

# Economic research note

## Monthly snapshot of the Australian economy

Date: 2 July 2008

### Executive summary

- The Australian economy's performance in the first half of 2008 has been characterised by its resilience despite a rising tide of uncertainty felt by businesses, investors and households.
- Recent GDP data has highlighted the strength of domestic demand in Australia that is buttressing household balance sheets against rising petrol prices and interest rates. Domestic demand on, an annual basis, is still rising at a substantial rate; supported by business investment, particularly in the mining sector, while household consumption remains strong. However, the current environment continues to be characterised by a myriad of concerns including rising prices and interest rates at a time of jittery asset markets.
- It is important, in this environment, for decision makers to discern the permanent shifts from the temporary trends. Are price levels for global commodities shifting to a new and higher equilibrium driven by increased demand from emerging markets? Or will high prices end as demand slows? The Reserve Bank of Australia (RBA) is confident that this is a global permanent shift.
- The RBA is tightening monetary policy in an attempt to manage inflationary expectations such that primary price effects do not induce further price pressures in the general economy. Recent policy action by the bank appears to be having its desired effect with most economic measures showing softer readings. However, further interest rate rises cannot be ruled out until there is a clear sign that inflationary pressures have abated.

## 1. Economic perspective

### Why the growing malaise?

The impact of rising interest rates on growth, coupled with higher fuel costs has dominated discussion of Australia's economy. There are concerns that the RBA's tightening of monetary policy to combat rising inflation, in the context of a spike in the price of oil and credit market turmoil, will lead to a hard landing for the economy.

However, the RBA has gone to great lengths in the first half of 2008 to highlight the positive influences on the economy; such as the extent of the current commodities boom, and its associated massive income effect, as well as the strength of households. Yet Australians as a whole, measured through various surveys, have generally shown a growing level of malaise.

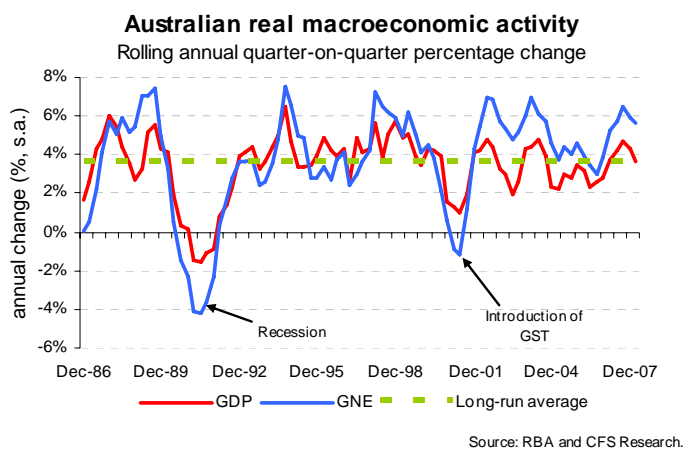
A spate of recent research from the RBA included a paper on Australian exports to developing Asia, observations on the cost of housing in Australia and a comparison of housing markets in the US and Australia that painted a positive picture of the Australian market. At the latest testimony before the Parliamentary Economics Committee, the Governor pointed out that despite the existence of pockets of financial stress, the number of people defaulting on their mortgage repayments was actually declining in aggregate. Further he added that the most impacted state, NSW, was also showing signs of a recovery in growth.

Yet despite this, consumer confidence, and more worryingly retail sales, has fallen substantially. Consumer sentiment in Australia is at levels not seen since the last recession and equity markets (as measured by the S&P ASX200 index) have retreated from nearly 6,000 points back towards 5,000 as concerns in the US economy mount.

While there is no doubt that weaker consumer confidence and more difficult capital market conditions will dampen growth in the short term, it is important not to lose sight of the favourable tailwinds provided to domestic economy via the resources boom which is a long term phenomenon. Hence, it is critical to remember just how well positioned Australia is compared to our peers.

