



Commonwealth Bank of Australia

January 2006



The Economic Backdrop

Prepared for

Pacific Rim Real Estate Society 12th Annual Conference

Michael Blythe
Chief Economist
(612) 9312 4135

Important Information



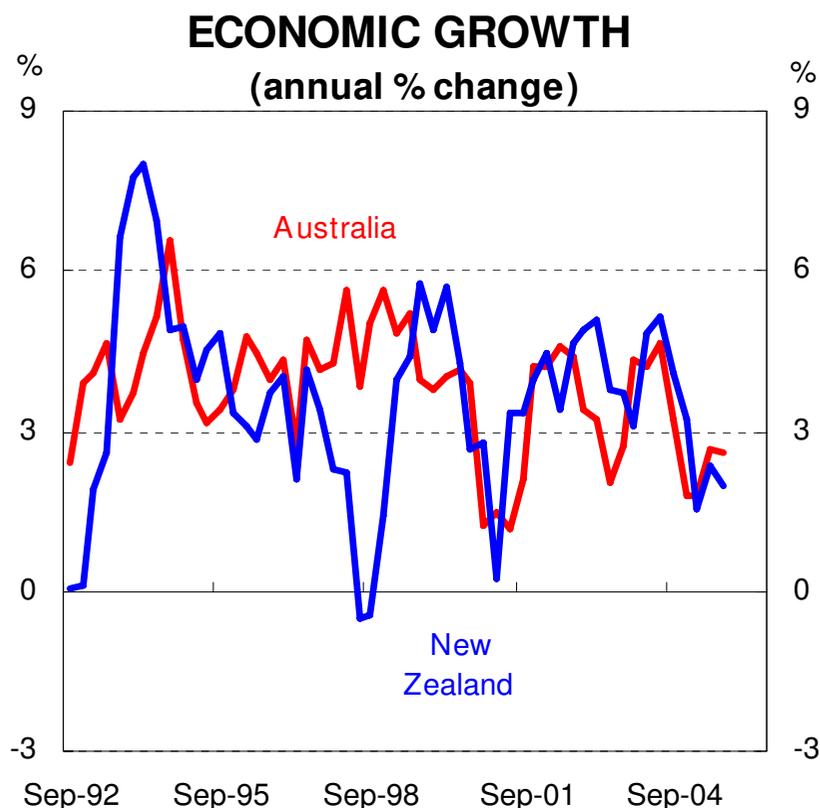
This advice has been prepared without considering your objectives, financial situation or needs, and before acting on the advice, you should consider its appropriateness to your circumstances.

Commonwealth Bank of Australia as a provider of investment, borrowing and other financial services undertakes financial transactions with many corporate entities in Australia. This may include any corporate issuer referred to in this report.



At the Frontier?

Full ahead or dead stop?

