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NAB's March 2008 Quarterly Business Survey & Forecasts

- Business confidence falls to lowest levels since 2001 while conditions also slow sharply – consistent with growth in domestic demand slowing to around 3½% in Q1;
- Near and medium term expectations also revised markedly lower;
- Interest sensitive sectors and finance bearing the brunt of the slowing;
- Wage pressures unchanged but expectations rising and inflation momentum very high;
- Global GDP forecasts unchanged at 3½% in 2008 – with the US in moderate recession but China still at very strong growth rates;
- Australian GDP forecasts unchanged – at 2¾% in both 2008 & 2009 but downside risks rising. RBA nervous on inflation but on hold in 2008 – still to cut significantly in 2009.

Key March Quarterly Survey Results:

Business confidence fell 10 points to -4 – the lowest reading since March 2001. Interest sensitive and finance confidence fell most. Forward orders also down 4 points to + 4 index points;

Business conditions fell 6 points to +13 – consistent with demand growth slowing to 3½% (at an annualised rate) in Q1. Trading and profitability fell sharply (down 12 and 11 points respectively to +17 and +8 respectively). Employment fell modestly – down 3 points to a still high reading of +11;

Near (3 month) and longer (12 month) term expectations were also revised down but by less than recent outcomes (down 5 and 6 respectively). Investment expectations remain robust – up 2 points to +28);

Capacity utilisation down 0.3 percentage points but remains at very high levels (83.9%). Difficulties in finding suitable labour hits a new high – with 72% respondents reporting difficulties in this area (up 4 percentage points). While labour costs remain contained, employers expect some future acceleration;

Retail price pressures accelerating – with retail margins still high albeit off the recent peaks.

NAB's Economic & Financial Forecasts:

Nab's global growth forecasts unchanged at 3.5% in 2008 and 3.7% in 2009. The US in moderate recession, with negative growth expected in the current half year and overall GDP growth in 2008 of only 1¼% and 2¼% in 2009 - and the Fed to lower Fed Funds to 1¾% by mid year. Other major economies expected to weaken (Japan, UK & Europe). China, while still strong, is forecast to slow to 9½% in 2008;

Australian GDP forecasts unchanged at 2¾% in 2008 and 2009. While the economy appears to be weakening faster than expected, higher terms of trade, income tax cuts and the farm rebound will help to partly offset this. Unemployment to rise in 2009.

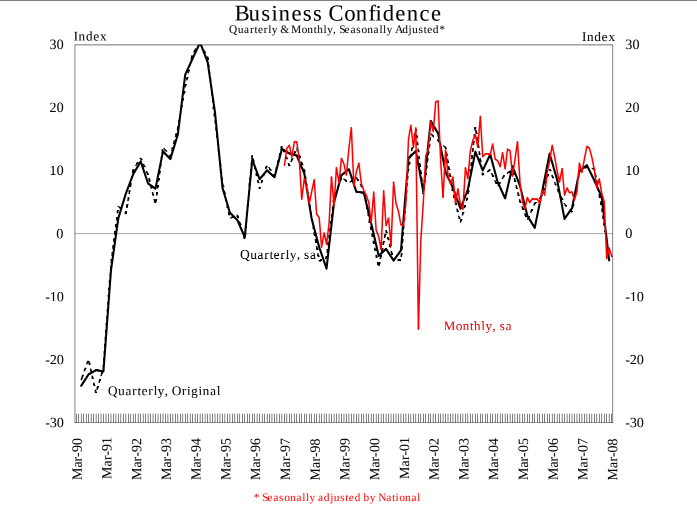
Core inflation very high and likely to be around 4% through most of 2008 - albeit we have technical concerns that the treatment of the financial sector during the credit crisis overstates the real rate of increase in core inflation. Rate cuts in 2008 now unlikely. A slight risk of another rise in mid / late 2008 unless demand slows. Core inflation not back into the RBA range till early 2009;

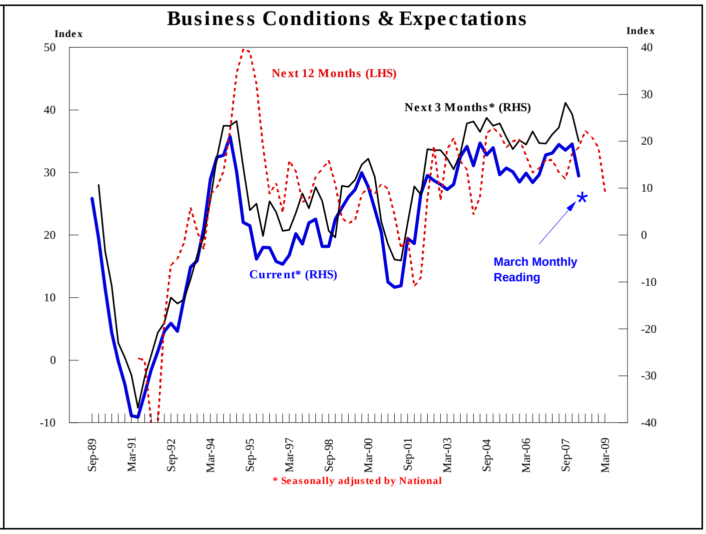
RBA with an upside bias over the next 6 months – worried about inflation but equally concerned about downside risks to growth (with moderate credit restrictions now likely). Nab still expects RBA cuts to begin from early 2009 with a cash rate of around 6% by late 2009 / early 2010.

National Australia Bank

Business Conditions and Confidence

The following charts show the movements in the Survey's key measures of business confidence and current and expected movements (short and longer run) in business conditions.

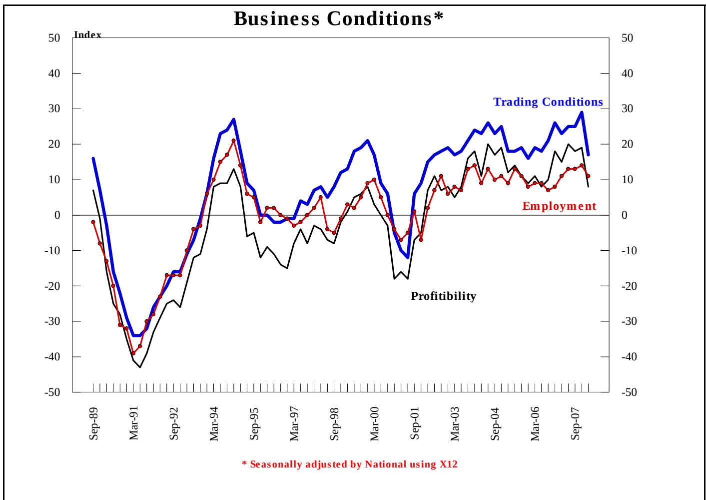


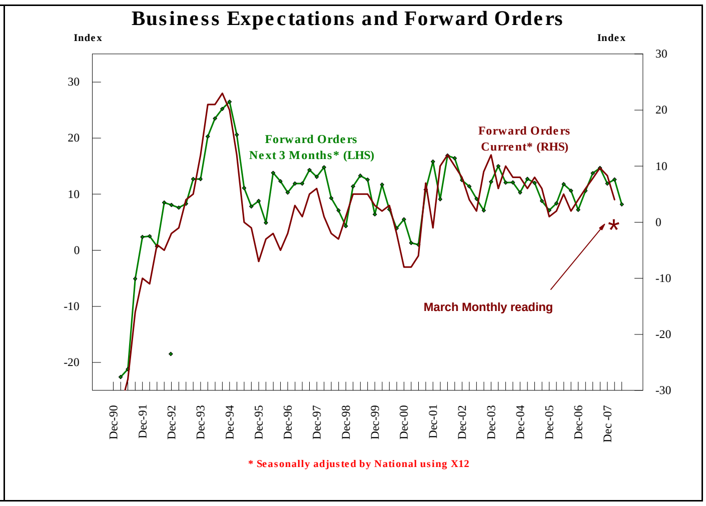


According to Alan Oster, the National's Group Chief Economist, the main message from the more comprehensive Quarterly Business Survey for the March quarter is – similar to recent Monthly Surveys – that the combination of much tighter financial conditions, falling global equity markets and the global credit crunch has produced a sharp fall in business confidence (down to 7 year lows – see chart above left hand panel). While the Monthly Surveys suggested that the fall occurred early in the quarter, the full Quarterly Survey confirms subsequent findings that actual activity levels are now also suffering. The full Quarterly Survey now suggests that business forecasts have been revised down – as reflected in moderate lowering of the 3 & 12 month expectations for forward business conditions (see chart above right hand panel).

