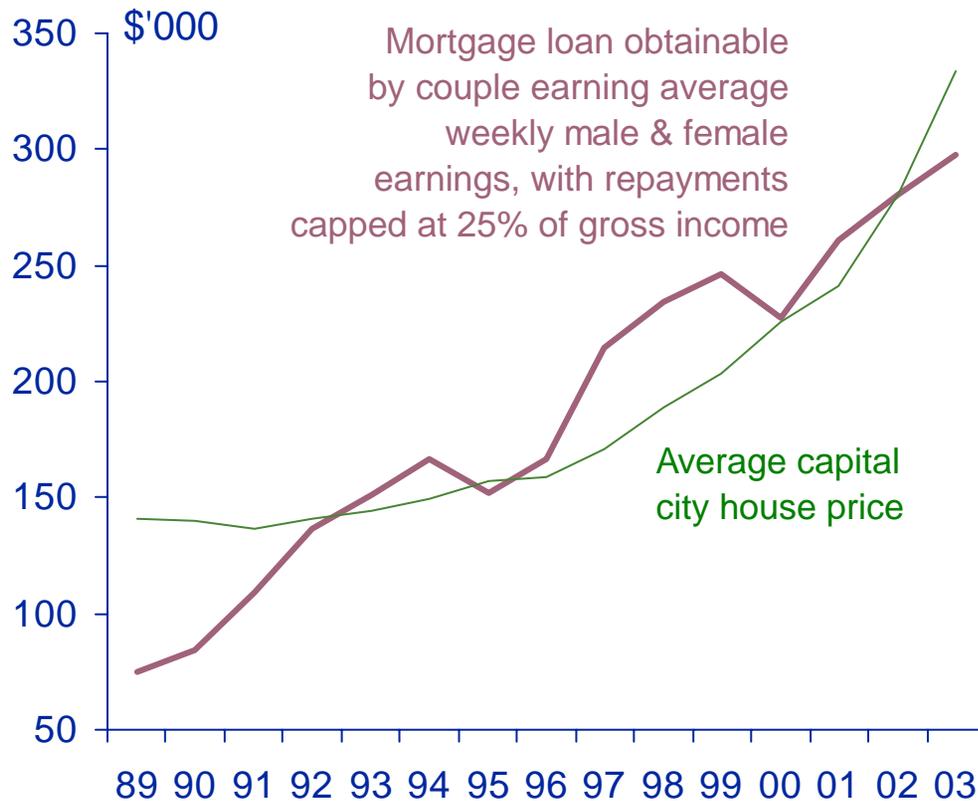
Household interest payments as a p.c. of disposable income



Sources: ABS; Economics@ANZ; RBA.

Rapid increases in household borrowing and house prices largely reflects a 'level shift'