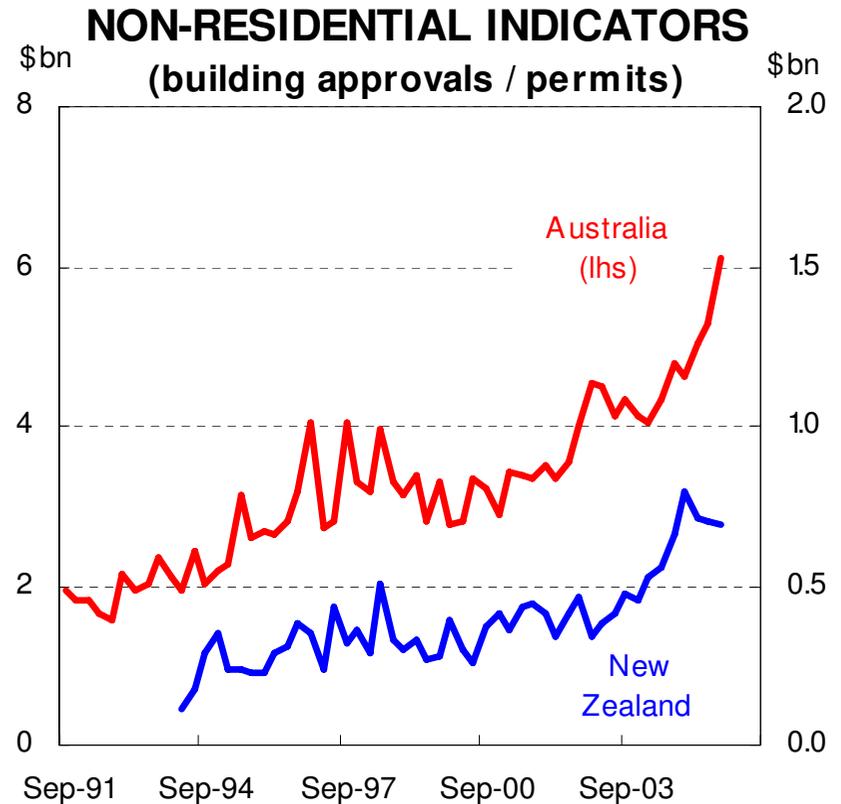
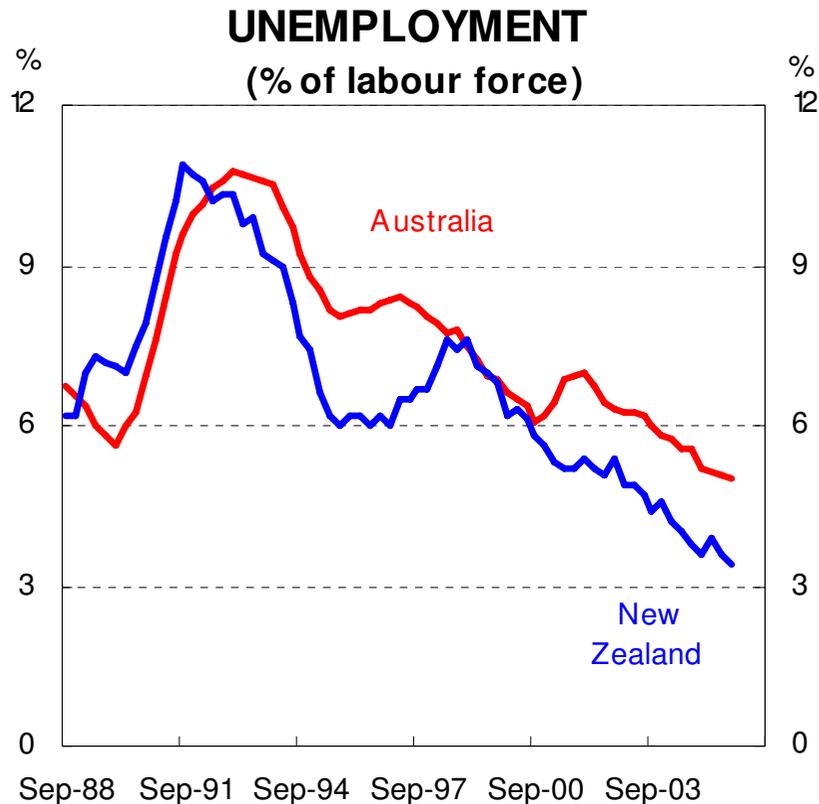


- Growth rates at the bottom end of the range of recent years.
- High oil prices, rising interest rates, higher currencies etc part of the story.
- But also indications that capacity constraints are biting.



At the Frontier?

