Economic Research

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OUR VIEW

Green shoots in developed countries provide impetus for a quick recovery

Green shoots in major developed countries such as the United States (US), Eurozone and Japan will support the Australian economy in 2009, making the current downturn not as severe as feared. A turnaround in major economies will have a positive effect on commodity prices in the medium term, giving an edge to major commodity-exporting countries like Australia. A steady rebound in industrial activity, evidenced by upturns in Purchasing Managers' indices (PMIs) in the US and Eurozone, will benefit Australia's external trade, giving an extra boost to the overall GDP growth.

China's recovery is an added plus

The recent rebound in economic activity in China augurs well for the Australian economy as the former is the main export market for Australia's major commodities. In addition, positive effects from China's huge fiscal stimulus package have been reflected in sharp 7.9% GDP growth in the 2Q2009 following a 6.2% expansion in the earlier quarter. Other signs of an upturn are accelerating fixed asset investments, a rebound in the PMI, a sharp increase in money supply and a jump in foreign exchange reserves.

Domestic factors spur the economy

Domestic factors will also support Australia's economic recovery in the near term. Rising consumer confidence and a relatively resilient labour market will support private consumption and the housing sector which will further benefit from a low interest rates environment. The strong banking sector ensures that lending will not contract as the effects of an accommodative monetary policy will spur domestic economy in the medium term.

A note on possible risks

Notwithstanding the above, certain risks should be considered. These include the risks of rising trade protectionism, premature removal of accommodative monetary stance and fiscal stimulus in fear of inflation and budget deficit, rising long-term bond yields, a sharp slowdown in bank lending, another downturn in commodity prices and a sharp deterioration in the budget and current account matrix.

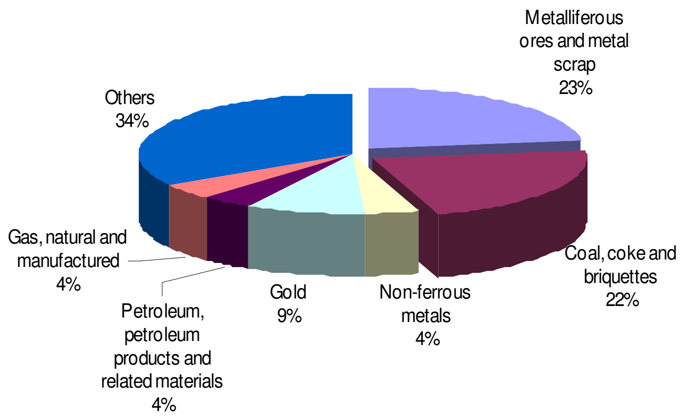
Overall positive on economic strength and competitive position

However, we feel that Australia is among the most resilient economies judging by its historical economic strength, global competitiveness and its attractive business environment. With the faster-than-expected recovery of China, and other positive domestic factors, the Australian economy will emerge stronger in the medium term.

Economic Status and Competitiveness

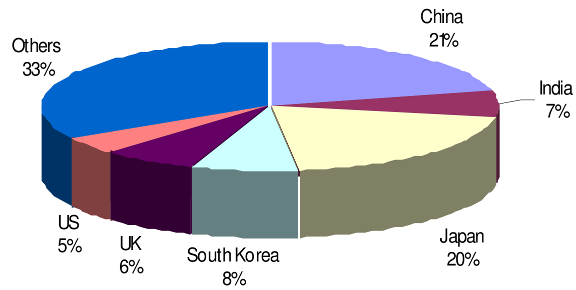
The economy is dominated by the finance & insurance sector as well as property & business services sector, which both accounted for 19.5% of GDP as of 2008. Two other main sectors – commerce and manufacturing – represented about 14% and 12% of the economy respectively. The mining sector, despite accounting for only 8% of the total output, is a major contributor to the export sector. A breakdown by products shows that metalliferous ores constituted 23% of total exports; coal, coke and briquettes 22%; and gold 9%. China and Japan are major export markets for Australia, accounting for 21% and 20% respectively in the first five months of 2009. Although world prices of commodities such as coal and iron ores have retreated from their highs last year, they have rebounded from their recent lows following signs of a recovery in the global economy, notably in China.

Chart 1: Exports by product - % of total YTD (Jan'09 to May'09)



Source: Australian Bureau of Statistics (ABS)

Chart 2: Exports by country - % of total YTD (Jan'09 to May'09)

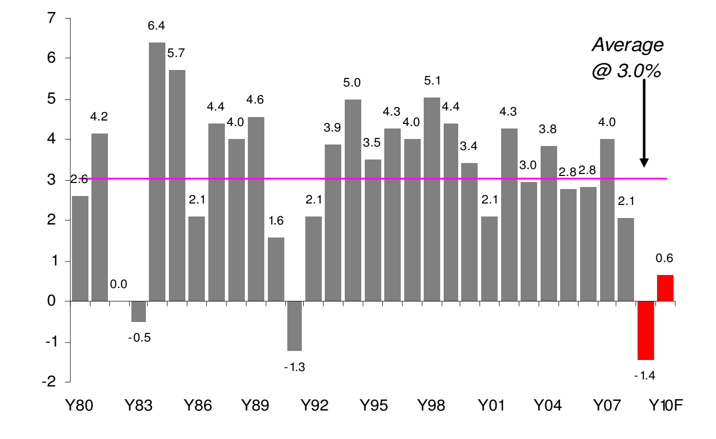


Source: Australian Bureau of Statistics (ABS)

