

# The global financial crisis and its impact on the Australian economy

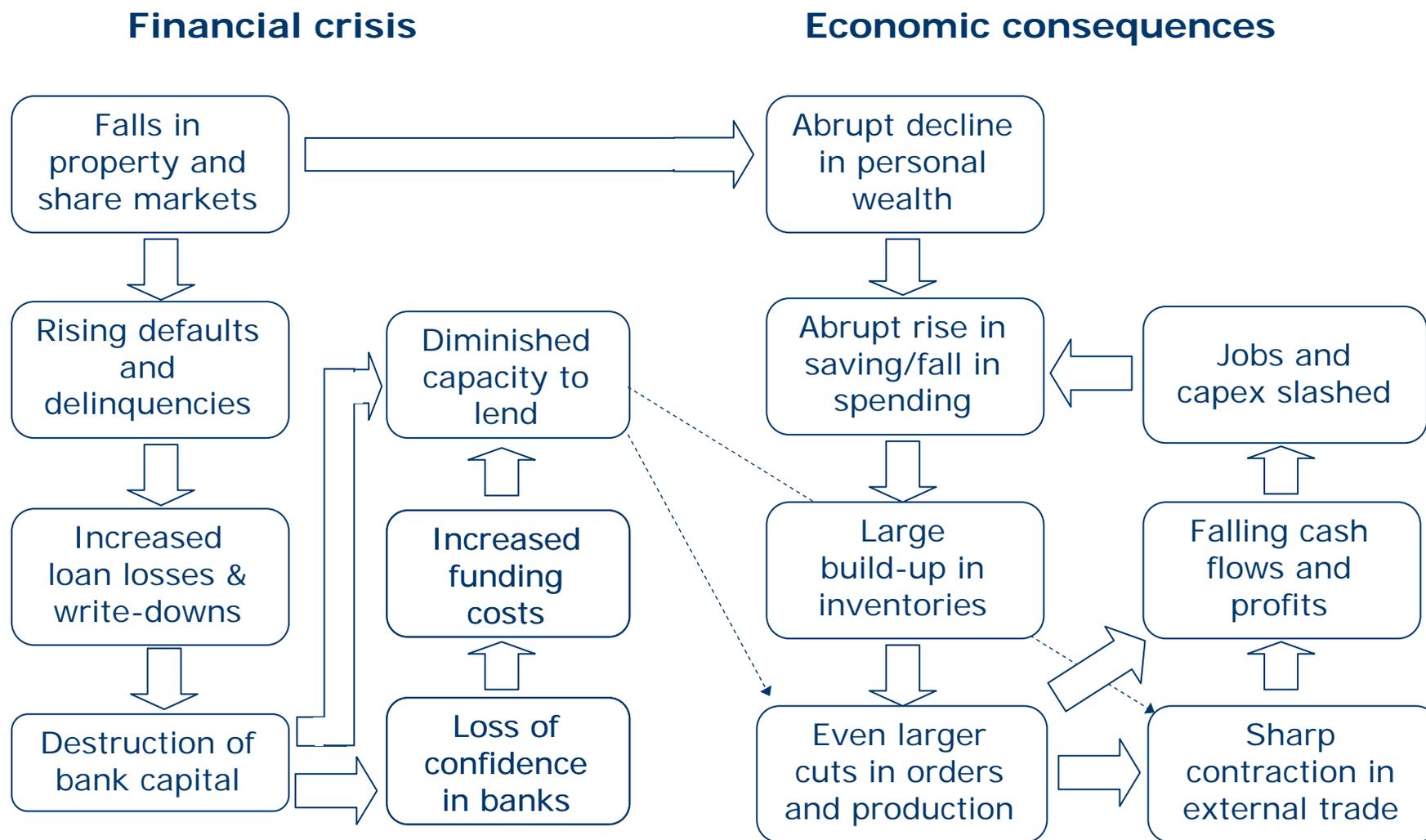
Presentation to the Queensland CFO Summit

Sofitel Hotel, Brisbane  
3<sup>rd</sup> June 2009

Saul Eslake  
Chief Economist, ANZ



# The financial crisis triggered and amplified a vicious contraction in economic activity around the world



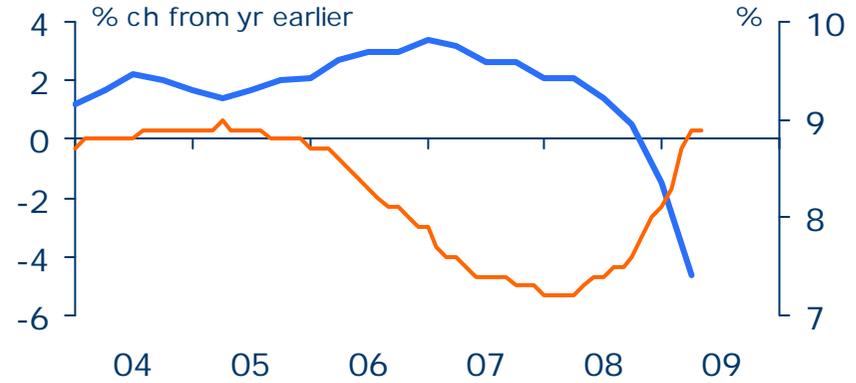
Economic activity has contracted sharply, and unemployment has jumped, in all of the major Western economies

**Advanced economies: economic (real GDP) growth and unemployment**

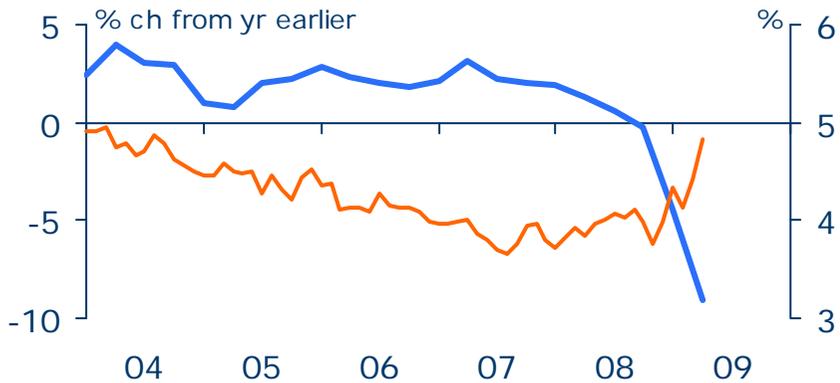
**United States**



**Euro area**



**Japan**



**United Kingdom**



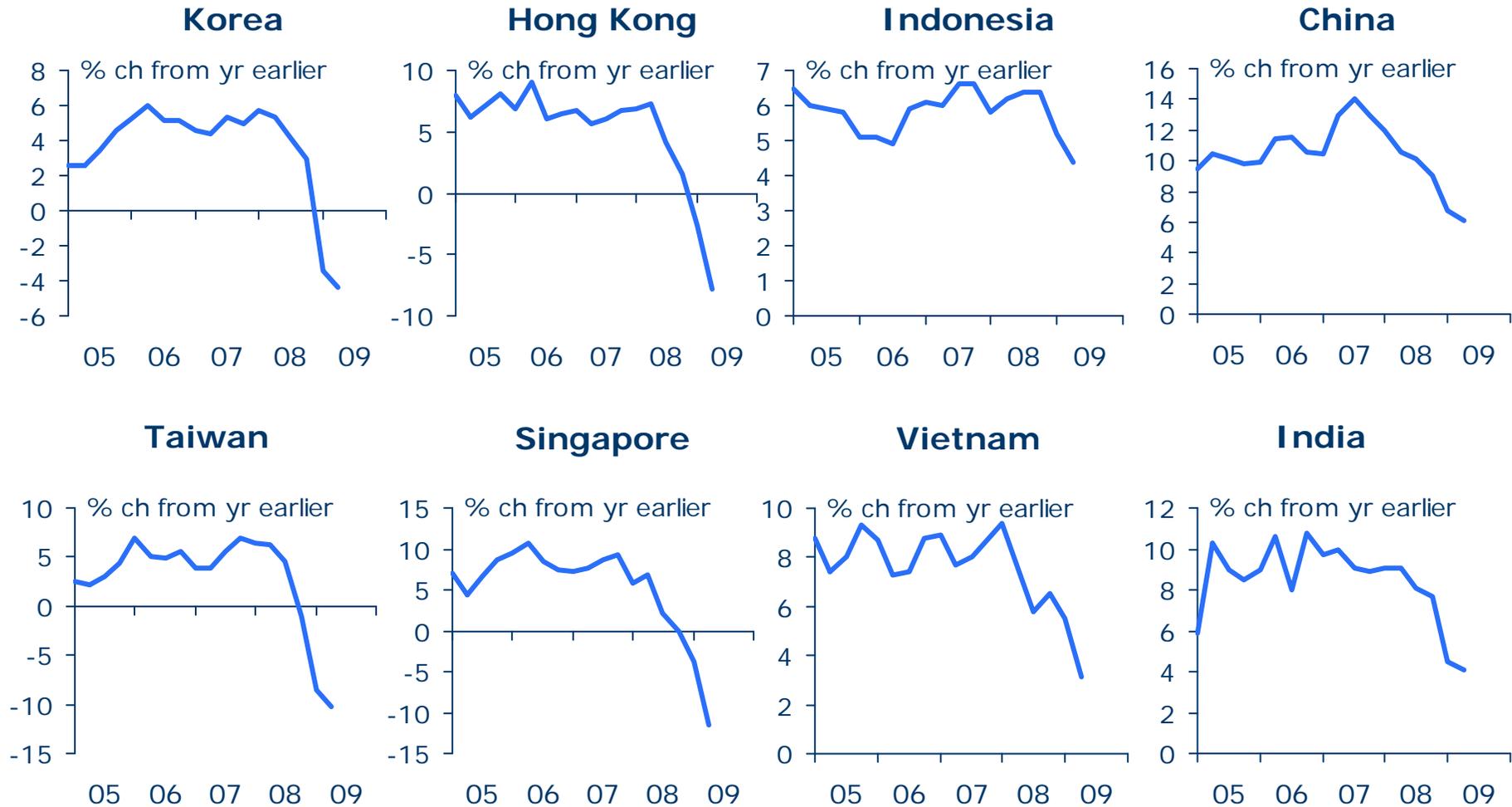
— Real GDP growth (left hand scale)

— Unemployment rate (right hand scale)



The more advanced and open Asian economies have also contracted sharply, while others have slowed significantly

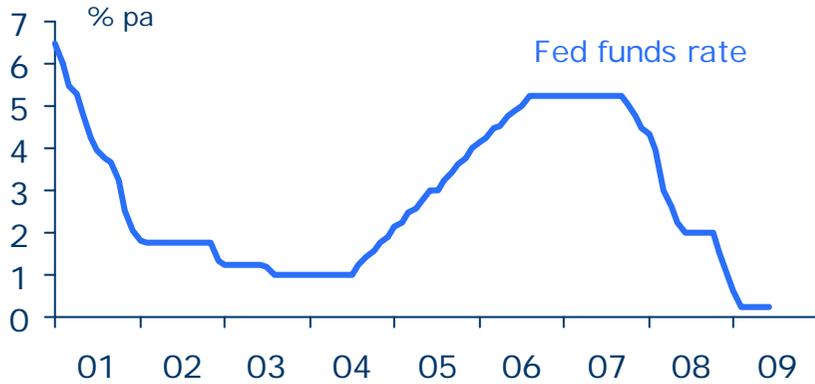
### Asian economies: economic (real GDP) growth



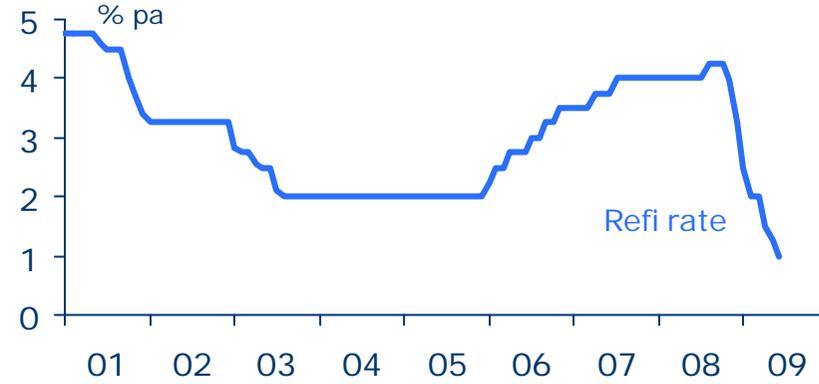
Most major advanced economy central banks (except the ECB) have cut their cash rates to near-zero levels

### Policy interest rates – major Western economies

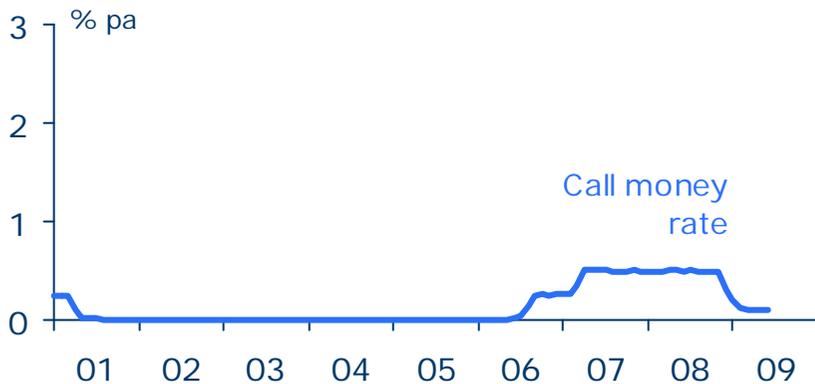
#### United States



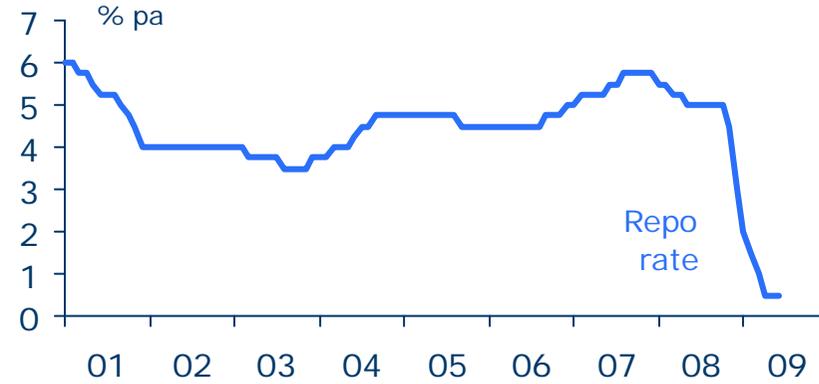
#### Euro area



#### Japan



#### United Kingdom

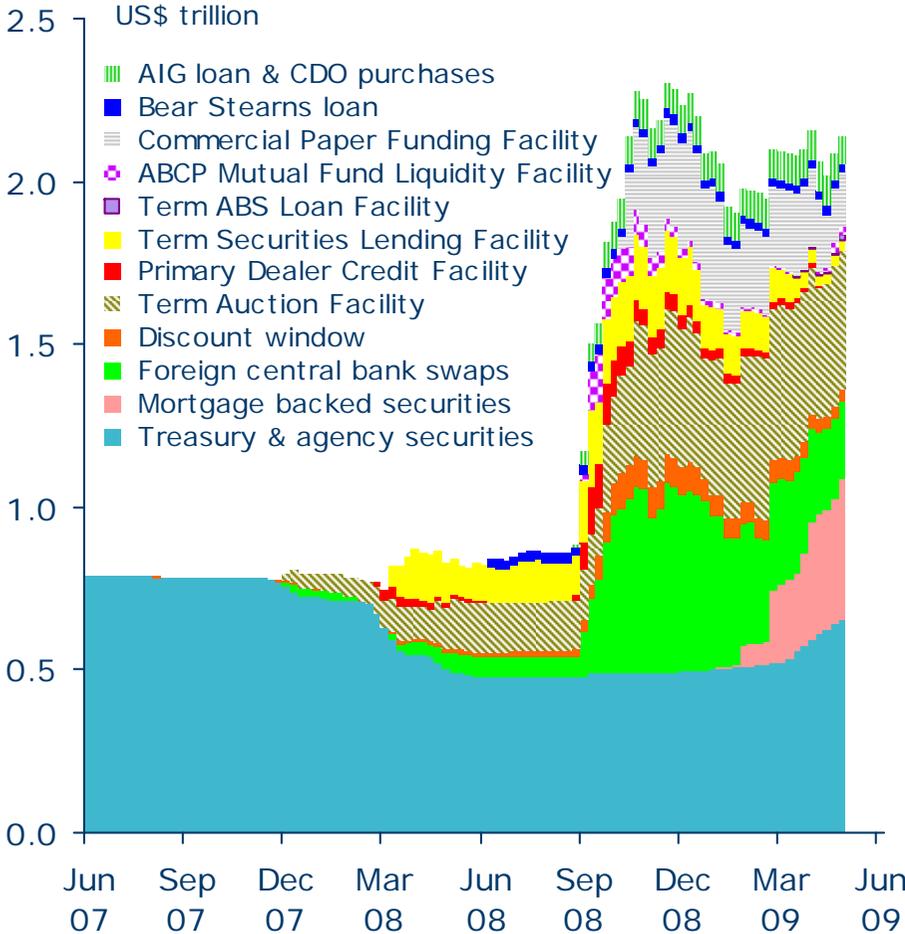


Sources: US Federal reserve; Bank of Japan; European Central Bank; Bank of England.