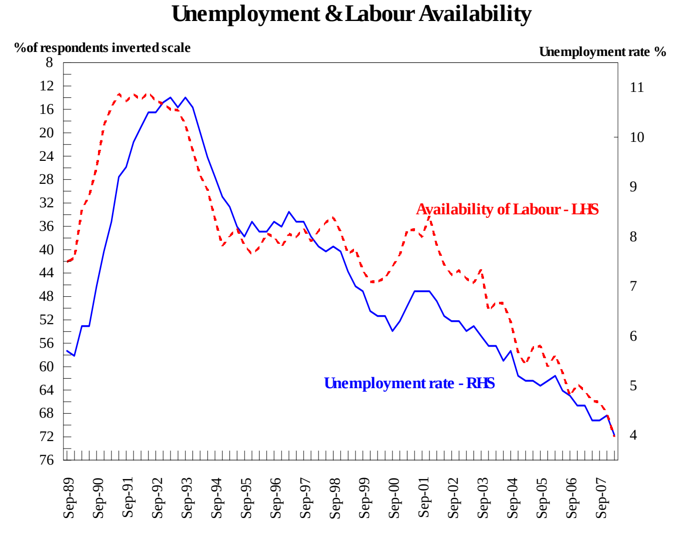
The fact that these expectations were not revised more could well be a result of business continuing to be surprised by the extent of the slowdown – in particular, as noted by the March monthly survey, there appears to have been a particularly sharp and unexpected further slowing between the months of February and March (which is not entirely captured by the full Quarterly Survey). This can be clearly seen by comparing the level of the Quarterly's business conditions reading with that reported in the March monthly (see chart above right hand panel). A similar result can be seen in the more rapid recent deterioration in new orders (see chart below right hand panel).

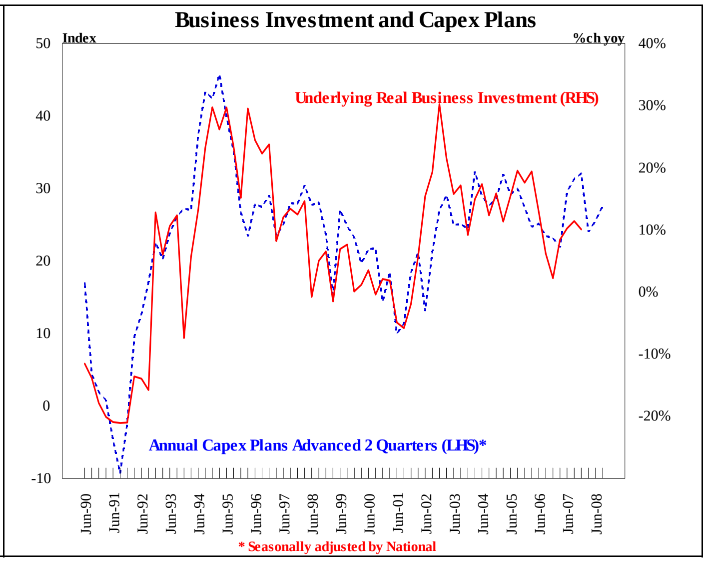
One feature common to both the full Quarterly and recent Monthly surveys is the much sharper correction in trading and profitability indexes relative to that occurring in employment – see chart below left hand panel. That pattern is however very consistent with what would be expected in the early phases of a cyclical slowdown.



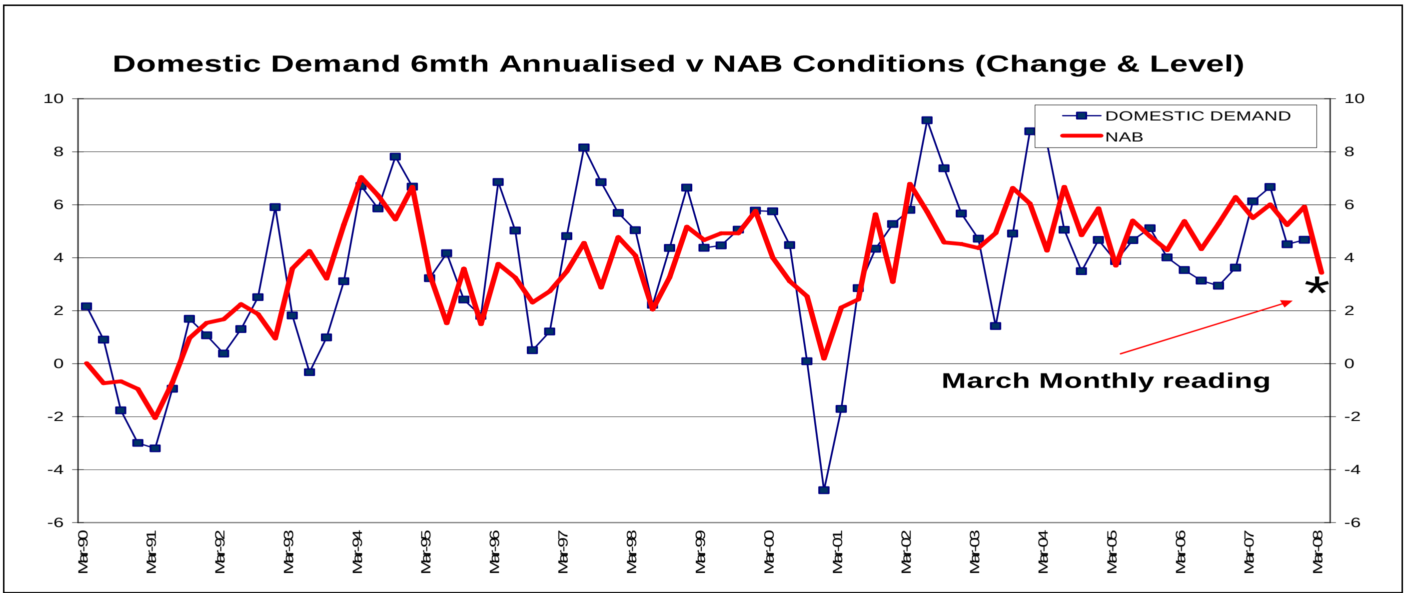


In many ways given the difficulty of hiring suitable labour – and this Survey suggests that a record high 72 percent of respondents now report this as a problem – business will be extremely reluctant to retrench in the early phase of an unexpected slowdown. As such the survey suggests that the labour market will remain very tight – with unemployment likely to stay around its current levels for the next 6 months or so (see chart below left hand panel). Also while there has been a slowdown in the growth momentum the level of capacity utilisation remains at a very high rate of 83.9 per cent (only 0.3 percentage points off the December quarter record highs). Also at this stage longer run capital expenditure expectations remain robust – and actually increased by 2 points to a very high reading of +28 points in the March quarter. That reading would – as shown by the chart below right hand panel – be consistent with ongoing real business investment of around 10 per cent over the next year or so.

