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ACCESS ECONOMICS' MEDIA RELEASE

Business Outlook

Please note the embargo to Friday 24 October 2008

STOP PRESS

- *Business Outlook* initially went to the printer less than a day ahead of the collapse in confidence in the global financial system. There have since been huge reactions from policymakers (interest rate cuts, emergency liquidity and funding measures) and from markets (a despairing dive). The same day saw the release of the latest Australian consumer confidence measure, which showed shoppers curling into the foetal position amid headlines that spoke not merely of the potential for Australian recession, but also of the potential for global depression.

- Bugger. *Business Outlook* was predicated on two key caveats – first, that China's economy did not join the walking wounded and, second, that Australian consumers did not lose heart. Both caveats are now in play. Our response has been to include this *Stop Press* so as to update you on where developments may now take the economy relative to the detailed commentary and forecasts in this current issue. We've also made partial changes to our forecasts, and minimal changes to the words which originally went to the printer (though the latter remain mostly unchanged). A full update for you will come with the next quarterly release of *Business Outlook*.

- One of the authors of *Business Outlook* was in the US Capitol when the House of Representatives voted down the initial US bailout plan. It was immediately obvious that global confidence would tank – and tank it has. The wheels of global commerce are oiled by the banking system, but the latter has shut up shop for now, leaving policymakers desperately trying to fill the gap by various emergency measures. **By definition those measures will fail. Governments and central banks just don't have the dollars to turn around markets in full retreat.** Once cracked, confidence is hard to repair. **Equally, however, current conditions are temporary.** At some stage markets in general and credit markets in particular will become less panicked, and the wheels of commerce will start to turn once more. That is why Access Economics takes some of the current pronouncements (of recession at home and depression abroad) with a grain of salt. However, the longer it takes markets to get their mojo back, the worse the short term outlook becomes for both Australia and the world.

- **We urge you not to overreact on your outlook for the economy.** Businesses and governments make their biggest mistakes amid both booms and busts. Over the last two years we consistently warned current conditions were not sustainable: for many businesses, they were simply too good. Equally, **current conditions are so dire they too cannot last too long, especially in credit markets.** And don't forget one simple but important point. Today's crisis is a hit to demand, not supply. The potential for economies to produce is driven by the number and quality of workers here and around the world, as well as the plant and equipment they have to work with. Neither element of that production potential has been damaged by today's crisis. Financial meltdowns have a history of weighing on confidence (and hence demand) for well over a year. But they will ultimately go away, allowing demand to lift back towards supply.

- **That doesn't say Australia is not at major risk. It is. But our risk focuses more on commodity markets** rather than financial markets (or credit markets in particular). As Access Economics has also stressed in recent years, Australia's national income has been massively pumped up by a surge in commodity prices. If those commodity prices reverse fast – an increasingly likely scenario – then a number of businesses and all governments can be entitled to fear the next few years. Keep watching China and commodity prices, particularly coal and iron ore prices. If the latter pair of prices fall out of bed, then so will Australia's short term fortunes.

❑ To date the slowdown in Australia's economic growth has been centred in consumer spending and housing construction, as they are very sensitive to interest rates and to the broader availability of credit, as well as to confidence. Interest rates are now lower, but confidence is too, and that is enough for us to expect that consumer spending and housing construction may be even weaker in the next little while. Rather more worryingly, fading prospects for the growth of emerging economies in general (and China in particular) may combine with difficulty in obtaining credit and an expected sag in business confidence to put a notable dent into what had been this nation's growth ace: business investment. The latter doesn't and won't turn on a dime, but it may well go from a key support to the overall growth outlook to something rather more modest.

❑ There may be little change elsewhere to the Australian growth outlook – government spending will continue unabated and, even amid rapidly gathering global gloom, export volumes should still lift. The latter is an important point, and one that many commentators may miss. When it comes to exports, our risk is lower prices rather more than it is lower quantities. The world will still want Australian industrial commodities in particular, but will pay us less than we'd like for them. Yet, with consumers cowed and business investment moving on to the back foot, GDP growth in Australia will be less than we had originally forecast in this edition of Business Outlook. The following report therefore contains updated forecasts – both tables and charts.

❑ Sectoral growth drivers are also switching. We had already made a point of that in the words you see in the publication here. However, the import of recent days means a rather larger and faster switch in the sectoral drivers has already occurred. Neither exchange nor interest rates are the negative they once were. And China is no longer the positive it once was. The impact of that is likely – on current developments – to be a narrowing of recent growth differentials rather than a reversal of them, though the latter now looks more of a possibility than it has done for years. After all, and even amid the rapid blooming of global gloom, Australian manufacturers and tourism operators will benefit from the impact on them of today's changed circumstances.

❑ **Global growth is also under the gun.** Just how much it is under the gun is unclear, but the longer the current crisis lasts, the worse it will be for global growth. Access Economics has long noted the importance of China in particular to local prospects. As we note yet again in the current edition of Business Outlook, "to repeat an old refrain, Australia is fine while China is fine. Or, to sit that on its head, if China stops being fine, then Australia runs the risk of being buggered. Is there a risk that China won't be fine? You bet there is." Well, that risk has just worsened again. Notably so. It won't be clear for some months yet just how much trouble China is (or isn't) in, but chances are that its growth will take a larger hit than earlier expected. We have therefore revised down our estimate of China's GDP growth in 2009 to 7.4% in the following report.