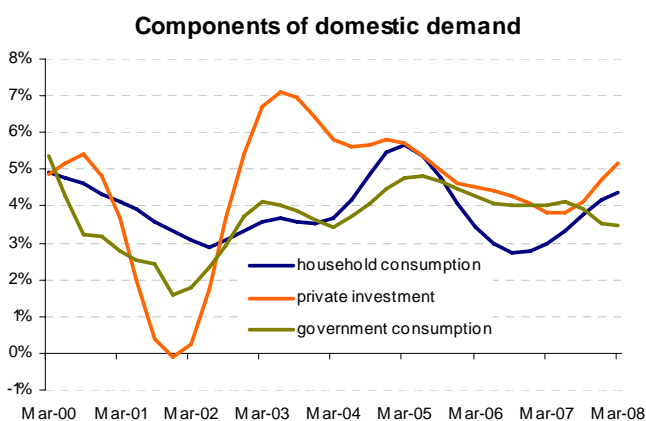
## 2. Key economic indicators

### GDP growth



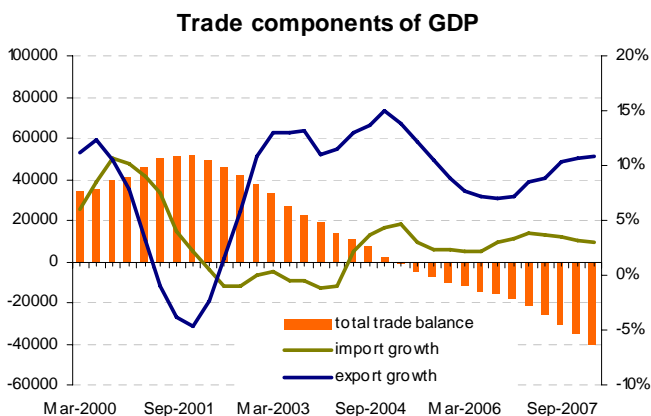
- Australian economic growth for the first quarter of 2008 was at its historic trend level of 3.6% per annum.
- The level of growth surprised many in the market on the up-side. Consensus forecasts for growth suggested a quarterly result of 0.3% compared to the actual of 0.6%.
- The key area was the strength of domestic demand.

### Domestic demand



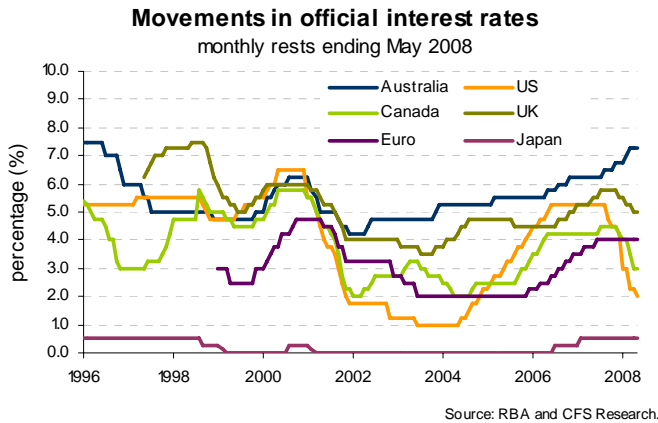
- Domestic demand is made up of three main components; household consumption, private investment and government consumption.
- The chart highlights a number of historical trends:
  - The government's role in constraining growth in recent times which will continue as evidence by the recent budget.
  - The improving position for households over the last couple of years.
  - Relatively high levels of business investment (especially in the mining sector), driven by the global commodity boom.

### Trade balance



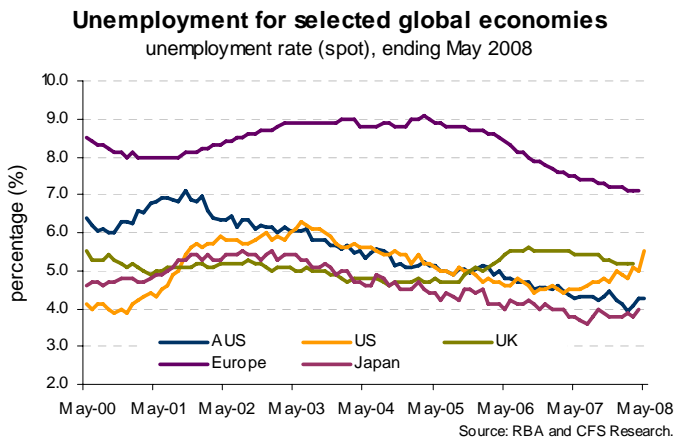
- A key drag on the Australian economy has been net exports, despite the current commodity boom.
- Imports have been high, supported by strong consumer spending and high capital spending.
- Volume growth in exports has been constrained by infrastructure bottlenecks.
- However rising commodity prices means that Australia's Gross Domestic Income (GNI), has risen significantly.

## Interest rates



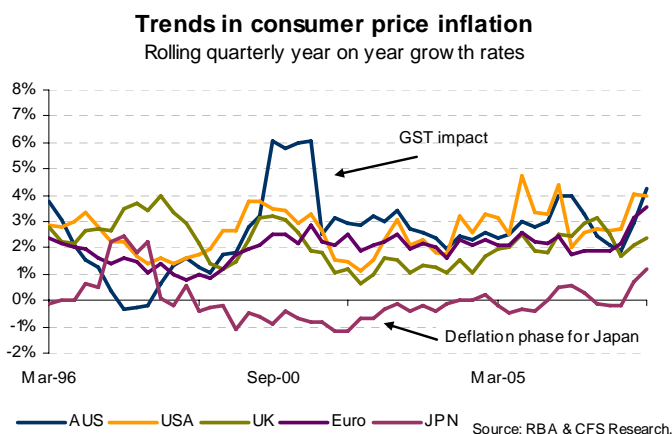
- The RBA is bucking the trend of cutting official interest rates; particularly in the Anglophone countries of the US, UK and Canada.
- Rate cuts reflect weakening consumer demand, high levels of household debt and falling asset values, particularly homes.
- While there are pockets of households in Australia with similar characteristics, in aggregate the RBA believes economy's larger problem is demand led inflation.

