



Macroeconomics



Industry & Commodity



Markets

## Australian Outlook – July 2007

NAB's key economic forecasts broadly unchanged – but watch the US  
**RBA is likely to take extra insurance in early August.**

### NAB's Forecasts:

*Global growth to be around 4¾% in 2007 and around 4½% in 2008;*

*At this stage stronger China more than offsetting weak USA. But latter needs to be watched. Housing problems and associated weaker US consumption expected to see Fed cutting in H1 2008;*

*Australian GDP forecasts unchanged at 4% in 2007 and 3¾% in 2008. Currency to stay strong given rate prospects and strong commodity price outlook;*

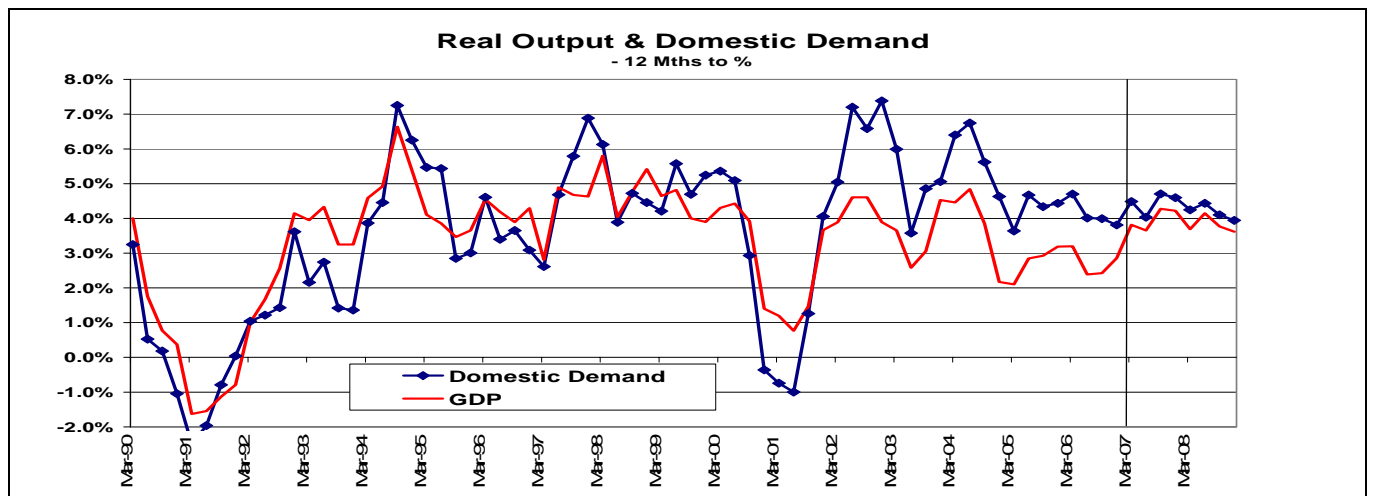
*Core CPI likely to move up to near 3% in early 2008, causing RBA to take added insurance in August. That, given our forecasts, should see core inflation easing back to around 2.6% by late 2008;*