Australia boasts one of the strongest economies in the world, recording 16 years of uninterrupted expansion from 1991 to 2007 despite slower growth in 2008 following the global economic crisis. Between 1980 and 2008, Australia's average GDP growth of 3.0%, topped the performances of major developed economies like the US (2.9%), UK (2.4%), Japan (2.3%) and Germany (1.9%).

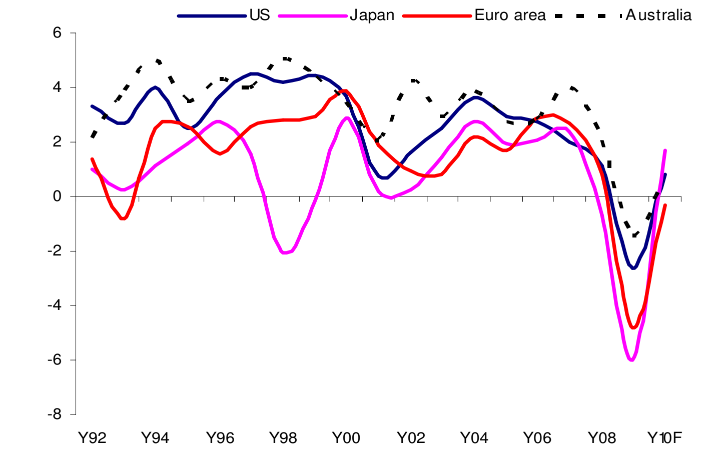
Australia's economic strength is also manifested in the expected shallow recession of -0.5% in 2009, as forecast by the International Monetary Fund (IMF) in its latest outlook, compared with its April forecast of a -1.4% contraction. This is in stark contrast with economies like the US, Eurozone and Japan, which are anticipated to register contractions of 2% to 6% this year. Historical growth rates also indicate that the economy has been more resilient during downturns. For instance, during the downturn in 2001, the US and Japan economies grew less than 1% while Australia chalked up a growth rate of 2.1%.

Chart 3: Australia's GDP growth since 1980



Source: International Monetary Fund (IMF)

Chart 4: Growth in comparison to G3 economy



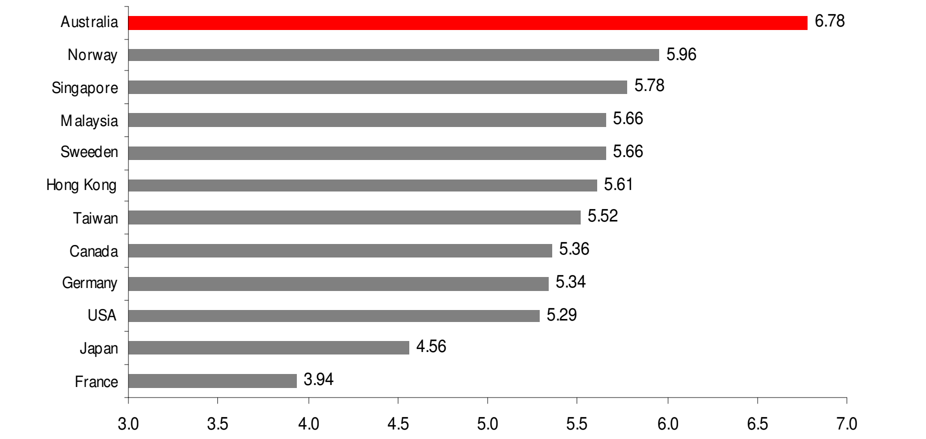
Source: International Monetary Fund (IMF)

The Institute for Management Development (IMD) World Competitiveness Scoreboard 2009 has retained Australia's position as the 7th most competitive country as in the preceding year, exceeding other advanced economies like Japan which ranked 17th, Germany (13th), Canada (8th), Netherland (10th) and the UK (21st).

Moreover, the country ranked first in terms of economic resilience, followed by Denmark and Switzerland. Major economies like the US and Japan were placed 21st and 32nd respectively in the same category.

In terms of reliability and business regulations, Australia also ranked favourably in 2008. The Economic Intelligence Unit (EIU) ranked Australia 6th in the world for quality and attractiveness of business environment. This ranking is based on factors such as political and macroeconomic environment, market opportunities, policies towards free enterprise, competition and foreign investment, exchange controls, taxes, financing, labour market and infrastructure.

