Economic research note

Monthly snapshot of the Australian economy

Date: 8th December 2008

Executive summary

- Many developed countries across the world have entered or are approaching a technical recession. Australia managed to avoid this fate in the September 2008 quarter. The latest release of Gross Domestic Product (GDP) figures show slight growth of 0.1%. The main contributors were private investment and government.
- In this low growth environment the Reserve Bank of Australia (RBA) acted to provide liquidity to credit markets and move the economy from the verge of recession. The RBA embarked on a drastic easing in monetary policy by cutting the Official Cash Rate (OCR) by 300 basis points (bps) over four months to 4.25% in early December 2008.
- The Federal Government has provided a temporary fiscal stimulus of $12.4 billion, supporting household consumption and aiding the automotive industry and investment in residential property. However, the current bearish environment increases the risk that the one-off government payment will be saved rather than support spending.
- In the short term (one year horizon) we expect economic growth to remain sluggish. Support to economic growth should come from lower petrol prices, expansionary fiscal policy, easing monetary policy and a relatively weak AUD-USD exchange rate. However, this will be partly offset by a sluggish outlook for resources.

1. Australia's economic growth prospect

The impact of the global credit crisis on capital and financial markets has spilled over into the real economy, weakening consumer sentiment and business confidence. Many developed countries across the world have entered or are approaching a technical recession. Consequently, in an attempt to improve liquidity and sentiment in financial markets and stimulate economic growth, central banks across the world have drastically cut interest rates while governments have announced substantial fiscal stimulus packages.

During the September 2008 quarter, Australia recorded weak growth (+0.1%) in GDP with a contraction in the non-farm sector. Economic activity was supported by fixed asset investment (engineering construction and dwelling) and public sector expenditure. Private consumption was sluggish, impacted by a decline in private wealth (via deteriorating equity and broader asset markets), high petrol prices and interest rates, and uncertainty surrounding job security. Investment activity slowed with residential construction suffering from plummeting building approvals. Despite tighter lending conditions, relatively high interest rates and uncertainty, investment expenditure remained positive during the September 2008 quarter. Net exports were a large detractor to growth. The rise in import volumes continued to outpace exports, detracting 0.4 percentage points from GDP.

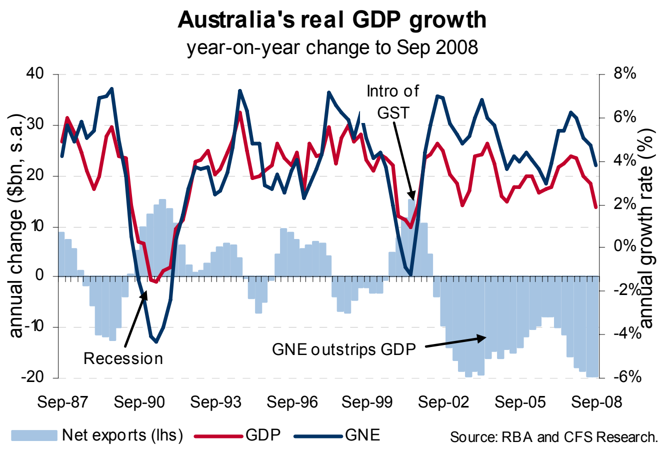
In order to avert the Australian economy from entering a recession, the RBA and the Federal Government have embarked on stimulatory monetary and fiscal policies. The RBA slashed the OCR during the four months to early December 2008 by 300bps to 4.25%. The Federal Government is providing a $12.4 billion fiscal stimulus to consumers and the automotive industry as a result of deteriorating consumer confidence and a sharp slump in car sales figures, an indicator of consumer discretionary spending. The one-off $10.4 billion payment to qualified families and pensioners aims to stimulate consumer spending while the $2.0 billion for the automotive industry is aimed at protecting jobs.

