

Economic Research Note

An overview of the Australian economy

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Executive summary

- The Australian economy continues to perform well. It has recorded strong growth, historically low unemployment, and a strong AUD/USD exchange rate. However, it also faces the prospect of higher price inflation over the short-term.
- Nevertheless, it appears that the Australian economy is close to the peak of its growth cycle and is likely to experience moderate growth in 2008. The real economy is expected to expand at a slower pace in line with historical trend growth.
- Financial conditions are set to tighten further in 2008 with further rises in the official cash rate. This monetary tightening is seen as a short-term policy initiative to combat the threat of inflationary price pressures, mainly driven by domestic factors.
- The global credit crisis is also of concern with its impact contributing to tightening financial conditions. However, it seems unlikely that this alone will be sufficient for the Reserve Bank of Australia (RBA) to cut rates in the near term at least.

1. Introduction

This economic research note provides a brief summary of the prevailing conditions and short-term (three-year) outlook for key indicators of the Australian economy. The economy is considered a key driver of underlying performance for many asset markets including property and infrastructure. Consequently, this information feeds through in the formulation of house views for selected markets.

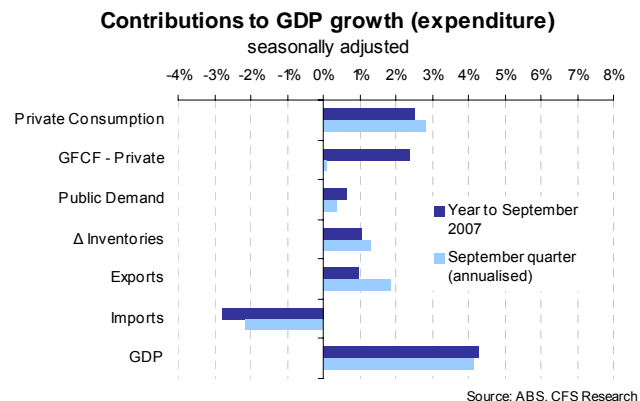
2. Key economic indicators

Domestic economic growth

Real GDP growth over the year to September 2007 was a strong 4.3%.

Figure 1 shows the main contributors to growth were private consumption and private investment (referred to as gross fixed capital expenditure). The strong contribution from private household consumption reflects positive consumer confidence as a result of income tax cuts, strong employment growth and consequently a 'cashed-up', job secure population. Private investment grew mainly in expenditure on mineral and petroleum exploration, as to be expected with current demand for commodities being relatively strong.

Figure: 1

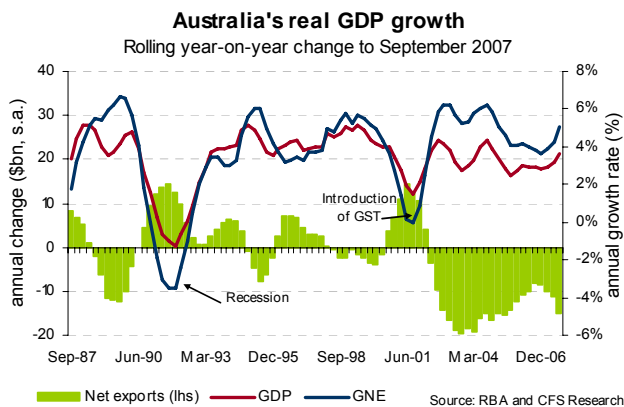


The detractor to growth was the external sector (or net exports) with imports outpacing exports. While the terms of trade have been favourable to the trade account, this had been partly offset by a strong AUD, making imports relatively more attractive to exports.

Figure 2 shows growth in annual real GDP split into domestic (gross national expenditure or GNE) and external (net exports) components. Notably, since 2001 the growth gap between domestic demand and

overall GDP has widened, reflected in a growing external imbalance.

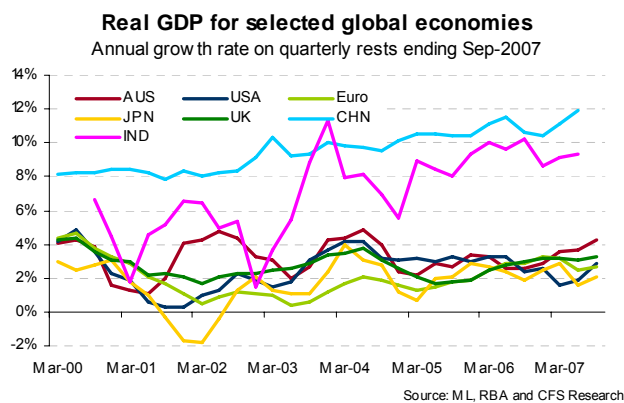
Figure: 2



Global economic growth

World real economic growth was 5.4% in 2006, the strongest growth in 30 years. Figure 3 compares Australia's performance with that of selected major global economies. Notably, while many of the developed economies are growing between 2-4%, both India and China are powering along with growth rates in the range of 9-12%.