Chart 5: Resilience of the economy to economic cycles in 2008 -



Source: Institute for Management Development (IMD)

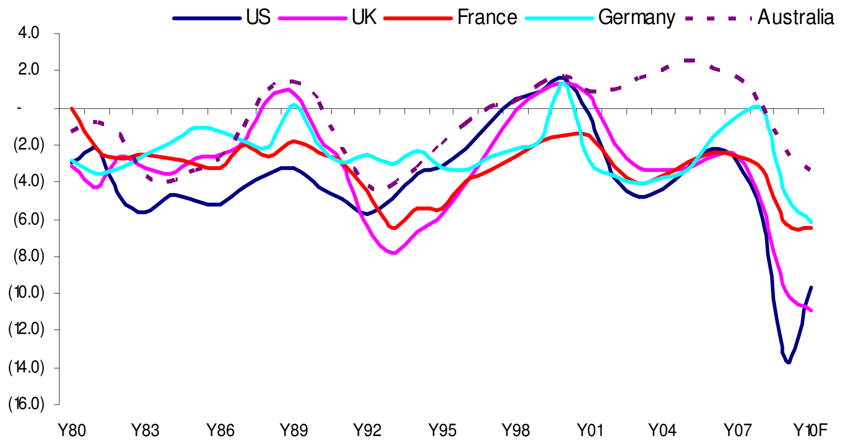
Table 1: Business environment (Ranks and Score)

	2008 Rank	2008 Score	2003 Rank	2003 Score	Change in Total Score	Change in Rank
Denmark	1	8.76	2	8.74	0.01	1
Finland	2	8.74	3	8.71	0.03	1
Singapore	3	8.73	1	8.84	-0.11	-2
Canada	4	8.71	5	8.64	0.07	1
Switzerland	5	8.68	4	8.67	0.01	-1
Australia	6	8.65	14	8.20	0.45	8
Hong Kong	7	8.64	7	8.64	0.00	0
Netherlands	8	8.63	8	8.59	0.04	0
Sweden	9	8.63	11	8.34	0.29	2
USA	10	8.60	6	8.64	-0.04	-4
Ireland	11	8.57	9	8.53	0.04	-2
UK	12	8.56	10	8.52	0.04	-2
Germany	13	8.48	15	8.13	0.35	2
New Zealand	14	8.29	13	8.20	0.08	-1
Austria	15	8.26	16	8.00	0.26	1
Belgium	16	8.25	12	8.22	0.03	-4
Norway	17	8.14	17	7.97	0.16	0
Taiwan	18	8.11	22	7.57	0.54	4
France	19	8.03	18	7.89	0.14	-1
Chile	20	8.02	19	7.80	0.22	-1

Source: Austrade

The country enjoys a stable AAA sovereign rating from both Moody's and Standard & Poor's, reflecting a strong capacity for the government to meet its financial commitments and withstand changing economic circumstances. Australia ranked favourably when compared to other major countries in the same rating band, especially with respect to budget deficits.

Chart 6: Fiscal balance as percentage of GDP



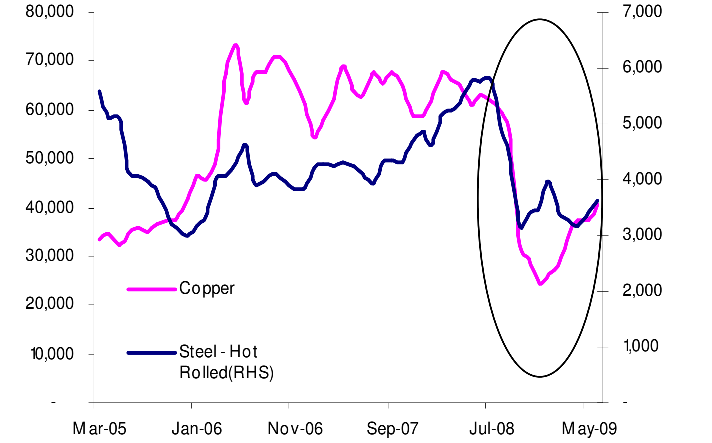
Source: International Monetary Fund (IMF)

Current Economic Strength

Green shoots in major developed countries provide impetus for a quick recovery

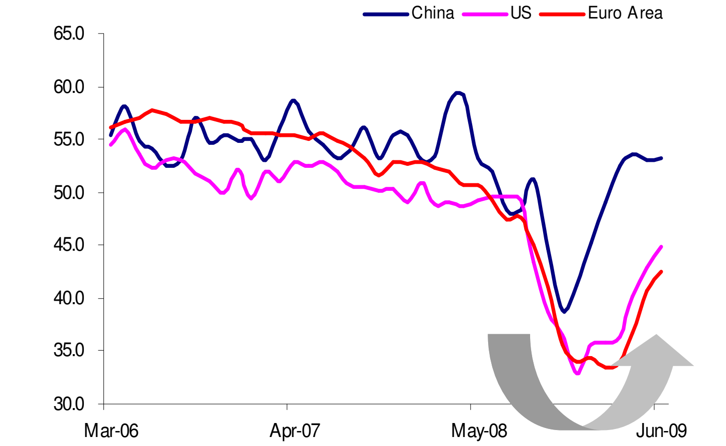
The rebound in PMIs in major developed countries indicates that economic activities may start to pick up the pace by late this year. For instance, in the US, the Institute of Supply Management (ISM) index has surged by 36.2% since hitting its trough in December 2008, suggesting that manufacturing activity, while still in contraction mode, is on the mend. Similarly, in the Eurozone, the PMI index has risen by 27.2% since reaching its bottom in February 2009. As an expectation of a further recovery pushed up prices of major commodities used in construction such as steel and nickel, Australia, which is ranked first in the exports of alumina and bauxite and second for gold lead, nickel, zinc and uranium oxide, will benefit significantly.