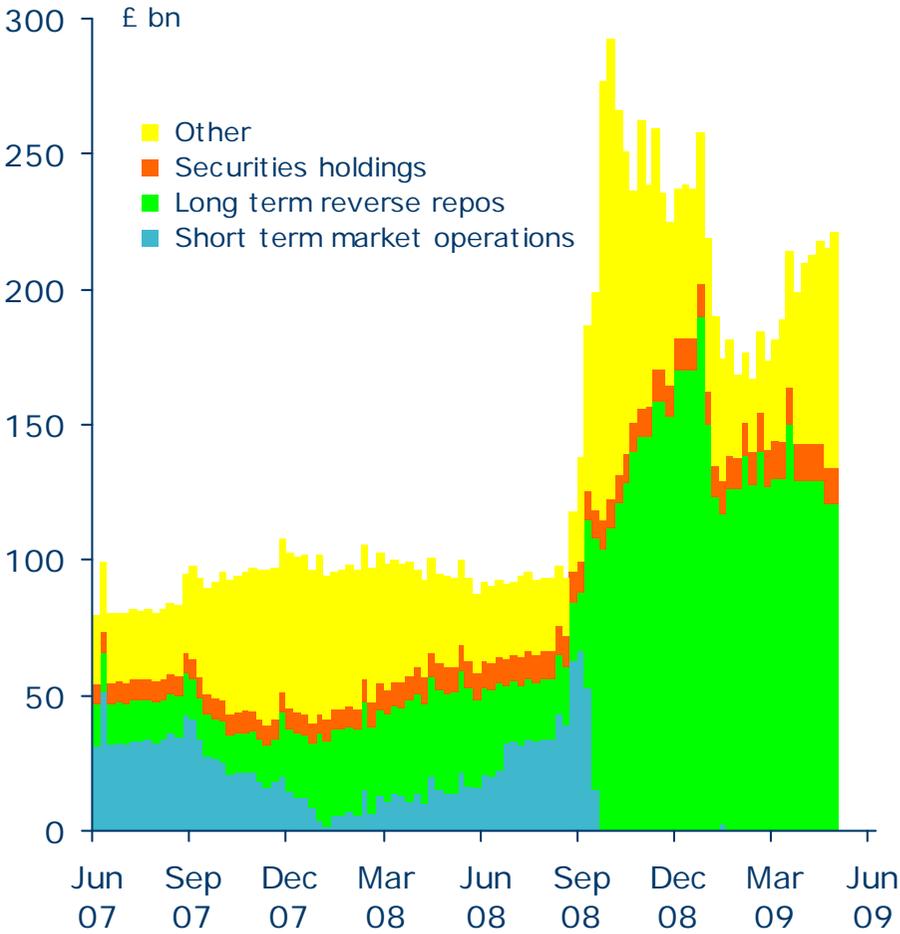


In addition, some central banks have substantially expanded their balance sheets through 'quantitative easing'

**US Federal Reserve balance sheet**



**Bank of England balance sheet**

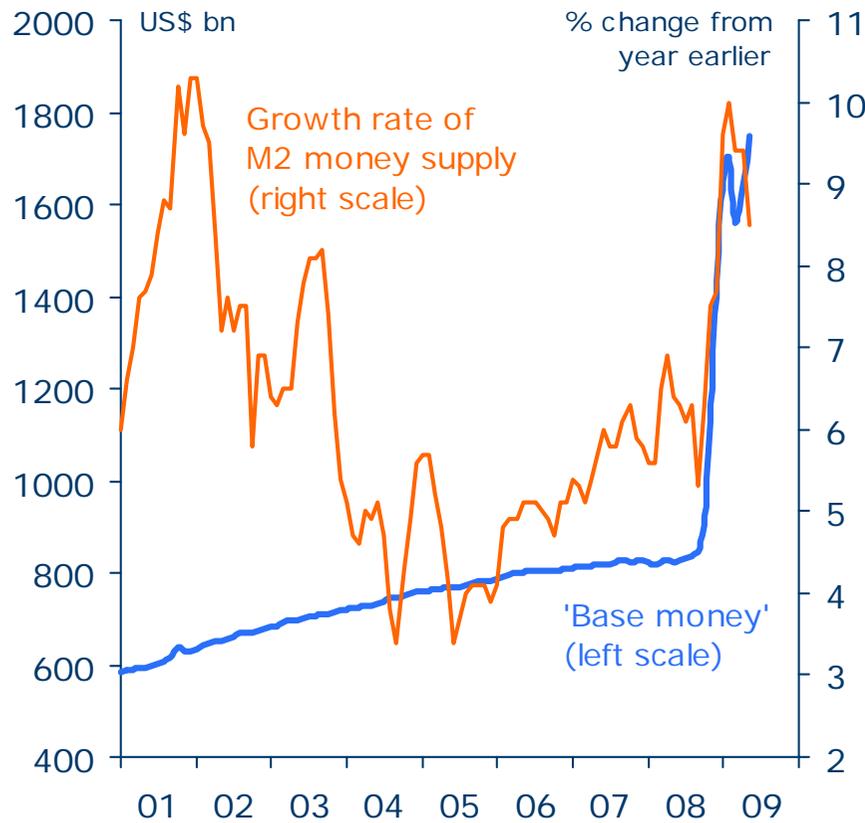


Source: US Federal Reserve Board; Bank of England; ANZ.

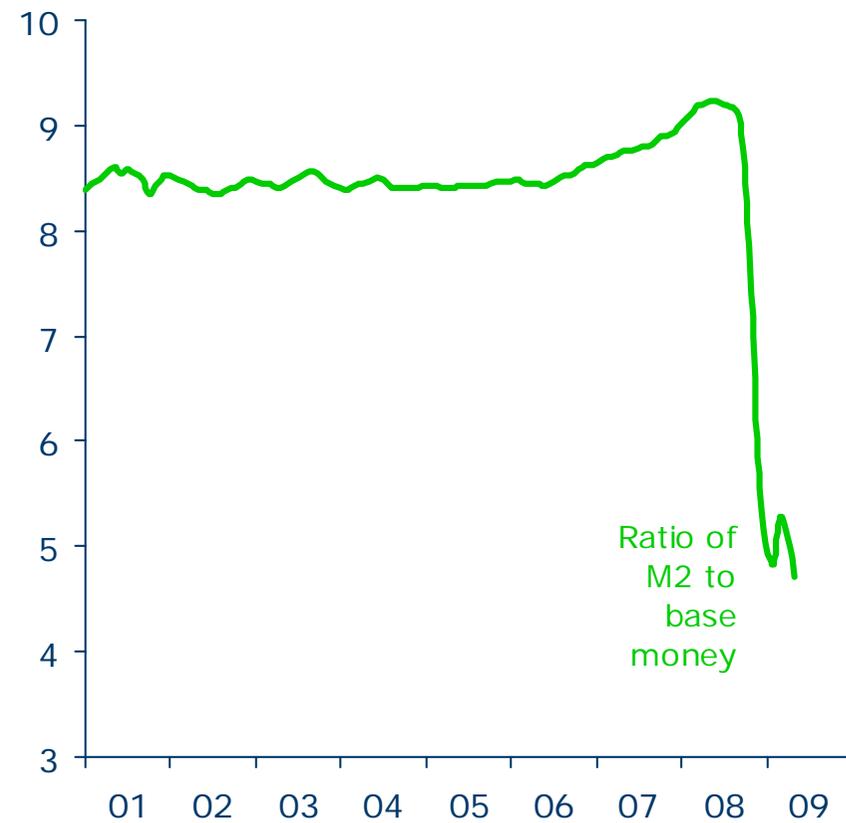


# Expanding the Fed's balance sheet has helped offset the collapse of the 'money multiplier' (a result of the credit crisis)

### US 'base money' and M2



### The 'money multiplier'

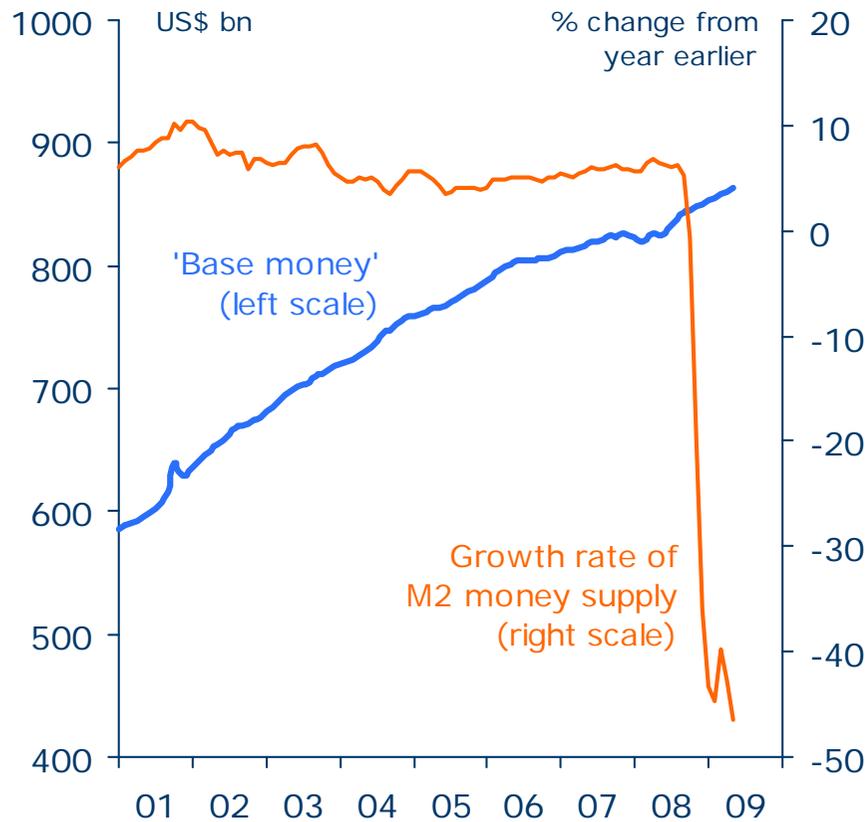


Sources: US Federal Reserve Board; ANZ.



Had the Fed not done this, the result would have echoed what happened at the beginning of the Great Depression

### US 'base money' and M2 supposing the Fed had not expanded its balance sheet



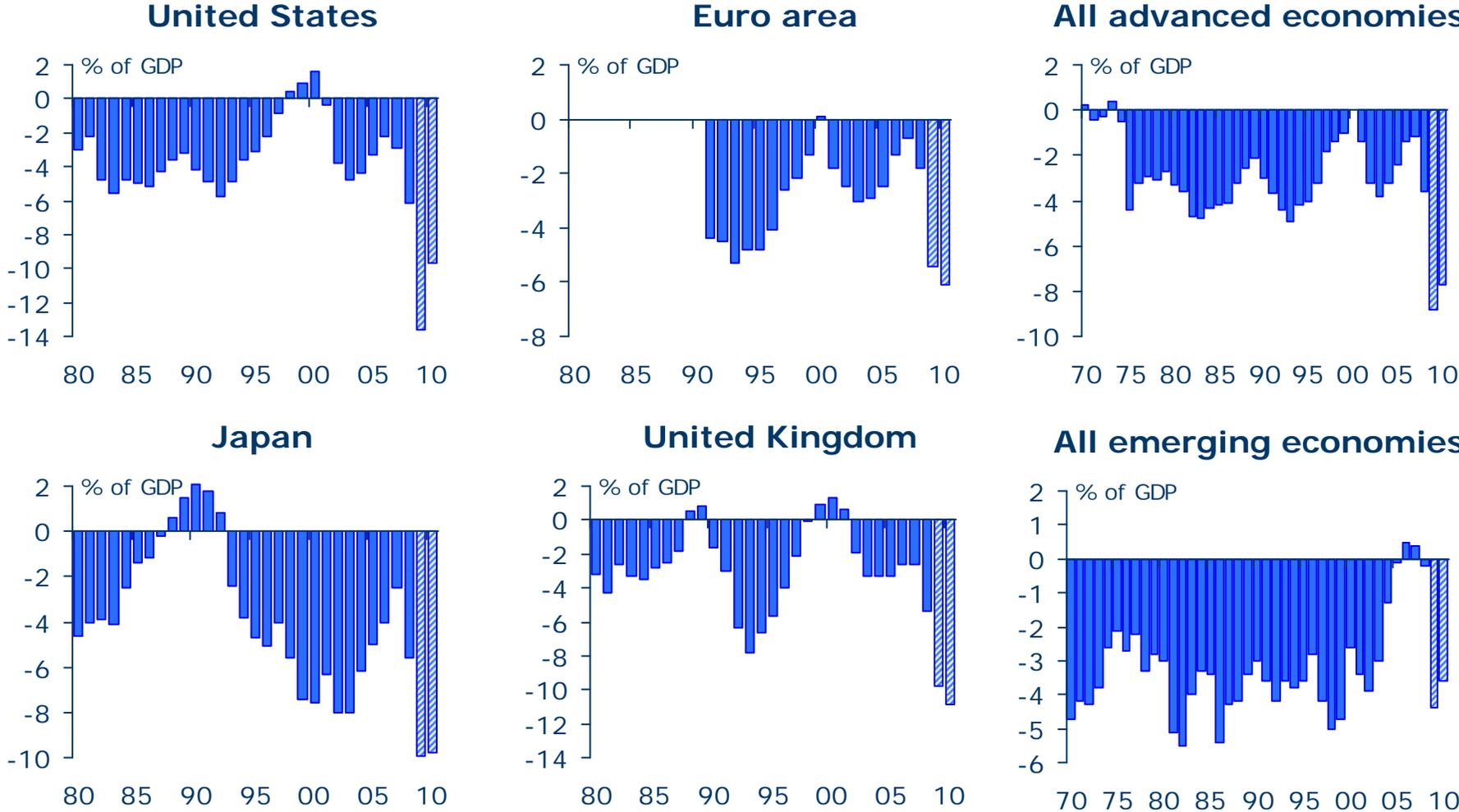
- Suppose the Fed had chosen to keep its balance sheet growing by ~ ¼% per month (as it had been doing before the collapse of Lehman Brothers)
- Suppose also that the 'money multiplier' had dropped from over 9 to just under 5 (as actually happened) after the collapse of Lehmans
- Then the broader M2 money supply would have shrunk by nearly 50%!
- This is what the Fed did in the early 1930s, and which helped bring on the Great Depression

Sources: US Federal Reserve Board; ANZ.



