Economic Update

Presentation to a luncheon hosted by Committee for Economic Development of Australia (CEDA)

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The world economy is experiencing its longest run of above trend growth in over 30 years

Global economic growth



Note: GDP is measured in US\$ at purchasing power parities. *Source:* IMF; Economics@ANZ.



It is becoming increasingly clear that the US housing market has peaked

House prices



Mortgage purchase applications



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Housing starts



Unsold new housing stock



And in the absence of any other source of stimulus that will lead to slower growth in the US economy

Consumer spending



Non-farm employment



Capital goods orders*



Purchasing managers' indices



4 *Sources:* US Bureaux of Economic Analysis and Labor Statistics; US Commerce Department; Institute of Supply Management

Global growth is being increasingly driven by developing economies

Real GDP growth 1970-2008

'Advanced' economies

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'Developing' economies



'Advanced' economies comprise the US, Western Europe, Japan, Canada, Australia and New Zealand. *Sources:* IMF, *World Economic Outlook September 2006* database; Economics@ANZ.

... which now account for just over 50% of world GDP and over 60% of the *growth* in world GDP

Shares of world GDP

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Shares of world GDP growth



'Advanced' economies comprise the US, Western Europe, Japan, Canada, Australia and New Zealand *Sources:* IMF, *World Economic Outlook*; Angus Maddison, *The World Economy: Historical Statistics*; Economics@ANZ.

Oil prices have been at elevated levels for some time now, and seem likely to remain so

Nominal and real oil prices



Note: Oil price is West Texas Intermediate. Shaded periods indicate 'oil shocks'. Source: Thomson Financial Datastream; Bloomberg; US Bureau of Labor Statistics; Economics@ANZ.

High oil prices aren't hurting growth as much as in the 70s/80s because it's a different type of shock





Note: shaded areas denote 'oil price shocks'. *Sources:* BP *Statistical Review of World Energy* 2006; ABARE *Australian Commodities* September Quarter 2006. *Conomics@*

Developing countries now account for over threequarters of world crude oil demand

Oil consumption

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Growth in world oil demand



Note: 'advanced economies' are the US, Western Europe, Japan, Canada, Australia and New Zealand. *Sources:* BP *Statistical Review of World Energy* 2006; Economics@ANZ.

Developing country demand for oil is likely to grow rapidly as incomes rise

Oil consumption and GDP per capita, 2005



Sources: The Economist 'Survey of the World Economy' 16 September 2006 p. 20; BP Statistical Review of World Energy 2005; IMF World Economic Outlook September 2006; Economics@ANZ.

Metal prices are at record highs in nominal terms though below previous peaks in real terms





Source: IMF *International Financial Statistics*; Economics@ANZ.



Base metal consumption in developing countries is likely to grow strongly over time

Base metal consumption and GDP per capita, 2004



Sources: ABARE Australian Commodities 2006; IMF World Economic Outlook
September 2006; Economics@ANZ.

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Metal supply has responded more slowly to the acceleration in demand than in earlier cycles

- Mining companies have to some extent been surprised at the strength of the upturn in demand
 - industry views on the outlook for prices were generally pessimistic in the aftermath of the Asian economic crisis
- The mining industry globally is more consolidated than in previous cycles
 - companies are more conscious of the impact that an increase in their own production may have on prices
- Mining companies now have alternative ways of spending windfall cash flows
 - expanding exploration or production is no longer the first instinct
 - takeovers, 'special dividends' and share buybacks are now much more common-place among mining companies



China's rapid growth and industrialization is a particularly & uniquely 'Good Thing' for Australia

Long-term price changes for Australian exports and imports



Note: the 'terms of trade' is the ratio of export to import prices; it is a measure of the international 'purchasing power' of Australia's exports. *Sources:* ABS; US BEA; Economics@ANZ.



Ratio of Australian export

prices to import prices

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'Terms of trade' gains since 1999 have been worth \$2,844 pa to each Australian, on average

Real gross domestic product and income

Real gross domestic product and income per capita



Note: Gross domestic income (GDI) is GDP adjusted for changes in the terms of trade (ratio of export to import prices). *Sources*: ABS; Economics@ANZ.



Higher commodity prices have prompted a surge in resources-related investment ...

Capital expenditure by the mining industry



Export-oriented infrastructure investment



16 Sources: ABS; Economics@ANZ.

... offsetting the slowdown in consumer spending since the end of the (east coast) housing boom

House prices



Household disposable income



Household saving rate



Household consumption spending



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The 'resources boom' has arrived at a time when the economy is bumping into capacity constraints







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So, increasingly, strong demand is not being met by increased domestic production

Real domestic spending and output

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How final demand has been met



Note: 'Final demand' is the sum of domestic final demand (consumption and fixed investment) and exports. It is met by a combination of increased domestic production (GDP), running down stocks and imports. *Source:* Australian Bureau of Statistics; Economics@ANZ.

Labour costs and other 'upstream' prices have been accelerating for some time



Property & business services 03 04 05 02 06 economics

04

03

(domesticallyproduced goods)

05

06

20 Source: ABS.

Businesses have found a little more leeway to pass on cost increases this year than in 2004-05

'Upstream' inflation

Consumer price inflation



^{*} weighted average of freight & storage and property & business services PPIs. *Sources:* ABS; Reserve Bank of Australia.



The economy has been much more resilient this year in the face of rising rates and petrol prices



Retail sales



 Note: vertical lines denote increases in the official cash rate.
Sources: Westpac-Melbourne Institute; National Australia Bank; ABS.