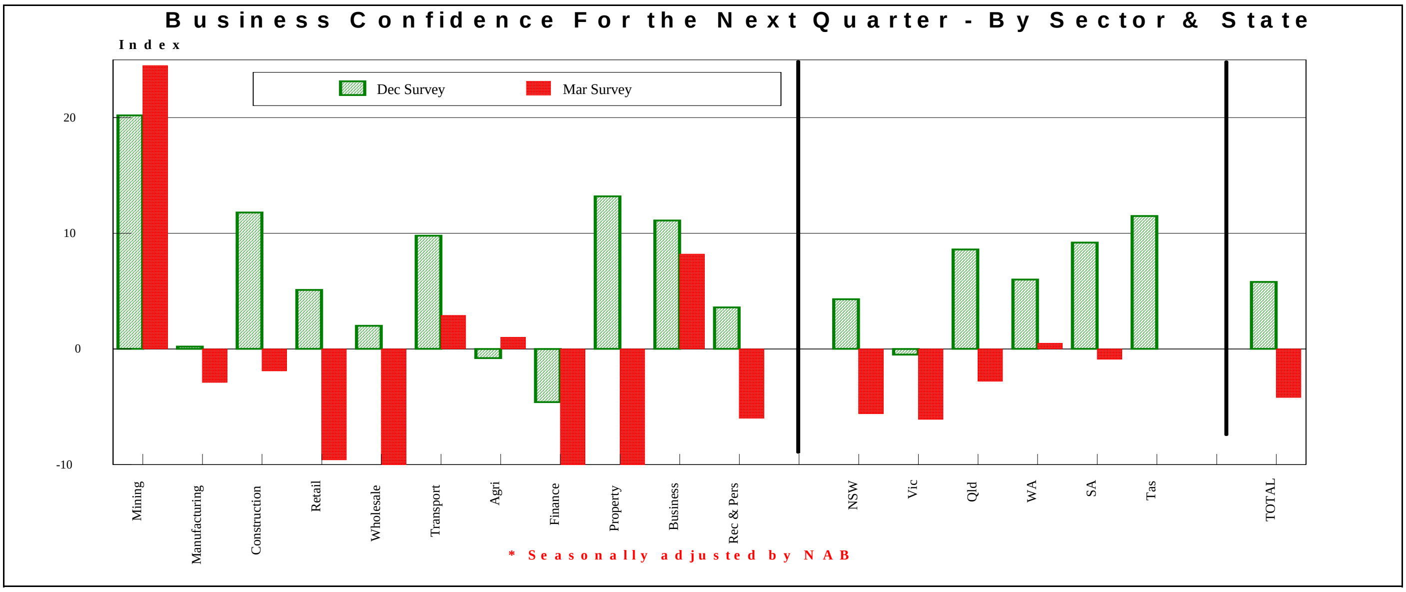




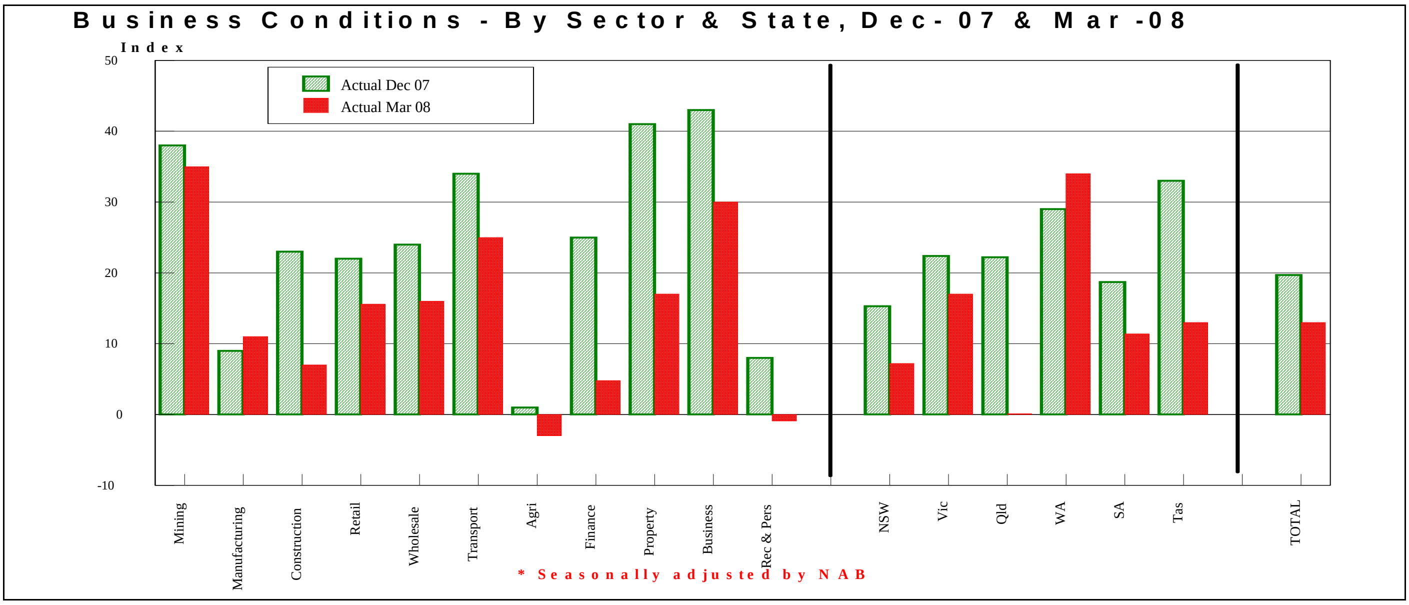
Overall then while the Survey continues to point to a significant slowing in the growth momentum it needs to be remembered where we were in late 2007. Thus, according to the National Accounts, domestic demand was growing at an annual rate of around 5½ per cent – or around 4¾ per cent at an annualised rate in the 6 months to December (this slightly lower number reflects the fact that the accounts had the peak quarterly rates around mid year). Lining up the survey readings against the accounts suggests that in March quarter, the 6 month annualised rate in demand had slowed to around 3½ per cent – with the March monthly reading pointing to a rate around the 3 per cent mark- see chart below.



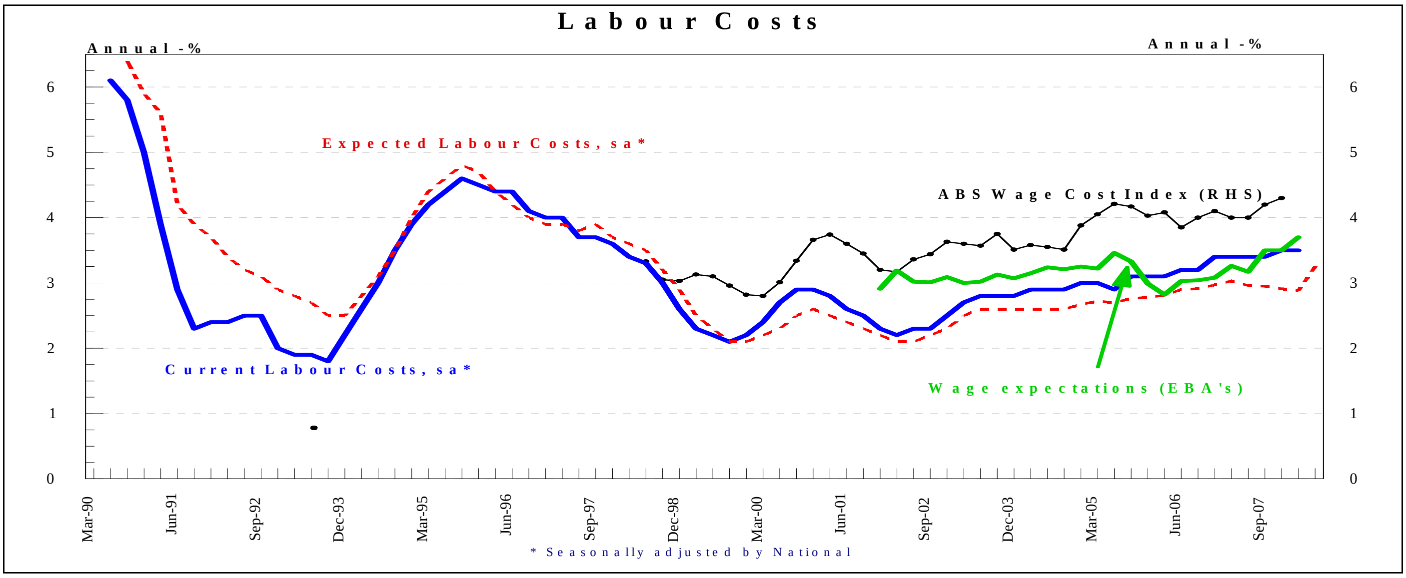
Returning to the full Quarterly Survey results by industry and region, the following chart shows dramatically where the big swings in confidence over the last quarter have been. The falls have been most marked in the retail, wholesale, manufacturing, construction, property and finance sectors - that is, interest rate sensitive sectors and those particularly sensitive to the global credit market disruptions. Personal and recreational services, on the other hand, has remained at lower levels in the face of the impact of the high Australian dollar on tourism and smoking bans in clubs and pubs. Against that mining confidence has remained at very robust levels. Equally very weak confidence is now reported in NSW and Victoria – and somewhat more surprisingly in Queensland.