*But no scope for further fiscal stimulus given current economic outlook.*

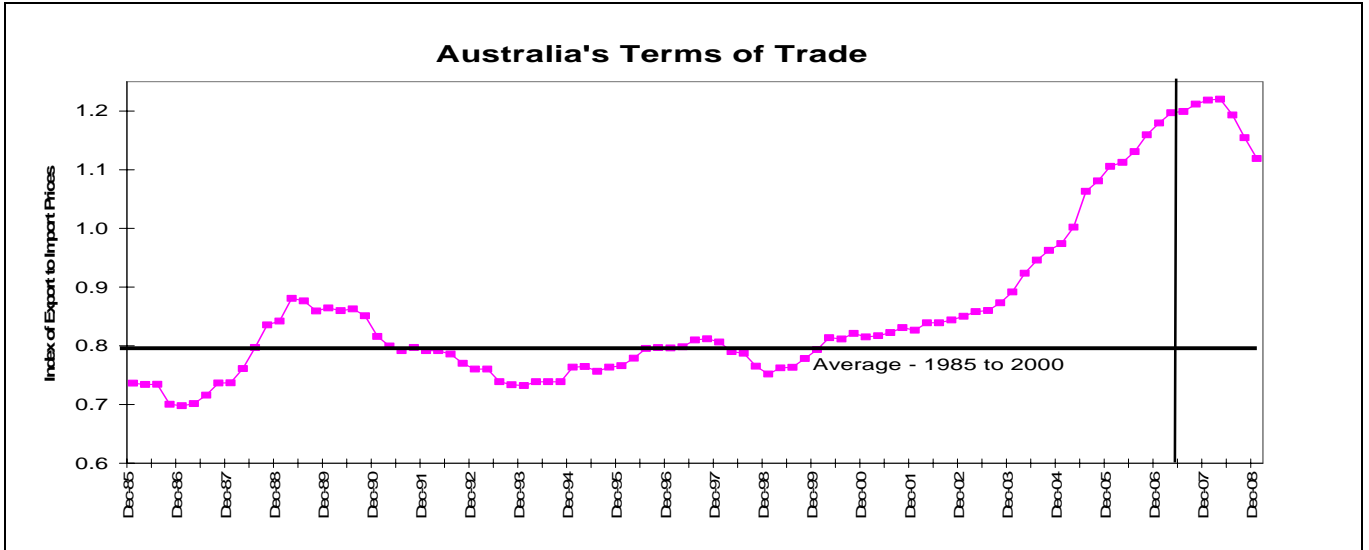
### Australian Outlook

Provided the US does not have a very hard landing, our judgment is that the global outlook has strengthened marginally and importantly will have a more favorable impact on Australian growth than we previously expected. That momentum however does not show up that much in our activity forecasts given our expected tightening of policy and the high currency.

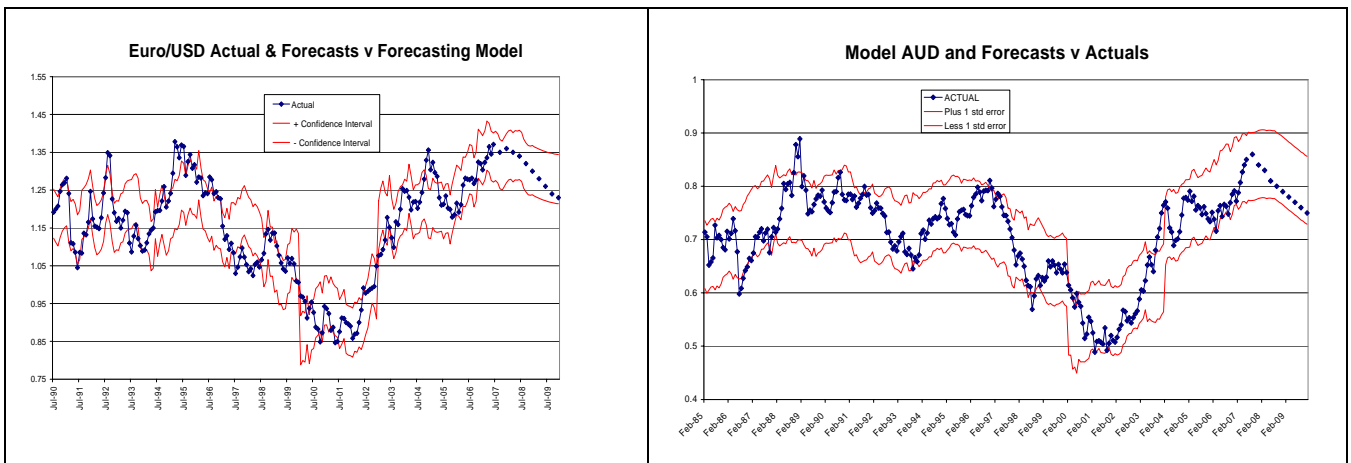
That is, Nab's forecast is for GDP to pickup to 4.0 per cent in both 2007 and 2007/08, before moderating to 3¾% in 2008. These forecasts also imply that the non-farm economy will average around 4½ per cent in 2007, before easing back somewhat in 2008. Farm GDP is expected to increase by around 15 per cent in 2007/08 (assuming the drought breaks) after declining by around 20 per cent in 2006/07. Continuing strong domestic demand means that employment growth will remain strong in 2007 (a touch below 3 per cent) before easing back to a rate of growth of around 2 ½ per cent in 2008. That would be sufficient for the unemployment rate to edge back down to 4 per cent by mid to late 2008. More detail on the composition of the forecasts are given in the detailed table at the end of this note.