Squaring the circle

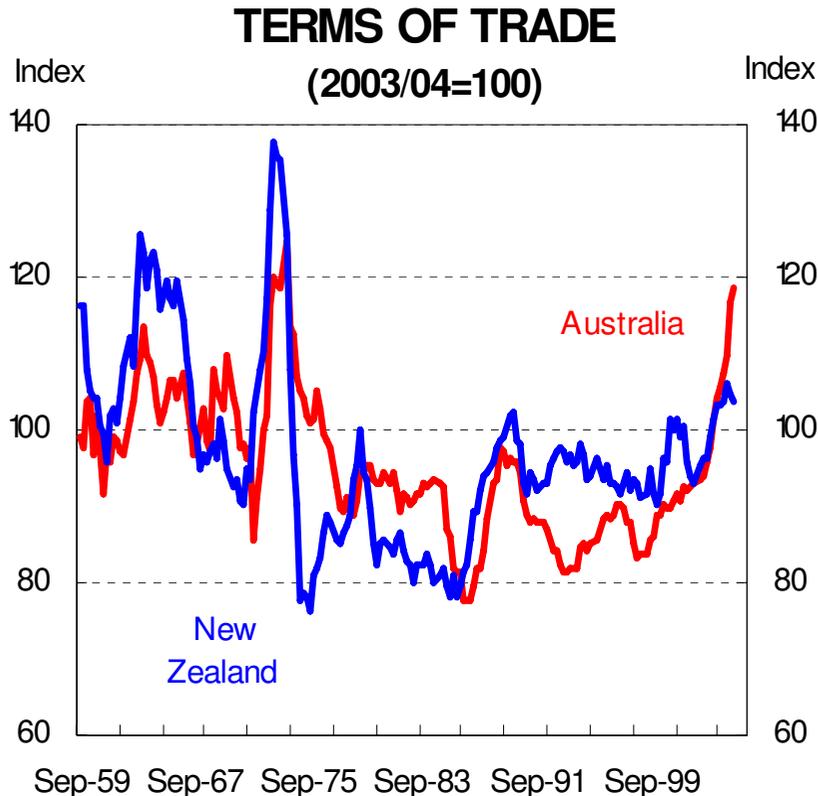


- Difficult to squeeze *additional* output from existing capital/labour inputs.
- Rising business investment part of the correction process.