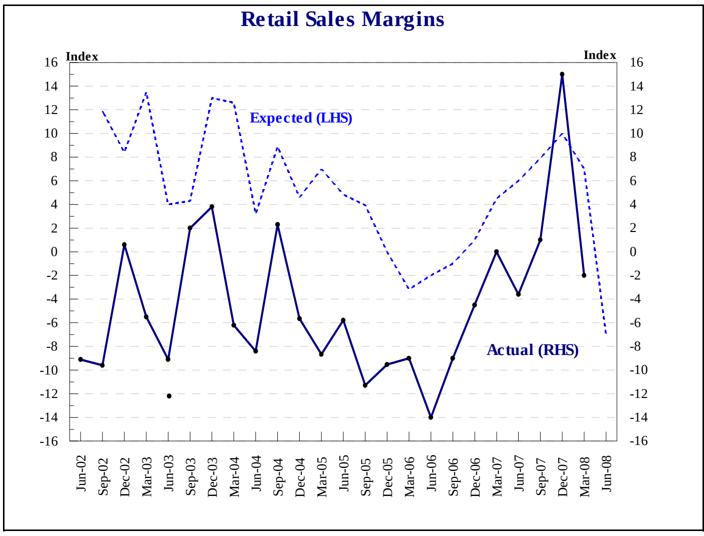
Turning to actual outcomes, the slowing, while generally broad based, are less dramatic than confidence. Once again mining activity remains at very robust levels – with clear positive flow on effects to the Western Australian economy. The largest slowing in the growth momentum in the quarter appears to be in construction, property related industries and finance. Retail and wholesale slowed more moderately – albeit the Monthly surveys suggest that the sharp slowing in those sectors was in the month of March. Somewhat surprisingly, agricultural business conditions remained very subdued – presumably reflecting increased costs and as yet little increase in supply post the drought (albeit confidence in agriculture has not fallen like most other sectors).

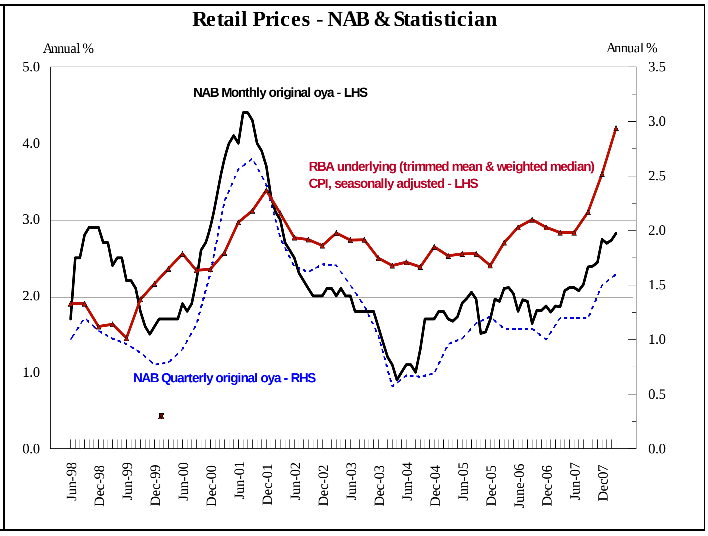


In both the Monthly and Quarterly Surveys, there has been little sign of accelerating wage outcomes in late 2007 and early 2008. That remains the case in the full March Quarterly Survey with wage growth unchanged at 0.9 per cent in the quarter – and 3.5 per cent over the past year (also unchanged). Many commentators – including the RBA – have been somewhat sceptical that our and the official ABS wages statistics continue to produce these outcomes. In part the answer appears to be very much along the lines that while some sectors are reporting higher outcomes (e.g. mining) that has largely been offset by slower wage outcomes elsewhere (e.g. agriculture and retail). Having said that, there does appear to be some expectation by business that wages inflation may accelerate from here. Evidence here includes both the (moderate) expected kick up in next quarter outcomes (1.1 per cent expected in the June quarter) and higher expectations for up coming enterprise based bargaining (EBAs) – which has now moved up to 3.7 per cent from around 3.2 per cent in mid 2007– see chart below. The chart also suggests that for some time now wage outcomes have exceeded businesses expectations and business may now be revising up their expectations as a result. Overall then, while wage pressures may not yet have accelerated further, there is clearly little room for error and the change in wage expectations needs to be very carefully watched.



Clearly, the near term price inflation pressures continue to mount – especially in the retail sector. While at lower levels relative to the Monthly Survey, price pressures in the Quarterly Survey have also kicked up in recent quarters – with the annual increase in retail prices up to 1.6 per cent in the year to March. As noted in the December Monthly Survey, the driving force behind this appears to be higher than expected retail margins (see chart below left hand panel). Purchase costs and overhead inflation remained relatively little changed. As a result, both the monthly and quarterly retail price measures in Nab's Surveys confirm the acceleration evident in the March quarter CPI – see chart below right hand panel. That said, the acceleration in the RBA's preferred measures probably overstates the implied rate of inflation due to its treatment of financial services (and could be worth around 0.5 percent to annual growth rate in core inflation).





Elsewhere in the Survey, there remains a very strong assumption of an upward shift in short term interest rates. In the March quarter, 84 per cent of respondents still expected another rate increase (85 per cent previously) with a mean expected increase of 57 basis points (53 points previously). However it may well be that these expectations (like those in financial markets) have subsequently been scaled back in the face of clearer signs of a slower domestic economy and a RBA more concerned about the potential for sharper than expected slowing in demand in both the local and global economies. House price expectations for the next 12 months have at the margin been scaled back to around +1 per cent (+2½ per cent previously). Finally, business expected the Australian dollar to edge down from its current level – with the mean expectation for the next 6 months at 91.5 US cents (previously 88.2 US cents). There was little change in the degree to which exporters have currency hedging (20 per cent) but the degree of hedging by importers was increased (from 30 per cent in December to 35 per cent at present).