Chart 7: Prices of steel and copper in RMB/MT



Source: Bloomberg

Chart 8: Purchasing managers index (PMI)



Source: Bloomberg

China's recovery is an added plus

China's economy is a critical factor for Australia as the latter exports the bulk of its commodities to support China's manufacturing process. Recent signs of a rebound in economic activity in China augur well for the Australian economy. These include:

- An accelerating GDP growth in the 2Q2009 to 7.9% from 1Q2009 6.1%, led by investments and private consumption.
- A rebound in retail sales by 15% year-on-year in May and June following steady expansion in private consumption.
- A sharp U-turn in China's PMIs by 29.2% since December last year.
- An upsurge in urban fixed asset investments by 33.6% in 1H2009 following a ramp-up in new government projects.
- An accelerating growth of money supply by 28.46% in June due to massive increases in bank lending activities.
- A jump in foreign exchange reserves to US$2.13 trillion in the 2Q2009 following the return of capital flows into the country.

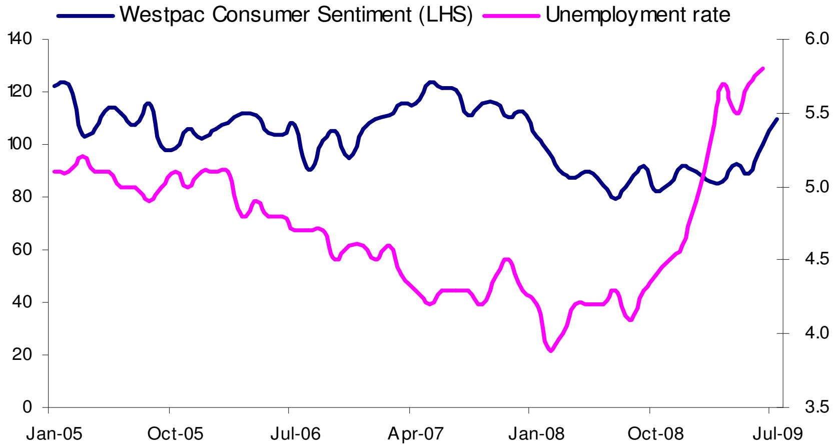
Domestic green shoots will also support the economy

In addition to a possible sustained recovery in global economic activity, domestic factors also support the optimistic view on the economy. Most notable is the recent surge in consumer confidence as evidenced by a sharp rebound of 23.2% in the Westpact Melbourne Institute index in the two months ended June, the strongest gain on record. While the reasons for rising optimism among consumers are debatable, much of it is likely related to favourable domestic factors such as a better macro outlook of the economy, a stable labour market, a resilient banking system and moderating inflation.

- ***Optimism arises from economic performance in the 1Q2009***

Consumers' rising optimism may be due to the economic performance in 1Q2009 which registered a 0.5% growth, averting the so-called technical recession. As consumers were generally prepared for the worst, a positive economic growth brought a burst of confidence. Such optimism will provide further support for the economy as an increase in consumer confidence generates positive business conditions, which in turn improves future employment prospects.

Chart 9: Westpac consumer sentiment index vs. unemployment rate



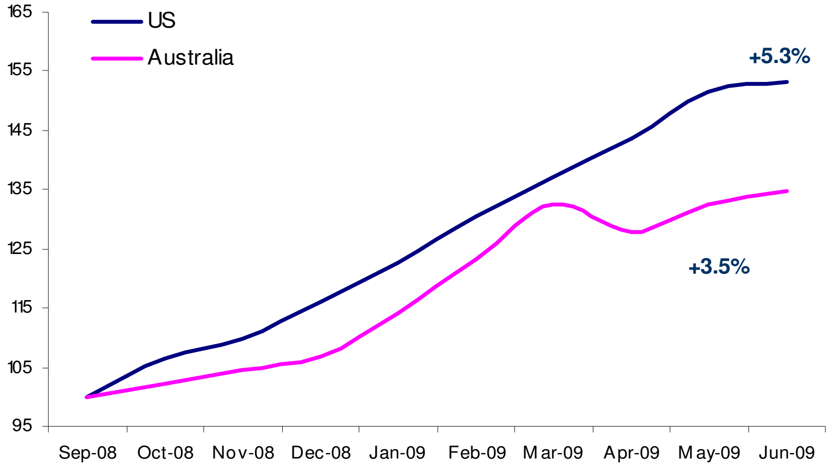
Source: Bloomberg

- ***No serious deterioration of the job market***

Although the unemployment rate has been climbing, overall labour market conditions are not likely to deteriorate as much as in other advanced countries. Incremental unemployment rate has been slower when compared to, for example, the US. Since the fallout of Lehman Brothers in September last year, the US unemployment rate grew by 5.3% as opposed to 3.5% in Australia. Moreover, labour market dynamics seem to suggest that the weakness in the Australian economy has been predominantly driven by a drop in global demand, thus affecting jobs in the export sector.