Borrowing capacity and house prices

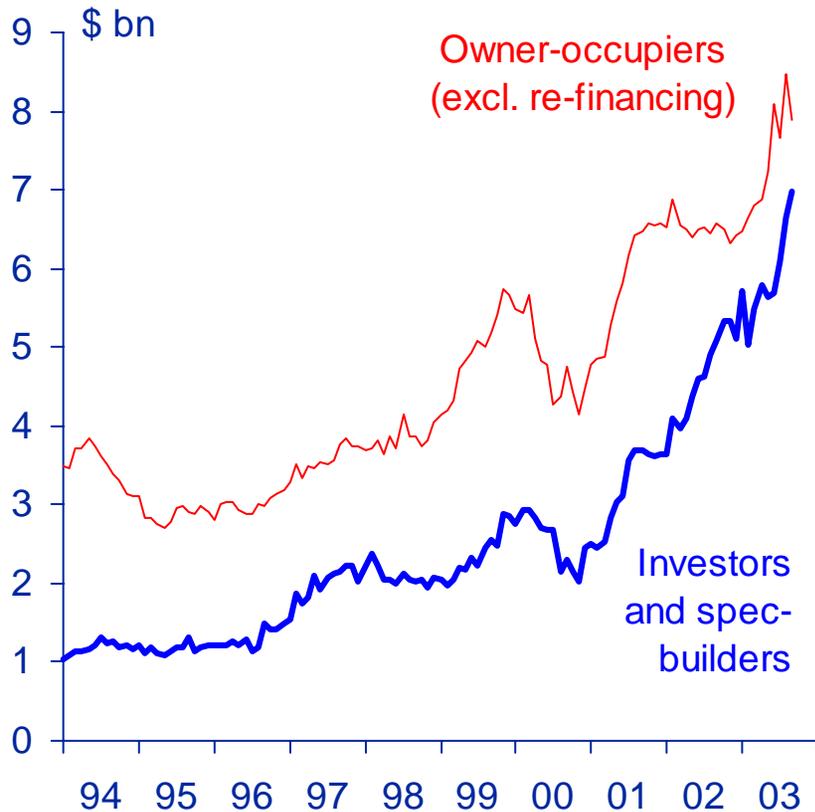


Note: data are for the June quarter each year.
Sources: ABS; REIA; Economics@ANZ.

- Over the past 12 years average incomes have risen by 63% while the mortgage rate has fallen by about half
- The borrowing capacity of an average-income household has risen by nearly 175% as a result
- Given the way the housing finance system works, it is hardly surprising that households have taken up this extra borrowing capacity
- With no net increase in the stock of dwellings this increase in 'purchasing power' has been capitalized into prices

What is worrying is that this 'level shift' appearst to have been mis-perceived by (some) investors

Housing loan approvals



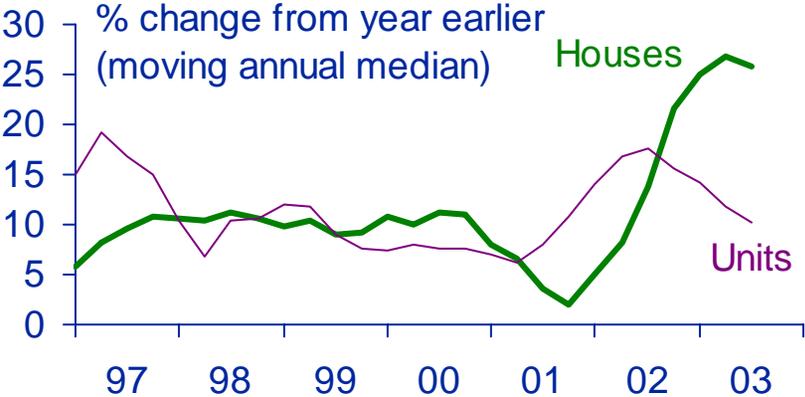
Investor loan approvals as a share of total housing finance



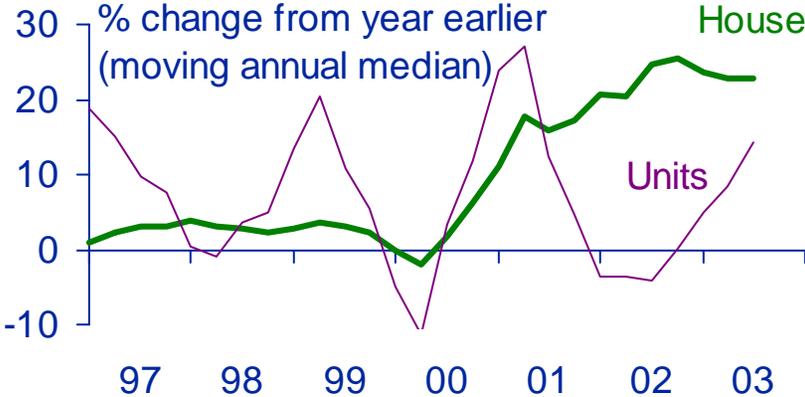
Sources: ABS; Economics@ANZ.

