

Group Economics



Australian Economic & Financial Outlook for 2008

Another Good Year, Notwithstanding US & Global Downside Risks in Near Term
Global Growth to Slow to Trend in 2008

Slower but Sustained Australian Growth, Low but Sideways Unemployment Rate
Upward Pressures on Producer Costs but Core Consumer Inflation to Ease
Tighter Financial Conditions & Cooling Equity & House Price Gains

Economic & Financial Forecasts:

Nab forecasts trend global growth of 4¼% in 2008 characterised by a US “growth recession” partly offset by continued strong activity in industrialising China & India.

Australian GDP forecast to rise by 3¼% in 2008 enough to keep low unemployment rate at around 4¼%.

Core CPI inflation to rise to 3½% in mid 2008, before tighter financial conditions & easing external & fiscal stimuli, bring core inflation (ex energy & food) back below 3% in late 2008.

RBA likely to tighten further in early 2008 – provided global financial pressures subside – before some unwinding of rate hikes in late 2008.

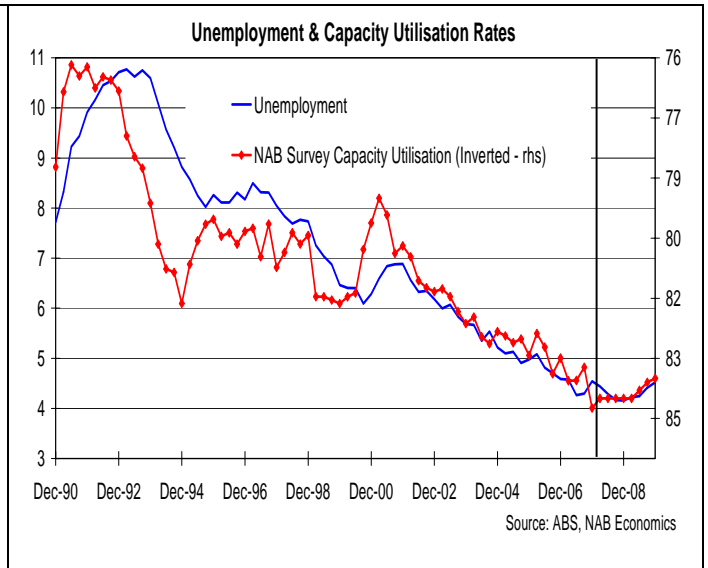
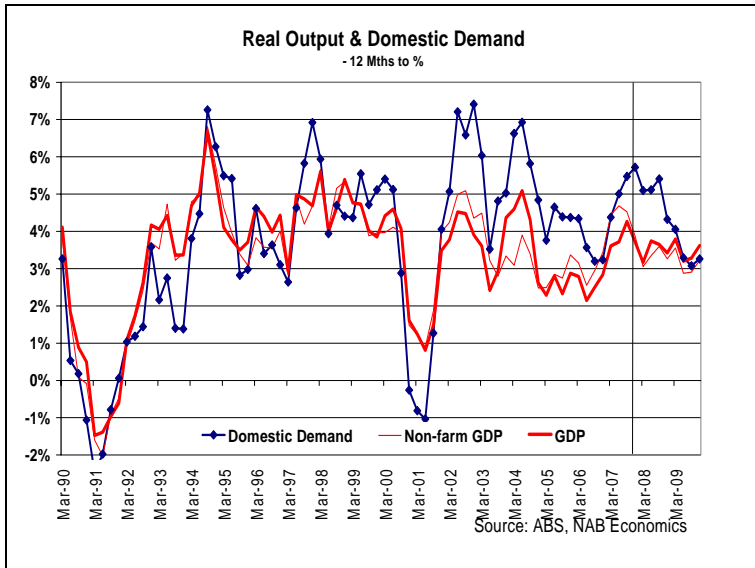
Lower export prices & interest rates eventually drive \$A lower – from high to low 80USc by end 200.

Domestic Activity

Nab expects Australian economic growth to moderate during the next year or so. The external stimulus from strong global growth and very high commodity returns will fade somewhat and tighter domestic financial and fiscal conditions at home will slow both business and household spending and more generally, aggregate demand and income growth. Overall, economic growth (GDP) is forecast to rise by a trend rate of 3¼% in 2008, following a rise of 3¾% in 2007. Allowing for an assumed return to normal seasonal conditions, farm output adds about a quarter of a percentage point to the bottom line for overall output in 2008, after a drag of half a percentage point in 2007. Put another way, our forecasts imply that non-farm activity is past the peak of the business cycle – albeit activity will remain sufficient to keep low unemployment.