Another critical point to note is that although unemployment rate has been rising, much of it can be explained by the rapid growth in the country's labour force rather than a sharp upturn in the number of job losses. This is reflected in the number of total employment, which dropped by an average 1,860 per month since early of this year while labour force continued to expand by 25,240 a month during the same corresponding period.

Chart 10: Unemployment rate – the pace of increases (Sep' 08 = 100)



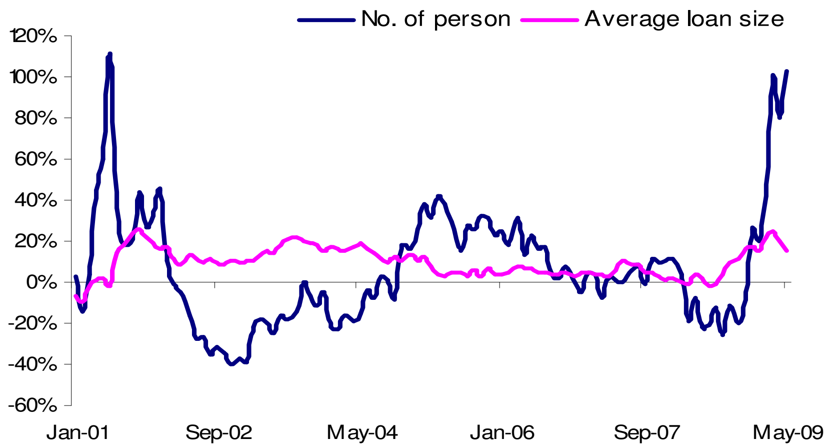
Source: Bloomberg

- ***Resilient banking and property sectors***

A strong banking system is a critical factor behind Australia's relatively resilient economy. Conservative lending practices have insulated the country's banking system from problems related to the sub-prime crisis. As statistics revealed that Australia's sub-prime loans to be less than 1%, a drastic increase in delinquency rates that could lead to foreclosures as in the US is less likely.

In addition, the banking sector was supported by a relatively steady property market, despite some weaknesses following softer economic condition. Although affected by the recent turbulence in the global economy, the weakness in the property sector was offset by demand from first time buyers who took advantage of lower mortgage rates following a rapid reduction in the benchmark rate by the Reserve Bank of Australia (RBA). Statistics showed that in the seven months up to May, housing approvals were up by more than 20%, largely attributable to demand from first time buyers.

Chart 11: First home buyers Y-o-Y%



Source: Australian Bureau of Statistics (ABS)

- ***Positive effects from fiscal and monetary policies***

Given the strength in its budgetary position prior to the crisis, the Australian government has some leeway in its spending plans to counter the effects of the recent economic slowdown. Between 2002 and 2007, government's budget surplus averaged about 1.3% of GDP following a steady growth in revenue by an average of 8.0%, compared to its expenses which expanded by 6.9%. Over the period, government's revenues were about 26% of GDP while expenses accounted for approximately 24%. As a result, the strong fiscal position has enabled the government to implement AUD28.8 billion package for schools, housing and roads, and AUD13.2 billion to boost incomes for low- and middle- income groups. The package is also meant to help support and sustain up to 90,000 jobs over the next two years.

On the monetary side, the rapid moves to reduce Australia's benchmark interest rate by the RBA were an important buffer against a sharp deceleration in economic activity. The declines in interest rates have helped support the housing sector by reducing mortgage rates that are largely dependent on the movements of the RBA's key rate.

Key risk areas

Despite the recent spate of good news globally, uncertainties over the sustainability of the current recovery still linger. In particular, global green shoots could be stunted by a return in risk aversion in the medium term. We foresee the following factors could derail the recovery of Australian economy and potentially affect its currency.

- **Unsustained growth of global green shoots**

While signs of a possible recovery have emerged in developed economies, global economic conditions could turn sour if some of the following development take place: (1) a rise in protectionism; (2) premature removal of accommodative monetary stance and government fiscal stimulus; (3) rapid increase in long-term bond yields; (4) slow growth in bank lending.

- ***Rising trade protectionism***

Protectionism is one of the major impediments for a sustained economic recovery as shown by the experience during the Great Depression in the 1930s. A rise in protectionism will prevent a turnaround in global trade, thus hindering a trade-dependent economy such as Australia from a sustained recovery. This is important as global trade is expected to shrink by 9.0% in 2009 after posting a minuscule growth of 2.0% in 2008, according to World Trade Organization (WTO).