Figure: 3



Nevertheless, the US economy is expected to experience a sharp slowdown in growth in 2008, underpinned by a significant contraction of activity in the housing sector, which will spill over into retail consumption. There is a high chance that the US economy will experience a recession in 2008 with recent economic statistics indicate a cooling in the labour market; reflected in rising unemployment.

Europe appears to be experiencing a pause in its growth trajectory induced by the global credit crunch. Yet price pressures are still persisting due to the rising cost of production inputs; especially commodities such

as oil – which reached record highs in nominal terms in recent months.

The economies of India and China, the drivers of the current commodity boom, are expected to be only mildly affected by any slowdown in the US economy as they both face robust domestic demand.

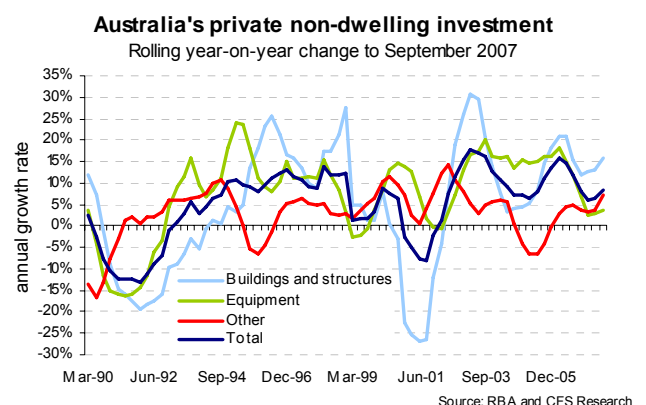
While the International Monetary Fund (IMF) is forecasting world economic growth to remain relatively strong for 2007 at 5.2%, it is predicting growth to moderate towards 4.8% in 2008 on the back of a marked slowdown in US economic growth and concerns associated with the global liquidity crunch.

Consequently, the outlook for Australia remains relatively positive in the short term. The Australian economy appears to be passing through the peak of the growth cycle with growth likely to moderate in 2008. While economic growth will be supported by Australia's leverage to Asia and India (via commodity exports), this will be offset by the combined impact of slowing global growth and domestic demand due to anticipated rises in domestic interest rates.

Business investment

Annual growth in real business (private non-dwelling) investment was 8.4% to September 2007, well above the average annual growth of 5.6% since the 2001 worldwide slowdown. This strong growth is underpinned by an upsurge in commercial construction activity. However, as Figure 4 illustrates, business investment sub-sectors are all positioned in the growth phase of a cycle, and it is expected that they will reach a peak in 2008/09.

Figure: 4



This strong growth in investment has been led by the strength of the Queensland and Western Australian economies due to the commodities boom. It is also worth noting that South Australia's mineral exploration

has been very strong, and there is thus likely to be a surge in linked infrastructure investment.

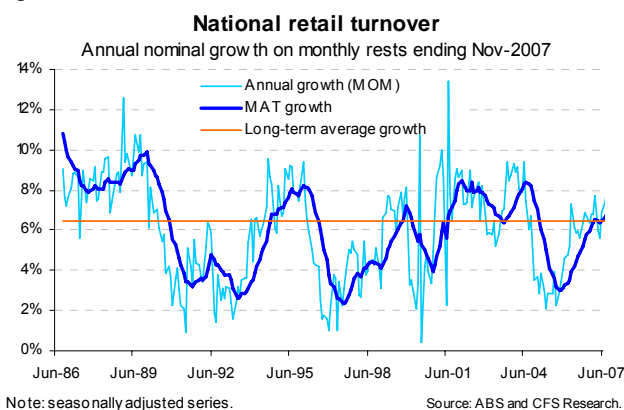
Retail trade

Retail turnover grew by 8.1% in nominal terms over the twelve months to November 2007, healthily above the long-term average annual growth rate of 6.5%.

The strength of retail growth is due to high consumer confidence and, as the RBA noted in its December minutes, “consumer sentiment, which [is] a volatile indicator, [has] remained well above its long-run average level”. This high confidence is partly due to the tight labour market (offering increased job security) and an increase in average household income due to on-going strength in the economy and income tax cuts over recent years.

Figure 5 highlights that growth in retail spending, based on moving annual turnover (MAT), appears to have reached a peak in the current cycle.