Unit prices appear to be levelling off, at least in Melbourne and Sydney

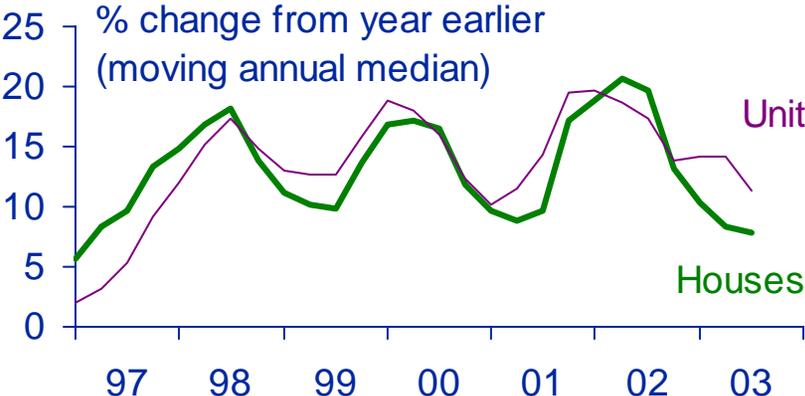
Sydney prices



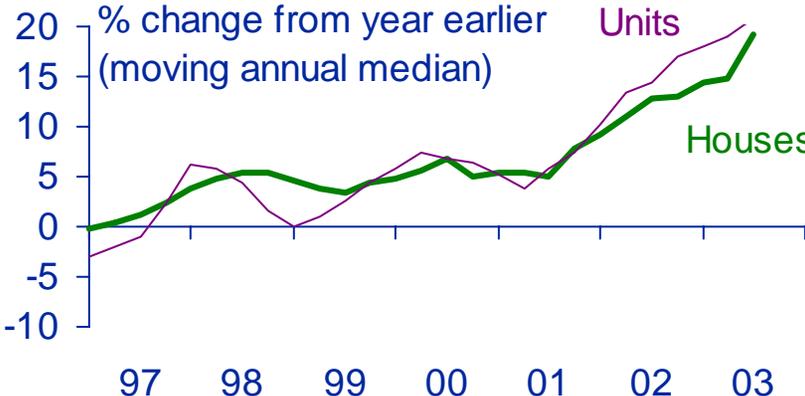
Brisbane prices



Melbourne prices



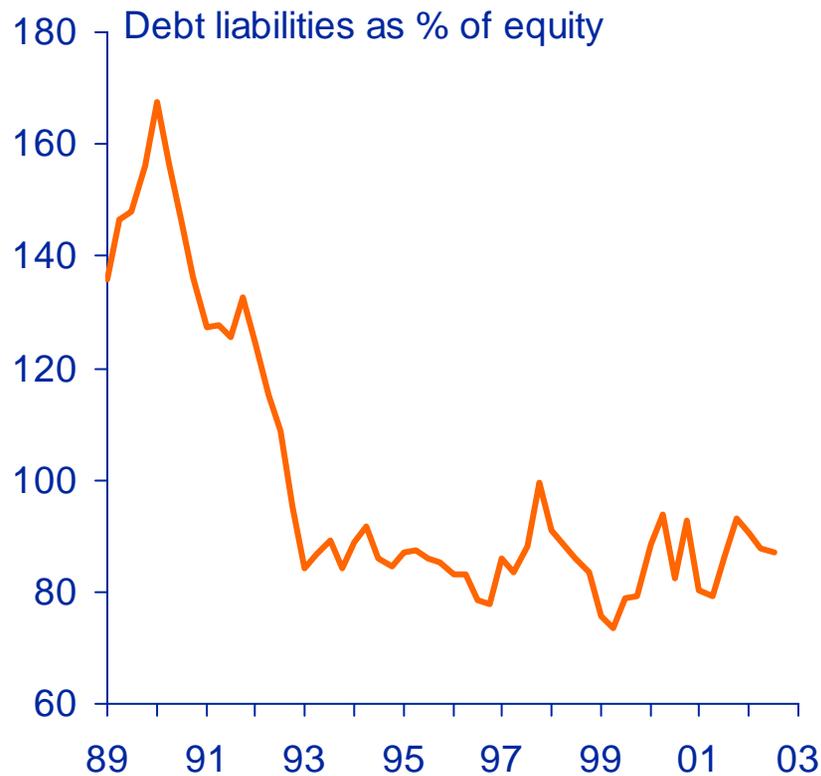
Other capitals prices



Sources: REIA; Economics@ANZ.