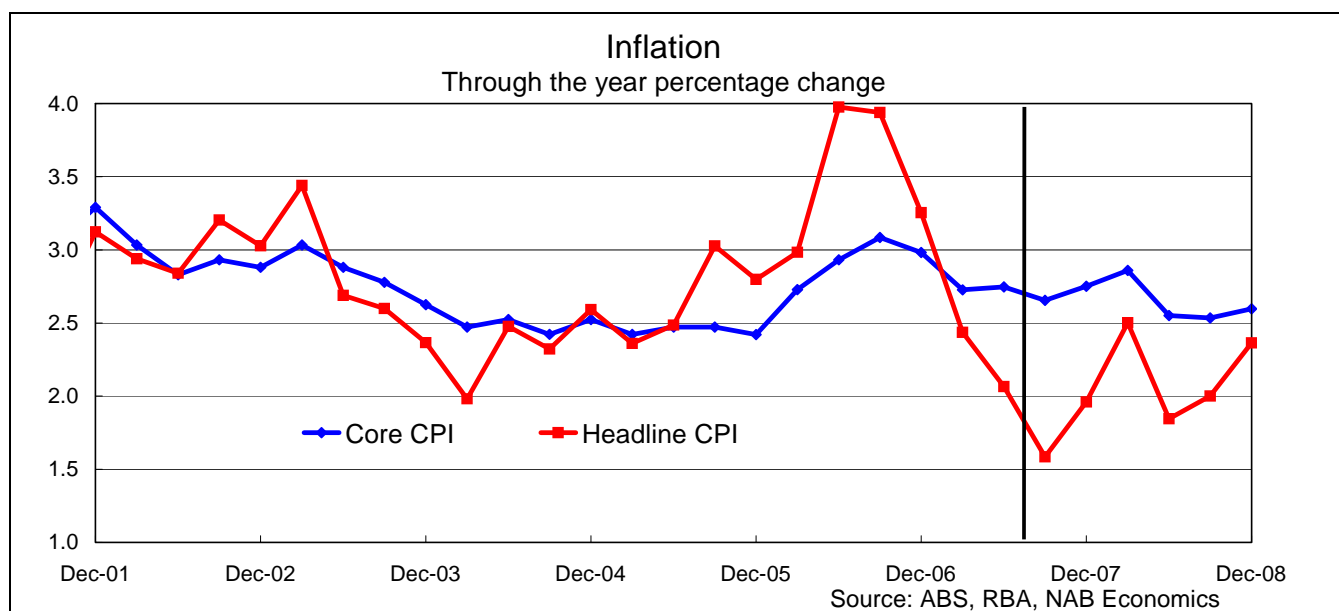
Our forecasts are based on oil prices remaining around current levels over the next year or so (at around \$US65 per barrel). We have also moved up our expectations for commodity prices reflecting stronger global growth and especially Chinese demand. Overall, we now see non-rural prices up 8 per cent in 2007 (largely already having occurred) with a slight decline (4 per cent) in 2008. On balance, there is a risk that non rural prices may be stronger than forecast – particularly in the area of iron ore and coal where supply remains constrained. A return to normal seasonal conditions is assumed to see rural prices increase by around 8 per cent in 2007/08. As a result, we now expect Australia's terms of trade to remain broadly unchanged till mid 2008 and then fall moderately during the following year (see chart below).



The strong terms of trade profile is one of factors leading to our view that the currency will remain at high levels. Beyond that we also have a rate rise in Australia and concern that the US economy may still end up in a hard landing. At the very least, we see further rate and activity dynamics favouring the Euro. As a result, the Euro/USD expected track stay at or above 1.35 till mid 2008. Our forecasts basically have the Euro around the top of a model based outcome for the next year before moving lower in late 2008 / early 2009 (see chart below – left hand panel). That additional USD weakness also reflects back into the AUD/USD rate – together with rate, commodity price and activity prospects all favourable to the AUD. As a result we see AUD/USD track rising a touch in coming months and remaining above 80c till mid 2008. The moderate weakening thereafter reflects both a turn in the commodity cycle and less USD weakness as doubts about the hard landing prospect ease and US growth starts to strengthen (we assume growth of around 2 ¾ per cent during 2008 in the US, after rate cuts in early 2008). As can be seen by the chart below (right hand panel), model results point to the potential for upside risk to these currency forecasts.



Clearly the June quarter core inflation readings were an unpleasant surprise. It now appears that inflation did not slow as much as had been previously thought. While it appears there was an element of seasonality in the result (and hence while June was not as bad as it printed neither was Dec/March as low), the bottom line is core inflation has slowed only to around 2 ¾ per cent. Looking forward in an environment of strong on going growth, tight labour markets and some evidence of widening margins our inflation expectations are for the RBA's core measures to track higher to nearly 3 per cent in early 2008. In 2008 the impact of faster current growth on the inflation outlook is partially mitigated by the strong AUD forecasts. Assuming another rate rise in August would however see our expectations of inflation easing back towards 2.6 per cent by late 2008 (see chart below).



