Economic Research
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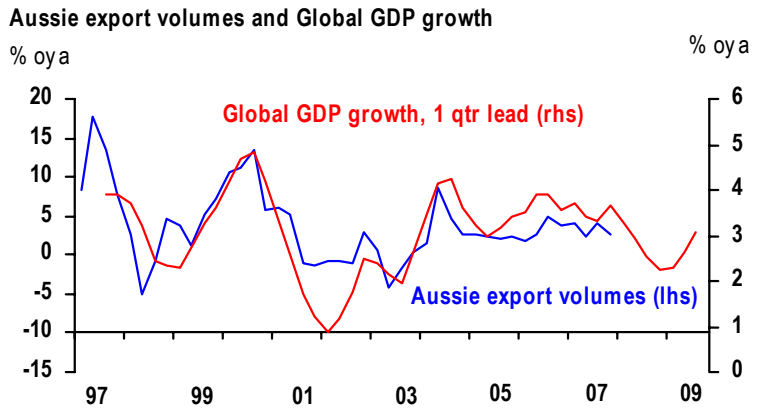
Australian economic update

Downgrades to Aussie GDP growth

Several weeks ago, we lowered our forecast for Australian GDP growth for 2008 and 2009 owing to two main developments: first, the unexpectedly assertive interest rate rises by the Reserve Bank (and the related, but disproportionately large, rises in market interest rates) and, second, the spike in energy prices. Both developments will leave dents in household disposable income and result in weaker consumer spending, which accounts for 60% of the economy. Also, on top of these two factors, we lowered expected growth in export volumes, which have been unexpectedly slow to improve, despite booming business investment, owing to the deterioration in conditions in Australia's major export markets and lingering capacity constraints in ports, rail, power generation and, increasingly, labour markets. Indeed, net exports again will subtract from GDP growth in 2008.

In the wake of this week's downgrades to JPMorgan's forecasts for global economic growth, however, we have further downgraded our forecast for Australia's GDP growth for 2008 to 3.1% (from 3.4%). This time, the main transmission mechanism will be softer export volume growth, owing mainly to the downgrades recently made to JPMorgan's growth forecasts for the economies in Asia, which receive nearly 60% of Australia's exports. The additional and simultaneous pain being inflicted on households by rising interest rates, plunging equity markets, declining confidence and high energy prices, however, means we now look for Aussie GDP growth of just 2.7% in 2009 (down from 3.2%).



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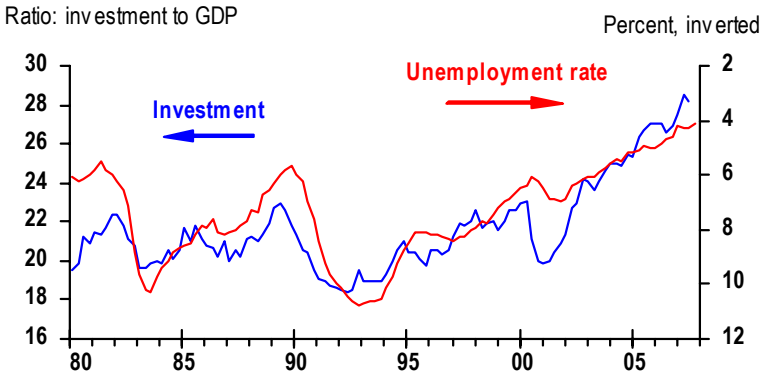
Previously, we had expected Australia's export volumes to rise 4.7% in 2008, and by a further 7.1% in 2009. With weaker growth now expected in Australia's major trading partners, we have trimmed these export growth forecasts to 3.8% and 6.3%, respectively. That is, we still expect decent export volume growth (finally!) as the capacity constraints are ironed out by the extension of the mining investment boom, but the upswing is less impressive than before. Partly offsetting this weaker export growth profile, though, is our expectation of firmer growth in private investment - the mining investment pipeline has become even more swollen by the entanglement of bureaucratic red tape and the lack of available skills and equipment. More capex spending, therefore, relative to our earlier forecasts, will take place in 2008. The most recent survey of firms' investment intentions showed a 24% rise in planned spending for the year ended June 2009.

Also, we have become more pessimistic about the outlook for Australian households which, until now, have rarely had it so good. Indeed, the key supports for Australian households remain in place. First, the job market is extremely tight, owing partly to the investment boom (chart), which has helped drive the jobless rate down to a 33-year low. Second, the soaring terms of trade is providing a massive boost to national income, mainly as the government recycles booming corporate tax receipts back to households via the personal tax system - the government remains committed to paying another round of personal tax relief from July, even though this is likely to aggravate RBA officials trying to slow growth in domestic demand to curb inflation.

Aussie investment and the jobless rate



On the flipside for households, though, key headwinds are becoming stronger. Record high crude oil prices will translate into substantially higher petrol prices in coming months, the RBA's assertive rate hikes are starting to bite (particularly for households in outer suburban areas of the big cities, where house prices are falling), plunging equity prices will leave a significant dent in household wealth, the unemployment rate will start to rise in the latter part of 2008 as the investment backlog is worked off, and there now is talk of credit being rationed by the major banks. As a result of these strengthening headwinds, predictably, consumer confidence has plunged precipitously to the lowest level in 15 years.

