

Economic research note

Monthly snapshot of the Australian economy

Date: 22 May 2008

Executive summary

- The Australian economy lies at a crucial inflection point in this cycle. The gathering momentum of the commodity boom has created employment, wealth and expanding budget surpluses but the price has been higher inflation. Annual price rises reached 4.2% in March 2008. The expansion has soaked up productive resources raising the cost of production while global commodity price rises, that support the boom, contribute to higher consumer prices.
- The economy approaches this inflection point in a strong position; growth of 3.9% in 2007 was above trend. In the labour market near record low unemployment of 4.2% is supported by employment growth of 2.9% year-on-year; above the ten year average of 2.2%.
- This central problem of growth in a rising price environment has been at the forefront of Reserve Bank (RBA) considerations for some time. Despite the negative impact on leveraged households of higher interest rates, the RBA has maintained an inflation targeting monetary policy that has necessitated two further rate rises in 2008.
- In May the federal government's addressed growth and inflation in its first budget. The budget followed through on tax cuts promised in the election but also ended other spending programmes and raised taxes elsewhere; allowing the government to say it was acting to constrain growth.
- Slower growth is a necessary condition for economic growth to maintain a sustainable path over the medium term in Australia. In the meantime, the fiscal and monetary authorities must act to constrain demand until such time that greater productive capacity can be created.

1. The Federal Budget

The Federal Budget, handed down on 13th May, provides a valuable reference point for the state of the Australian economy and its anticipated future direction. The concerns it addresses, highlights the competing pressures in the economy; the rising cost of living for households and the positive boost to income of the commodities boom.

The budget created a surplus amounting to 1.9% of GDP and includes tax cuts of \$47 billion over five years, the creation of three funds, totalling \$40bn, for infrastructure, health and education and cuts to a number of the former Howard government's spending programs. The expanding surplus and spending cuts means the budget is contractionary. The contractionary pressure will fall on middle to high income earners with means testing applied to incentives, including the Baby Bonus and Solar Panel programs.

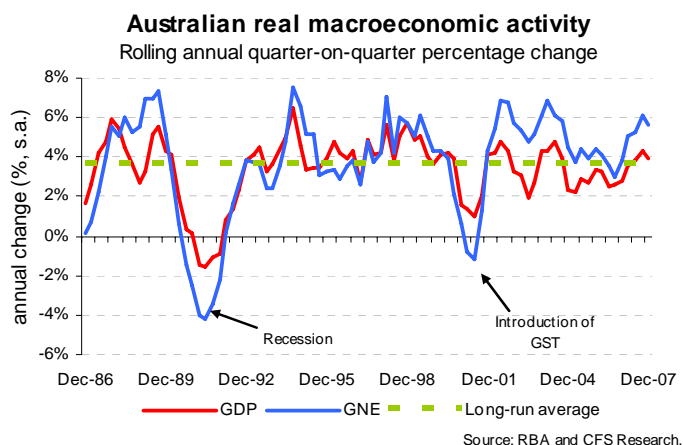
The budget lowered economic forecasts for 2007/08 from previous Treasury estimates. 2007/08 growth is expected to be 3.75% compared to a forecast of 4.25% in December 2007 and inflation is forecast at 2.5% in the same period.

The budget also revealed the full extent of the windfall gains delivered by the commodities boom. 2007's mid-year economic forecasts projected a 2008 surplus of \$14.7 billion. The budget raised this forecast to \$21 billion; a 50% increase despite falling capital gains revenues in line with a weaker equity market.

The budget offered few surprises, given election promises and recent policy leaks. While it may be contractionary, it is likely that the RBA will remain very vigilant to upside inflation risks.