Figure: 5



In all, the retail sector is expected to remain relatively solid over the short term, with more moderate growth (i.e., below the long-term average). While retail spending will be supported by the proposed income tax cuts from mid-2008, this will be offset by the interest rate rises in 2007 and the anticipation of further rises in 2008.

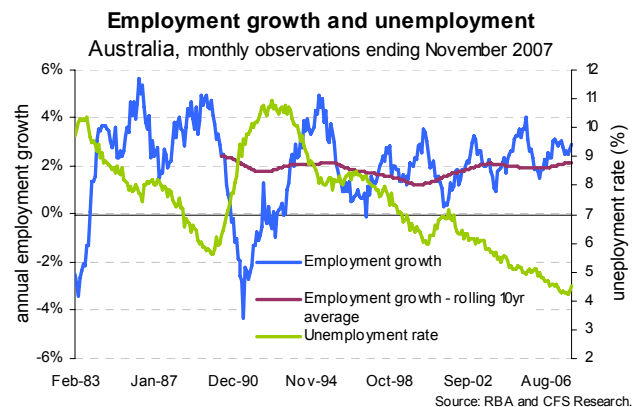
Labour market

The labour market remains generally tight with the national unemployment rate at 4.5% (up from 4.3%) and annual employment growth of 2.9% as at November 2007.

Figure 6 shows that employment growth is quite cyclical in nature. In contrast, the unemployment rate

has been steadily trending down since the early 1990s.

Figure: 6



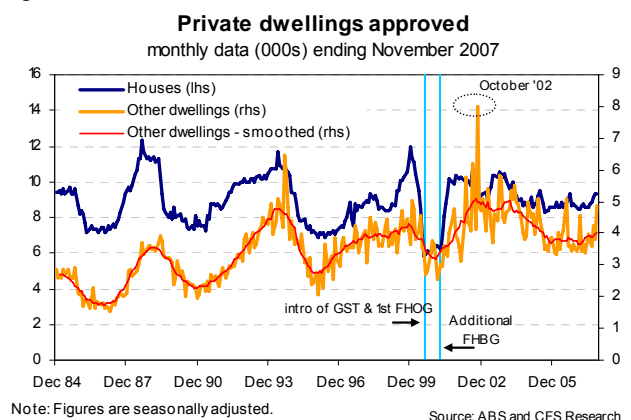
Since 2004, the declining unemployment rate has been associated with an ongoing increase in the participation rate. This is partly due to the changing composition of the labour force. For instance, improved retention of mature-aged workers and migration each stimulated increases in the working age.

The slight rise in the unemployment rate may well signal a turning point in the economic cycle. The unemployment rate is likely to hover around 4.5% while employment growth will experience a cyclical softening in the short term, as domestic demand moderates.

Housing sector

Buildings approvals rose 8.9% in November and 14.6% over the 12 months to November 2007. It was largely driven by approvals for ‘other dwellings’ (mostly apartments and townhouses). Approvals for houses rose for the sixth consecutive month, but by a mere 0.3% over the month and 6.3% over the year. Figure 7 highlights that the housing sector is in the early stages of an upturn.

Figure: 7

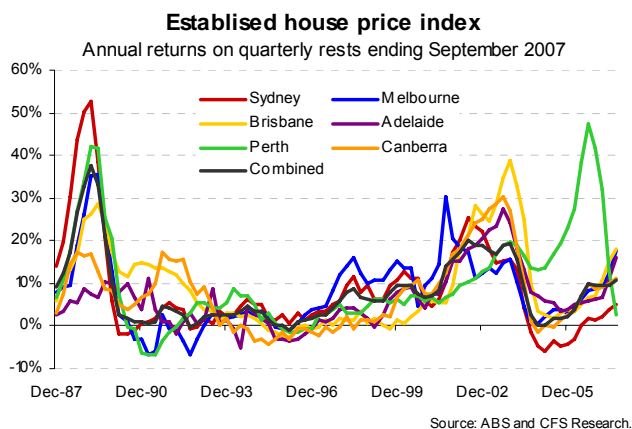


Nationally, house prices have grown by 10.6% over the year to September 2007. Prices in Sydney and Melbourne are showing early signs of an upswing with those markets recording the strongest growth of the major capital cities since 2004. A housing shortage in all capital cities has tightened vacancy rates, resulting in the most significant rental growth in decades. As dwelling approvals remain historically low, the undersupply of housing will continue into the medium term, causing further rental and income yield growth, and potentially attracting investors back to the market.