# Governments around the world are running the largest budget deficits since World War II ...

## Government budget balances

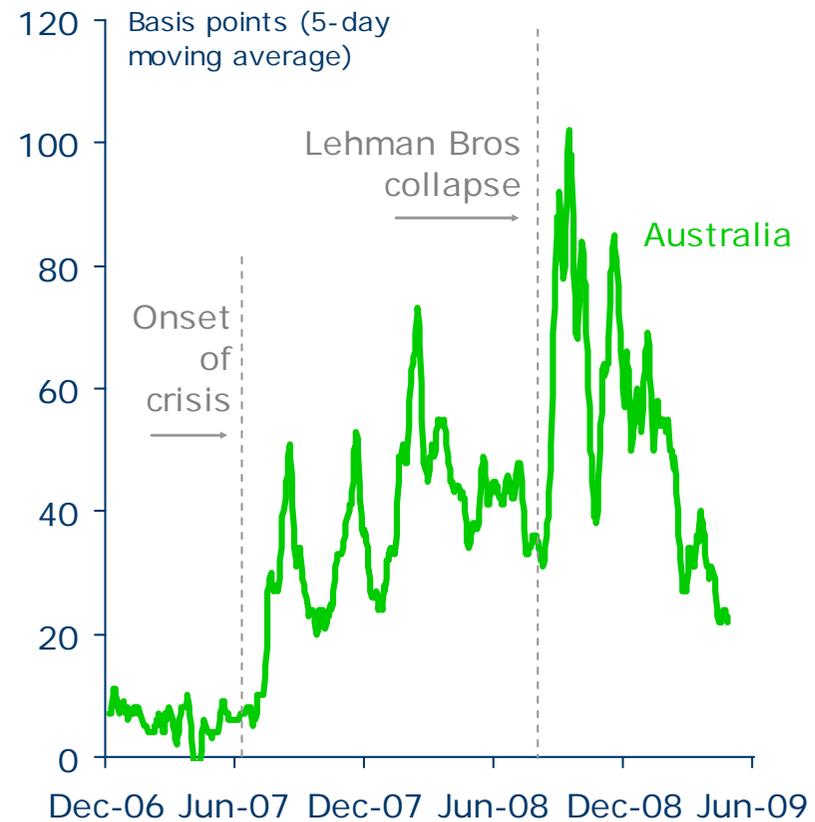
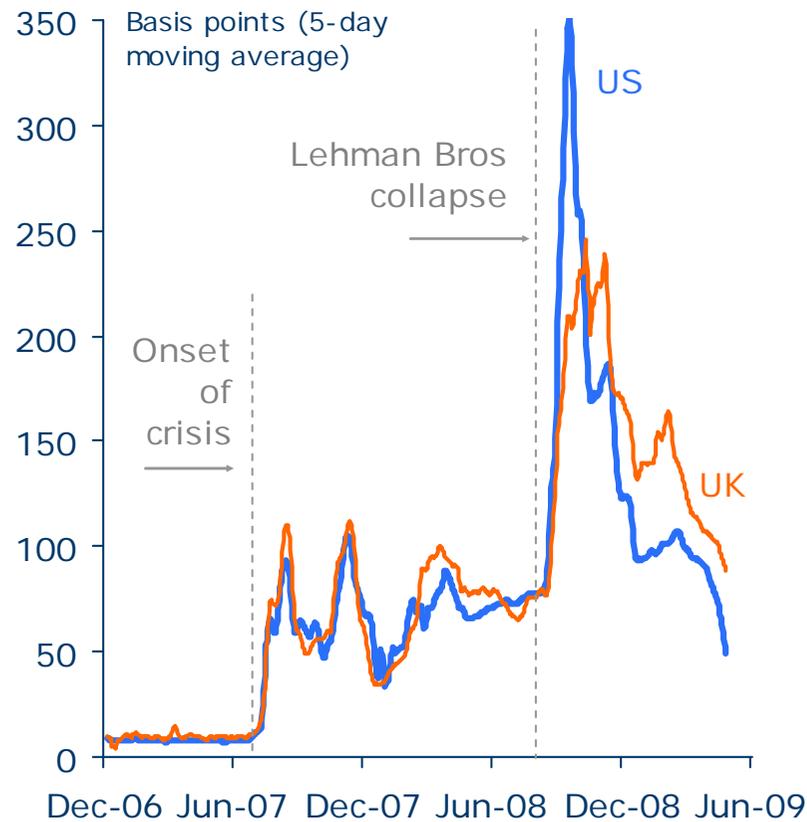


Source: IMF, World Economic Outlook April 2009 database



# Bank wholesale funding spreads have narrowed back to pre-Lehman collapse levels (though still above pre-crisis norms)

## Bank wholesale funding cost spreads (margin between what banks have to pay for funds borrowed in wholesale money markets and central bank official cash rates)

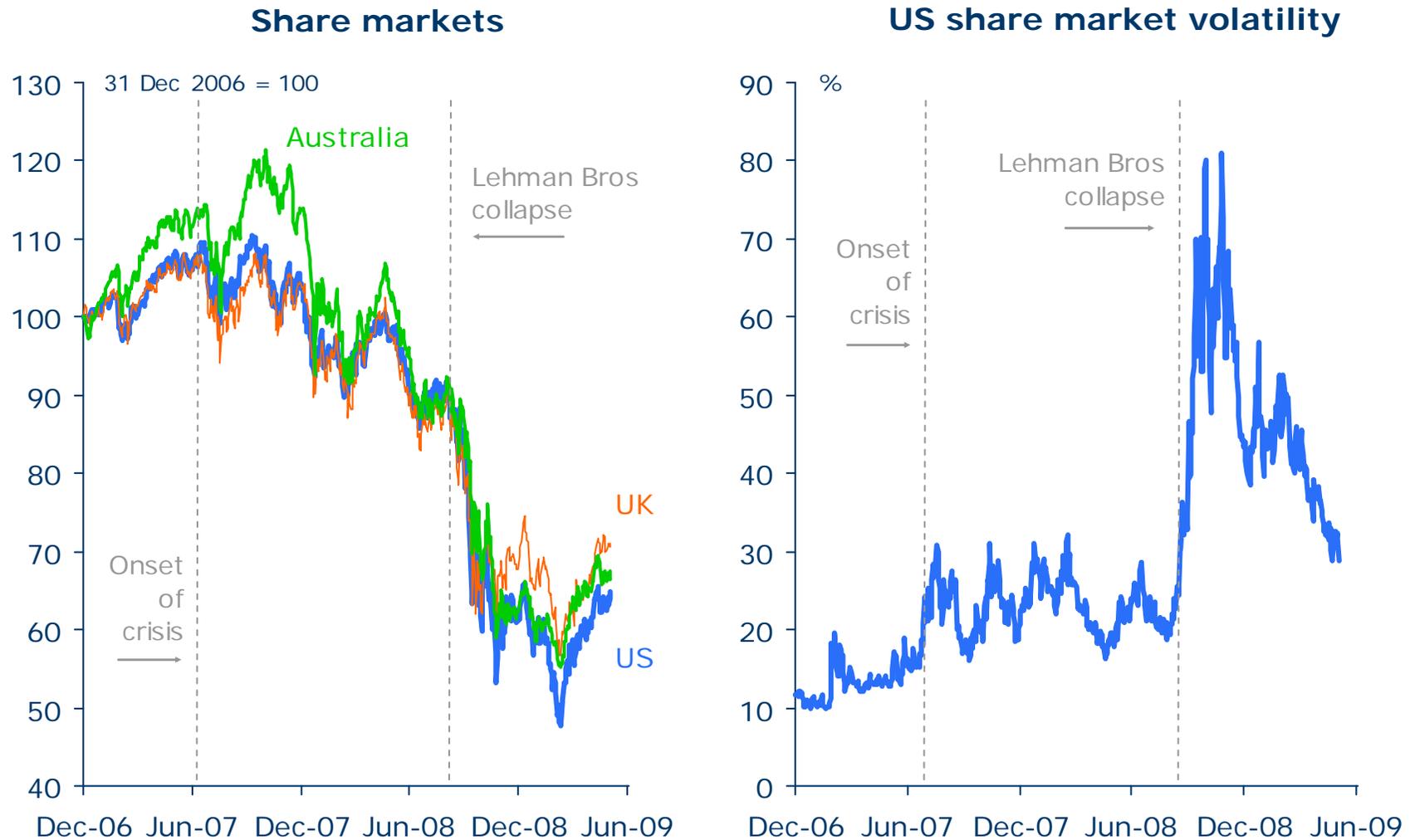


Note: the 'wholesale funding margin' is the spread between the 3-month Libor and the 3-month overnight index swap (OIS) rate which measures market expectations of future changes in the official cash rate.

Sources: Bloomberg; ANZ.



# Sharemarkets have staged a significant recovery – and market volatility has declined to pre-Lehman collapse levels <sup>11</sup>



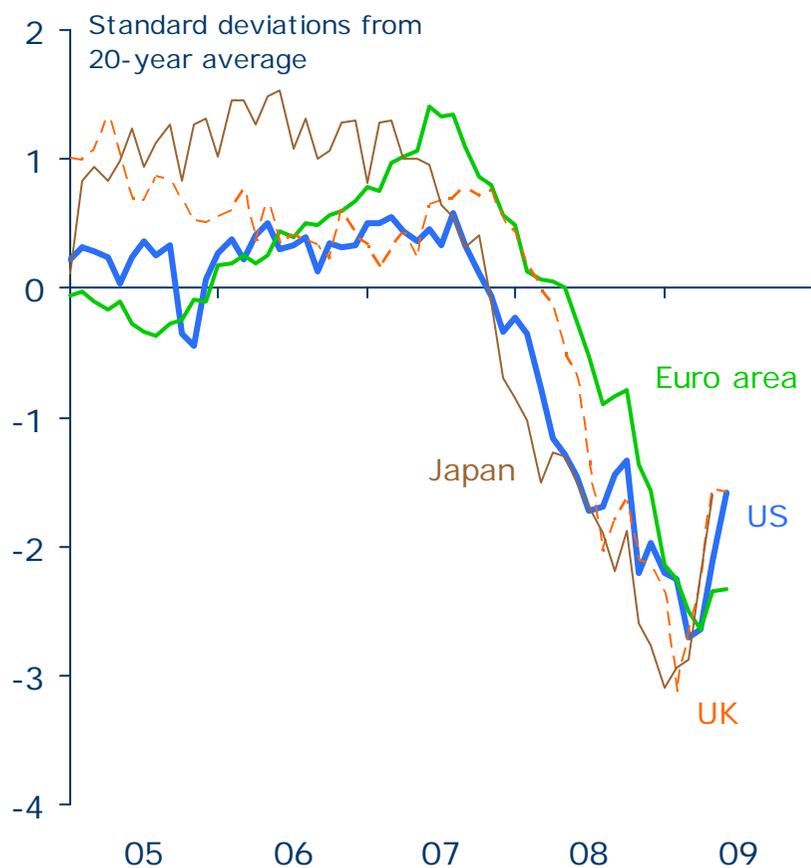
Note: US sharemarket volatility is measured by the implied volatility of options on S&P 500 index futures (the 'VIX' index). Sources: Datastream; ANZ.



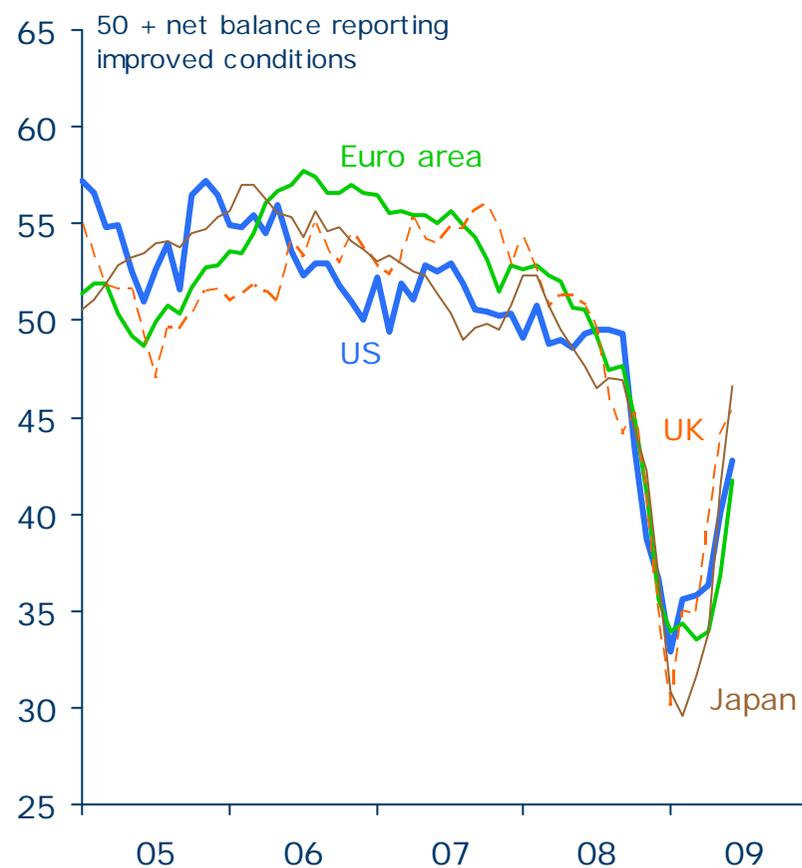
'Leading indicators' for major economies suggest that although recovery hasn't started yet the worst of the downturn may be over

### 'Leading indicators' of major advanced economies

Consumer confidence



Purchasing managers' index



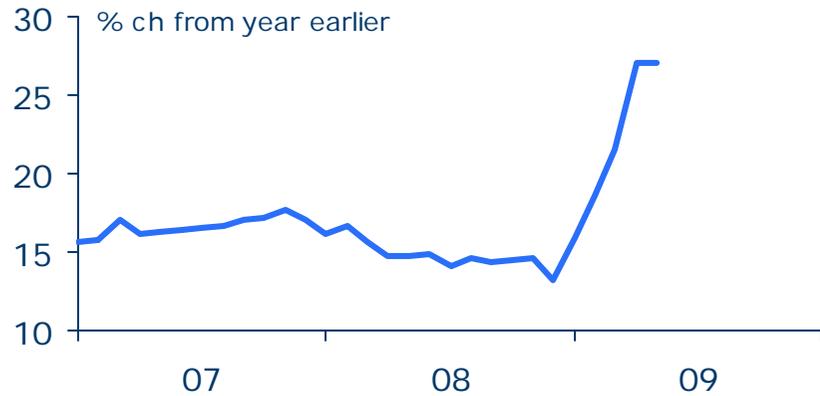
Sources: The Conference Board; Eurostat; Japan Economic & Social Research Institute; US Institute of Supply Management; UK Chartered Institute of Purchasing Management; Markit Economics; ANZ.