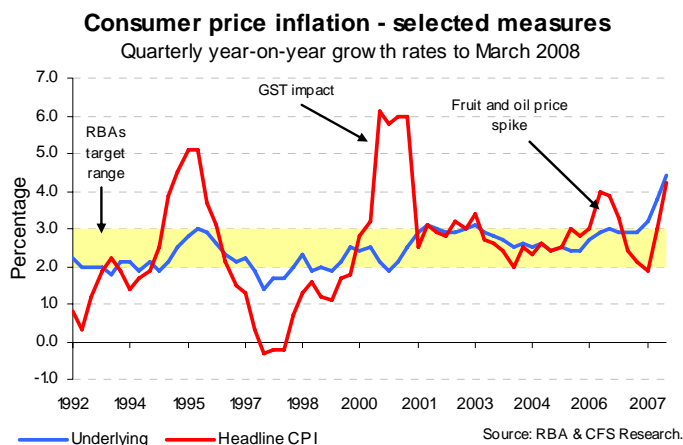
2. Key economic indicators

GDP growth



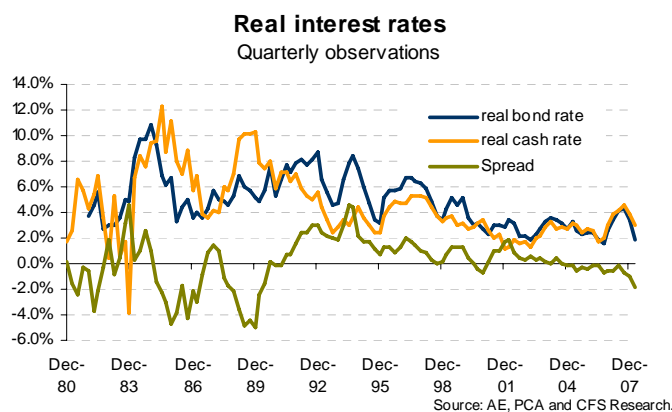
- GDP growth in 2007 of 3.9% was slightly above the long term average of 3.8% per annum.
- The strength of the domestic economy since 2000 has supported economic growth in Australia. Conversely, the external sector has detracted from growth.
- Australia's weak external performance is in spite of a record rise in the terms of trade. Supply constraints have limited the volume of exports and imports have been strong; particularly for consumption, business investment and the higher price of oil.

Inflation



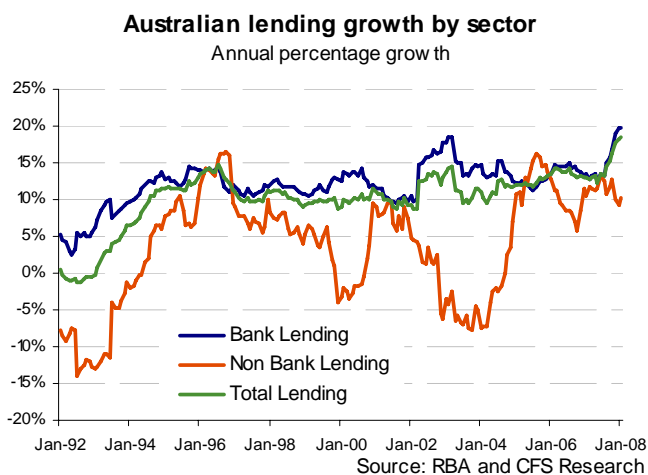
- Underlying inflation has risen to its highest level in the current expansion that began in 1993. It is a strong signal of the capacity constraints in the economy.
- At the same time, headline inflation is also elevated; a function of higher global commodity prices, including fuel and food.
- The combination of supply constraints, growing labour costs and rising global prices suggests underlying inflation will remain above the RBA's comfort level for a sustained period.