The Terms-of-Trade Supercharger

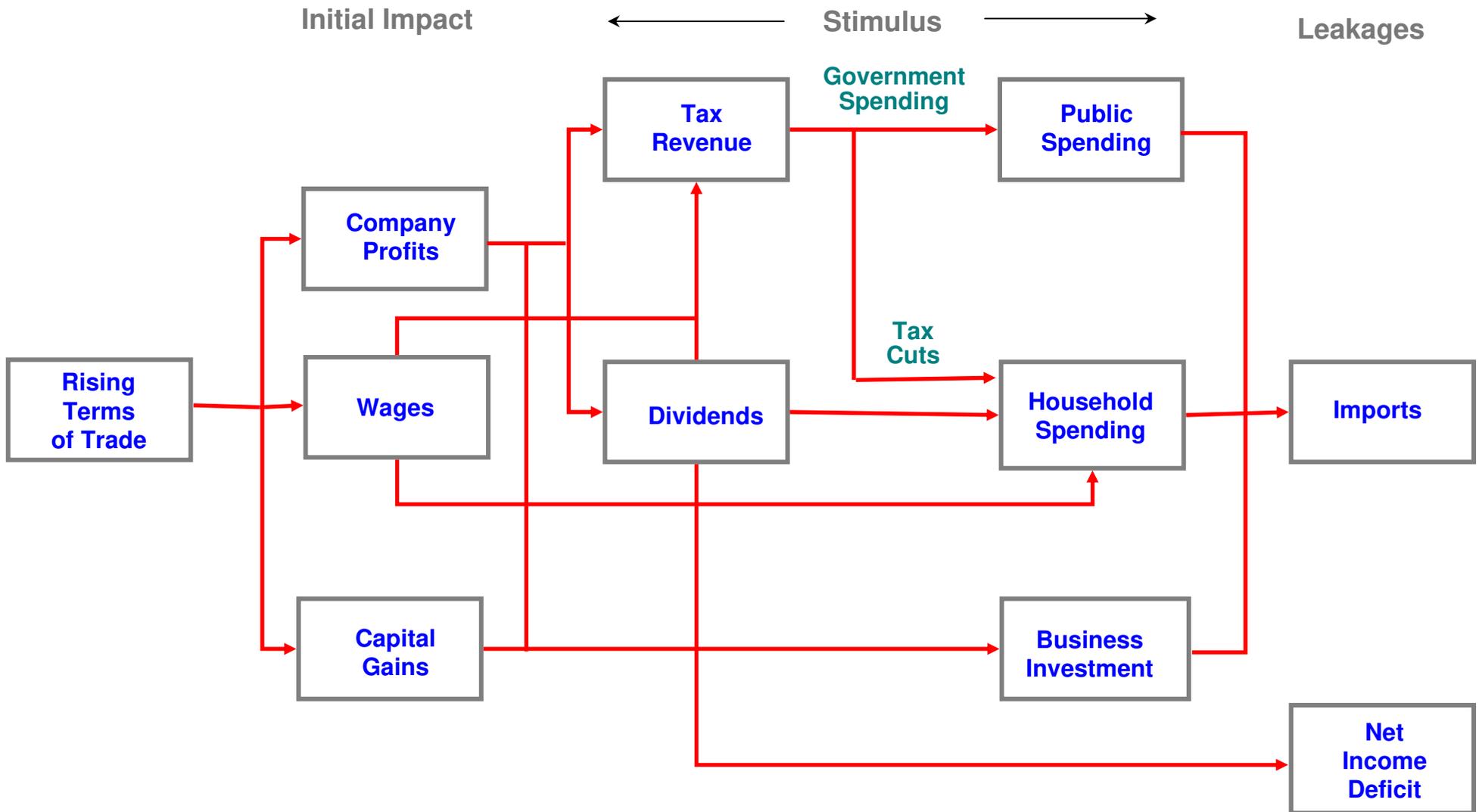
Fattening the wallet



- The terms-of-trade (ratio of export prices to import prices) at highest levels since mid 1970s.
- Rising incomes keeping *spending* strong even as capacity constraints slow *production*.