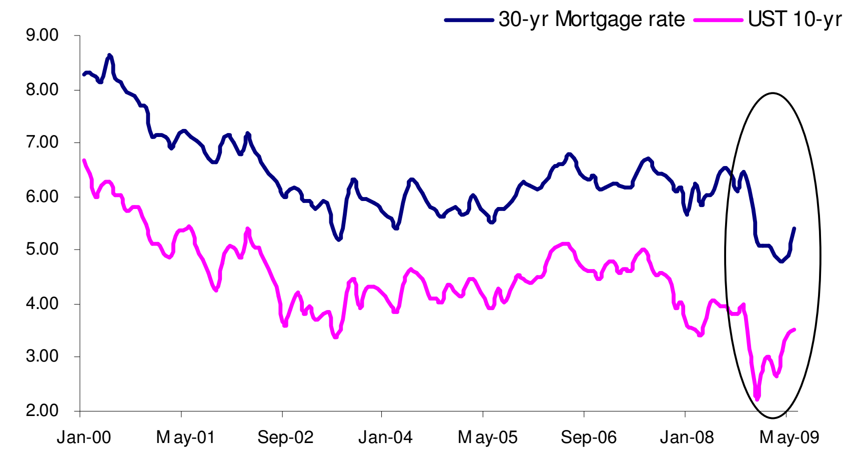
- ***Premature removal of accommodative stance and government stimulus***

A premature removal of accommodative stance by central banks in fear of spooking inflation will also be a factor that could stall the global economic recovery as this could lead to a return of dislocations in credit markets. While credit default spread (CDS) in Australia has declined since October last year, an early removal of monetary accommodation could lead to an increase in risk aversion, putting an upward pressure on the CDS. Similarly, government's reluctance to implement its stimulus package in fear of rising budget deficit will hamper a meaningful recovery, risking a relapse in economic downturn.

- ***Rising long-term yields***

The rapid upward movement in long-term yields in the US Treasuries and other government securities across the globe have increased the risk of a delay in the recovery of the housing sector , which in the case of the US, was one of the primary causes of the crisis. This is especially true when mortgage rates are commonly pegged to long-term yields of government securities. In the US, the average 30-year mortgage rate has risen from less than 5% to 5.42% recently as 10-year bond yields rebounded to 3.53% from as low as 2.21% in December last year.

Chart 12: US long-term rates

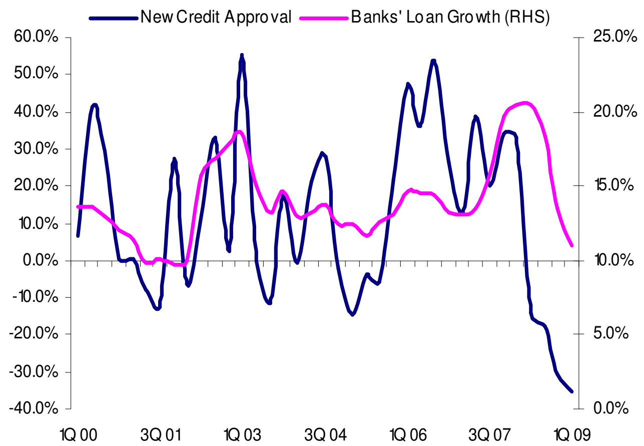


Source: Bloomberg

- ***Slowing bank lending***

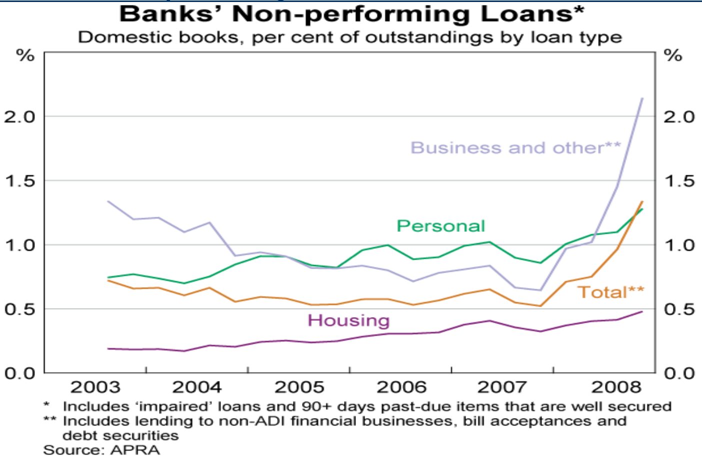
Although global risk aversion has slowly dissipated, the global economy will not see a sustained recovery if banks continue to hoard cash and refuse to lend. Lending is the key to continuous recovery in global economic activity. A good example is the sharp rebound in China's economic growth in the 2Q2009 which followed a dramatic increase in lending by state-owned banks, resulting in a surge in the growth of money supply. Thus far, lending activities among Australian banks have been lethargic with loan growth now lingering at a single-digit of 9.6% in May, after registering a double-digit expansion in the past years. Deterioration in asset quality has caused banks to remain extra cautious in lending as more loan loss provisions have to be set aside.