On interest rates:

- We see the combination of continuing strong growth and a higher starting point for inflation as fundamentally altering the RBA's perceptions of the policy risks;
- Our forecasts for core inflation (as used by the RBA) look to be rising to very close to the top of the RBA's target band by early 2008. A strong domestic economy, tight labour markets and very robust business expectations all point to growing unease for the RBA. Extra global growth (and especially increased Chinese demand) means that the terms of trade will also be adding to nominal incomes (albeit that may be partly offset by the higher currency). In the near term credit growth has accelerated (and will especially do so in June – due to superannuation flows) and house prices (especially at the top end) have strengthened;
- At this stage there is still little evidence of wage pressures accelerating generally – and indeed, as recently noted by RBA Governor Stevens, the supply side of the market appears to be behaving in a classical manor. More supply side responsiveness to tax and social security reforms probably now mean that unemployment can fall further before wage pressures intensify;
- That said there are limits to how far these processes can go before the RBA wants to take some added insurance. Our judgement is that point was crossed post the higher CPI and strengthening global outlook. We do not, however, see the August rate rise as a done deal. Our judgement is the risk is around 60 per cent;
- The main factor arguing against the rise is, as it has always been the US. While equity markets are very volatile our core scenario does not see a US economic meltdown. Rather we see the US economy struggling in the second half of 2007 in the face of the housing problems (which has much further to go) and associated weakness in consumer spending (from house price wealth effects). The

main factor arguing against the rise is, as it has always been the US. While equity markets are very volatile our core scenario does not see a US economic meltdown;

- On that basis we see one further rate rise in August. Beyond that (and barring worse news out of the USA) the RBA would still have a significant upside bias. Any policy moves that add to the demand outlook – such as aggressive fiscal promises in the upcoming election – would almost certainly push the RBA across the line for a second rate rise (in late 2007 or early 2008);
- We have not changed our long bonds forecasts – despite recent rallies in the US long bond. That is we continue to see the UD 10 year bond at around 5 per cent and the Australian equivalent at around 6 per cent. Further weakness in the US markets is less likely to fully flow into the Australian market given the fundamentally different growth and rate outlook in the two economies.

### International Outlook

The following table summaries our global forecasts for key economies:

<b>Global GDP Forecasts</b>					
December year annual average % change	2004	2005	2006	2007(f)	2008(f)
<b>US</b>	3.9	3.2	3.4	1.8	2.5
<b>Japan</b>	2.7	1.9	2.2	2.7	2.0
<b>UK</b>	3.3	1.9	2.8	2.8	2.3
<b>eurozone</b>	1.8	1.5	2.9	2.7	2.3
<b>Canada</b>	2.9	2.9	2.7	2.1	2.4
<b>Australia</b>	3.8	2.8	2.7	4.0	3.7
<b>New Zealand</b>	4.4	2.1	1.7	3.0	3.1
<b>China</b>	10.1	9.9	10.7	11.5	11
<b>India</b>	7.3	8.7	9.1	8.5	7.8
<b>World</b>	5.0	4.5	5.1	4.7	4.5
<b>Non-Japan E Asia</b>	8.8	8.2	9.1	9.4	9.4
<b>Latin America</b>	5.5	4.1	4.7	4.5	4.2
<b>G10</b>	3.0	2.4	3.0	2.3	2.2

While there have been minor upward adjustment to 2007 growth forecasts for Japan and Europe (both by around ¼ of a per cent) to reflect stronger than expected growth rates in H1 of 2007, the main reason we have revised up our global growth numbers is China – where the economy continues to accelerate with stronger industrial production underpinning a more robust commodity price profile and hence the Australian currency.

- On China, economic growth has again outstripped expectations with real GDP expanding at the remarkable rate of 11.9% yoy in the June quarter, up from 11.1% yoy in the March quarter. On previous occasions accelerations in these quarterly growth numbers have looked odd in the light of trends in such partial economic indicators as retail spending, industrial output or export deliveries. This time all the data lines up – the business surveys and an array of partial economic data agree with the quarterly growth numbers to confirm that the economy did indeed quicken through the first half of 2007. This is precisely the reverse of what the Government had been hoping to achieve by its interest rate increases, bank reserve rises and currency appreciation. Nevertheless, we expect more of the same medicine with two more rate hikes of around 25 bps by early next year and further renminbi appreciation. Inflation is also

outstripping the official forecast but the recent price pressure reflects higher food prices so we do not expect the central bank to aggressively tighten rates.