In the short term (one year horizon) we expect economic growth to remain sluggish. Support to economic growth should come from lower petrol prices, expansionary fiscal policy, easing monetary policy and a relatively weak AUD-USD exchange rate. However, a recovery in consumer spending is expected to be slow as concerns regarding job security (due to a softening labour market) and weak global demand (due to the deteriorating global economy) persist into 2009. Furthermore, credit rationing in credit markets is likely to continue to curb investment activity.

Key downside risks to growth for the Australian economy include an ongoing cooling in global economic activity, especially in Asia, continued volatility in asset markets as well as ongoing softening in the labour market.

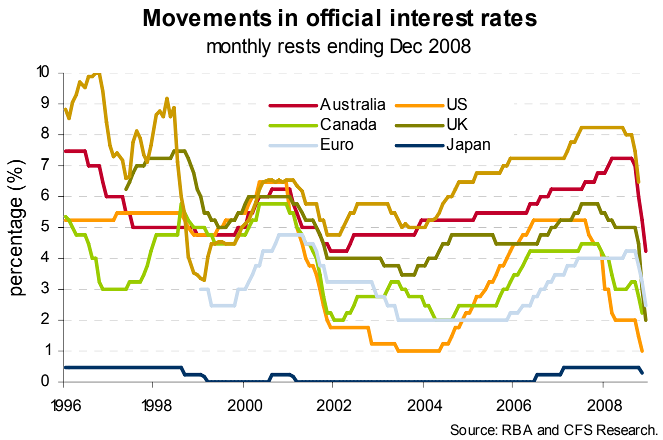
2. Key economic indicators

General economic activity



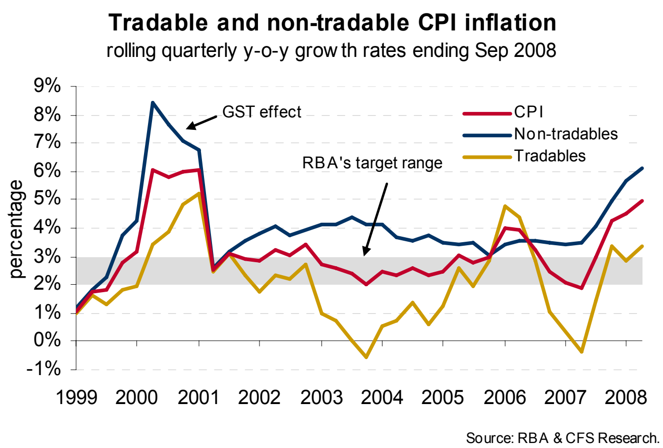
- The Australian economy slowed significantly during 2008. In Q3, 2008 real GDP rose by 0.1%, the slowest pace of quarterly growth since December 2000 when the economy contracted by 0.8%. Annual growth in September 2008 stood at 1.9%.
- The strongest contribution to growth in Q3 2008 came from private investment and government; while net exports represented the key detractor.
- Q4 2008 is likely to remain sluggish; consumer spending should experience a temporary improvement but will be tempered by the uncertainty regarding the labour market.

Global interest rates



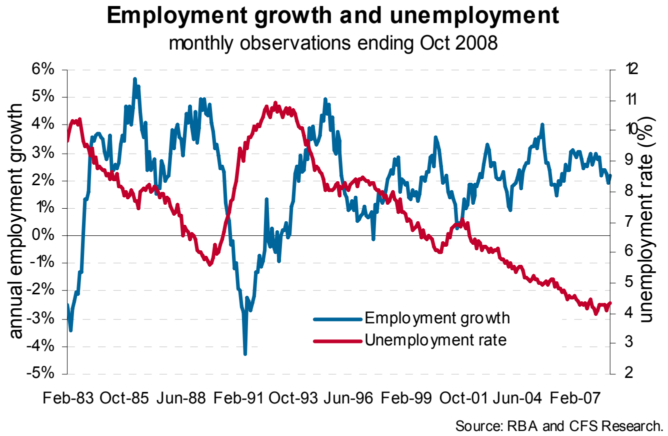
- The RBA has embarked on a drastic easing in monetary policy by cutting the OCR during the four months to early December 2008 by a total of 300 basis points, down to 4.25%.
- During the same period, many major developed countries across the world have also recorded a significant easing in monetary policy. The central banks of England, Europe, the US (and Canada) have cut their rates by 300bps, 175 bps, and 100 bps respectively.
- These cuts are intending to avert a global recession by stimulating growth, boosting liquidity and supporting confidence within financial markets.

