

Economic research note

Monthly snapshot of the Australian economy

Date: 11 August 2008

Executive summary

- The latest Consumer Price Index (CPI) statistics show inflation pressures rising in the Australian economy. The CPI for the June quarter 2008 jumped to 4.5% over the year to June 2008. This result was a confluence of price pressures stemming from the credit crisis, global commodity prices, and strong domestic demand.
- Employment growth is softening with expectations that it will fall below trend. Annual employment growth has slowed to 2.3% in July 2008 from 3.0% in February 2008. The current rate is only slightly higher than the ten-year rolling average of 2.2%. Uncertainty over the global outlook is weighing considerably on businesses' hiring intentions.
- Retail sales in the month of June 2008 fell 1.0% from a month earlier and rose only 3.2% over the year, well below trend annual growth of 6.1%. This is the slowest pace of growth since October 2005 and expectations are for further falls over coming months due to pressure on household budgets from high fuel and the cost of finance.
- Consumer confidence was further dented by a fall in nominal house prices across Australia in the June quarter. This was the first time since September 2005 that such a fall had been observed. The biggest price falls were in Perth (2.4%) while there were small price rises in Sydney (0.3%) and Brisbane (0.6%).
- The offsetting effects of global developments, coupled with an erosion of the Reserve Bank of Australia's (RBA) ability to directly control domestic demand, have presented a significant policy challenge for the RBA. Faced with a finely balanced economy, we believe the most appropriate course of action for the RBA is to keep rates on hold in the near term.

1. The credit crisis frustrates monetary policy

Over the June quarter, inflation in Australia reached 4.5% on an annual basis; its highest level since 1995. This exceeded the consensus forecast of around 4%. The high CPI result was a confluence of price pressures, most notably in particular financial services (which rose at an annual rate of 9.9%), transportation (6.8%) and food (3.9%).

The existing inflationary pressures domestically – which have been driven by strong domestic demand and supply constraints, have been present since 2003. This has been most evident in the tight labour market. However, global developments have exacerbated this situation. The price oil has risen from US\$19 a barrel in 2001 to US\$145 a barrel in 2008, while increased demand in emerging economies have triggered a rise in the price of ‘soft’ commodities such as rice, grain, sugar and other foods.

More recently, the credit crisis has added an element of complexity for the RBA. This is because, faced with the higher cost of credit prevailing in global debt markets, domestic banks have raised their interest rates independently of the RBA-effected changes in the official cash rate (OCR). Consequently, the degree of direct control the RBA can exert on the economy has eroded somewhat.

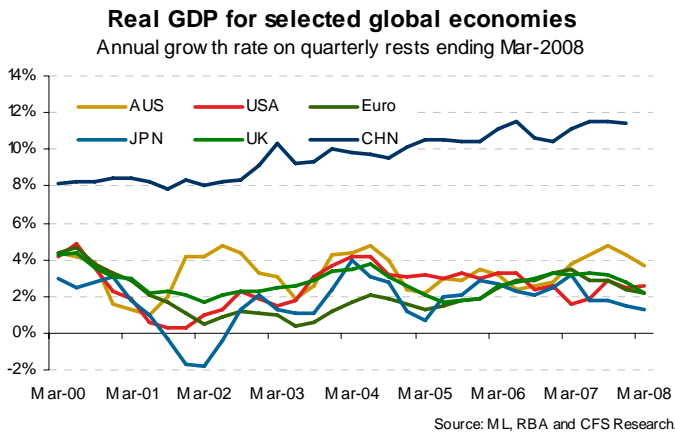
For Australian households, the rise in mortgage rates adds further pain to the succession of rises in the OCR over the past 18 months. The raft of corporate earnings downgrades and fall in consumer confidence have added to fears that economic growth will slow down. In Australia, retail sales growth has already fallen to below-trend levels – and there are signs that the worst is yet to come.