Figure 8 shows the historical annual growth in house prices across major cities since the late 1980s. Over the past four quarters, the Perth housing market has moderated markedly with its astronomical growth slowing to low single digits. Prices in Brisbane and Canberra continue to appreciate, whereas Melbourne, Sydney and Adelaide have recently begun trending upwards.

In all, house prices are set to experience further upward movement over the next few years, driven by strong demand due to migration and greater investor activity.

Figure: 8

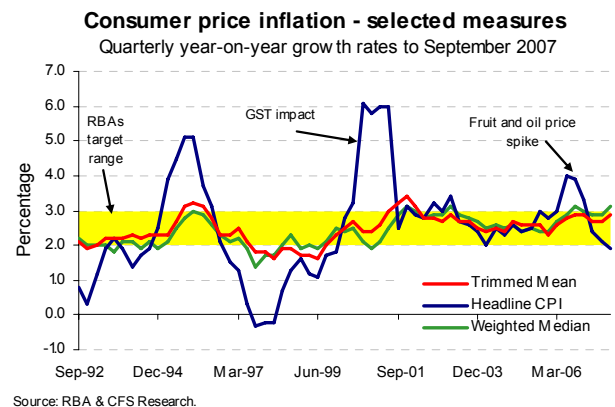


Consumer price inflation

As at September 2007, annual growth in headline consumer price inflation (CPI) came in at 1.9%, well below the RBA's upper target range of 3%. However, underlying or 'core' inflation was around 3%. Figure 9 shows the movement of headline and core CPI (measured by the weighted median and trimmed mean) since 1992.

During the quarter, annual CPI growth was relatively high in health (+4.3%), housing (+4.2%), education (+4.1%), finance and insurance services (+3.2%) and alcohol and tobacco (+3.1%).

Figure: 9



Clearly, the mounting inflationary pressures are largely domestically driven with non-tradable items experiencing a price growth of 3.5% during the year versus tradable goods which have experienced a contraction in prices of 0.3% during the year. The latter reflects the strength of Australian dollar while the former mirrors a combination of supply side constraints as well as demand pressures.

Wages growth

Wages growth continues to 'behave' (with annual growth in average weekly earnings of 4.5% to September 2007) against a historical ten year annual average growth of over 4%.

There are a number of reasons promoted explaining the muted response of wages in the face of falling unemployment and the skills shortage faced by employers:

- personal income tax cuts (which have consistently featured in recent budgets) have had a dampening effect on wage demands (the wage-tax trade-off);
- the influx of additional skilled migrants has increased labour supply, without adding to inflationary pressures;
- the increased incidence of non-wage remuneration to attract and retain staff in the current tight labour market will not directly affect wages growth; and
- structural changes in the composition of the labour force, in terms of type (i.e., full-time versus part-time), gender and age.

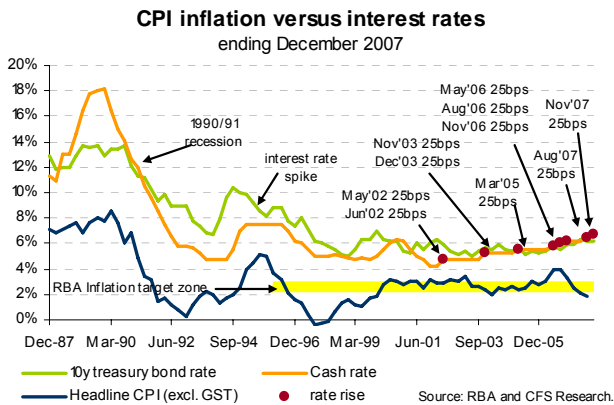
The other point of note is that any wage pressures appear to be localised to a few industries, such as utilities, construction and mining, fuelled by the ongoing demand for Australian commodities.

Overall, we expect growth in wages to remain at steady over the short term. While changes to the current industrial relations framework may pose upward pressure on wage growth, greater risks on this front are posed by the current skilled shortages (due to the tight labour market) and commodity boom.

Interest rates

The official cash rate (OCR) currently stands at 6.75% after the RBA raised the OCR twice in 2007 (in August and November), by 50 basis points (bps) in total. Figure 10 provides a historical account of interest rate rises since 2002.

Figure: 10



The RBA has been in the midst of a tightening cycle since May 2002. Strong domestic demand and favourable external conditions have contributed towards above-trend growth for the majority of this period.

Inflationary price pressures have emerged over the course of the current tightening cycle and continue to threaten medium-term price stability. Specifically, the RBA is concerned that rising global commodity prices, strong domestic demand and continual supply-side constraints will lead to further rises in prices.