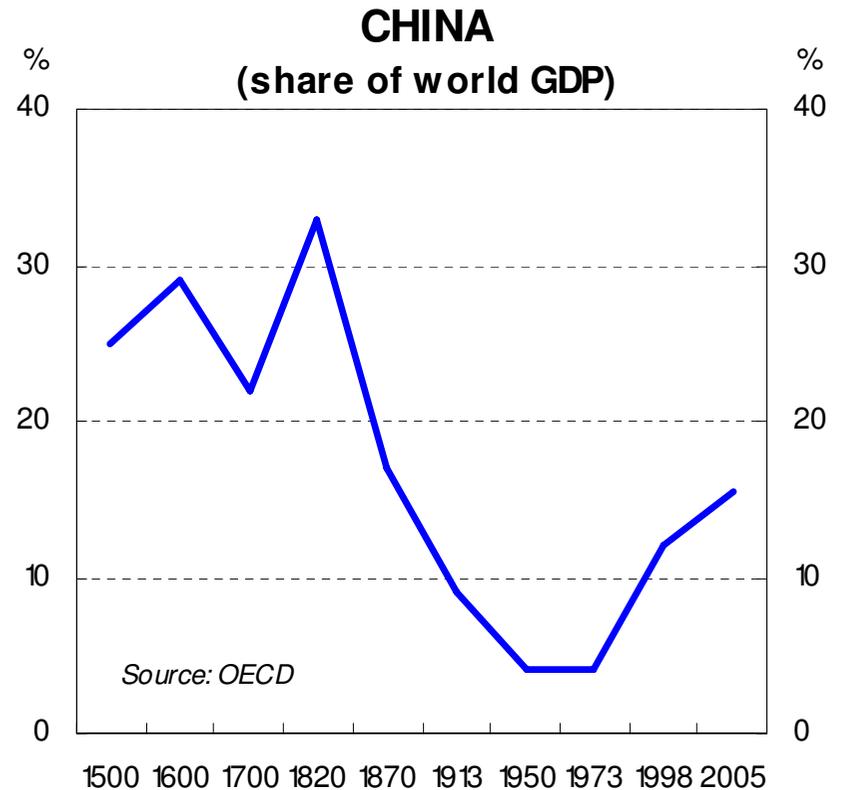
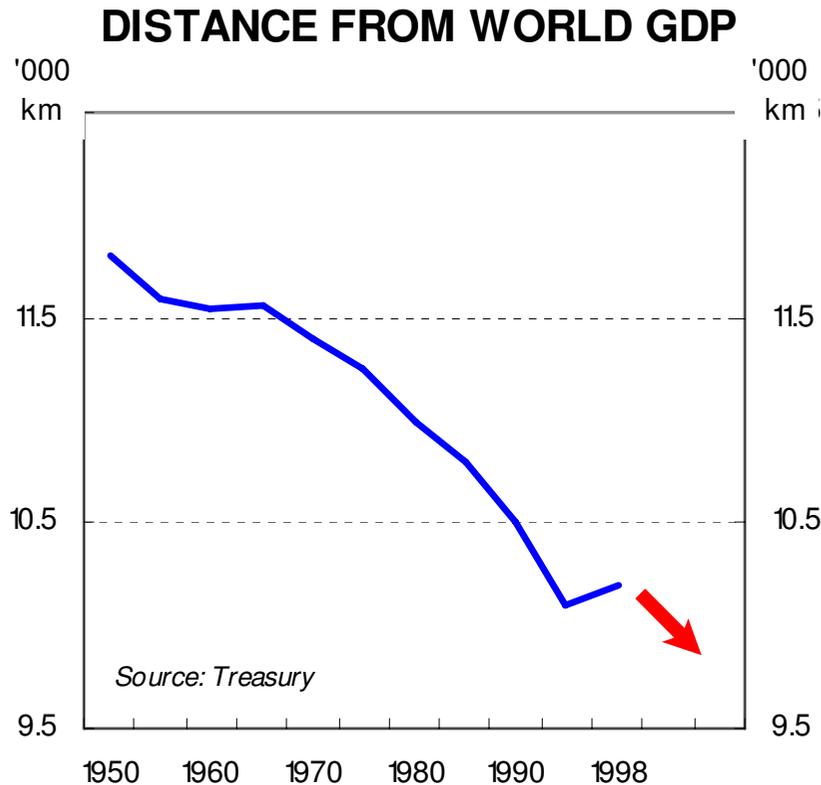