Chart 13: Banking activities Y-o-Y%



Source: Australian Bureau of Statistics (ABS)

Chart 14: Non-performing loans

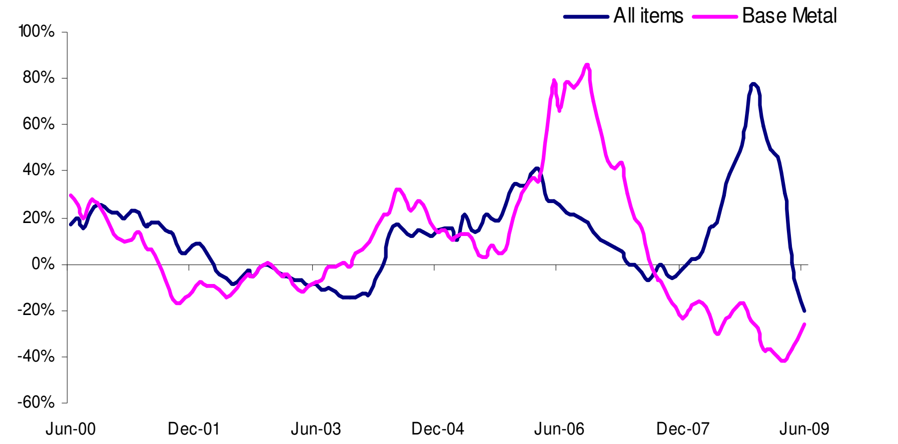


Source: Reserve Bank of Australia (RBA)

Falling commodity prices

A major risk for a commodity-export country like Australia is the sharp decline in commodity prices. Australian export performance was significantly affected by the collapse in prices of major commodities in 2008 following the burst of the commodity bubble. The recent recovery in prices of several commodities, however, has boosted the Australian export sector, spurring a faster recovery than other major economies. Notwithstanding this, the fundamentals behind rising demand for major commodities are debatable as the upsurge in prices may have been in response to an increase in expectation rather than a real change in global demand.

Chart 15: RBA index of commodity prices (Y-o-Y%)

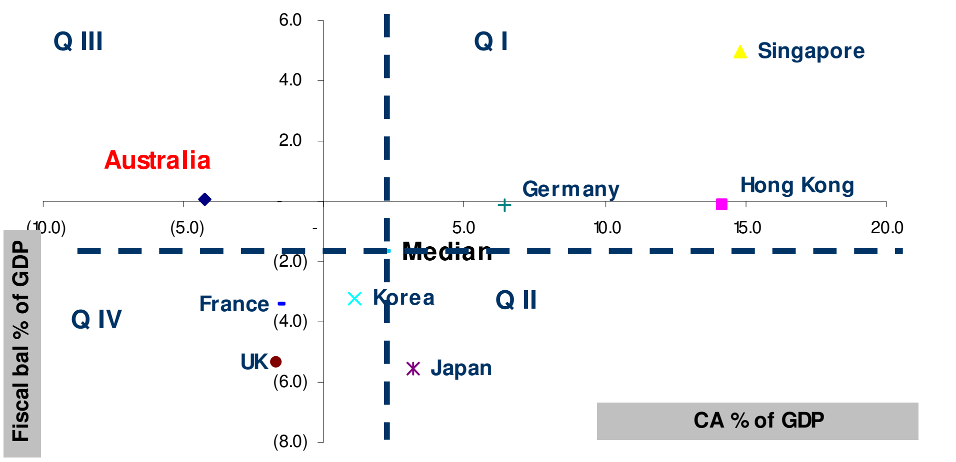


Source: Reserve Bank of Australia (RBA)

A sharp deterioration in the budget and current account matrix

Although the country has managed to avert a serious deterioration in its budgetary position, a fiscal deficit in 2009 will cause Australia to experience the so-called twin deficits – a deficit in both government and current account balances. Such a condition may adversely affect investors' perception on the economy, at least in the short term, putting a downward pressure on Australian Dollar (AUD).

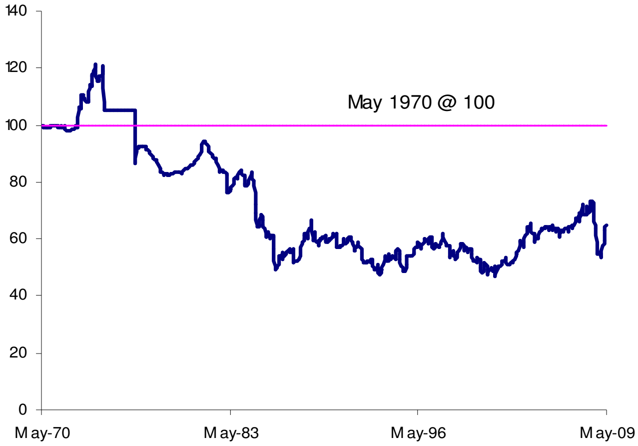
Chart 16: Current account and fiscal balance matrix 2008



Source: IMF & MARC Economic Research

The outlook for the AUD in 2H2009 is less positive because of several reasons: (1) the rising strength of the USD as the recovery process proves to be bumpier, (2) a correction in the AUD due to a sharp appreciation in 1H2009 and (3) increase unwinding of carry trade activities which will result in appreciation of yen against AUD. Given such a backdrop, we anticipate the AUD to move in the lower part of the trading band and within the range of 73 and 77 US cents per AUD in the 2H2009. However, a firmer recovery in the global economy in 2010 will likely lead to a steady appreciation in the AUD to around 85 – 90 US cents/AUD.