Against this scenario of doom and gloom, however, it is worth remembering that the Australian economy remains in a fundamentally sound position, and is in an enviable position with regards to its ability to weather the credit crunch. In the second half of the year, further stimulus to national income is expected from the impending rise in our terms of trade. We believe this has largely been overlooked by the market.

The equation for the RBA, then, is a finely balanced one. Global developments have added to price pressures on the one hand, but helped reduce aggregate demand on the other. We believe that the RBA's most appropriate course of action is to hold rates as they are for the near future. While we do not discount the possibility of a near-term rate cut, we consider this unnecessary given the strength of the domestic economy from a medium-term and structural perspective.

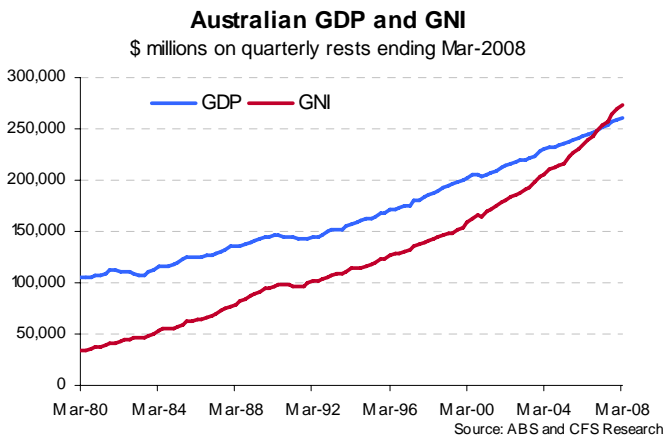
2. Key economic indicators

GDP growth



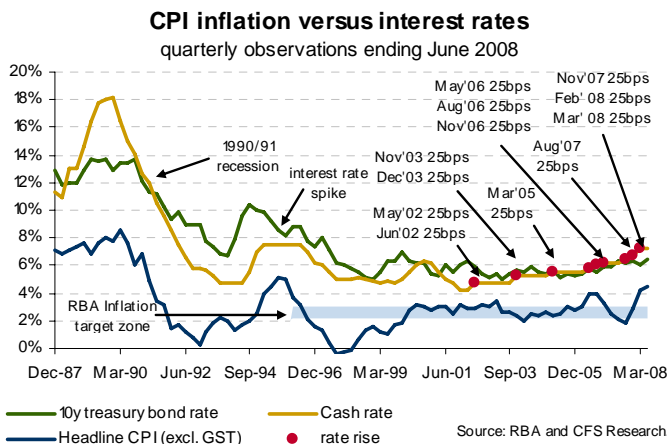
- Economic growth in Australia for the first quarter of 2008 was in line with its historic trend level of 3.6% per annum, though a slowdown from recent quarters.
- Australian growth compares favourably to growth paths in other industrialised economies. There are concerns that the economies of the UK and the US will suffer recession this year.
- The growth in emerging markets, particularly China, will remain a considerable support to Australian exports.

Gross national income



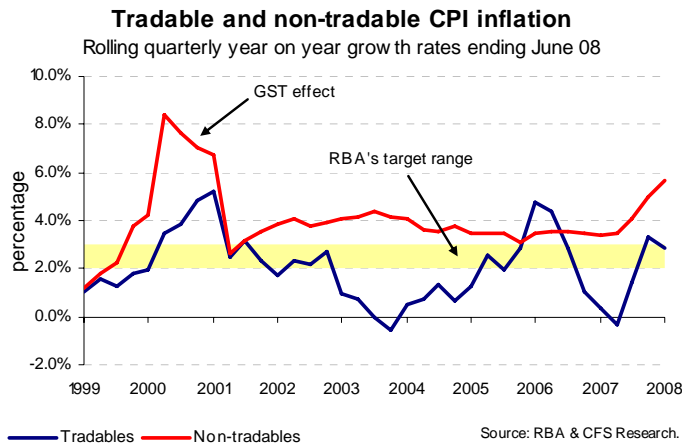
- Gross national income (GNI) is a measure of the Australian economy that in part captures the impact of a change in the terms of trade on the nation's wealth.
- The data shows that income growth has supercharged the benefits from growth in GDP, particularly over the last eight years.
- The data implies that Australian growth is stronger than understood and may need structurally tighter monetary policy to restrain demand.