Finally, the newly-elected Rudd Labor government has unleashed a razor gang to slash public spending. According to a recent report by the Treasury, recent growth in public spending was the fastest since the aftermath of the last recession in the early

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1990s. We, therefore, have trimmed our forecast for growth in public spending to 3.7% in 2008 (down from 4.8%) and 2.8% in 2009 (down from 3.5%). Of the other components of GDP growth, we still expect dwelling investment to rise as the housing shortfall is made up, but there probably will be a larger inventory correction as firms attempt to boost working capital and lower costs by carrying less stock.

For the RBA, despite the Aussie growth downgrades and our forecast of more aggressive easing by other central banks, we are sticking with our forecast for another 25bp rate hike by the RBA in early May, on the assumption that the 1Q CPI print (in late April) will show inflation well above the RBA's 2-3% target range, with headline inflation running close to 4%. That said, with the dysfunction in global money and credit markets getting worse (market interest rates again have spiked well above cash) and, according to our US macro team, the US economy now in recession, the chances of the RBA delivering a tightening in May have diminished. Even if the tightening cycle is over, the RBA probably will leave the cash rate at the current 7.25% for an extended period to squeeze inflation from the economy - rate cuts are out of the question given the dire inflation outlook.

Australia: GDP growth

	Annual change (%)						
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Household spending	3.5	5.9	3.1	2.9	4.5	3.5	2.0
Government spending	3.7	3.9	3.0	3.8	3.0	3.7	2.8
Business investment	15.4	10.6	16.3	8.2	11.4	3.6	-0.7
Dwelling investment	5.4	3.0	-3.5	-2.6	3.5	2.9	3.6
Change in inventories (cont.)	2.1	0.0	0.9	-1.2	2.3	-1.4	-0.4
Exports	-1.2	4.3	2.3	3.3	3.3	3.8	6.3
Imports	11.1	15.0	8.9	7.2	10.7	5.1	2.5
Net Exports (cont.)	-2.1	-1.9	-1.3	-0.9	-1.7	-0.4	0.7
GDP	**3.0**	**3.8**	**2.8**	**2.8**	**3.9**	**3.1**	**2.7**

The risks to our Australian growth forecasts are not symmetric. Unexpected strength in the global economy, relative to our new forecasts, would deliver even firmer growth in Aussie exports and fuel further investment. On the flipside, however, if we are over-estimating the strength of global growth, the negative impact on Australia will be acute, given that most of the stimulus to growth in the real economy, employment, and national income is coming from the export-oriented resource sector. Unexpectedly weak growth in Australia's major export markets, relative to our already downgraded forecasts, would see our forecast growth in Aussie export volumes fail to materialize, investment in mining and infrastructure being delayed or cancelled, which would be an anchor on employment growth, and the terms of trade reversing as commodity prices fell.

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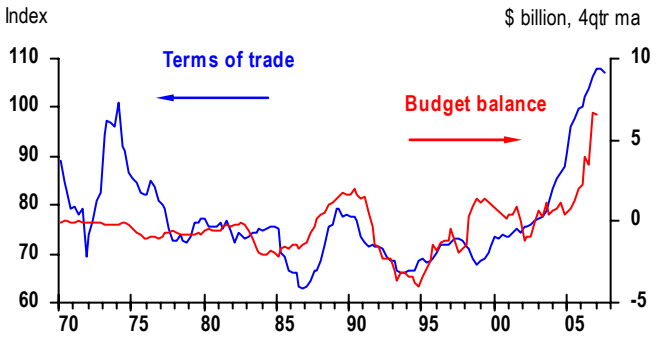
A sustained terms of trade correction would be a substantial drag on national income growth - in particular, it would squeeze the government's corporate tax collections and, therefore, imperil the government's ability to fund its promised personal income tax cuts. In all likelihood, under this scenario, AUD would fall even faster than forecast as commodity prices declined. This would exacerbate Australia's already chronic inflation problem, and could trigger even more assertive rate hikes by the RBA. Clearly, this would be a dead weight on consumers. After many years in which booming domestic demand more than offset a disappointing export performance, under the "perfect storm" described above, Australia's external and domestic economies simultaneously would deteriorate and GDP growth in 2009 probably would be well south of 2%.

Terms of trade bolsters budget surplus



Also, we have downgraded slightly our forecast for GDP growth in New Zealand in 2008 to 2.3% from 2.5% (we trimmed the 2009 forecast from 2.8% to 2.7%). Export growth will slow by more than previously expected under the weight of stronger NZD and the weaker profile for global demand, and particularly in Australia, New Zealand's largest trading partner. Private consumption growth will slow as record high interest rates, elevated petrol prices, and a turning housing market rein in household spending. This is especially likely given that domestic banks recently have started to pass on higher funding costs from credit market tightening, even though the official cash rate has remained steady since July 2007. The RBNZ is likely to keep the cash rate unchanged for some time, owing to elevated inflation above the RBNZ's 1-3% target range.