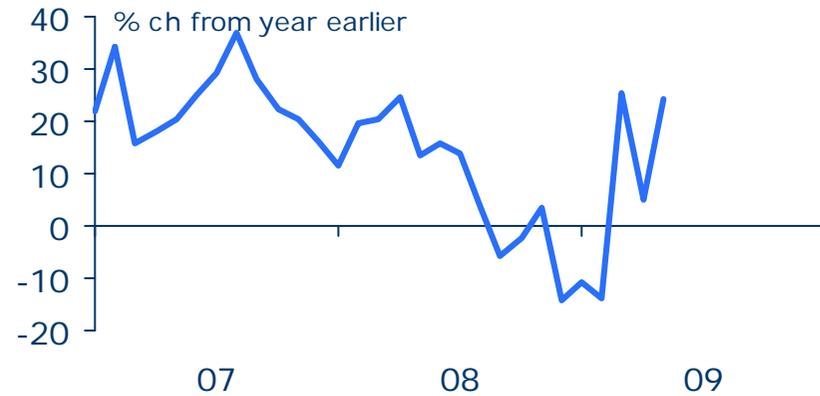
Chinese government efforts to revive domestic demand appear to be working – even though exports remain weak<sup>13</sup>

**China: monthly economic indicators**

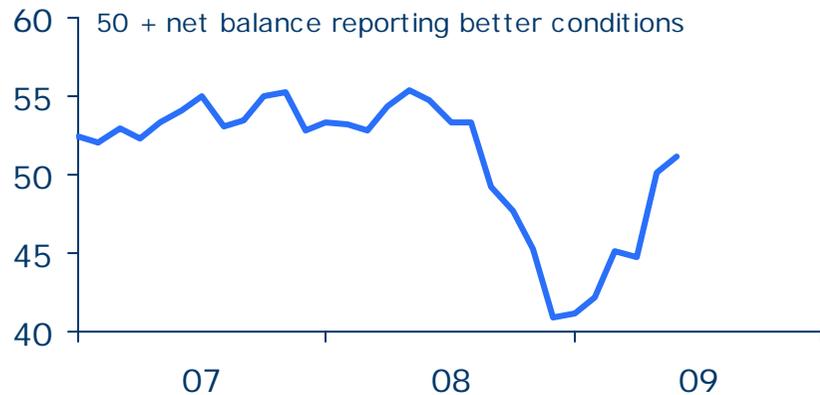
**Bank lending**



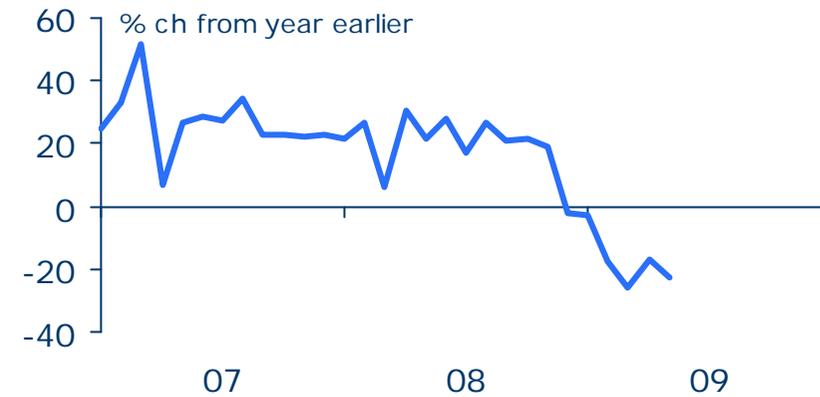
**Motor vehicle sales**



**Purchasing managers' index**



**Exports**



Sources: People's Bank of China; CLSA; China Steel Industry Association; China Association of Automobile Manufacturers; China National Bureau of Statistics.



Industrial production seems to have bottomed out in East Asia, if not yet in the US and Europe

### Industrial production



Sources: US Federal Reserve; Eurostat; Japan Ministry of Economy, Trade & Industry; CEIC; ANZ.

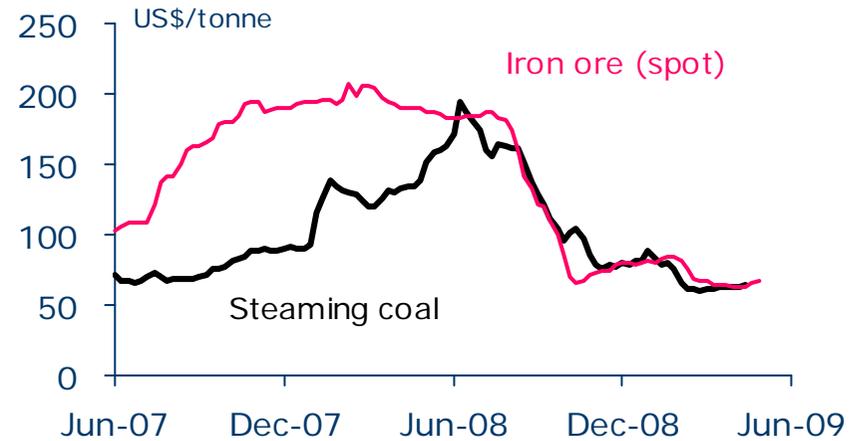


# The turnaround in industrial production is assisting a recovery in metal and energy commodity prices

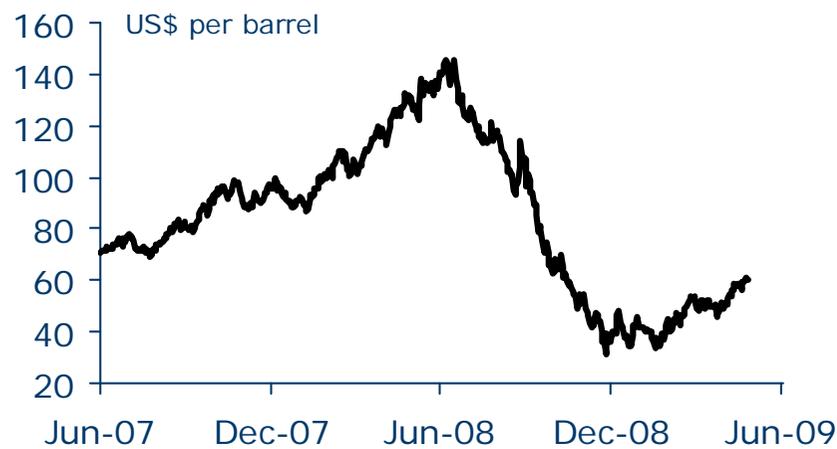
### Base metals



### Bulk commodities



### Crude oil



### Shipping freight rates



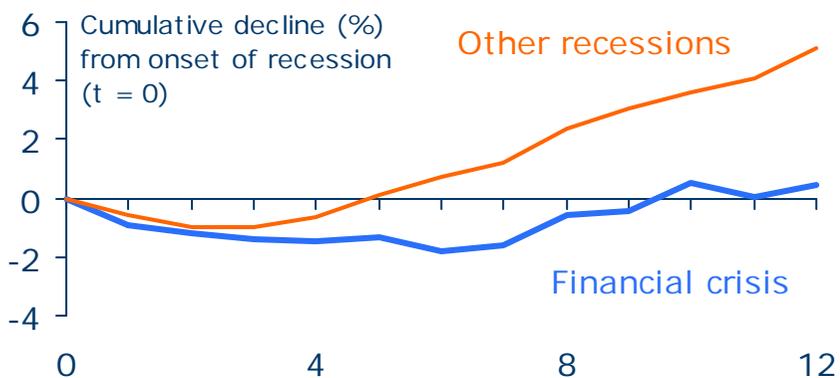
Sources: The Economist; Bloomberg; Datastream; ANZ.



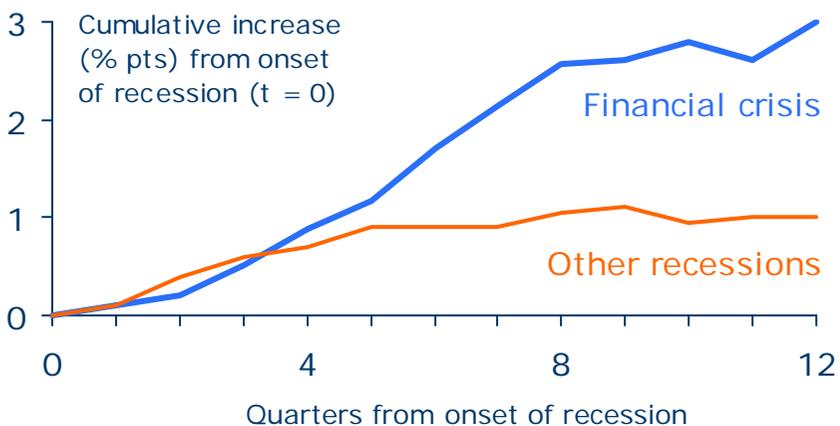
Since this is a highly-synchronized global recession after a financial crisis the recovery is likely to be unusually slow

### Recessions induced by financial crises

#### Real GDP

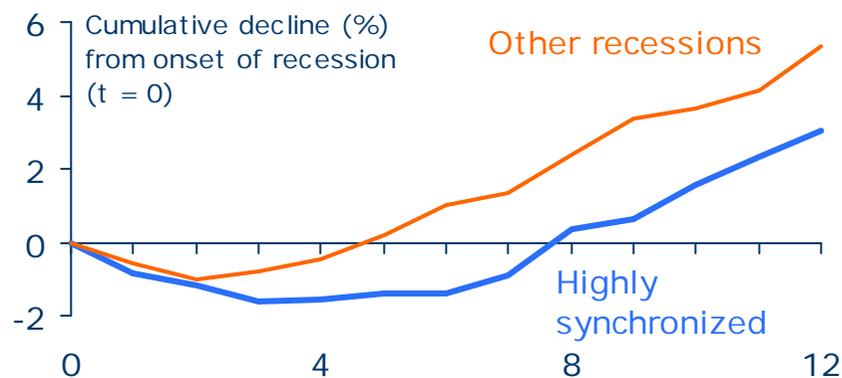


#### Unemployment

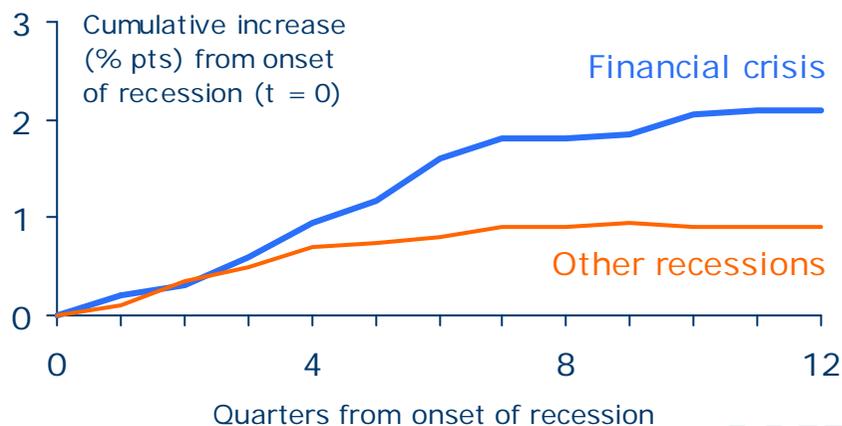


### Recessions highly synchronized across countries

#### Real GDP



#### Unemployment



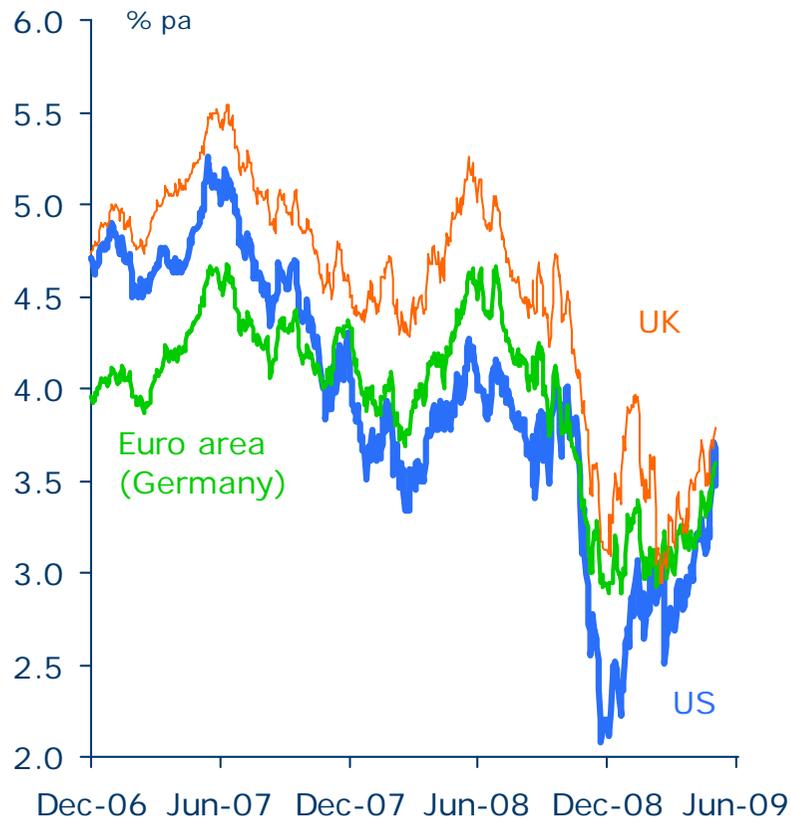
Source: IMF, *World Economic Outlook*, April 2009; based on 122 recessions in 15 advanced economies since 1960.