❑ Turning to other elements of the forecasts, **inflation is likely to be a little worse than initially forecast.** Again, we have adjusted the forecasts in the attached. However, the change is minimal – with inflation expected to be a little faster in the short term as the $A's fall from grace pressures retail pricing more than the souring economy reduces demand-driven inflation risks. Keep an eye on import prices in particular.

❑ On the outlook for interest and exchange rates, clients know we have long forecast a sharp fall in both, but we didn't foresee the extent of the financial firestorm of recent weeks. We see the Reserve Bank cutting cash rates to 5% in coming months as it takes out further insurance to avoid Australian economic growth getting caught up in the global maelstrom. Note that forecast assumes a weaker China rather than a flattened one. Were the latter to occur, then the RBA would drop rates even further still. The $A went from dicing with parity to cellar dweller in very short order, dropping well below the US 72 cents it has averaged since the $A first floated a quarter of a century ago. We don't see the $A fading too much further again over the next year, but the caveat to that is very much China's outlook – the worse that China (and commodity prices) look, then the lower the $A will go.

❑ The job market has been Australia's star performer for a long time. The accompanying forecasts here expected it to stay that way. We haven't had time to revisit those forecasts, but our earlier hopes for continuing outperformance on the labour market front are fading. The performance of job markets may yet still beat the forecast Treasury made last May, but there is now no certainty of that.

❑ The first signs of difficulties ahead are there to be seen. Commodity prices have fallen notably already. And although that is not yet true of coal and iron ore prices, steelmakers around the world are complaining that the current price for their product is barely ahead of the cost of making it. That suggests both (a) the mothballing of steel expansions and (b) price falls ahead for coal and iron ore in the contracts to run from April 2009. And rumours are rife of buyers of iron ore starting to request delays to their deliveries – an ominous sign. Meantime, the price of aluminium has fallen so much that

Alcoa has just shelved all non-essential capex – a reminder of the (eventual) vulnerability of Australia's record pipeline of construction work yet to be done.

❑ Access Economics already had a sombre view of commodity price prospects, so the recent ructions on markets don't particularly affect our view on the outlook for the balance of payments. However, as Australia's economics lesson back in 1986 (during the days of the 'banana republic') remind us, 'the J-curve' effect sees the current account deficit get worse before it gets better. We import a bit more than we export, so a drop in the $A will tend to add more to the cost of imports than it saves us through higher export earnings. That said, a couple of years from now the lower $A will be starting to show up in healthier external accounts for Australia.

❑ And as for public sector accounts, they too remain in the thrall of commodity prices. If the latter tumble, then Australia's Federal fiscal surplus will be at risk of melting. That may not happen as fast as Lehmann Brothers bit the dust, but it would happen. (And Australians may then regret the years of big public spending and free-wheeling tax cuts which preceded it.).

❑ An accelerating credit crisis and (what were until recently) eye watering commodity prices have seen weakness proliferate around **the globe**, with economies contracting across the Eurozone (including in each of Germany, France, Italy and Denmark), in Japan, in Canada, and in NZ, while UK growth has stalled. The US is still growing, but its economy will be shrinking soon too, and China will slow more than earlier expected. Although interest rates and commodity prices (including oil prices) are now lower, the globe is slowing rapidly, and 2009 will be a rather weaker year than 2008 – much weaker, if the Chinese domino falls. We expect China to slow to 7-8% growth in 2009. If it ends up less than that, then today's ugliness could become even uglier**… see pages 1-8.**

❑ Consumers are taking a back seat, but businesses and governments are still spending, and exports are lifting. Moreover, interest rates, petrol prices and the $A are all off their highs. As that unholy trinity cut into domestic demand in the first place, the loosening of that noose suggests some of the negatives in play may soon pass their worst. Provided confidence doesn't fall too much further, that points to the potential for recovery in consumer spending and housing construction through 2009. Australian **output growth** will get worse before it gets better, but it may trough by mid-2009, and then spend 2009-10 regathering some speed amid lower interest rates and improving export volumes. The biggest question marks over the outlook still revolve around prospects for China and commodity prices**… see pages 9-29.**

❑ **Inflation** is still a problem, but it may not stay that way. That's the very punt the Reserve Bank is making by reversing course – it thinks there is enough slowdown in the system to bring inflation back to heel. We agree, to the point that (as we've forecast for a while), we see underlying inflation back under 3% by late 2009, well before the RBA forecasts it there. But the inflation challenge is changing shape too – demand pressures may be less of a threat, but labour cost pressures remain higher than would be consistent with falling inflation rates and, boosted by a weaker $A and rising costs out of China, non-oil import prices are about to loom as the biggest threat that they've been since early this decade**… see pages 52-60.**