Consumer price inflation



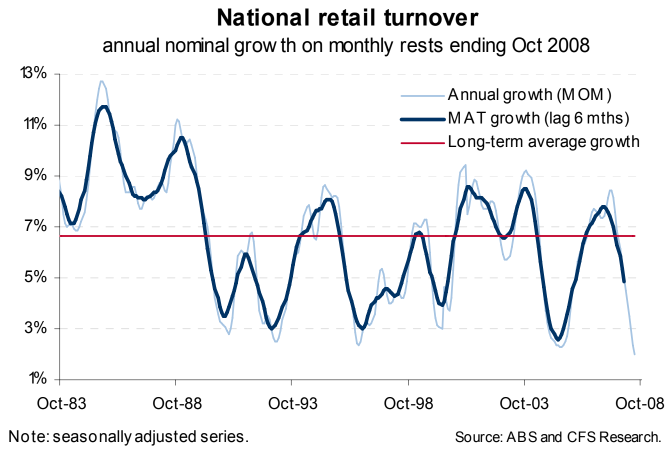
- In September, annual growth in consumer inflation in Australia reached 5.0% well above the RBA's target range of 2%-3%. Contributors were non-tradables that climbed to 6.1% while tradables reached 3.4%.
- In the near term, inflationary pressures should ease due to a low interest rate setting, slowing economic activity and global demand, and a decline in commodity prices.
- However, the relatively weak dollar has flow-on effect on trade, improving export activity but also increasing the prices of tradables.

Labour market



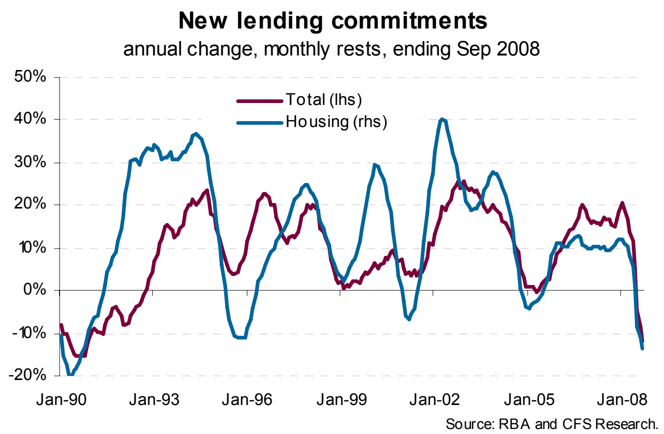
- During October 2008, the unemployment rate remained steady at 4.3% while annual employment growth increased by 0.3% percentage points to 2.2%.
- In the short term, domestic unemployment is expected to rise to reflect the reverberation of instability on financial markets flowing through to the real economy.
- The shift in the labour market from full time to part time employment will likely continue as the economic activity slows further.

Retail sector demand



- The moving annual trend (MAT) in national retail turnover growth in October 2008 was 4.8%, below the long-term trend of 6.6%.
- Turnover growth has declined sharply from the cyclical peak of 8.5% reached in October 2007 to 2.0% in October 2008; the lowest level witnessed in a cyclical downturn. This is due to deterioration in private wealth, uncertainty regarding job security and weak household sentiment.
- With government fiscal stimulus in December 2008, low petrol prices and interest rates, retail turnover will likely be temporarily supported in the near term. Yet uncertainty regarding the job security will restrain consumer spending.