The global credit crunch is also of concern with its impact contributing to tightening financial conditions. However, it seems unlikely that this alone will be sufficient for the RBA to cut rates in the near term at least.

We are forecasting two additional rises in the cash rate in 2008, in Q1 and Q2, in an attempt to curb the currently strong domestic demand. We forecast the first cut in the cash rate in mid 2009 with a significant easing in growth and moderation in inflationary price pressures.

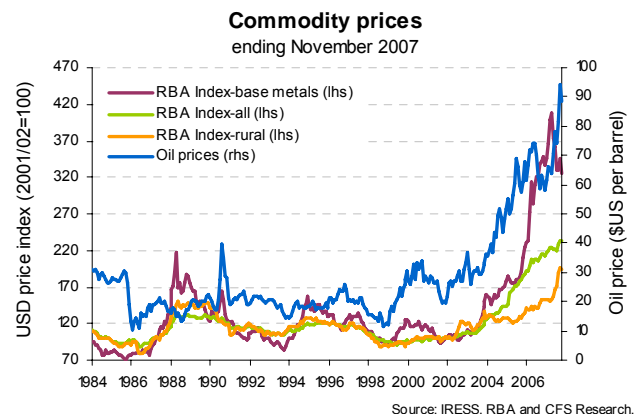
A key risk to our view lies with developments in the international economy; the global credit crunch and the expected slowdown in global growth due to a cooling in the US economy. Another key risk lies with domestic supply-side factors which will require active fiscal policy as part of the solution.

[For more information on the outlook on interest rates, please refer to CFS Research’s File Note on the “The Outlook for Interest Rates in Australia”, dated the 7th January 2007].

Commodity prices

The general strength of global commodity prices is reflected in rising costs for raw materials. In gauging the movement in commodity prices Figure 11 shows the RBA’s Index of Commodity Prices (ICP) since 1984. Notably, the ICP index reached a historical high in October 2007 (on an SDR basis)¹ with the main drivers being base metals and oil prices.

Figure: 11



These prices have had significant and opposing impacts on the Australian economy:

- The oil price rise adversely affects retail consumption and raises transport costs. Oil prices have increased due to both, higher global demand, and supply problems caused by geopolitical tensions. Continued strong demand is expected to keep oil prices at the current high levels in the near future.
- Rising base metals prices have on the other hand positively affected Australian economic growth, as it is a net resource exporter. Demand for these resources is expected to remain firm in the short run, as the Chinese economy continues to

¹ Special Drawing Rights, a weighted measure of international currencies published by the IMF.

experience very strong growth, and to moderate over the medium term.

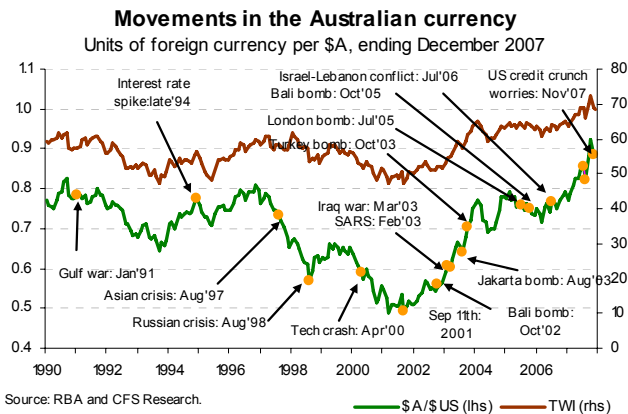
The RBA expects that commodity prices will soften slightly over the short-term, and notes that futures markets are priced according to this scenario.

Exchange rates

The exchange rate reached record highs during November, trading at \$0.93 to the USD. It has since flattened out to range in the high \$0.80s. The currency's strength has benefited those companies which make significant offshore asset purchases.

Internationally, this is partially due to a notable depreciation of the US dollar against all currencies (except the Yen); an impact of jitters in US financial markets (associated with the Credit Crunch) and likelihood of global slowdown. However, the Trade Weighted Index (TWI) also indicates a significantly strengthened AUD – trading at 22 year highs in November this year, as evident in Figure 12.

Figure: 12



Domestically, the ongoing strength of the Australian economy, the sky-rocketing of the terms of trade, driven by the strength of Australia's commodities

exports, and the large interest rate differentials between Australia and the rest of the developed world, have all provided positive support to the currency.

The recent credit crunch coupled with an expected significant slowdown in US growth increases the propensity for further rate cuts in the US. However, in contrast, the mounting inflationary pressure in the domestic AUS market will see an interest rate rising; at least in the short term. Thus, the interest rate differential between AU and US is expected to support the Australian currency, due to strong domestic demand and the tight labour market.

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