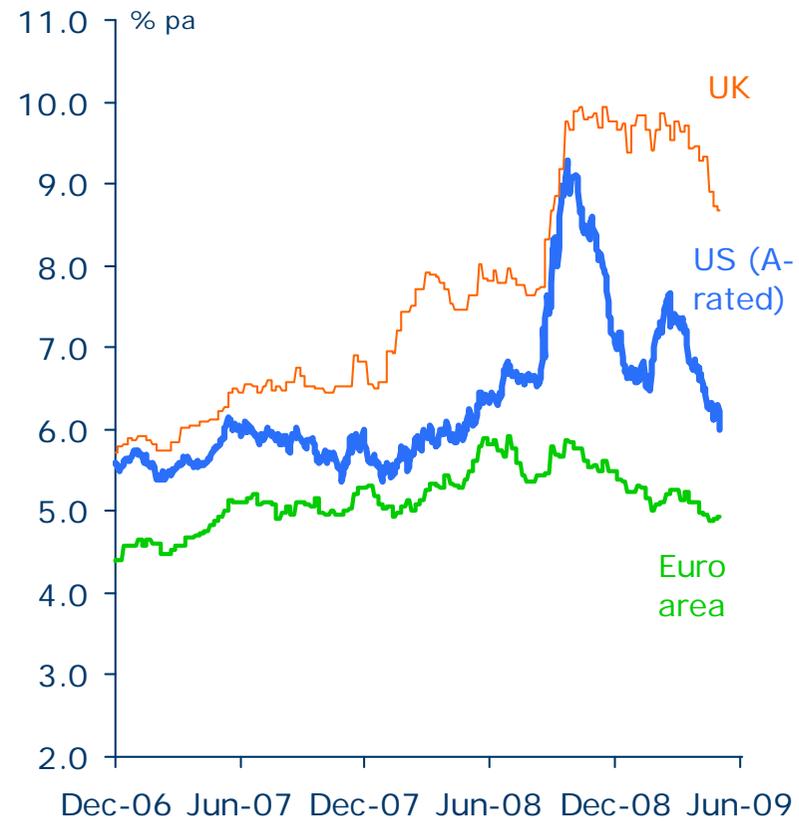
The rise in government bond yields this year is another sign of financial system healing, not worries about public debt <sup>17</sup>

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### Government bond yields



### Corporate bond yields

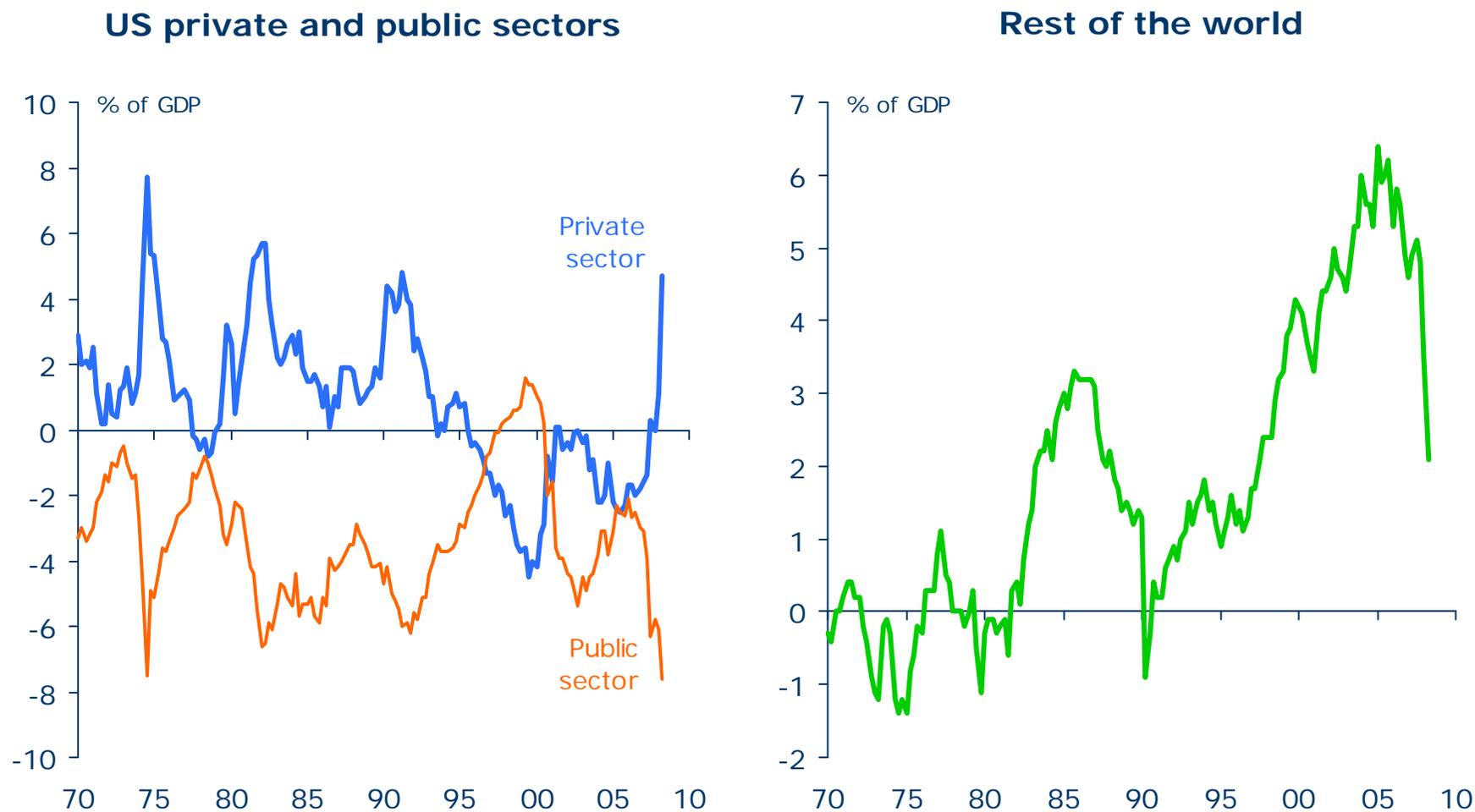


Sources: Datastream; ANZ.



Increased borrowing by the US government sector (the budget deficit) is more than offset by increased private sector saving

### Net lending to the US by various sectors

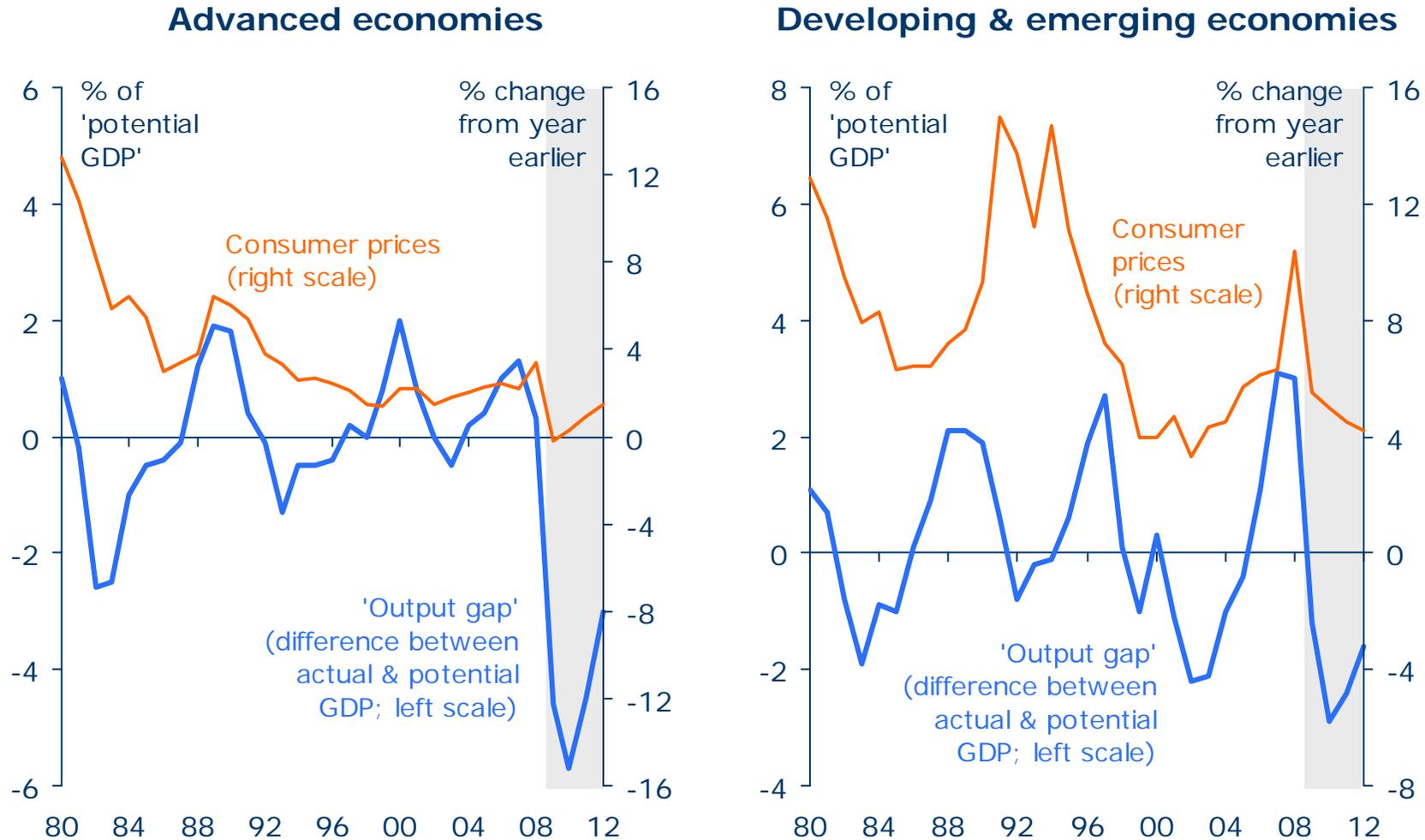


Sources: US Bureau of Economic Analysis; ANZ. Net lending is the difference between gross saving and gross investment.



An upsurge in inflation is most unlikely with so much spare capacity around the world

### Global 'spare capacity' and inflation



Source: IMF World Economic Outlook April 2009 database; ANZ.



Any downward pressure on the US dollar is more likely to be reflected in gold prices than against other major currencies

### US dollar vs Japanese yen and Euro



### Gold vs US dollar



Sources: Bloomberg; Datastream; ANZ.



Australia's economy is also now in recession – but it will be a less severe recession than in most other advanced economies

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### **Influences pushing Australia into recession**

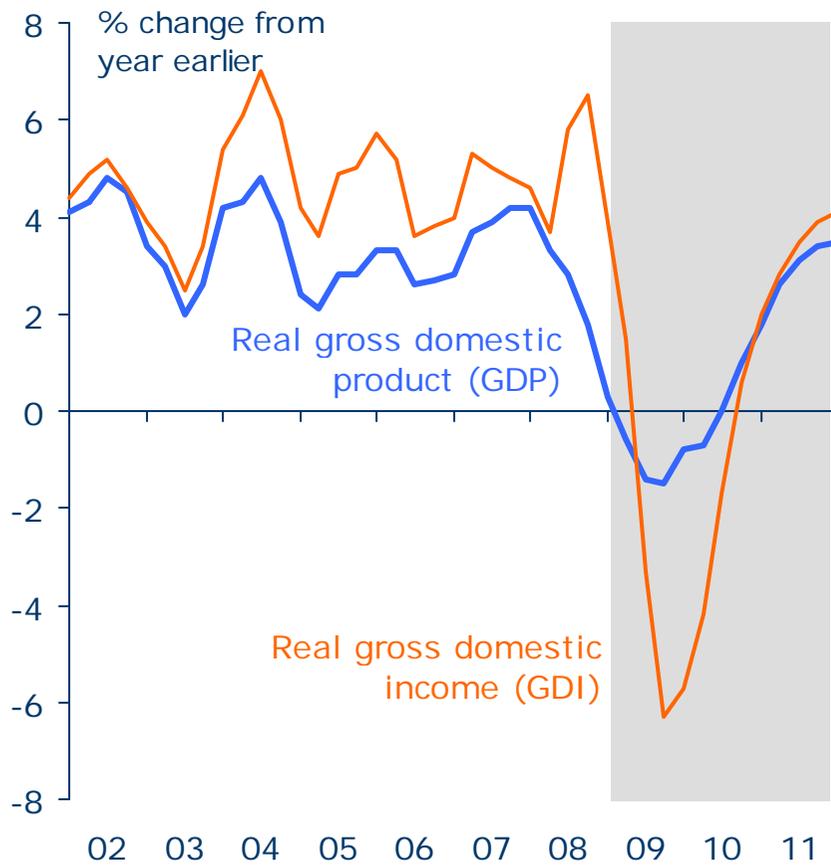
- Declines in personal wealth from fall in share prices prompting higher saving and reduced consumer spending
- Abrupt falls in minerals & energy commodity prices and falls in export volumes
- Slump in business confidence leading to job-shedding and cutbacks in capital spending
- Greater difficulty in obtaining finance
- Lagged impact of previous increases in interest rates

### **Influences helping Australia fare 'less worse' than others**

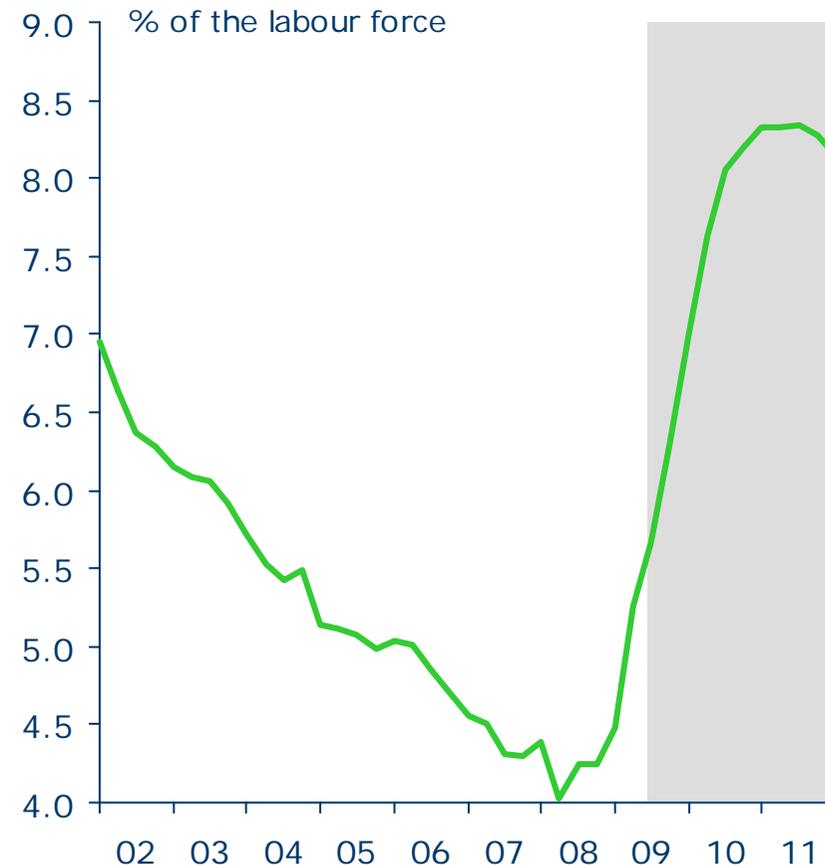
- Strength of the banking system
- Comparative resilience of the residential property market
- More rapid population growth
- Flexible exchange rate
- Limited exposure to downturn in global trade in manufactures
- Unusual (for Western economy) trade orientation towards more resilient Asian economies
- More timely, substantial and effective monetary and fiscal policy responses

# Australia is in recession - and the recession will continue into 2010, with unemployment not starting to fall until 2011