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Monetary policy isn't yet really 'tight' by the standards of the 'low inflation' (post-1992) era

Interest rates

Real cash rate



* Standard variable mortgage rate. Dotted lines show averages since 1993. *Sources:* RBA *Statistical Bulletin*; Economics@ANZ.



Fiscal and monetary policy are now working at 'cross purposes'

- Households have (as of 31 March) almost \$1 trn of debt and just under \$400bn of bank deposits and other interest-earning assets
 - each ¼ pc point rise in interest rates costs households around \$1¾ bn in aggregate (allowing for the fact that some deposits don't attract interest)
 - the combined impact of the May and August rate increases is thus to reduce household spending power by \$3½ bn
- The average household buys about 35 litres of petrol (or diesel/LPG) a week (or 1,820 litres per annum)
 - so the roughly 14¢ per litre increase in petrol prices so far this year will cost Australia's 7mn households about \$1³/₄bn per annum (down from nearly \$3bn pa at average August prices)
- Against this, the personal income tax cuts which took effect on 1 July (including those foreshadowed in last year's Budget) will boost household disposable incomes by around \$9bn pa
- So for Australian households in aggregate (if not for each individual household), tax cuts more than outweigh the impact

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of higher interest rates and petrol prices

Each year, the Government collects tens of billions of dollars more than originally forecast

Successive Budget estimates of total tax revenues



²⁵ Sources: Budget Papers 2002-03 through 2006-07.

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Much of these windfall revenue gains have come from company tax

Successive Budget estimates of company tax revenues



The Government has had a \$263bn windfall over the past 4 Budgets – and 'spent' \$248bn of it

Net 'bottom line' impact of 'parameter variations' vs 'policy decision' (tax cuts or spending increases)



The government is saving almost none of the windfall gains produced by the resources boom

Commonwealth 'underlying' cash balance



28 Sources: 2006-07 Budget Paper No. 1, Statement 13, Table 1 (and previous issues).

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It's likely that there will be at least one more rate increase before the middle of next year

Interest rates



Shaded areas denote forecasts. *Sources:* ABS; RBA; Economics@ANZ.

- In its most recent Statement on Monetary Policy, the Reserve Bank raised its forecast for 'underlying' inflation to 3% - the top of its 'target range'
- It also raised its forecast for economic growth to 3½% - at the top of the range of estimates of Australia's 'potential' growth rate, at a time when idle resources are becoming increasingly scarce
- With another pre-election Budget likely next May, the clash between monetary and fiscal policy will continue ...
- ... creating a situation where further increase(s) in interest rates are likely *economics@ANA*

Steady or lower US rates doesn't mean the RBA won't raise Australian rates

Australian and US real GDP growth

Australian and US official cash rates



Sources: ABS; US Bureau of Economic Analysis; RBA; US Federal Reserve **CONOMICS**

The resources boom is keeping the A\$ stronger than it otherwise would have been

Economic influences on the value of the A\$



Sources: Datastream; Reserve Bank of Australia.

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Commodity prices and interest rate differentials have been working in opposite directions on the A\$

Alternative hypothetical scenarios for the A\$



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32 *Sources:* Datastream; Reserve Bank of Australia; Economics@ANZ.

It's inevitable that different States will grow at different speeds

Mining and manufacturing as a share of State economies



Current differences between growth rates of different States are less than in previous cycles

Dispersion between fastest and slowest State economic growth rates



Sources: ABS *State Accounts*; State Budget Papers 2006-07; Economics@ANZ.



Different growth rates across the States aren't unusual: what is unusual is NSW coming last

State and national real growth rates

New South Wales

Queensland

South Australia







Victoria



Western Australia



Tasmania



Different growth rates across the States aren't unusual: what is unusual is NSW coming last

State and national population growth rates

New South Wales

Queensland

South Australia







Victoria



Western Australia



Tasmania





Summary

- Growth in the world economy is now being driven primarily by 'developing' economies
 - although some of their rapid growth is in turn being driven by exports to rich countries (especially the US)
- Developing country demand will keep commodity (incl. oil) prices relatively high by historical standards
- The 'resources boom' has prolonged Australia's recordbreaking run of economic growth beyond the end of the residential property boom (unlike the US)
- However the resources boom has arrived at a time when the Australian economy is already encountering capacity constraints and at risk of accelerating inflation
- The resources boom (and its impact on the A\$) is shifting economic activity away from south-eastern Australia towards the west and north

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- The so-called 'two-speed' pattern of growth across Australia is far from unusual
- The resources boom is generating massive revenue windfalls for the Commonwealth Government
 - but the Government is 'spending' most of them on tax cuts, increasing pressure on interest rates

Summary of Australian forecasts

	Years ended 31 December			
	2005	2006	2007	2008
Real GDP growth (%)	2.7	2 ³ /4	31⁄4	3
Employment growth (%)	3.2	2	2	2
Unemployment rate (%) ^(a)	5.2	4 ³ ⁄ ₄	5	51⁄4
Housing starts ('000s)	152	148	145	162
CPI inflation (%) ^(b)	2.7	31⁄4	2 ³ ⁄4	21⁄2
Current account deficit (\$bn)	56	53	59	64
Net foreign debt (% of GDP) ^(a)	49	50	52	54
RBA cash rate (%) ^(a)	5.50	6.25	6.25	6.00
Variable mortgage rate (%) ^(a)	7.32	8.07	8.07	7.82
10-year bond yield (%) ^(a)	5.20	5.75	5.80	6.05
A\$-US\$ (a)	0.74	0.74	0.73	0.71
A\$-¥ (a)	88	83	76	73

(a) December (b) Year to December quarter; all other forecasts are year-average

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