The Terms-of-Trade Supercharger



The Terms-of-Trade Supercharger

The China boost



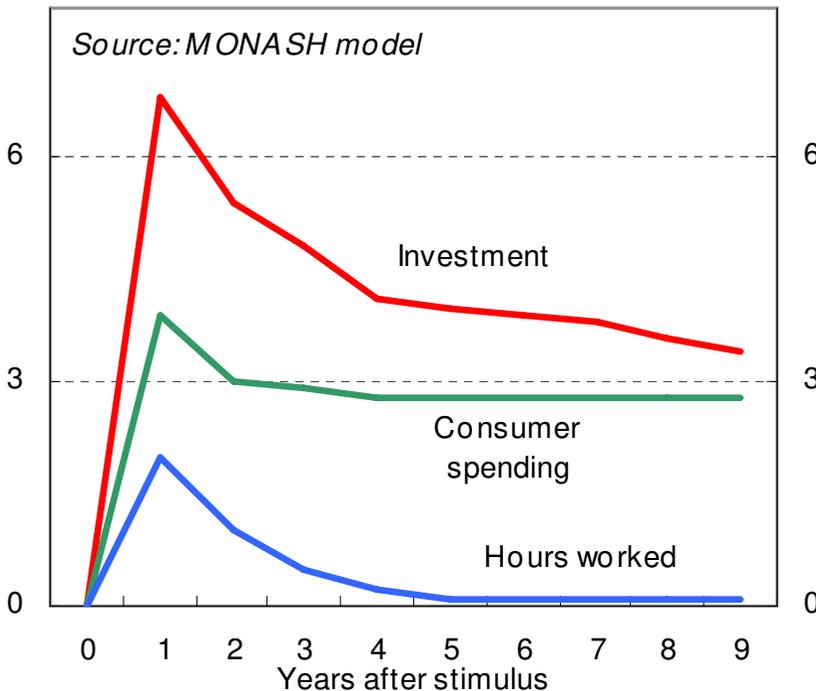
- Centre of world economic gravity shifting toward Asia.



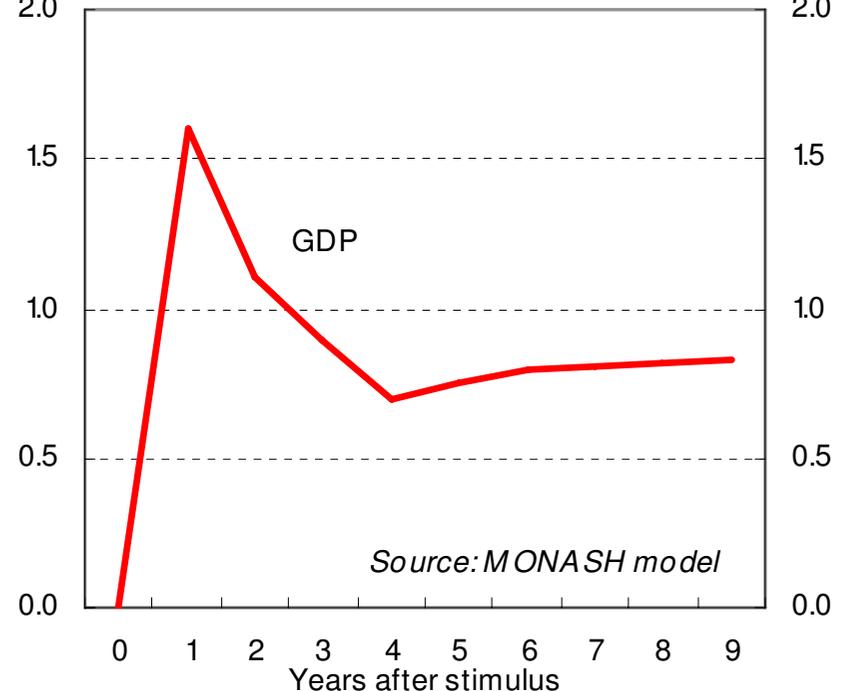
The Terms-of-Trade Supercharger

Australia: more income = more spending = inflation risks?

IMPACT OF A 10% RISE IN THE TOT
(% deviation)



IMPACT OF A 10% RISE IN THE TOT
(% deviation)