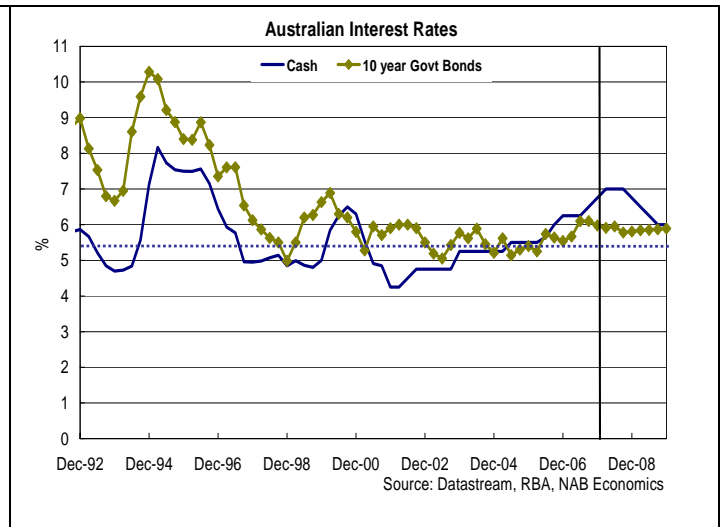
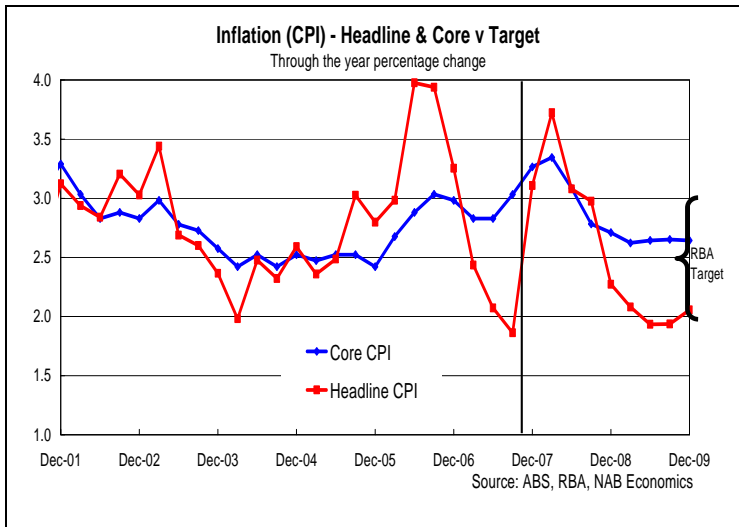
Household spending in real terms will moderate to trend growth at about 3½% during 2008 due to the lagged effects of higher interest rates and cooling asset gains being partly offset by continued strong income gains after further personal tax cuts in mid 2008. Easing demand pressures and smaller profit gains will also slow growth in business investment from its current double digit pace during the next year or so. Public sector spending by both Federal and State governments is expected to continue at a relatively strong annual rate of around 3½%. Implicit in these forecasts, however, is the assumption that the Federal government will significantly tighten its fiscal stance in the May 2008 Budget. Export volumes are forecast to pick up during 2008 – boosted by a breaking of the drought, increased non-rural resource capacity (especially iron ore, coal and gas) and an easing in the Australian dollar.

With aggregate demand growth set to return to trend during 2008, employment gains are forecast to be sufficient to keep the unemployment rate at around 4¼ per cent during 2008 – around a 30 year low. Put another way, the labour market will remain tight and labour availability and wage and other cost pressures (especially from energy) will bear watching.



Inflation & the RBA

In the near term, there is still a short term inflation problem – with Nab’s forecasts pointing to the RBA’s core measures rising to nearly 3½ percent in early 2008 (see chart below). Fundamentally we still see strong domestic demand allowing business to widen sales margins together with increased flow on effects of higher oil prices and the drought. Nor it is likely that wage pressures will slow any time soon – and indeed our forecasts imply some deterioration in unit labour costs via reduced cyclical productivity gains. Slower demand in 2008 will help ease inflationary pressures, but even so core inflation will not be below 3 per cent till late 2008.



Against this domestic backdrop, Nab still considers that it is likely the Reserve Bank will raise cash rates another 25 basis points to 7% in early 2008 - to take out some insurance on core inflation moving back into its target band during 2008. However, this domestic policy adjustment is far from a certainty in the near term. The current liquidity and credit issues in global financial markets via their direct impact on the cost and availability of finance (debt, deposits and equity) could put the RBA into “wait & see” mode during early 2008. More critically, the nature of the economic slowdown underway in the US and prospects of softer global growth could well mean that the RBA has already reached the peak of its current tightening phase. In Nab’s view, by end 2008, the surprise for financial markets may well be that the RBA will be easing cash rates back to a more neutral, but still firm position. Given the eventual peak and easing in both domestic cash rates and global commodity prices, the Australian dollar is forecast to fall from the high to low 80 US cents during 2008.

Global Outlook

As noted above, the key big picture issue in the first half of 2008 will remain the nature of the US “growth recession” and its flow on elsewhere. Nab’s base case is for global growth to slow to around 4¼% in 2008, from 4¾% in 2007. However, this global economic outlook masks differences across regions – in particular, the slowdown underway amongst major

developed economies (the US, Eurozone, Japan & UK) vis a vis continued strength in China, India and resources-orientated economies (such as Australia, the Middle East and Latin America).