NAB Economic and Financial Forecasts:

Global Forecasts

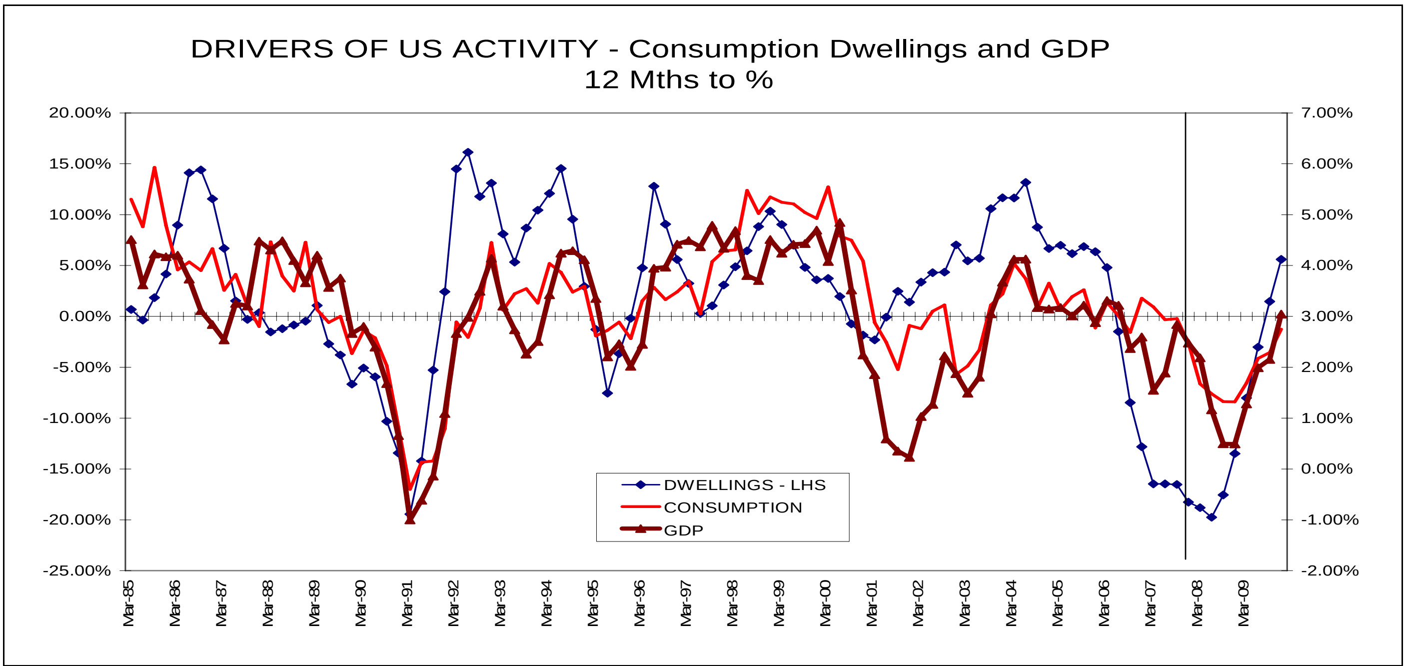
As noted earlier, we have kept our global economic forecasts unchanged - at 3½ per cent in 2008 and 3¾ per cent in 2009. The key activity forecasts are as follows. Importantly, we are not expecting a global recession but rather a period of sub trend growth. That said the pattern of growth will be very varied across regions.

Global GDP Forecasts

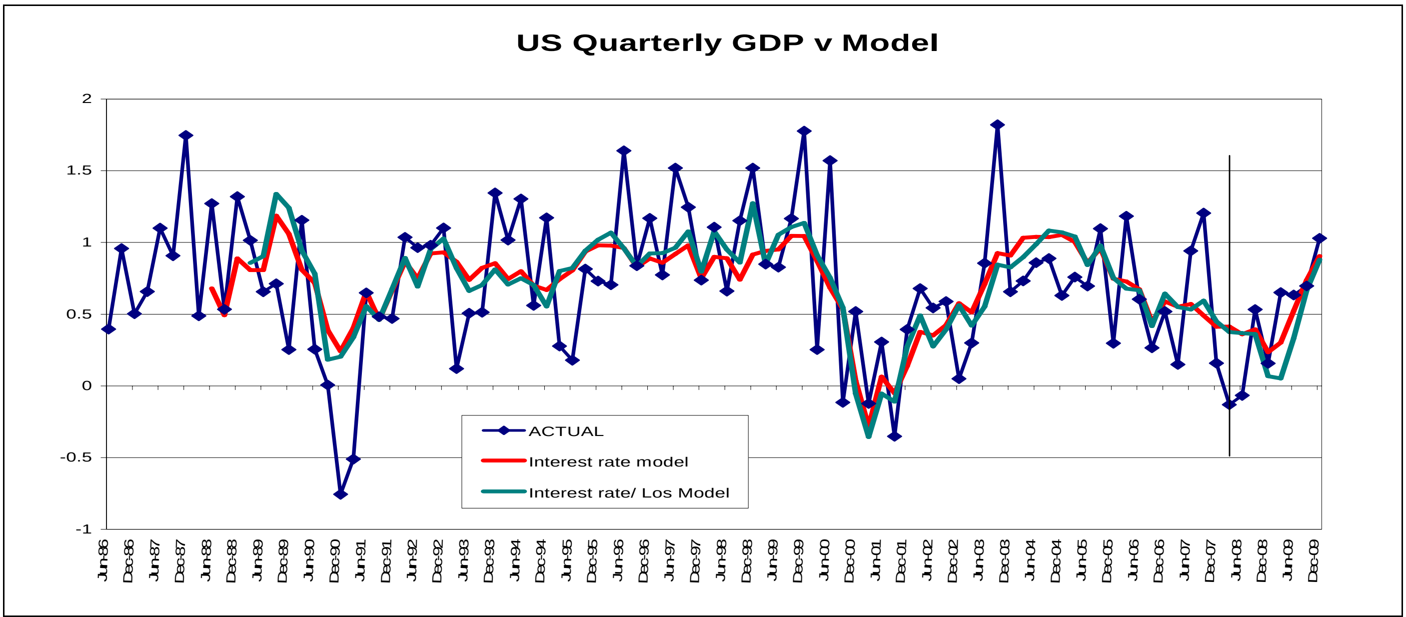
December year annual average % change	2005	2006	2007	2008(f)	2009(f)
US	3.1	2.9	2.2	1.2	2.2
Japan	1.9	2.2	1.9	1.3	1.7
UK	1.8	2.8	3.0	1.7	2.0
eurozone	1.6	2.9	2.7	1.7	2.0
Canada	2.9	2.8	2.4	2.0	2.3
Australia	2.6	2.6	4.0	2.8	2.8
New Zealand	2.7	1.7	3.1	1.4	1.4
China	9.9	10.7	11.4	9.5	8.3
India	8.7	9.6	8.7	7.6	6.4
World	*4.5*	*5.1*	*4.4*	*3.5*	*3.7*
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
G-10 (Ex China)	2.3	2.8	2.4	1.4	2.1

In particular, we are happy to maintain our US growth forecast of 1¼ per cent in 2008.