### Real gross domestic product (GDP) and income (GDI)



### Unemployment rate



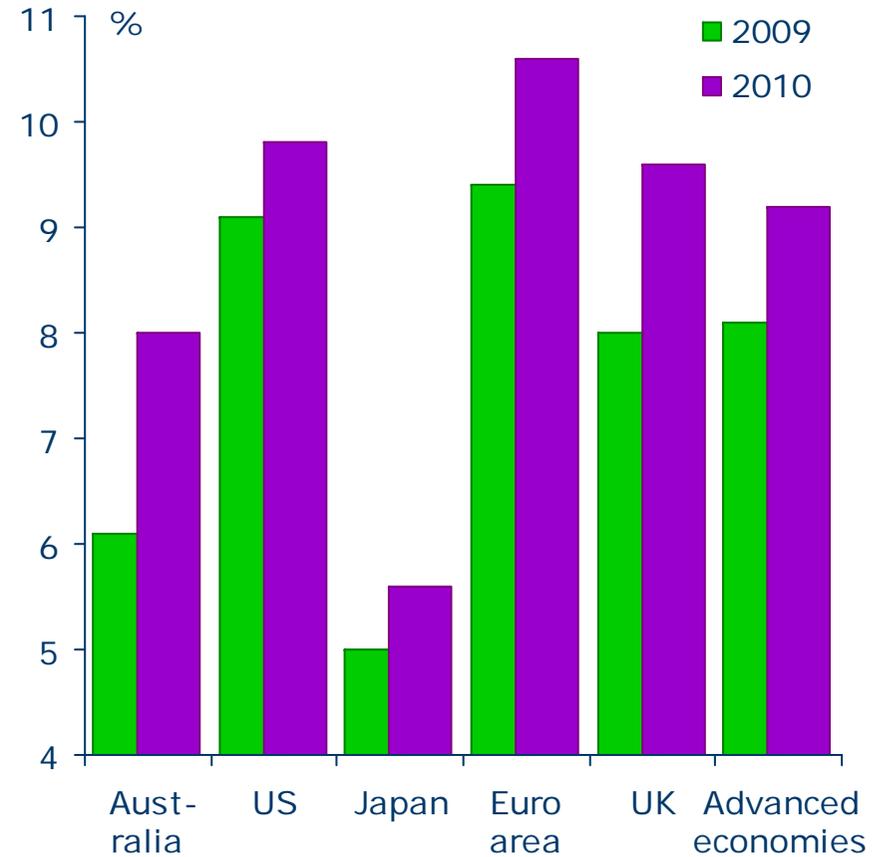
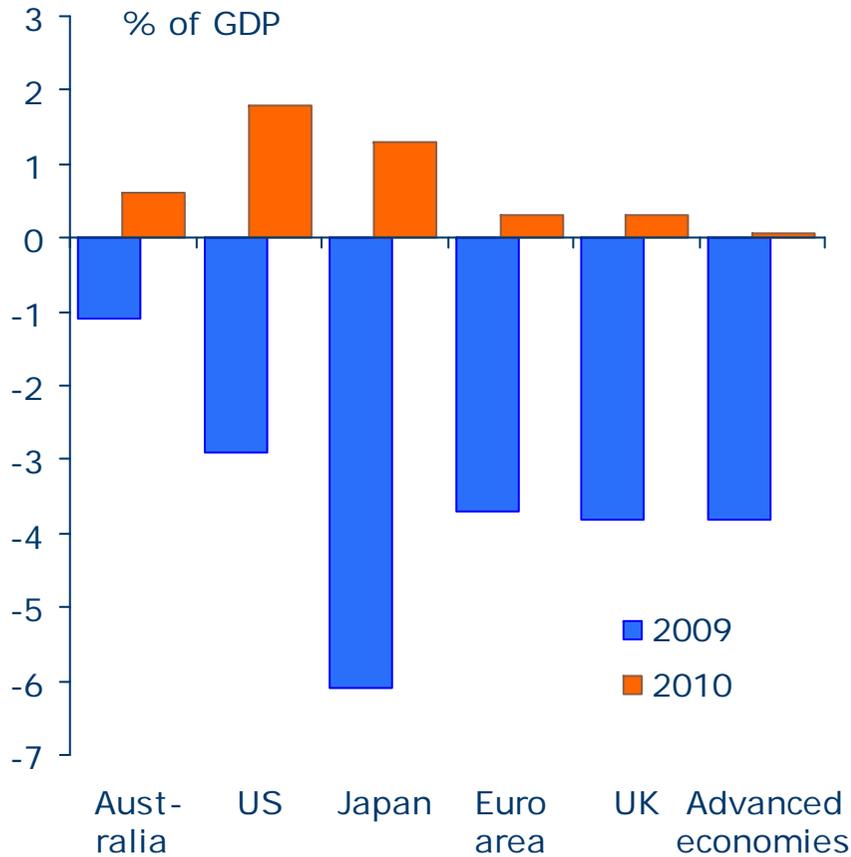
Note: Real gross domestic income is real GDP adjusted for changes in the terms of trade (export relative to import prices). Shaded areas denote ANZ estimates or forecasts. Sources: ABS; ANZ.



# Australia's recession will be milder, in most respects, than those of other comparable countries

**Real GDP growth, 2009 and 2010**

**Unemployment, 2009 and 2010**



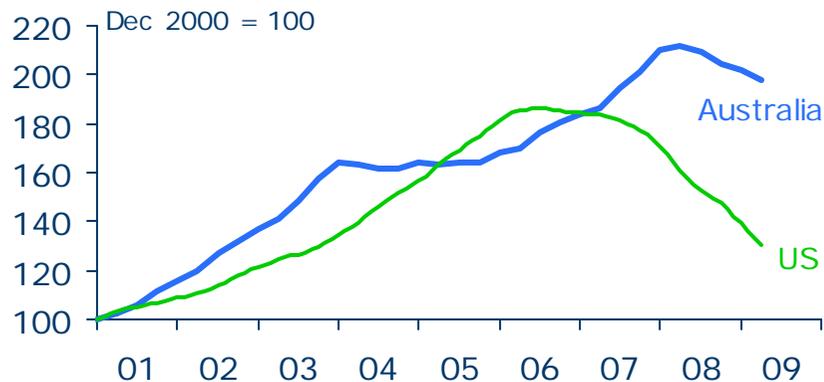
Source: ANZ; Consensus Economics May 2009 (for US, Japan, Euro area & UK); IMF (for advanced economies as a group, which includes Korea, Taiwan, Hong Kong & Singapore)



Despite looking 'expensive' by many yardsticks Australia's residential property market has so far held up quite well

### Australian and US housing markets

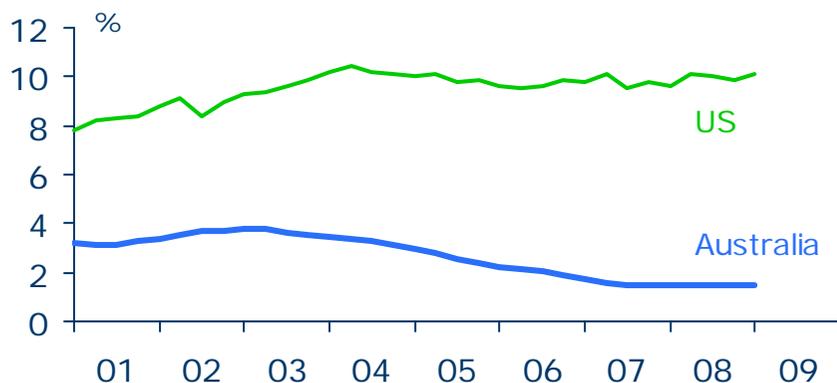
House prices



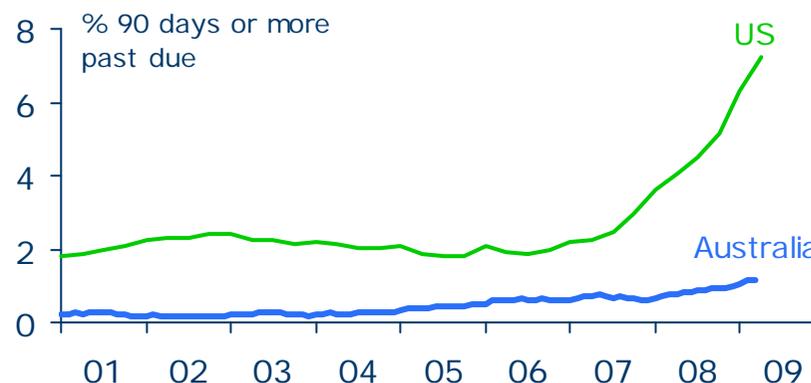
Residential building approvals



Rental vacancy rates



Mortgage delinquency rates



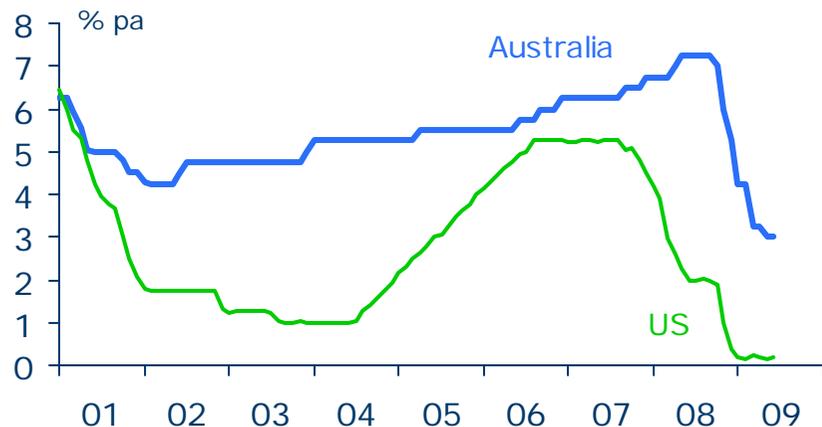
Note: Australian mortgage delinquencies are for securitized mortgages only.

Sources: ABS; S&P; Real Estate Institute of Australia; Mortgage Bankers' Association of America; US Commerce Department; US National Realtors' Association.



# Monetary policy is 'working' more effectively in Australia than in the US, in part because the banking system is in better shape <sup>25</sup>

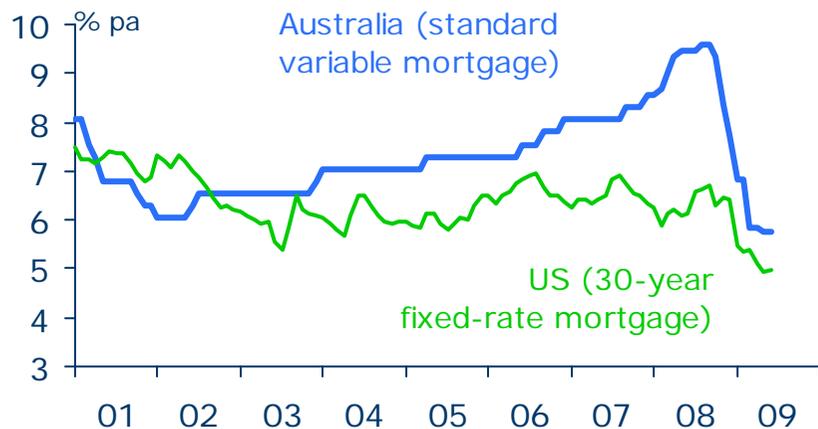
### Official interest rates



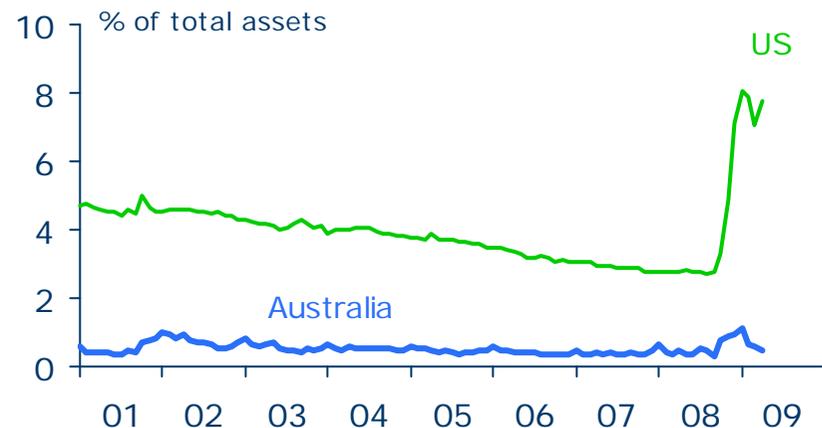
### Bank lending



### Most common mortgage rates



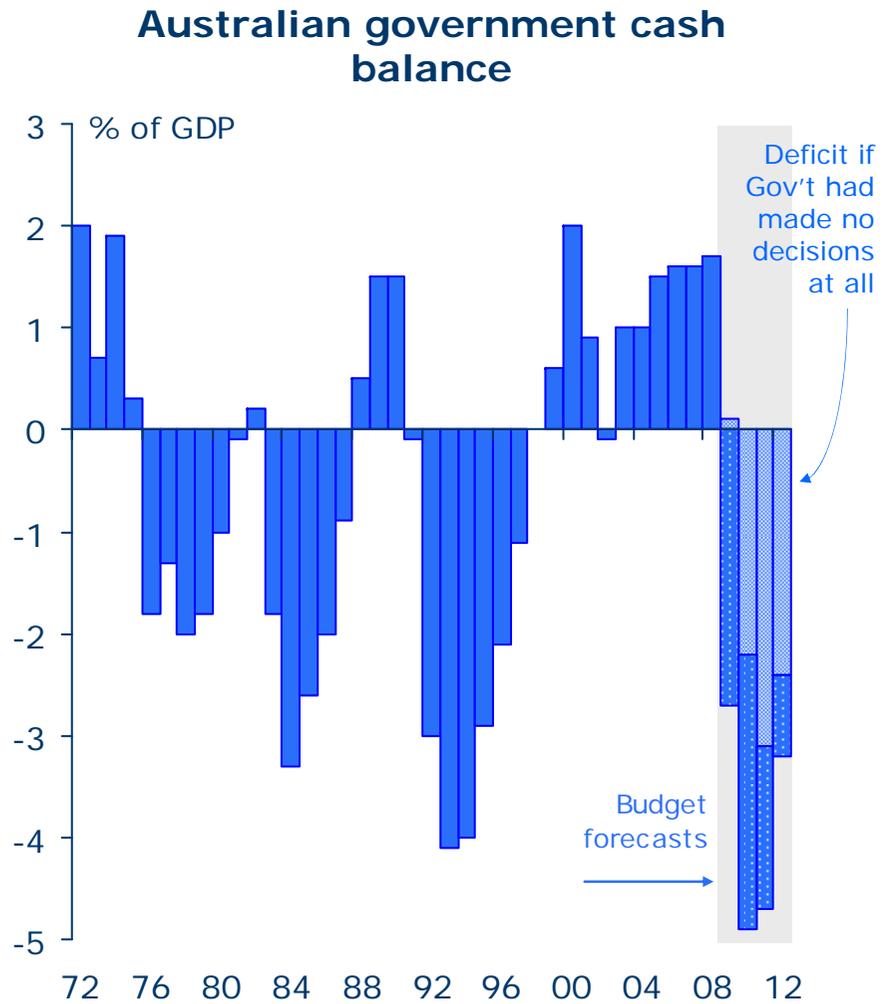
### Bank cash holdings



Note: 'Cash' includes deposits with the central bank. US banks are subject to required to hold cash reserves against their transactions account balances and thus typically hold a higher proportion of their assets in cash than Australian banks which are no longer subject to such requirements. Sources: RBA; US Federal Reserve; Datastream.