The business sector is less sensitive to interest rate movements than in the late 1980s

Corporate sector debt-equity ratio



Corporate sector interest cover ratio



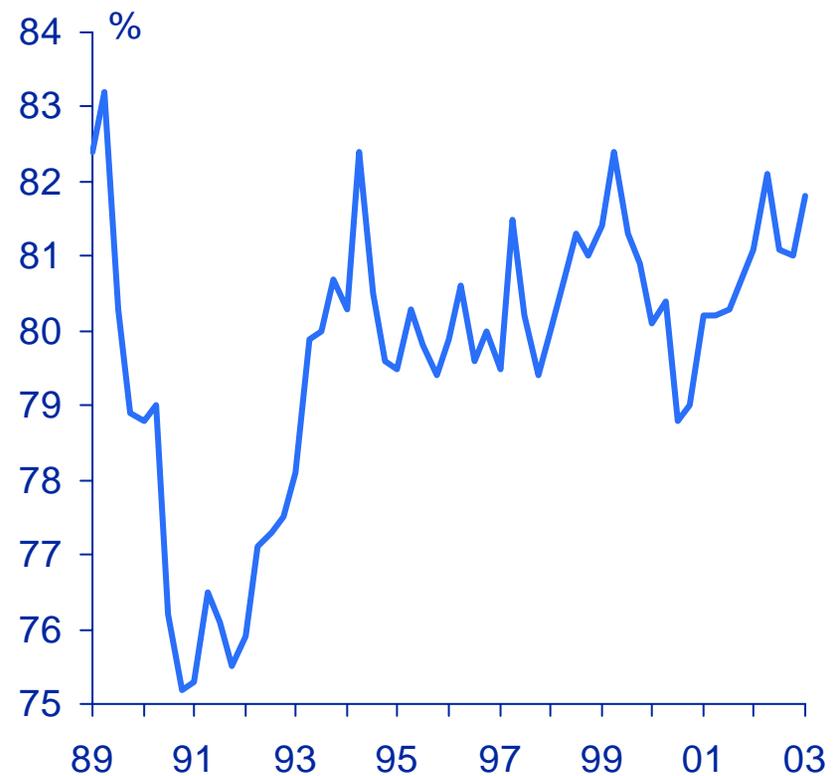
Sources: ABS; Economics@ANZ..

How close is the Australian economy to any binding 'capacity constraints'?