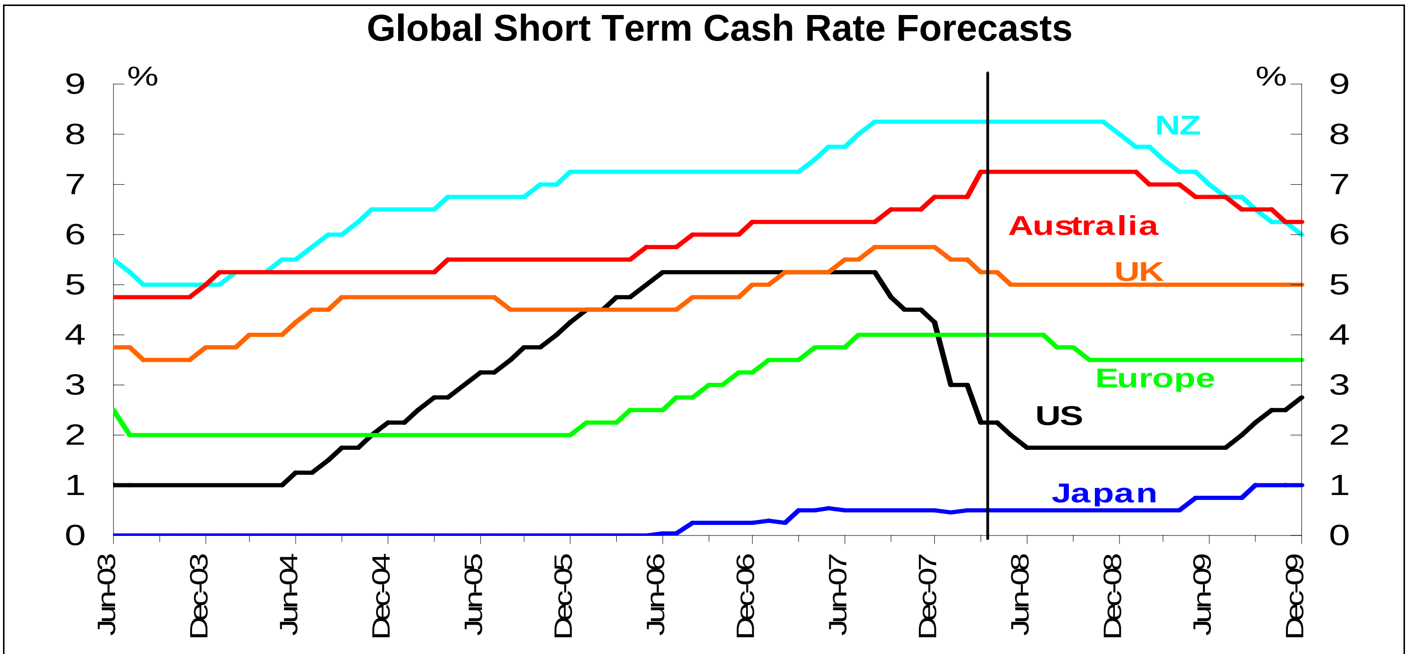
- That forecast suggests that the US is in for a very tough time due to the impact of the excesses of the housing construction cycle, falling house prices, increased funding costs and second round impacts of further capital losses, higher costs of capital, tightening of credit standards and now the wealth effects of lower equity prices. For 2008, even with a fiscal expansion package and aggressive rate cuts, we see GDP growth stalling and indeed edging backwards in the first half of 2008 before recovering marginally in late 2008. Strong growth does not return in our US forecasts till H2 2009;
- We also see the Fed's action as trying to provide a circuit breaker by cutting interest rates as much as needed. At this stage, we see another 50 points of cuts by mid 2008 – bringing the Fed Funds rate down to 1¾ per cent by mid 2008;
- While these forecasts would probably be considered by the NBER as a recession – and indeed our forecasts are not much better than 2000/01 which was called a recession, the real question is whether the "recession" will be large and protracted (e.g. 1990/91) or not. At this time, we see little reason to expect that and hence maintain our judgment that much of the current commentary and some market reactions are overblown;



- Of course there are still risks that the US outcome may be worse than we expect. Some of the dynamics here can be shown by the use of our internally developed mini-model of US demand. The model drives off the following variables (all estimated with separate lag structures): real short term rates (Libor); house prices; equity markets; currency; commodity prices and the price of oil. We also include the loan officer survey to give a proxy for credit rationing (and in the forecasts we estimate the impacts of tighter credit than 1990 – with the loan officer survey index going to +70). The result with and without the credit rationing term compared to our forecasts are shown below. What the model (estimated quarterly) suggests is the potential for a "lower for longer" US activity profile – with growth of less than 1 per cent through the year to mid - 2009. This growth profile is very much driven by credit rationing and the long lags (around 12 months) from higher oil prices.



The following chart also summarizes our short term official interest rate forecasts:

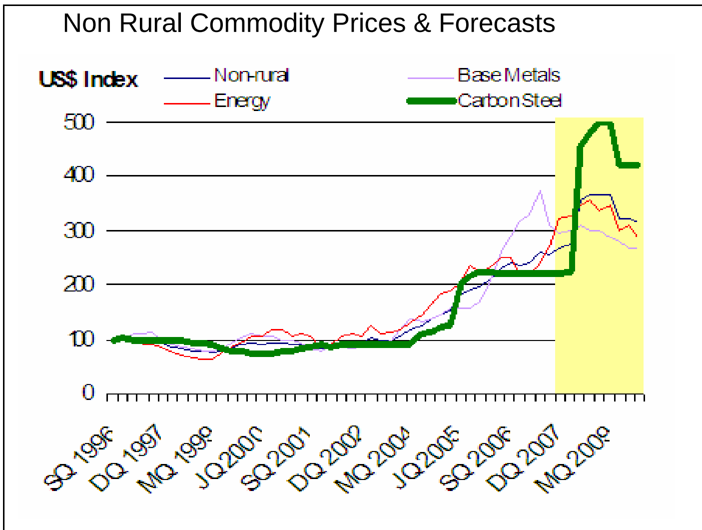


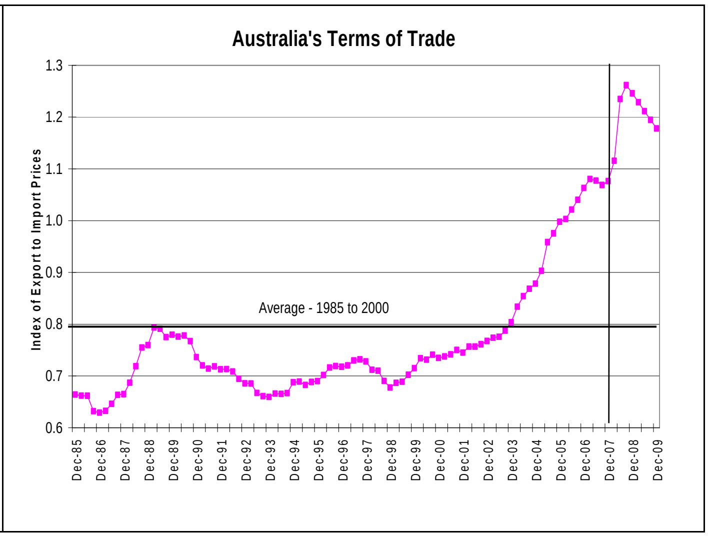
Australian Outlook

Clearly the Survey is signaling that the Australian economy may be slowing faster than we had expected. But against that there are still the impacts of income tax cuts, higher commodity prices and a rebound in farm output (of around 20 per cent) to come. Certainly it is clear that financial conditions have been (more than) tightened enough to cause a draw back in interest sensitive sectors – including the consumer. While we are clearly highlighting potential downside risks to the forecasts, on balance, we are happy to stay with our current activity forecasts. That is, we expect:

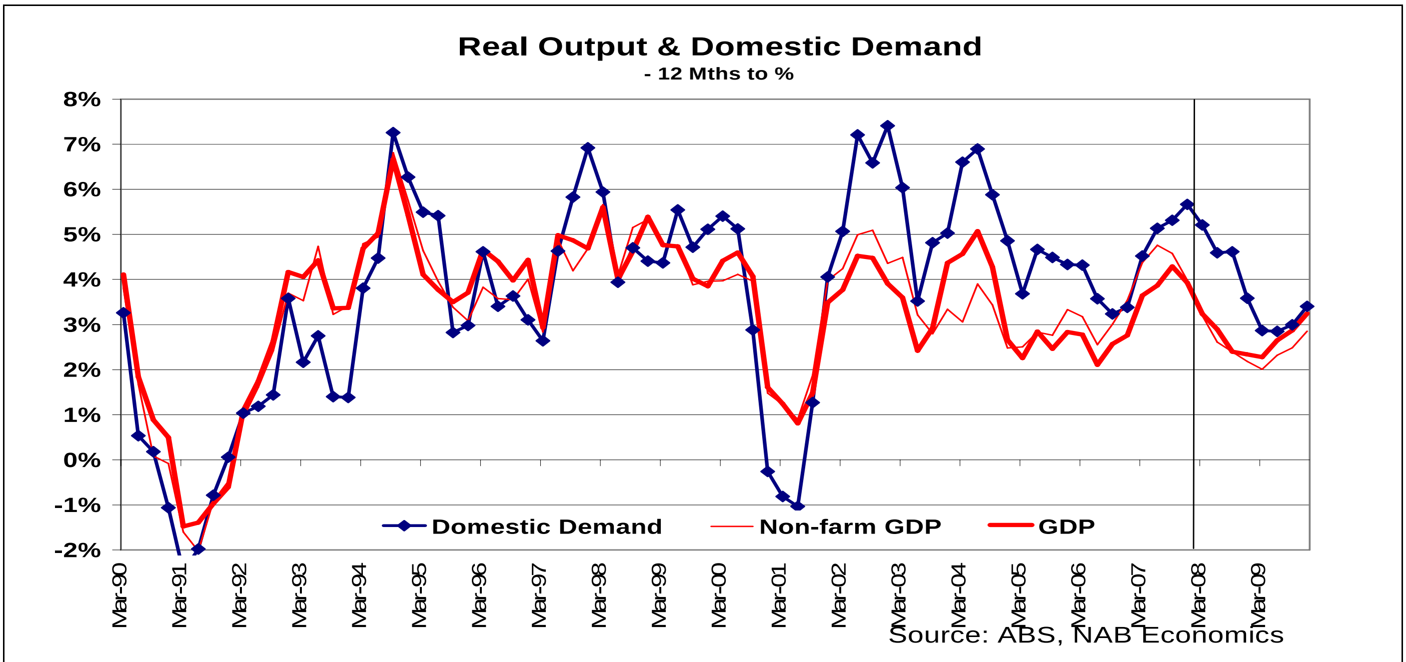
- GDP to increase by 2¾% in both 2008 and 2009;
- The 2009 forecasts mask a further slowing in non-farm GDP to around 2½% offset by a rebound in farm GDP by around 20%;
- For the financial year 2007/08, these forecasts are consistent with GDP growth of 3½% in 2007/08 and 2½% in 2008/09.

Despite current uncertainties about the global outlook, with China still strong, we have seen very large commodity price increases in iron ore (65 per cent) and coal negotiations (up to 280 per cent). As a result, Australia's terms of trade will move up significantly further during mid 2008, before starting to ease back from late 2008/early 2009.- see chart below. That, together with personal tax cuts and the farm sector rebound should provide powerful offsets to an overly hard landing in Australian activity – especially in 2008 but also probably in 2009 as well.

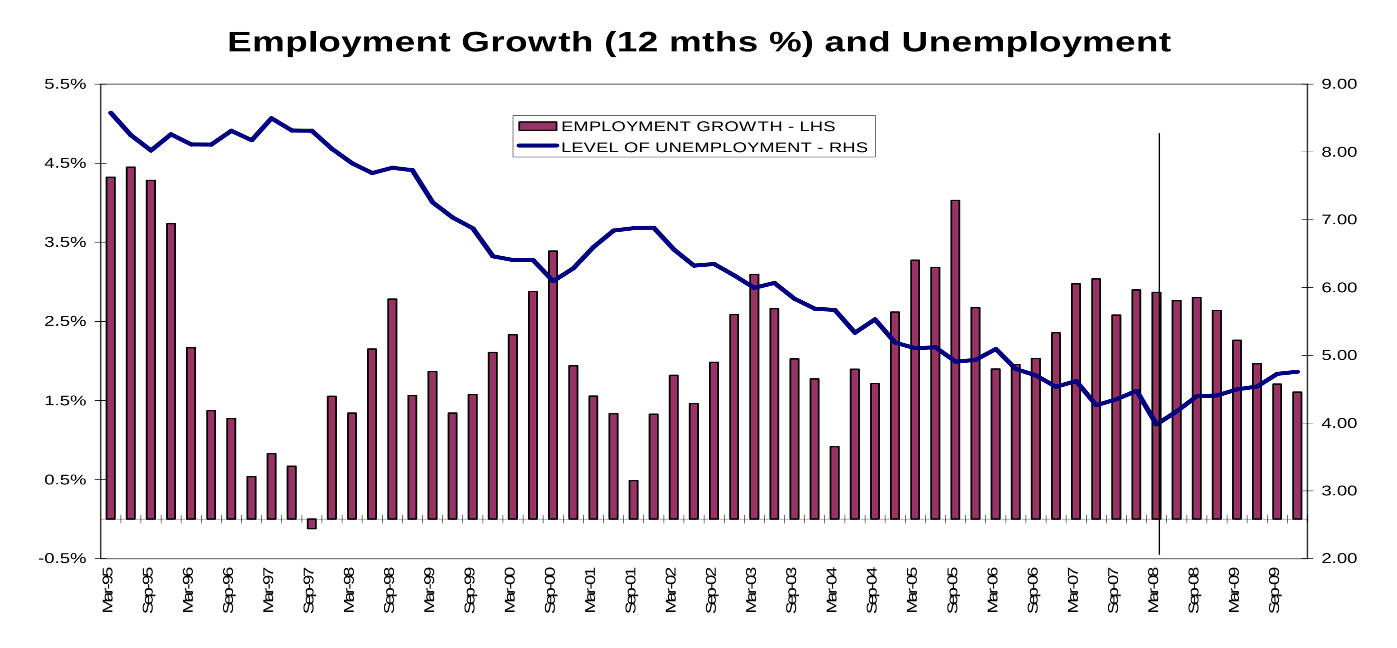




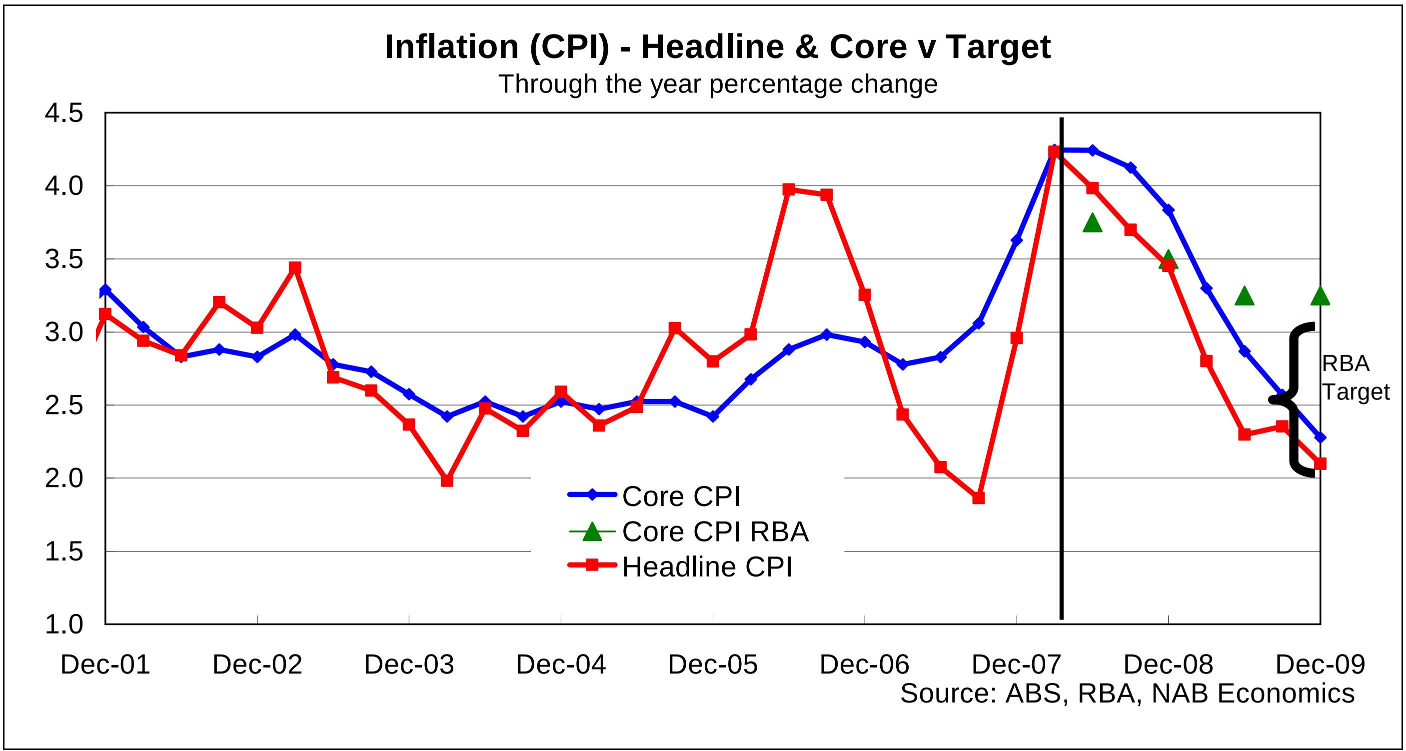
Reflecting tighter financial conditions and associated lower growth in asset prices (house price increases are expected to slow to around 4 per cent in 2008 and little growth is expected in equity markets in 2008), our forecasts see the pace of domestic demand slowing from the current annual rate of 5½ per cent to nearer 3½ per cent during 2008 and a touch lower in 2009 – see chart below.