Interest rates



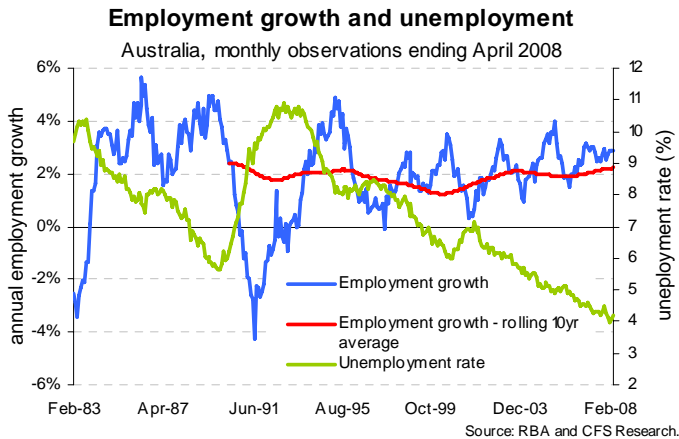
- The RBA has raised the cash rate eight times in the last three years from 5.50% to 7.25%.
- However, real interest rates (the cash rate or bond rate less inflation) are now approaching cyclical lows, driven by higher inflation and a belief in the bond market that the cash rate is close to its peak in this cycle.
- The RBA will be concerned that high prices have shifted the cash rate from moderately tight to moderately loose. This would be a signal for further rate rises given the pressures on underlying price growth.

Lending



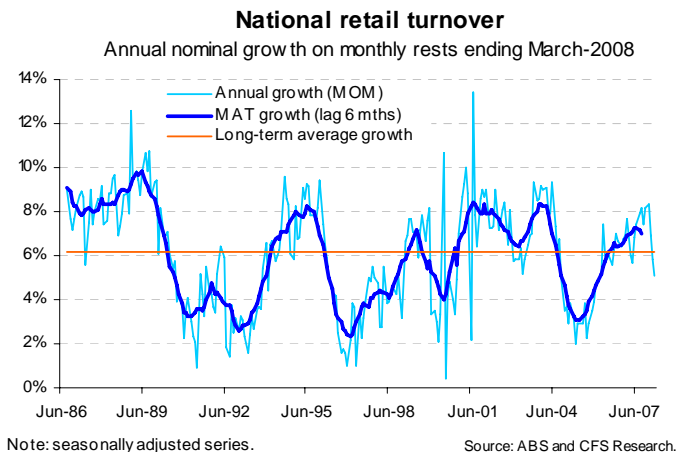
- In spite of the global credit crunch, lending to businesses and households has grown significantly since August 2007. As of February 2008, bank lending growth was up 19% year-on-year.
- The impact of the credit crisis has been greatest in the non-bank sector. In this sector, lending growth has fallen from 13% to 9% as market share was lost to the banks.
- The strong lending reflects the strength of the Australian economy despite global turbulence and an attempt by banks to take advantage of their relatively better funding positions.

Labour market



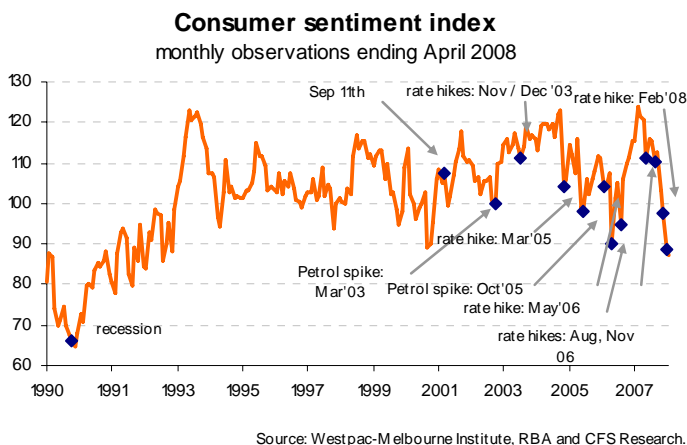
- The strength of the labour market has supported domestic demand in the face of pressures from higher commodity prices, interest rate rises, and volatility in asset prices including residential property and equities.
- The upward trend in employment growth has seen unemployment fall to new record lows, which has attracted more people into the labour market, raising the participation rate to record highs.
- Recent strong employment growth of 2.9%, compared to a 10 year average of 2.2%, casts doubt over the budget forecast for the unemployment rate to rise from 4.2% to 4.75% over the course of 2008.