Unemployment



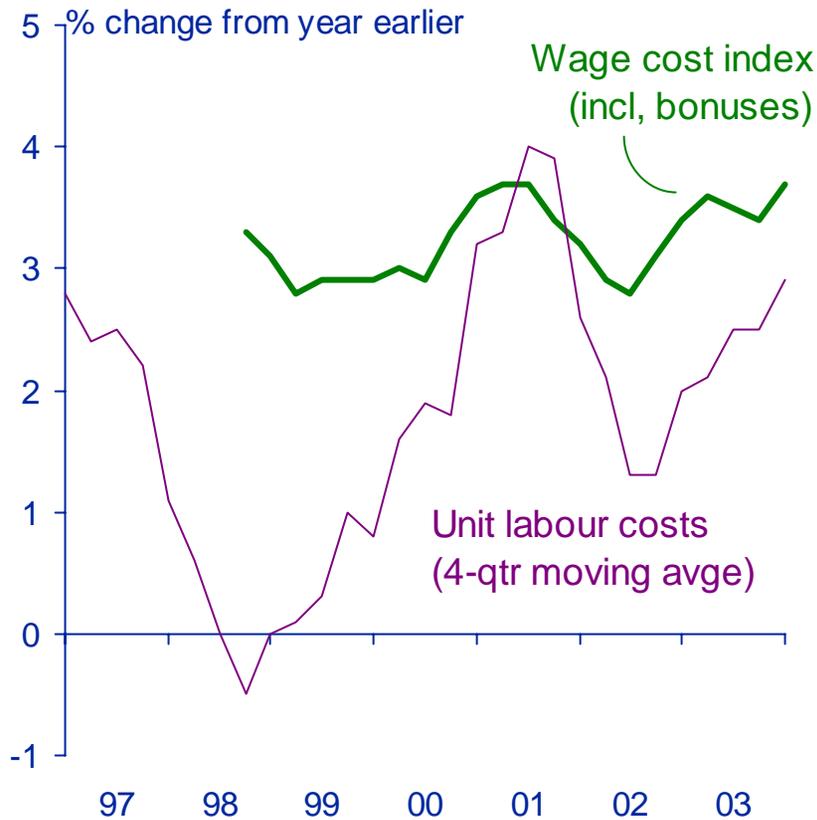
Capacity utilization



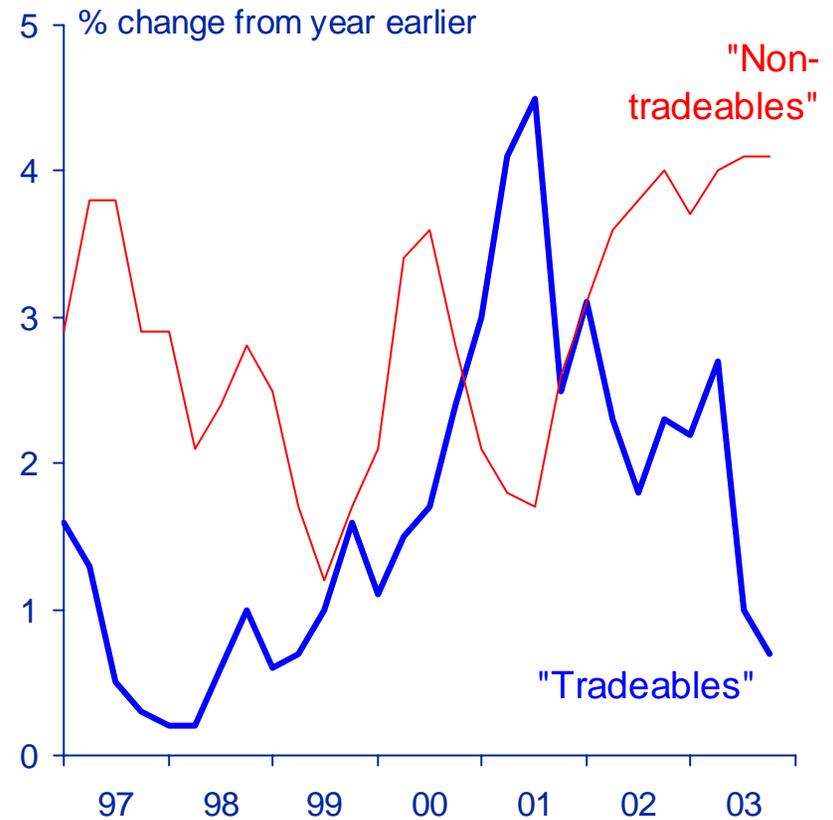
Sources: ABS; National Australia Bank.

Regarding the possible emergence of cost and price pressures, be 'alert but not alarmed'

Labour costs



Prices



Sources: ABS; Commonwealth Treasury.