Chart : Chinese economic growth % change

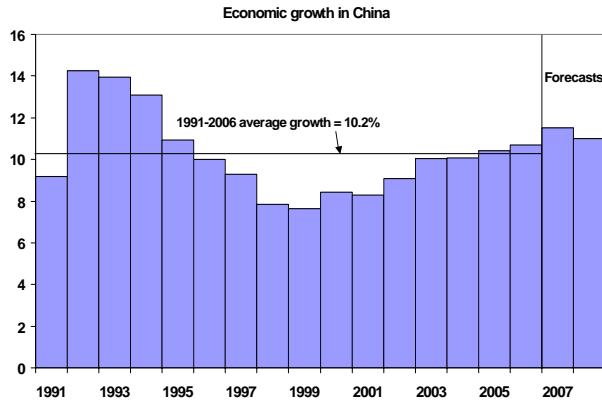
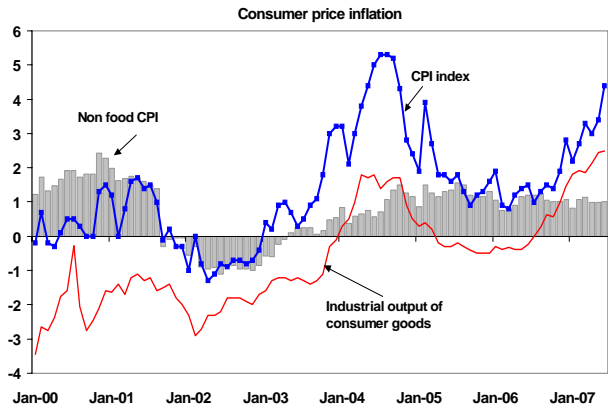


Chart Chinese inflation % yoy



If China is the upside surprise, we still however continue to be worried about the US outlook. Certainly the second quarter GDP estimates (at an annualized growth rate of 3.4 per cent) are better than the near flat first quarter outcome but the composition of that growth hardly inspires confidence going forward – with much of the growth from government spending and the inventory cycle (cars). While better exports are encouraging (and probably reflect the weaker currency), the sharp slowing in consumption to an annualized growth of 1.3 per cent is the real concern. With the housing correction still on-going, and wealth effects from slower / lower house prices only just biting we still expect sluggish growth in H2. As a result, we have maintained our forecasts of 1.8 per cent in 2007 and 2.5 per cent in 2008. With inflation likely to become less threatening, we still see the Fed cutting rates by early 2008.

More details on our Australian economic and financial forecasts are in the table below.

## Australian Economic and Financial Forecasts

	Fiscal Year		Calendar Year	
	2006/07	2007/08	2007	2008
Private Consumption	3¾	3½	4	3
Private Investment – Dwelling	4½	4¾	6½	4½
– Underlying Business	5¼	13¾	10¼	11¾
Underlying Public Final Demand	4½	2	1½	3
<b>Domestic Demand</b>	<b>4</b>	<b>4¾</b>	<b>4½</b>	<b>4½</b>
Stocks (a)	0	0	½	-¼
<b>GNE</b>	<b>4¼</b>	<b>4½</b>	<b>5</b>	<b>4¼</b>
Exports	4½	6	5	7¼
Imports	9½	8	9¾	6¾
<b>GDP</b>	<b>3¾</b>	<b>4</b>	<b>4</b>	<b>3¾</b>
– Non-Farm GDP	4	3¾	4½	3¾
Current Account Deficit – \$b	-59	--59	-59	-60
– % of GDP	-5½	-5.6	-5½	-5¼
Employment	2½	2¾	3	2½
Terms of Trade	7	5½	6	3
<b>End of Period</b>				
Average Earnings	4½	4	4	4
Total CPI	2	1¾	2	2½
Underlying CPI	2¾	2½	2¾	2½
Unemployment Rate	4¼	4	4¼	4¼
RBA Cash Rate	6¼	6½	6½	6½
10 Year Govt. Bonds	6	6	6	6
\$A/US cents	85	80	80	80
\$A - Trade Weighted Index	68.9	65	65	65

(a) Contribution to GDP growth

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