Inflation and interest rates



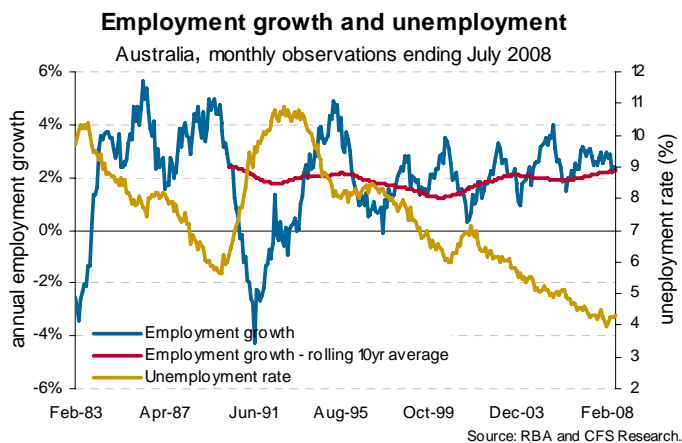
- Inflation has been driven by strong global demand and domestic demand and supply constraints.
- The market was surprised by an annual rate of 4.5% for the June quarter of 2008, rising from 4.2% in the previous quarter and from 2.1% in June 2007.
- Until signs emerge of a significant slowdown in domestic demand, particularly a weaker labour market, monetary policy will remain tight.

Inflation contribution



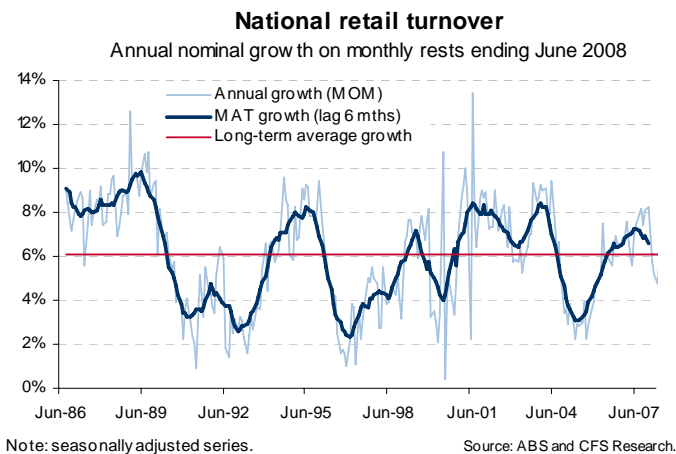
- The chart breaks inflation into two parts: price rises in goods and services that are traded (tradeable) and goods and services that can not be traded (non-tradeable).
- The chart shows a strong rise in non-tradeable inflation (6.0% annually), particularly due to financial services that surprised the market.
- The supply constraints that are driving non-tradeable inflation remain. However they may be subdued by short term weakness in demand.

Labour market



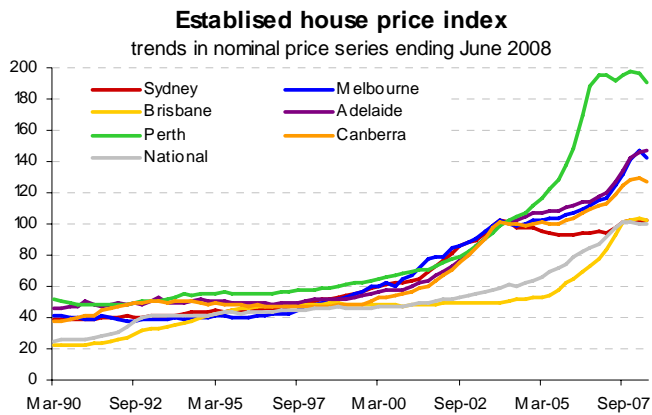
- It seems unlikely that the long term trend of lower unemployment can persist much further.
- Employment growth was 2.3% annually in July. The unemployment rate was unchanged in July from June at a near record low of 4.3%.
- Employment growth in the next six months is expected to moderate below the long term trend growth rate of 2.2%. Accordingly unemployment is likely to rise.