Lending commitments

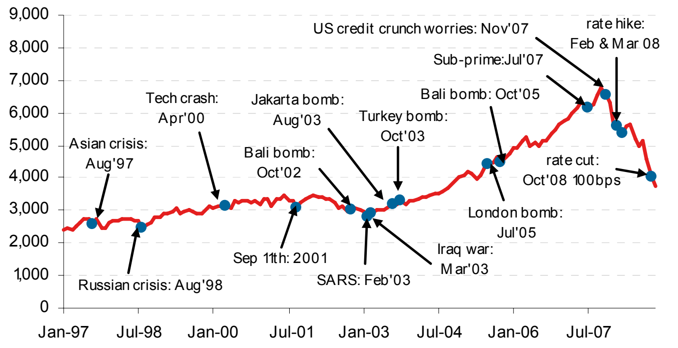


- In September 2008, total housing - comprising of owner occupied and investment construction, existing dwellings, and refinancing - recorded a negative growth of 13.7%.
- This has been in line with a decline in total lending commitments (personal and commercial).

Australian equity market

Australian listed share market

S&P/ASX 200, monthly price index ending Nov 2008



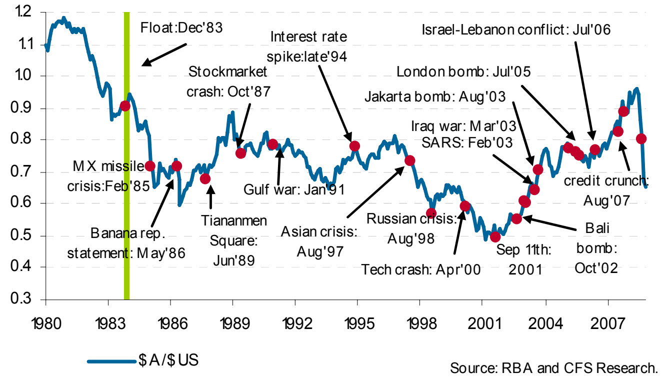
Source: RBA and CFS Research.

- Since its peak in October 2007, the S&P/ASX 200 has fallen by 44.6% to 3,743 points at the end of November 2008, bringing the market back to May 2004 levels and wiping off not realised gains made since then.
- Despite the efforts of central banks and government treasuries worldwide to shore up financial systems; global markets have continued to fall heavily during the three months to 30 September due to re-pricing of risk, and weak consumer and business sentiment.

Exchange rate

Movements in the Australian currency

Units of foreign currency per $A, ending Nov 2008



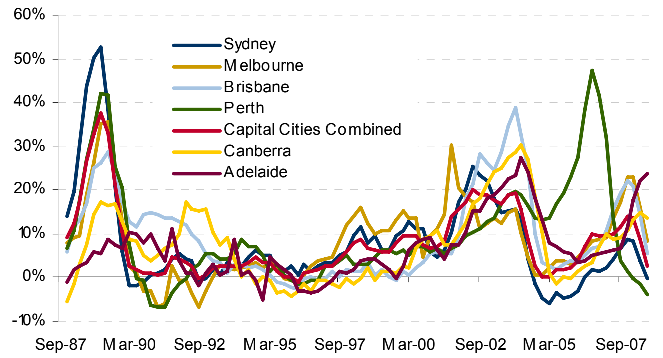
Source: RBA and CFS Research.

- The Australian dollar (AUD) has experienced a steep decline, depreciating by 30% between July 2008 and the end of November 2008, when it closed at $0.66.
- The sharp fall in the AUD has occurred on the back of the decline in commodity prices and re-pricing of country risk, resulting in shift in risk appetite away from commodity driven currencies towards stronger currencies.
- In the near term, the weak AUD will continue to support exporters while contributing to tradables inflation.

House prices

Growth in establised house prices for AUS cities

annual returns on quarterly rests ending Sep 2008



Source: ABS and CFS Research.

- In the September 2008 quarter, a decline in annual house price growth was recorded in all major cities nationwide, with Sydney and Perth recording negative growth of 0.4% and 4.1% respectively. In contrast, Adelaide was an out-performer but is now slowing quite rapidly.
- Deterioration in housing and equity markets has resulted in private wealth destruction weakening consumer confidence. Despite the low interest rate setting, concerns regarding job security will persist in the short term, affecting consumer's appetite and restraining activity in the housing market.

3. Research team

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