Retail sales



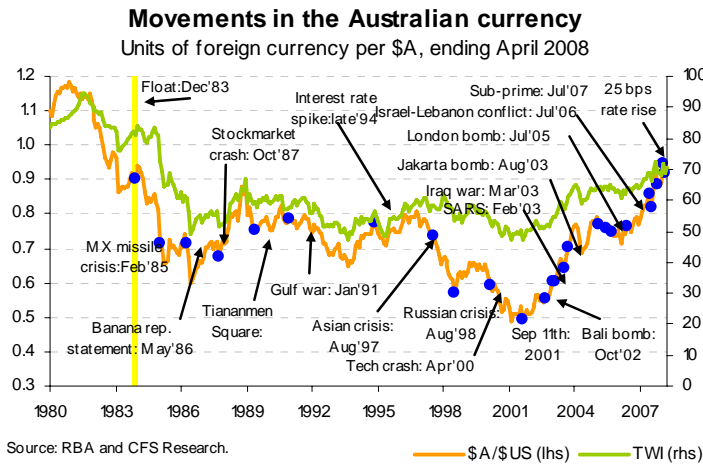
- Retail sales have been the most volatile core indicator of the Australian economy over the last five years.
- The impact of higher commodity prices, interest rates and greater uncertainty in the economy suggests the retail sector is set for further moderation.
- However, there are some key supports for the retail sector; including robust employment growth, tax cuts and the strong Australian dollar's impact on lowering the cost of consumer imports.

Consumer sentiment



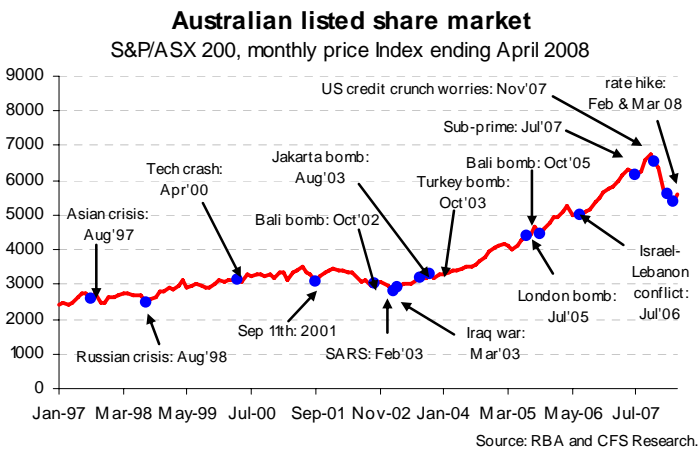
- Since reaching record highs in February 2007, consumer sentiment has been on a downward trajectory.
- The falling index has been driven by consecutive rate hikes, rising prices and less confidence in the global economy.
- This suggests that the RBA's monetary tightening action is beginning to have the desired effect.

Exchange rates



- The Australian dollar continues to maintain its strength against the greenback, and has been oscillating in a range between US\$0.90 and US\$0.95 over the last month.
- The current range trading reflects uncertainty in a number of areas. Particularly, the market may be considering an end to the US dollar weakness, the end of rising commodity prices and a smaller interest rate differential between Australia and the US.
- In the future the Australian dollar will remain tied to external developments; particularly the pace of future US interest rate rises to deal with anticipated inflationary pressures and the strength of demand for commodities.

Equity market



- The equity market has made a strong recovery from its lows around 5,200 in March and April.
- A recent rally in the Australian index brought the ASX200 within range of the 6,000 point level. However, concerns over rising oil prices and a sluggish short-term outlook for the US economy have weighed on sentiment.
- Despite global uncertainty there are some compelling valuation stories in the Australian market. Some examples include the miners, strong banks relative to global peers and property and infrastructure trusts trading well below NAV.

3. Research team

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