Retail Sales



- The combined impact of higher prices, rising interest rates and falling consumer confidence have triggered steep falls in the growth rate of retail sales in Australia.
- On an annual basis, retail sales are rising at 3.2%; the lowest level of growth since October 2005.
- The short-term outlook for retail sales will remain weak with annual growth likely to fall to levels last seen in 2004-05 as spending suffers due to uncertainty over the economic outlook and the higher cost of essentials such as food and fuel.

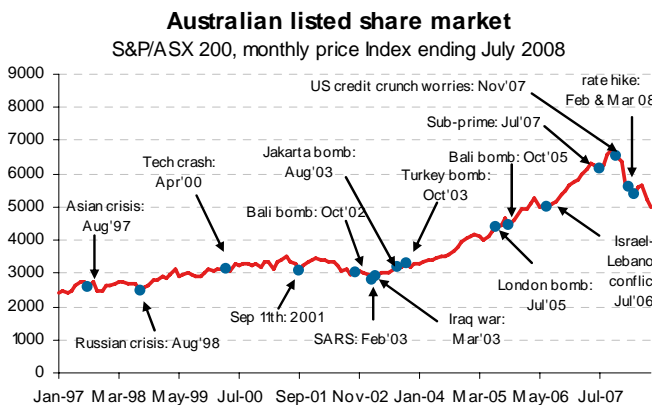
House prices



Source: ABS and CFS Research.

- House prices in Australia have fallen on a nominal basis between the March and June quarters of 2008; reflecting rising credit costs and weak market sentiment.
- The national established house price index fell 0.8% between the June and March 2008 quarters. This was the first fall since September 2005.
- Conditions for home buyers, as measured by affordability, may be about to improve as price growth remains soft.

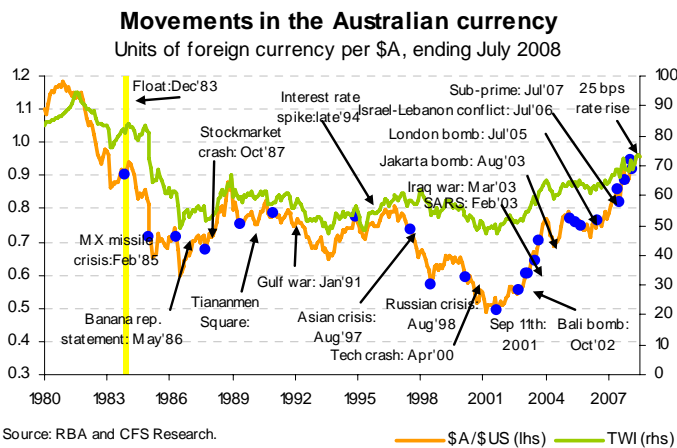
Equity market



Source: RBA and CFS Research.

- The fall in the Australian listed equity market that commenced in late 2007 extended further in July 2008.
- The equity market finished July below the key resistance level of 5,000 points; down 27% from a November 2007 high.
- In July two of Australia's largest banks (NAB and ANZ) announced increased provisions that had not been expected by the market. Their respective share prices fell 19.5% and 16.5%.

Exchange rate



Source: RBA and CFS Research.

- The Australian dollar remained around its cyclical highs of close to US\$1.
- The Australian dollar has nearly doubled from its low in March 2001 of US\$0.49 to reach US\$0.97 in July.
- Over the medium term the Australian dollar is likely to be supported by ongoing interest rate differentials with the US and strength in demand for commodities.

3. Research team

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