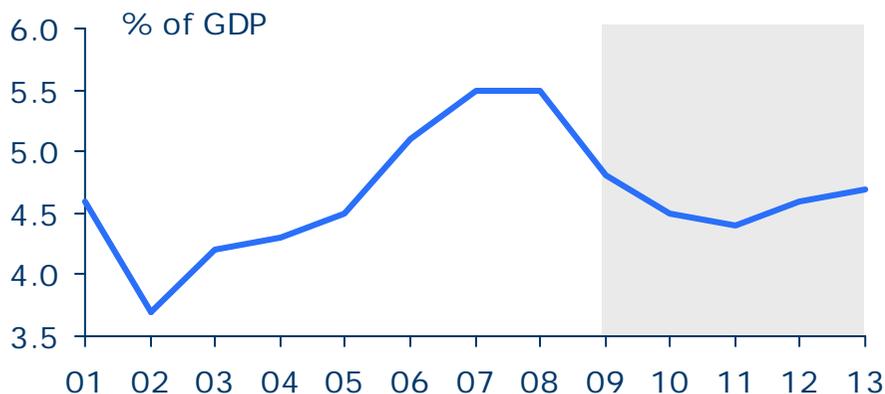


# Australia will be running large budget deficits by historical standards –

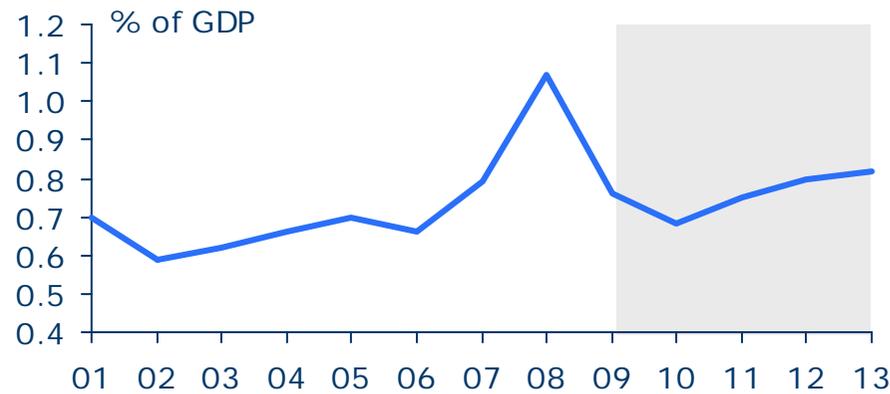


# Temporary windfalls from the mining & asset price booms were used to fund permanent income tax cuts <sup>27</sup>

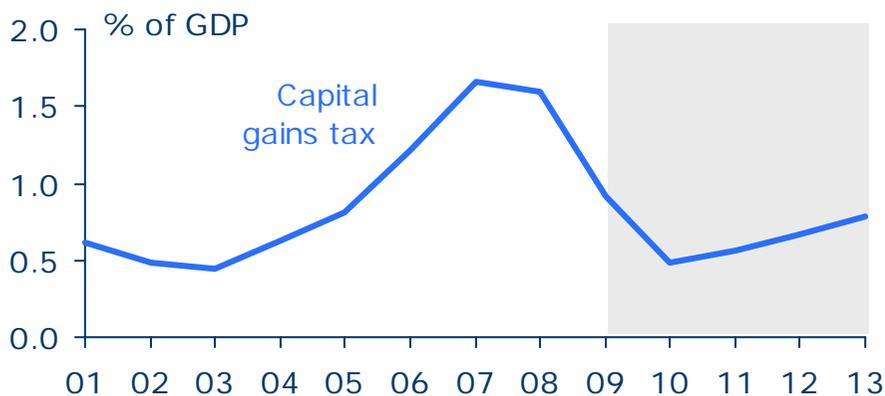
### Company income tax



### Superannuation fund taxes



### Capital gains taxes



### Personal income tax



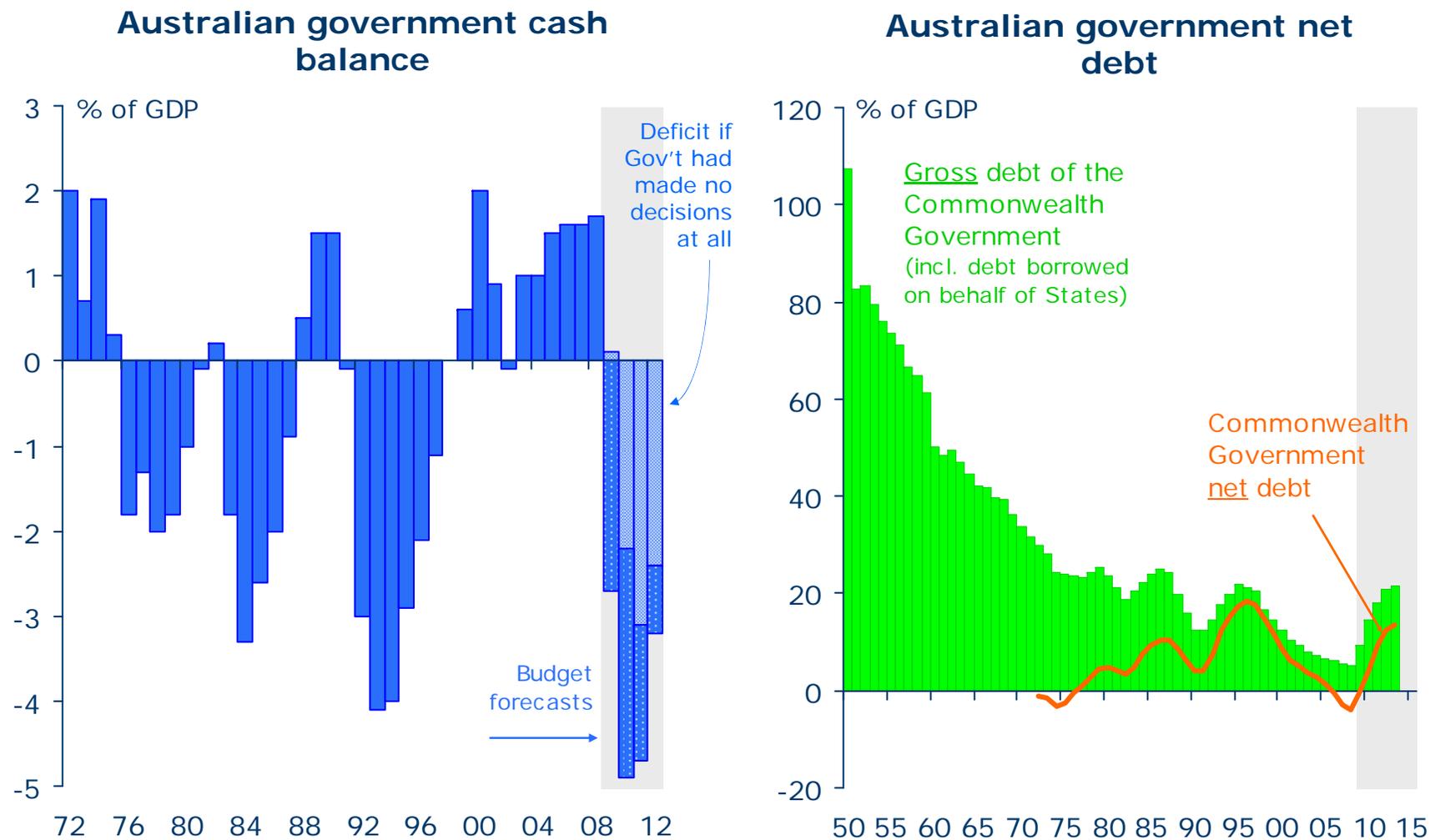
Financial years ended 30 June

Financial years ended 30 June

Sources: 2009-10 Budget Paper No.1; ABS; ANZ.



# Australia will be running large budget deficits by historical standards – but the resulting public debt will be relatively small

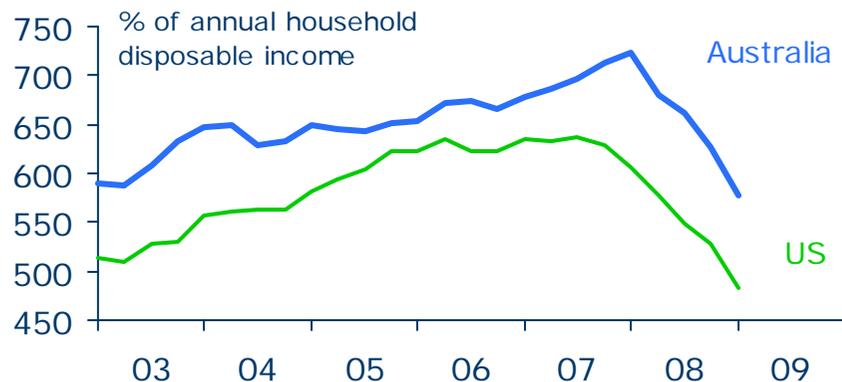


Sources: 2009-10 Budget Paper No.1; RBA Occasional Paper 8A.

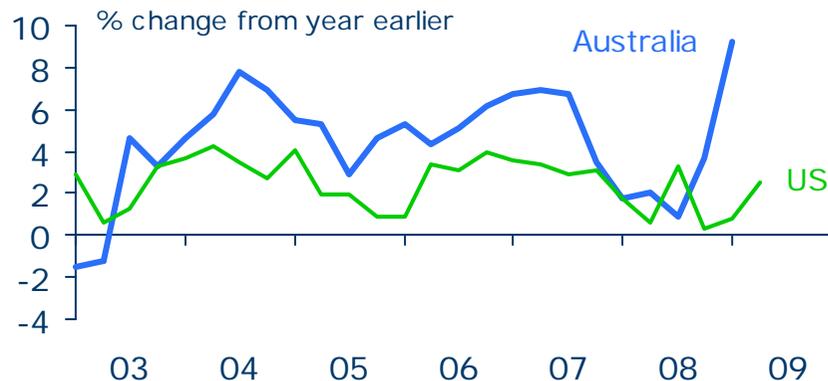


# Lower mortgage rates and the 'cash splashes' have allowed Australians to increase saving without cutting spending

### Household net worth



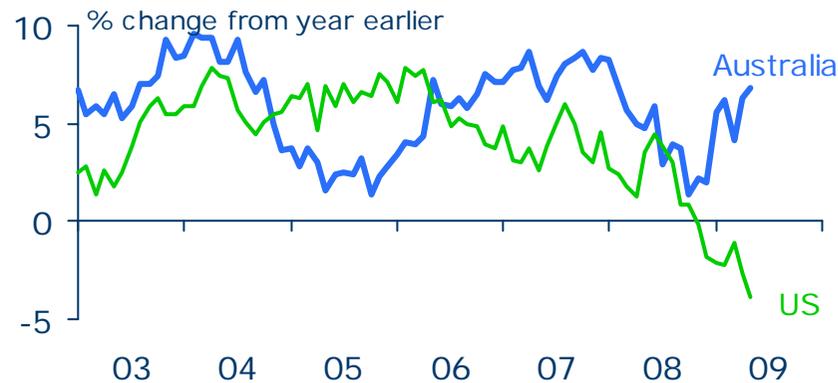
### Real household disposable income



### Household saving



### Retail sales



Sources: Datastream; ABS; US Bureau of Economic Analysis.



However falling profits are prompting the business sector to cut <sup>30</sup> back capex, stock and employment – which will intensify this year

**Pre-tax profits**



**Inventories**



**Capital expenditure**



**Employment**

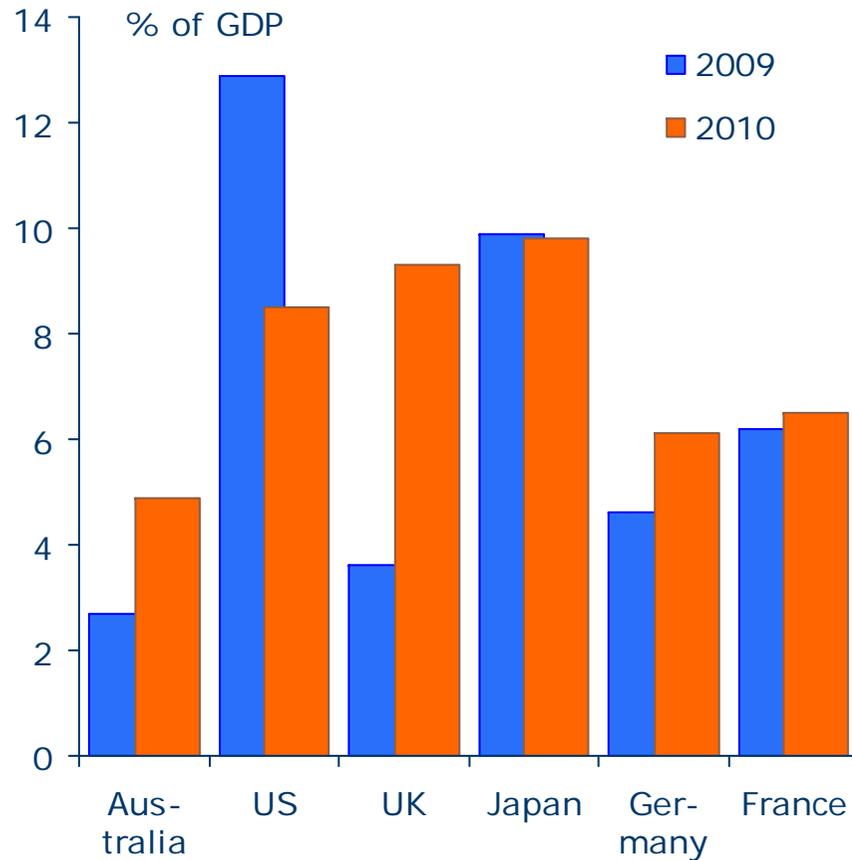


Sources: ABS; ANZ.