The implied slowing in domestic demand will also slow employment growth from the current rate of around 2¾ per cent to around 2¼ per cent by early 2009 and nearer 1½ per cent by late 2009. That in turn will see unemployment remaining in the 4 - 4¼ per cent range for most of 2008, before moving moderately higher during 2009, as the forecast slowing in demand eventuates (with unemployment between 4¾ - 5 per cent by late 2009 – see chart below). Our commodity, activity and interest rate forecasts see the USD/AUD moving up to around 96 US cents in mid 2008 and staying above 90 US cents until 2009.



After the very disappointing inflation numbers for the March quarter, we now see the RBA's core inflation measures staying around 4 per cent for all of 2008. With oil prices and upstream pressures very high, the RBA will be on aggressive inflation watch for some time with a clear upside bias. Any signs of accelerating wages, a stronger economy or labour markets could well see the RBA in action again. That said, we still see downside risks to demand and expect core inflation to be back into the target range by mid 2009.



On interest rates:

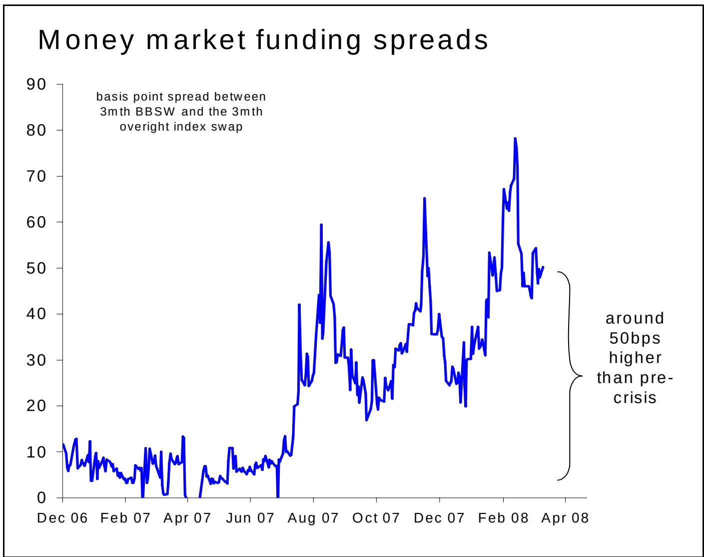
- The RBA has recognized that their recent actions (together with lenders' additional funding cost increases) represents a "substantial" tightening of financial conditions – and they are watching to see how effective those actions will be in slowing demand substantially;

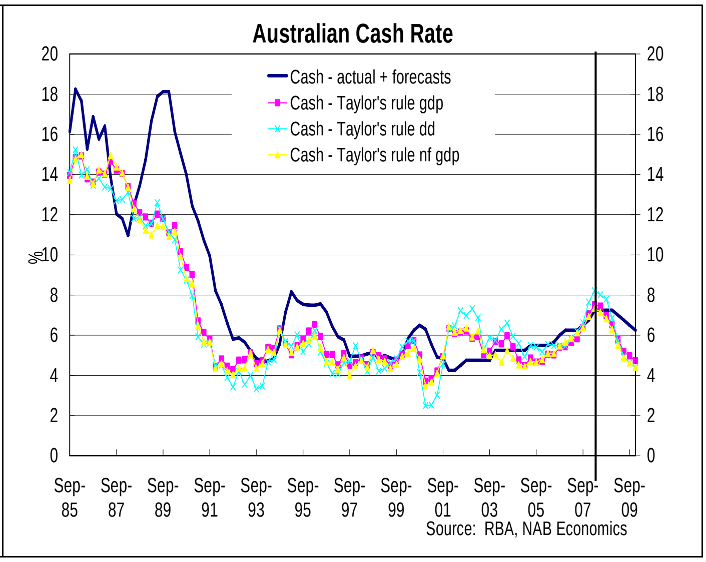
- The RBA has started to acknowledge that there are early signs that demand is slowing. The results from the March Monthly and Quarterly Surveys strongly reinforce the view that a significant slowing **has** already occurred and has occurred faster than we expected. Other recent "weaker" data include retail sales and the credit numbers;

- It should also be acknowledged that the disruption in financial markets is far from over. Indeed, as shown by the chart below, additional costs on banks' near term funding costs (above that imposed by central banks) remain substantial. Similar increases in banks' longer term funding costs are also apparent. That combination, together with increased demand for corporate funding could well see Australian banks moving to ration credit (as is already the case in the USA and Europe) in late 2008 – with further downside potential for growth;

- Against that, the latest core inflation numbers (even if there are marginal technical queries on them) were dreadful. Clearly the RBA will now be on aggressive inflation watch with a clear upside bias. Any signs of strengthening growth, labour market or especially wages could well trigger another rate tightening. Were that to happen, we would expect it in August /November rather than May. With core inflation to remain around 4% in 2008 rate cuts this year are very unlikely. Going forward, while there will be some nervous days ahead, we still see rates on hold through 2008 with the RBA increasingly focusing on the downside risks to activity. That also implies downside risk to their inflation forecasts (as our inflation forecasts imply);

- On balance, we are happy to stay with our medium term forecasts of rate cuts of 125 points in 2009 bringing the cash rate back to 6 per cent by late 2009/early 2010. That type of adjustment would be consistent with bringing monetary policy settings back to a more neutral (but still a firm) policy stance (see the chart below for a Taylor rule perspective – based on our demand and inflation forecasts).





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Australian Economic and Financial Forecasts

	Fiscal Year		Calendar Year	
	2007/08	**2008/09**	**2008**	**2009**
Private Consumption	4½	2¾	3½	2½
Private Investment – Dwelling	2	3½	2¾	4½
– Underlying Business	10	8	10	5
Underlying Public Final Demand	4¼	3	4½	2¼
Domestic Demand	**5¼**	**3½**	**4½**	**3**
Stocks (a)	¼	-¼	-¼	-¼
GNE	**5½**	**3¼**	**4¼**	**2¾**
Exports	3¼	4½	3¾	5¾
Imports	7¾	7	7¾	7¼
GDP	**3½**	**2½**	**2¾**	**2¾**
– Non-Farm GDP	**3½**	**2¼**	**2½**	**2½**
– Farm GDP	3½	12	9	20
Current Account Deficit – $b	71	53	62	54
– % of GDP	6¼	4¼	5¼	4¼
Employment	2¾	2½	2¾	2
Terms of Trade	5½	12	14¼	0
End of Period				
Average Earnings	3¼	4	4	4
Total CPI	4	2¼	3½	2
Underlying CPI	4¼	2¾	3¾	2¼
Unemployment Rate	4¼	4½	4½	4¾
RBA Cash Rate	7¼	6¾	7¼	6¼
10 Year Govt. Bonds	6	5½	5½	5¾
$A/US cents	92	86	90	84
$A - Trade Weighted Index	70½	65¾	69	67

(a) Contribution to GDP growth

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