Chart 17: Trade weighted index (May 1970 = 100)



Source: Reserve Bank of Australia (RBA)

Chart 18: US Dollar per AUD

Source: Reserve Bank of Australia (RBA)

Country Fact Sheet

FY June	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09*
National Account (growth)								
Gross Domestic Product	**3.8%**	**3.2%**	**4.0%**	**2.8%**	**3.0%**	**3.3%**	**3.7%**	**1.2%**
Supply Side								
Agriculture, forestry and fishing	3.2%	-23.5%	28.2%	4.1%	2.9%	-17.7%	6.9%	13.6%
Mining	0.1%	-0.3%	-3.3%	4.6%	1.1%	7.7%	2.5%	3.1%
Manufacturing	2.1%	3.6%	0.9%	-1.2%	-0.5%	1.9%	3.3%	-3.0%
Construction	11.9%	16.4%	6.6%	4.8%	8.3%	5.3%	6.5%	4.1%
Services	3.7%	3.5%	3.8%	3.2%	3.2%	3.8%	3.7%	0.7%
Demand Side								
Consumption:	2.9%	3.4%	5.1%	4.3%	2.6%	3.8%	3.6%	1.6%
General government	*2.8%*	*3.2%*	*3.9%*	*3.8%*	*2.5%*	*3.0%*	*3.4%*	*3.0%*
Household	*3.0%*	*3.4%*	*5.4%*	*4.4%*	*2.6%*	*4.0%*	*3.7%*	*1.2%*
Gross Fixed Capital Formation:	9.7%	14.4%	8.3%	6.2%	8.8%	5.5%	9.9%	5.6%
Public sector	*9.8%*	*16.3%*	*8.4%*	*5.8%*	*8.7%*	*4.9%*	*10.6%*	*5.2%*
Private sector	*8.9%*	*4.4%*	*7.6%*	*8.7%*	*9.5%*	*8.8%*	*6.4%*	*8.4%*
Exports	-1.0%	-0.4%	2.1%	3.1%	2.2%	3.8%	4.1%	3.0%
Import	1.5%	13.1%	13.0%	12.1%	7.2%	9.2%	12.9%	1.3%
Balance of Payments								
Current Account ($ Million)	(18,553)	(38,186)	(45,590)	(56,325)	(52,627)	(58,529)	(70,632)	(23,014)
% of GDP	-2.5%	-4.9%	-5.4%	-6.3%	-5.4%	-5.6%	-6.2%	-2.5%
Capital Account ($Million)	20,436	38,664	46,059	57,389	53,691	59,444	69,394	23,756
% of GDP	2.8%	4.9%	5.5%	6.4%	5.5%	5.7%	6.1%	2.6%
Official Reserve Asset ($Million)	37,435	40,759	50,343	56,171	63,814	79,682	35,857	35,086
Government Finance								
Revenue ($ Million)	190,345	206,770	222,044	242,398	260,802	278,015	303,831	295,900
% of GDP	25.9	26.5	26.4	27.0	27.0	26.6	26.9	24.7
Expenses ($ Million)	192,792	201,164	215,277	229,153	241,624	258,521	280,551	324,400
% of GDP	26.2	25.7	25.6	25.5	25.0	24.7	24.9	27.1
Net Capital Invesment ($ Million)	382	287	660	1,034	2,498	2,333	2,837	4,300
% of GDP	0.1	-	0.1	0.1	0.3	0.2	0.3	na
Fiscal Balance ($ Million)**	(2,830)	5,319	6,107	12,211	16,680	17,161	20,443	(32,900)
% of GDP	(0.4)	0.7	0.7	1.4	1.7	1.6	1.8	(2.7)
External Debt								
Gross External Debt ($ Million)	501,320	537,401	619,452	682,118	819,158	932,417	1,002,962	1,134,194
% of GDP	68.1	68.7	73.6	76.0	84.7	89.1	88.7	94.1
Inflation & Interest Rate								
CPI (%)	2.80	2.70	2.50	2.50	4.00	2.10	4.50	1.50
Cash Rate (%)	4.75	5.00	5.50	5.75	6.00	6.25	7.25	3.00

Source: Australia Bureau of Statistics, Reserve Bank of Australia & MARC Estimates
** 9M Fiscal Year*
*** Budget 2009-10*