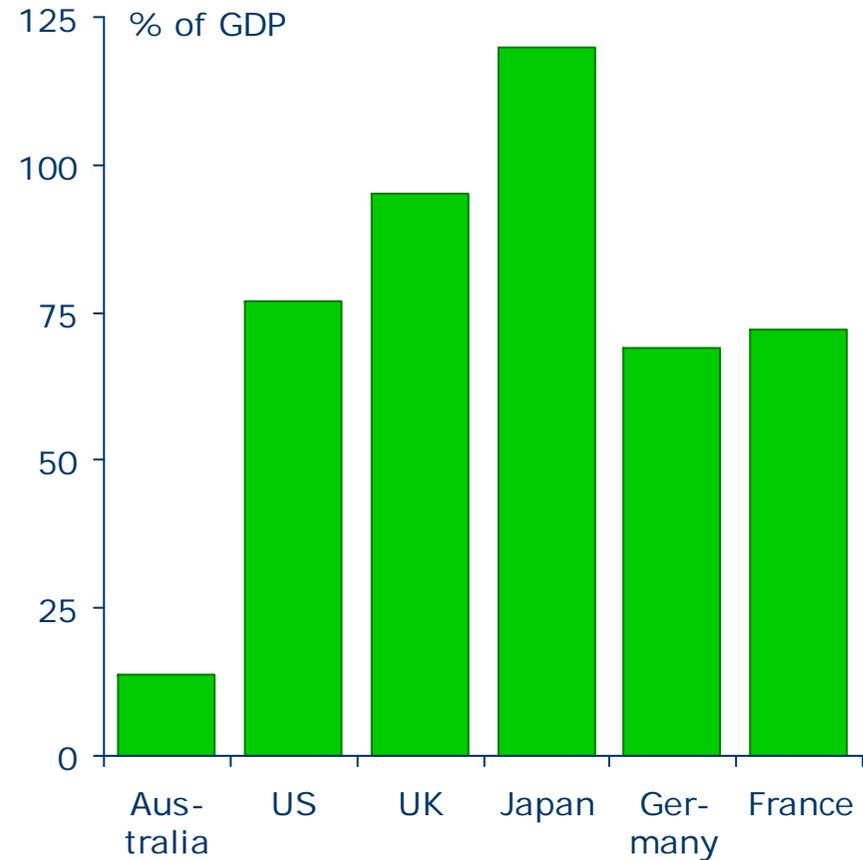


# Australia's budget deficits the resulting build-up in public debt are quite modest compared with most other Western nations

### Budget deficits, 2009 & 2010



### Net public debt, 2013

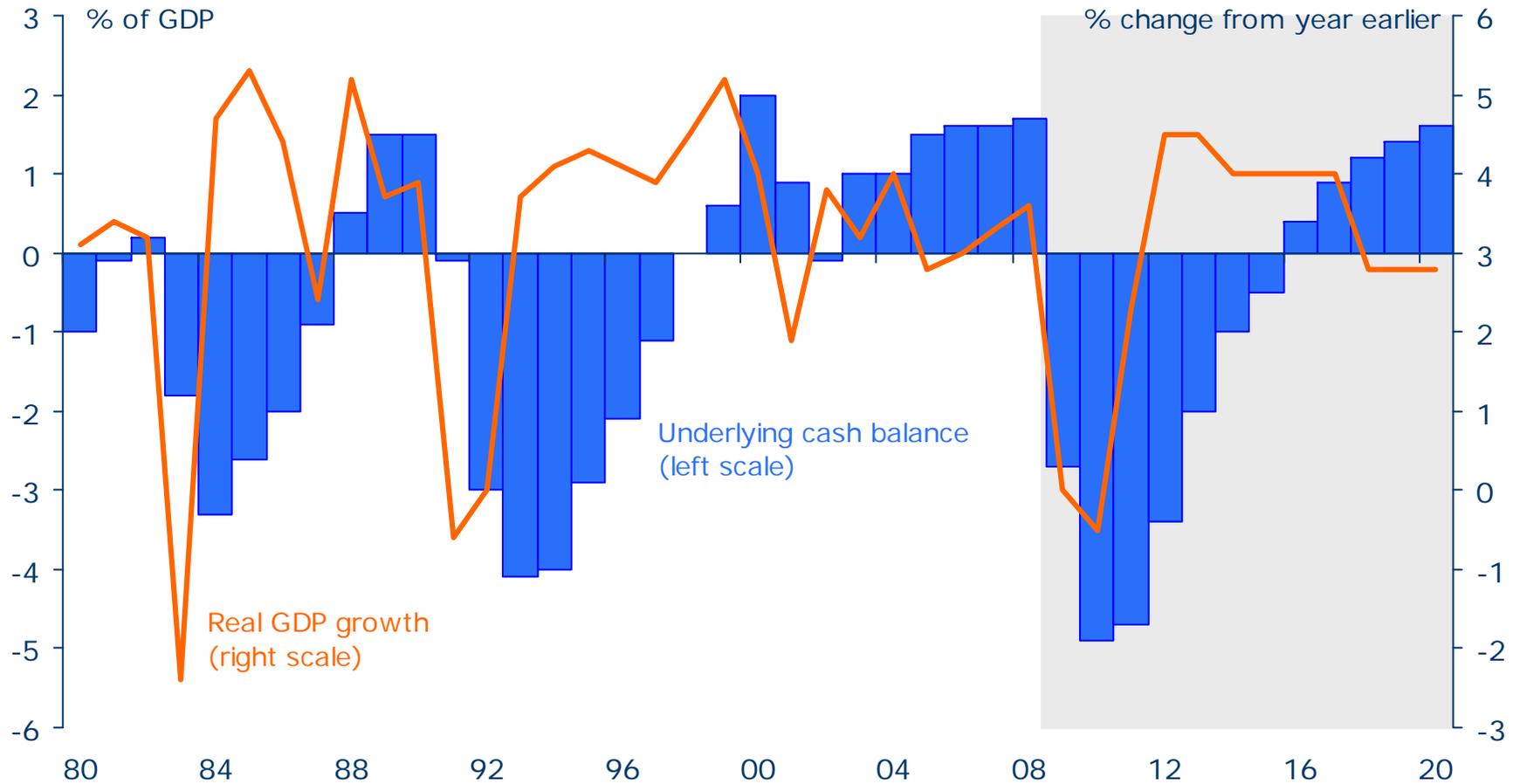


Sources: Australia, US and UK figures are for fiscal years and sourced from national Treasuries or budget agencies. Deficit figures for other countries from IMF. Public debt figures from S&P.



# The most controversial part of this year's Budget has been the promise to eliminate the Budget deficit by 2015-16

### The budget deficit and economic growth



Source: 2009-10 Budget Paper No. 1, Statements 4 and 10; figures provided by Treasurer Hon. Wayne Swan MP in Parliament 22 & 28 May 2009; Speech by Treasury Secretary Ken Henry to Australian Business Economists 18 May 2009; ANZ.



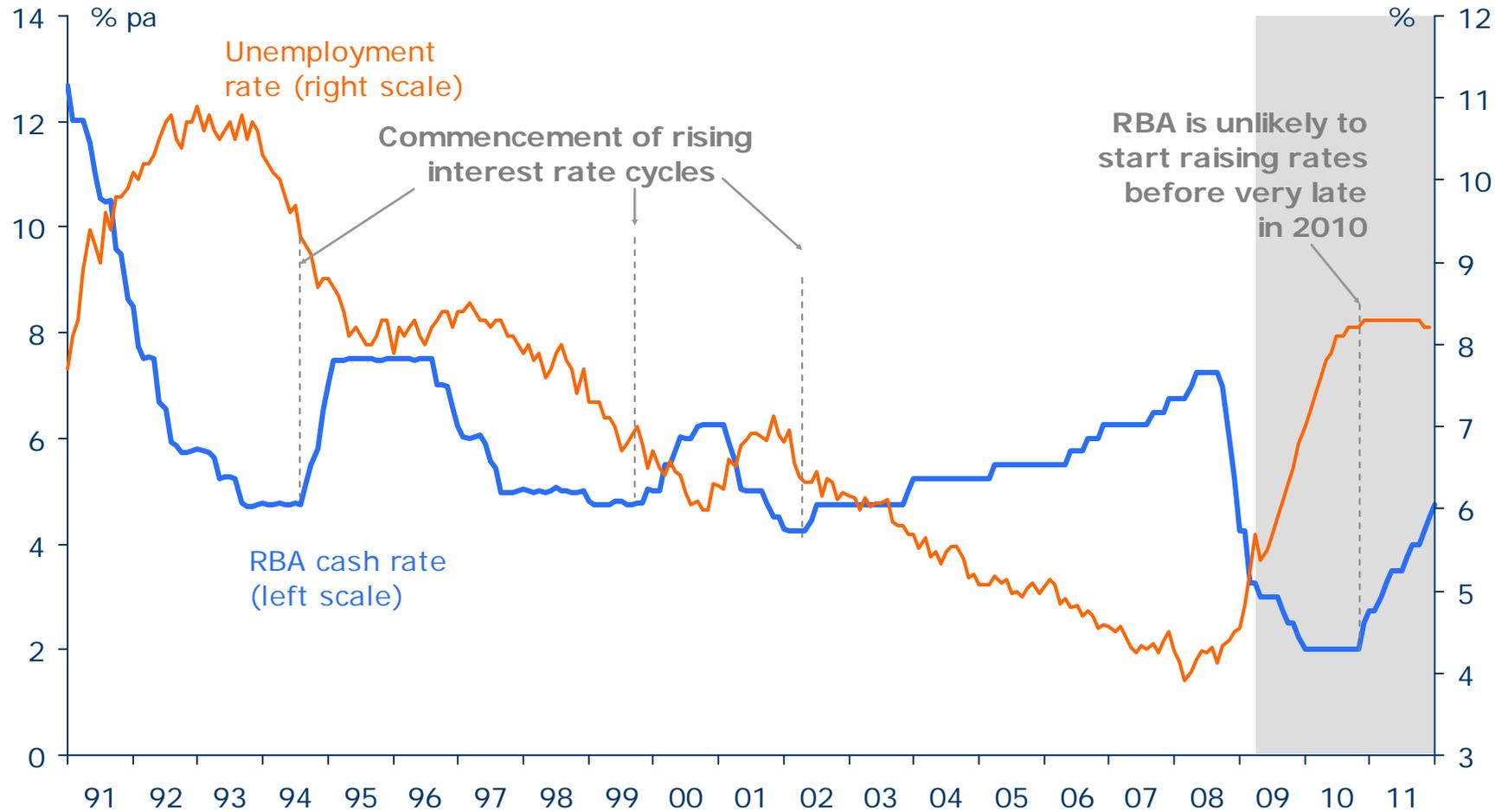
But it's by no means assured that the budget deficit will be eliminated by 2015-16 as the Government asserts

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- The Government's stated intention of returning the budget to surplus by 2015-16 relies on two crucial assumptions:
  - that the economy will grow by 4½% pa in 2011-12 and 2012-13, and then by 4% pa from 2013-14 through 2016-17
  - and that real growth in government spending will be constrained to no more than 2% pa from 2011-12 through 2015-16
- The medium-term economic growth projections -
  - allow for a longer period of below-trend growth than around previous recessions
  - are not inconsistent with the experience of previous business cycles
  - and are based on plausible assumptions about the supply-side growth potential of the Australian economy once the current recession has passed
- ... but it may well be that foreign and domestic demand will not grow strongly enough to induce the increase in aggregate supply projected in the Budget
  - and some other policies (eg labour market changes, emissions trading scheme) may detract from growth)
- There have only been two four-year periods in the last 50 years in which real spending growth has been held below 2% pa –
  - 1985-86 through 1989-90, including three consecutive years in which government spending actually fell in real terms (largely through cuts in payments to States)
  - 1994-95 through 1997-98, which included some genuinely tough budgets
- There'll almost certainly have to be tougher decisions in future Budgets than there were in this one if this target is to be attained

The RBA usually keeps cutting rates while unemployment is rising and doesn't begin raising them until it has begun to fall

### The official cash rate and unemployment



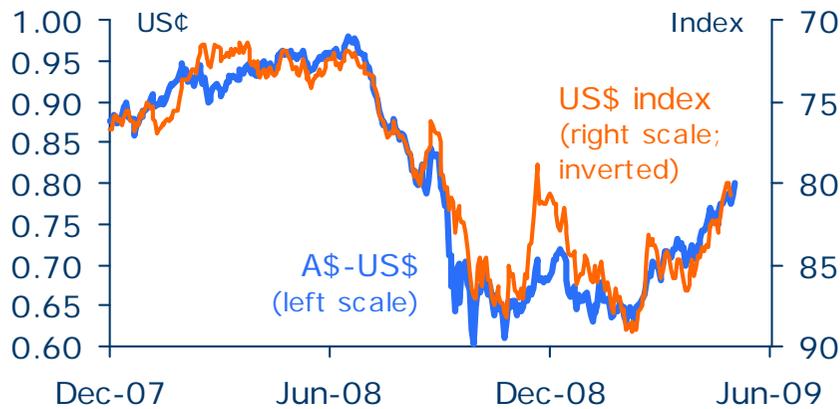
Sources: RBA; ABS; ANZ.



A\$'s recent strength mirrors US\$ weakness, rebound in shares and commodities, and relatively higher Australian interest rates

### Major influences on A\$-US\$ exchange rate

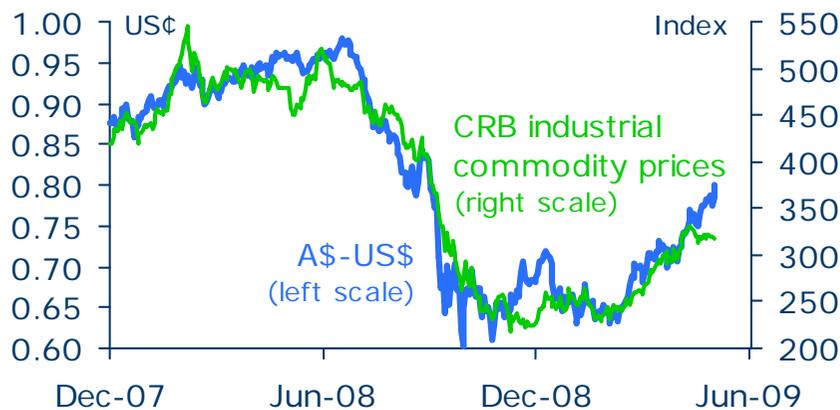
US\$ trade weighted index



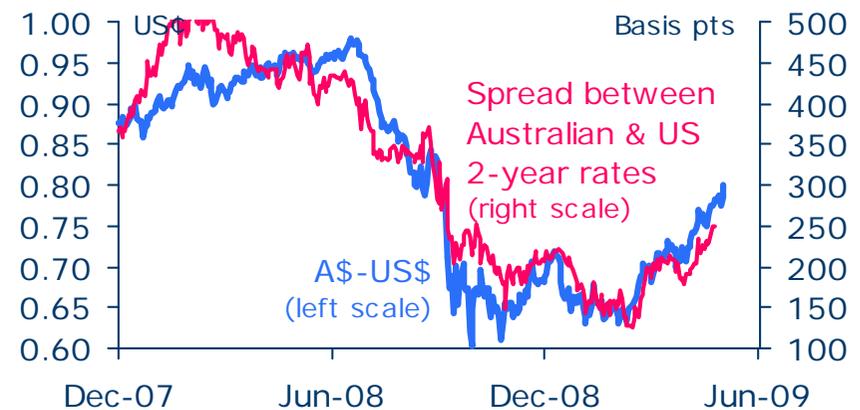
Share prices



Commodity prices



Australia-US interest rate spread



Sources: Bloomberg; Datastream; ANZ.



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- The global financial crisis which began in mid-2007 has induced the most serious downturn in the global economy since the end of World War II
  - Resolving the financial crisis and dealing with its economic consequences has required central banks and governments to take extraordinary monetary, budgetary and other policy measures – measures which carry some risks – but the alternatives would have been even worse
  - There are some tentative signs that these measures are beginning to have their intended effect
    - financial markets have stabilized
    - economic activity is no longer contracting as sharply as it was in the final months of 2008 and early 2009
  - ... but the global recovery will be slow and gradual
  - Australia has not been able to escape the effects of the global downturn, but our recession will be less severe than elsewhere among advanced economies
    - reflecting the absence of some of the sources of weakness in the US and Europe
    - the different structure and orientation of our trade
    - and the timeliness and effectiveness of Australia's policy responses
  - There's no reason for undue alarm at Australia's return to budget deficits and public borrowing, although 'harder decisions' will be required if the deficit is to be eliminated by the middle of the coming decade
  - Interest rates may fall a little further over 2009-10, and won't start to rise again until towards the end of 2010 at the earliest

# Disclaimer

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