## Labour market



- Recent rises in unemployment, particularly in the US, have supported the consensus of a weakening outlook for global growth.
- However only in the US has a clear trend to higher unemployment emerged.
- Furthermore, unemployment has fallen substantially from cyclical highs in all regions apart from the UK.
- Australian employment fell by 20,000 jobs having added 457,000 jobs since the last fall in October 2006.

## Inflation

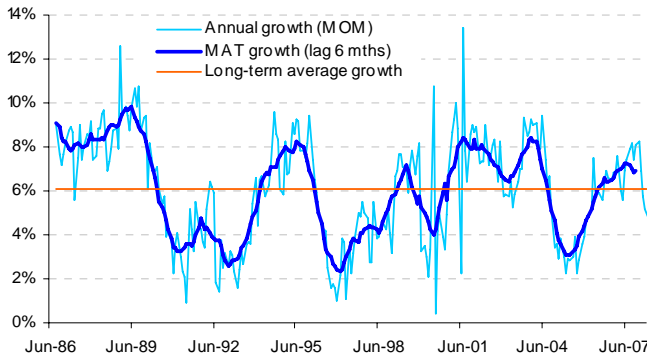


- Rising inflation has emerged as an important macroeconomic trend across the world.
- Inflation is above the comfort zones of the world's major central banks and continues to rise steeply.
- However, as seen above, only the RBA (and to a lesser extent, the ECB) is acting to slow price growth.
- Other central banks, especially the US's Federal Reserve, believe the slowdown in demand will be sufficient to slow price growth despite emerging market strength.

## Retail Sales

### National retail turnover

Annual nominal growth on monthly rests ending May 2008



Note: seasonally adjusted series.

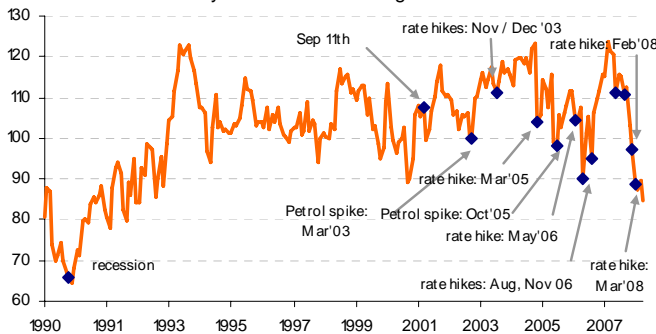
Source: ABS and CFS Research.

- Month on month retail sales growth in Australia is falling precipitously and it seems likely that annual growth will fall below trend in the next couple of months.
- The scale and duration of the weakness in retail sales growth will be dependent upon the state of the labour market, interest rates and petrol prices.

## Consumer sentiment

### Consumer sentiment index

monthly observations ending June 2008



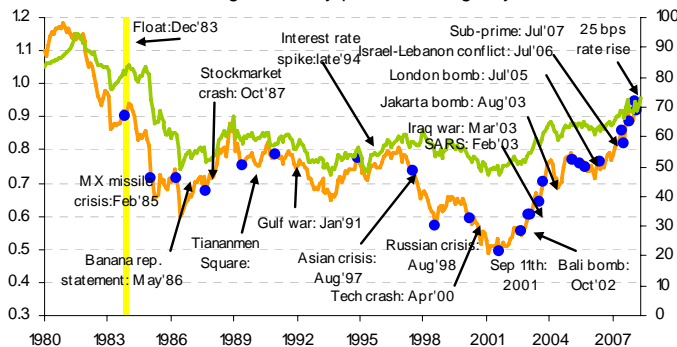
Source: Westpac-Melbourne Institute, RBA and CFS Research.

- Consumer confidence reached its lowest reading in June 2008 (84.7) in fifteen years. Due primarily to the impact of four successive interest rate rises coupled with soaring fuel and food prices.
- Concerns are that this will lead to a sustained slow down in actual spending.
- However there remains a weak statistical link between consumer sentiment and the actions of consumers. It is likely that only a weaker labour market will lead to the type of outcome the index is currently suggesting.

## Exchange rate

### Movements in the Australian currency

Units of foreign currency per \$A, ending May 2008



Source: RBA and CFS Research.

— \$A/\$US (lhs) — TWI (rhs)

- The significant rise in the value of the Australian dollar relative to the US dollar has strengthened with the AUD reaching a new post-float high of US96.68 cents.
- Uncertainty has caused increased volatility with the pair trading within a range of 94c to 96c.
- The market is weighing concerns of a slowing economy with the likelihood of a further 20% rise in Australia's terms of trade.

### 3. Research team

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