In the US, the economic news on activity and credit markets continues to deteriorate. Housing construction is contracting, house prices are down around 5% over the past year and Nab sees the housing slump as continuing until late 2008. These factors will negatively impact consumer spending and push up unemployment. In response, Nab expects further prompt and aggressive policy action from the US Federal Reserve. The Fed is expected to cut its funds rate from a recent peak of 5¼% to 3½ per cent by mid 2008. That together with a lower US dollar and the likelihood of fiscal initiatives in the forthcoming "State of the Nation" should increasingly support US activity during 2008. On average, Nab's US forecast is for a rise in US GDP of 2% in 2008 – well down on the 3% per annum recorded prior to the unexpected financial shock in US housing emerged in mid 2007.

Against that, the Chinese economy grew by 11.5% in the year to September – with more recent indicators pointing to sustained growth. At the same time, there has been some acceleration in Chinese inflation driven very much food shortages, while "core" inflation remained low. Hence, further tightening in monetary policy is likely during 2008, after the Chinese authorities significantly raised interest rates during 2007. With real lending rates at around 6%, policy is relatively tight and is expected to act to slow domestic activity during 2008. Overall, Nab expects China to grow by around 10% in 2008, following a rise of about 11½% in 2007, while India is expected to continue to grow at around 7½% in 2008, and Latin American growth is expected to slow to around 4½% in 2008.

Global GDP Forecasts

December year annual average % change	2005	2006	2007	2008(f)	2009(f)
US	3.1	2.9	2.2	2.0	3.0
Japan	1.9	2.2	1.9	1.7	2.0
UK	1.8	2.8	3.0	1.9	2.2
eurozone	1.6	2.9	2.7	2.1	1.7
Canada	2.9	2.8	2.4	2.1	2.3
Australia	2.8	2.7	4.3	3.2	3.0
New Zealand	2.7	1.7	3.1	1.8	1.8
China	9.9	10.7	11.4	9.9	8.3
India	8.7	9.6	8.7	7.6	6.4
World	4.5	5.1	4.4	4.2	4.0
Emerging E Asia	4.4	5.3	5.2	4.7	5.1
Latin America	4.2	5.0	4.9	4.5	4.1

Summary

In summary, Nab's base economic case for Australia and more generally, the world is another relatively strong performance in 2008 – notwithstanding several negative shocks overhanging the outlook. Fortunately, the financial losses and tightening of credit associated with US growth "recession" (as well as higher oil prices) have emerged at a time of strong world trade and output growth driven by emerging countries and low global inflation as well as generally sound profits and business balance sheets. The process of the re-pricing of credit and discovery of capital losses in the global financial system will be watched closely during early 2008, while real economic activity is expected to be sustained at about trend in Australia and abroad.

Jeff Oughton, Nab's Head of Australian Economics

8 January, 2008

DISCLAIMER: [While care has been taken in preparing this material,] National Australia Bank Limited (ABN 12 004 044 937) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this document ("Information") are accurate, reliable, complete or current. The Information has been prepared for dissemination to professional investors for information purposes only and any statements as to past performance do not represent future performance. The Information does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. In all cases, anyone proposing to rely on or use the Information should independently verify and check the accuracy, completeness, reliability and suitability of the Information and should obtain independent and specific advice from appropriate professionals or experts.

To the extent permissible by law, the National shall not be liable for any errors, omissions, defects or misrepresentations in the Information or for any loss or damage suffered by persons who use or rely on such Information (including by reasons of negligence, negligent misstatement or otherwise). If any law prohibits the exclusion of such liability, the National limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable. The National, its affiliates and employees may hold a position or act as a price maker in the financial instruments of any issuer discussed within this document or act as an underwriter, placement agent, adviser or lender to such issuer.

UK Disclaimer: So far as the law and the FSA Rules allow, National Australia Bank Limited ("the Bank") disclaims any warranty or representation as to the accuracy or reliability of the information and statements in this document. The Bank will not be liable (whether in negligence or otherwise) for any loss or damage suffered from relying on this document. This document does not purport to contain all relevant information. Recipients should not rely on its contents but should make their own assessment and seek professional advice relevant to their circumstances. The Bank may have proprietary positions in the products described in this document. This document is for information purposes only, is not intended as an offer or solicitation nor is it the intention of the Bank to create legal relations on the basis of the information contained in it. No part of this document may be reproduced without the prior permission of the Bank. This document is intended for Investment Professionals (as such term is defined in The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001) and should not be passed to any other person who would be defined as a private customer by the rules of the Financial Services Authority ("FSA") in the UK or to any person who may not have experience of such matters. Issued by National Australia Bank Limited A.C.N. 004 044 937, 88 Wood Street, London EC2V 7QQ. Registered in England BR1924. Head Office: 500 Bourke Street, Melbourne, Victoria. Incorporated with limited liability in the state of Victoria, Australia. Regulated by the FSA in the UK.

U.S. DISCLAIMER: This information has been prepared by National Australia Bank or one of its affiliates or subsidiaries (collectively, "NAB"). If it is distributed in the United States, such distribution is by National Australia Capital Markets, LLC (NACM) which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to NACM, 200 Park Avenue, New York, NY 10166 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of NACM or NAB and/or its affiliates may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.