❑ **Interest rates** will fall from here – both globally and locally. Gathering global gloom means the policy switch from fears about inflation to fears about growth will spread rapidly through the world. The Reserve Bank's move to cut cash rates to 6% came earlier than expected, though given the collapsing confidence in markets and continuing pressure on credit spreads further cuts are likely from here. Targeting lower mortgage interest rates will help to offset the relapse in consumer confidence in the wake of recent market mayhem. Lower interest rates and falls in commodity prices have seen the $A slump sharply back well below the US 72 cents it has averaged since first floating**… see pages 61-69.**

❑ Past commodity booms saw Australian families, businesses and governments spend up during the good times. And, oops, we've done it again. With coal and iron ore prices through the roof, that won't stop Australia coming close to a **trade** surplus this year. Yet, as history repeats, the current account deficit will shift to a higher average plateau now that commodity prices are falling back once more**… see pages 70-75.**

❑ Forward indicators of job growth (such as job ads) have tanked, and the Reserve Bank has added its own sombre employment and unemployment forecasts to echo those that Treasury released some months back. Yet great profits have made workers a bigger bargain than ever before. Despite recent market mayhem and the effect of that on confidence, there remains a chance that job growth will beat Treasury's expectation of a slowing to 80,000 job gains in the year to mid-2009**… see pages 76-84.**

❑ As commodity prices turn, the **fiscal** bonanza of recent years will start to reverse. Commodity prices have underpinned lax spending by the Feds and some States, and have paid for a series of personal income tax cuts (with more already promised). They have also let populism run rife – 'the surplus is big, why can't pensions go up?' But the party could be pooped as commodity prices turn. So if you want to know what Federal and State fiscal policies will do, then keep watching coal and iron ore prices**… see pages 84-91.**

The drivers of sectoral balance are starting to change ... see pp 30-51

❑ Recent years have seen an increasingly consistent split through Australia's industrial landscape. **Sectors** for whom China is a customer have grown fast and have made big bucks, shrugging off the jump in the costs arising from tight capacity constraints, as well as negatives such as higher interest rates and the higher $A. For other sectors, however, China has been more a competitor than a customer, and/or the mix of high interest and exchange rates has proved all-too-toxic. The 'two-speed economy' has been splitting further apart as a result, though it is clear that some major drivers of that long-running split are changing course. In particular, interest rates are now heading down rather than up, the $A has shed a lot of excess weight (and remains a likely loser of more altitude over the next year or two) and, related to that, a bunch of commodity prices are well off their peaks. That changes the sectoral balance. However, while coal and iron ore prices remain at their current heady heights, this reversal of fortunes is likely to narrow growth differentials rather than reverse their polarity (mining and engineering will remain strong, while much of manufacturing will still grow slowly), though these forecasts point to further changes over time which should continue to narrow growth differentials.

Resource states still dominating ... see pp 92-115

❑ Among the **States and Territories**, the resource States are still stomping all over the performance of the weaker States, with NSW's economy in almost as much trouble as its politicians. However, although it may take a couple of years to become notable, the necessary pre-conditions to narrow that performance gap between those with and without mineral riches are now evident. Commodity prices have fallen, and so too have both interest and exchange rates. That combination reduces the attractiveness of the resource States on the one hand, and on the other hand also reduces some of the pressures on those States with big mortgages and even bigger manufacturing sectors.

❑ Latest data from **NSW** look gothic in their horror. Yet the cavalry is coming. Interest and exchange rates have fallen, and they'll fall further. Petrol prices are off their peaks. And, in the biggest positive of all, everybody in NSW now realises the State faces a genuine crisis.

❑ **Victoria** is slowing – slightly. Confidence has cooled, retailers are on the ropes, the credit crunch will be bad news for business services, and lingering pressure on manufacturers means Premiers (past and present) are asking for Canberra's help to prop up weak industries.

❑ **Queensland's** growth took a knock from flooded coal mines, but population gains are picking up pace once more, leaving the Sunshine State growing by an extra 100,000 residents next year, a key positive for retail and housing construction, the centre of its current slowdown.

❑ **South Australian** growth is solid in part as its economy is more resilient to interest rates than is the rest of Australia. Retail remains remarkably strong, as do car sales, suggesting the smaller debts among SA families helped them to stare down the evils of high interest rates.

❑ Disrupted gas supplies hurt **WA**, but its growth is still accelerating. It isn't financial markets that WA need fear, but commodity markets. Our mantra that the State is fine while China is fine remains true in spades (and in diamonds, gold, iron ore and gas …). A China stumble would (eventually) hit hard.

❑ **Tasmania's** economic momentum remains very healthy – which is all the more good news given that Gunns looks like a goner. It looks as if the Gunns pulp mill is now less than likely to go ahead, raising growth challenges for a small State lacking economies of scale.

❑ The **Northern Territory's** economy has navigated some tricky shoals, and is still in pretty good shape. Population growth is still accelerating; unemployment is back near record lows, and there is talk of a second LNG plant in Darwin. That would be very good news.

❑ The **ACT** has been slowing for a while, as its big mortgage belt is smarting amid high interest rates, and its commercial construction sector has completed some of the bigger jobs around town. The upshot is that most demand indicators are signalling at least amber.

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