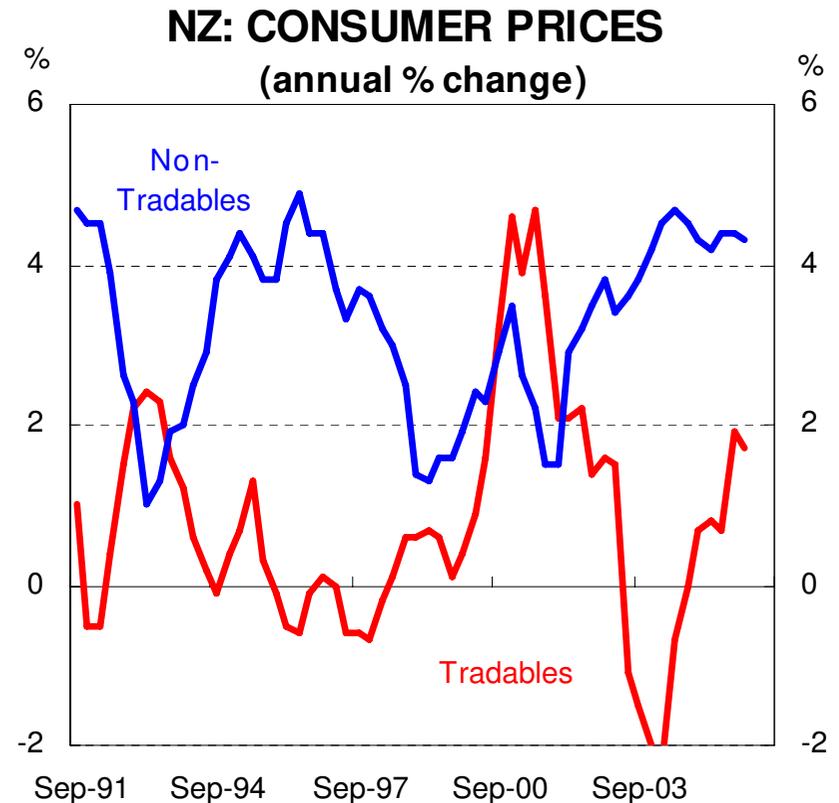
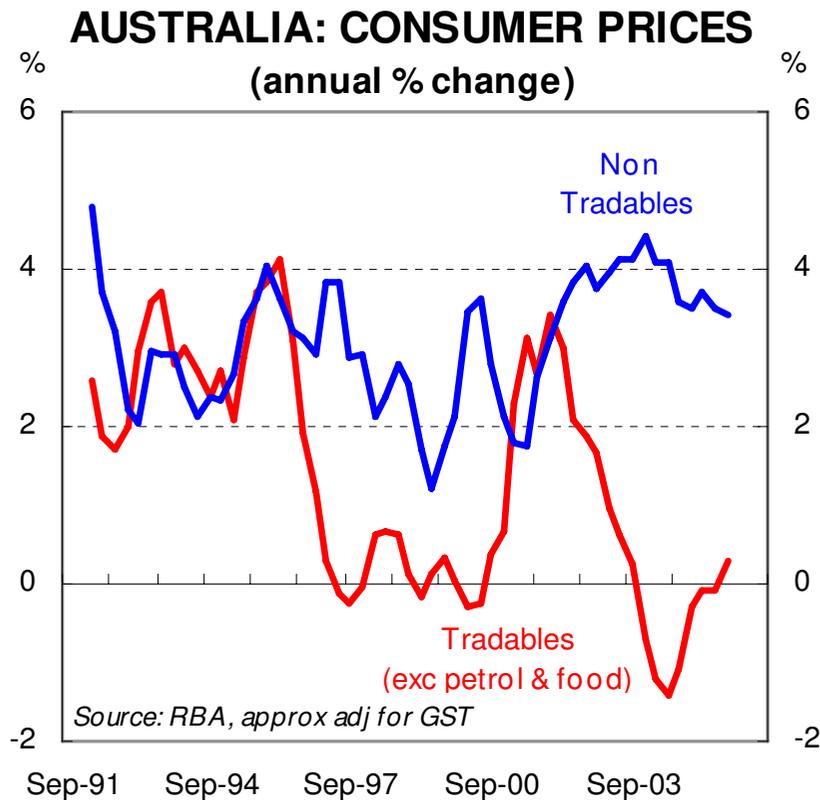


- **Rising terms-of-trade boosts incomes, spending and employment.**
- **If capacity constraints prevent GDP response, then inflation risks rise.**



Inflation Risks

Mind the gap

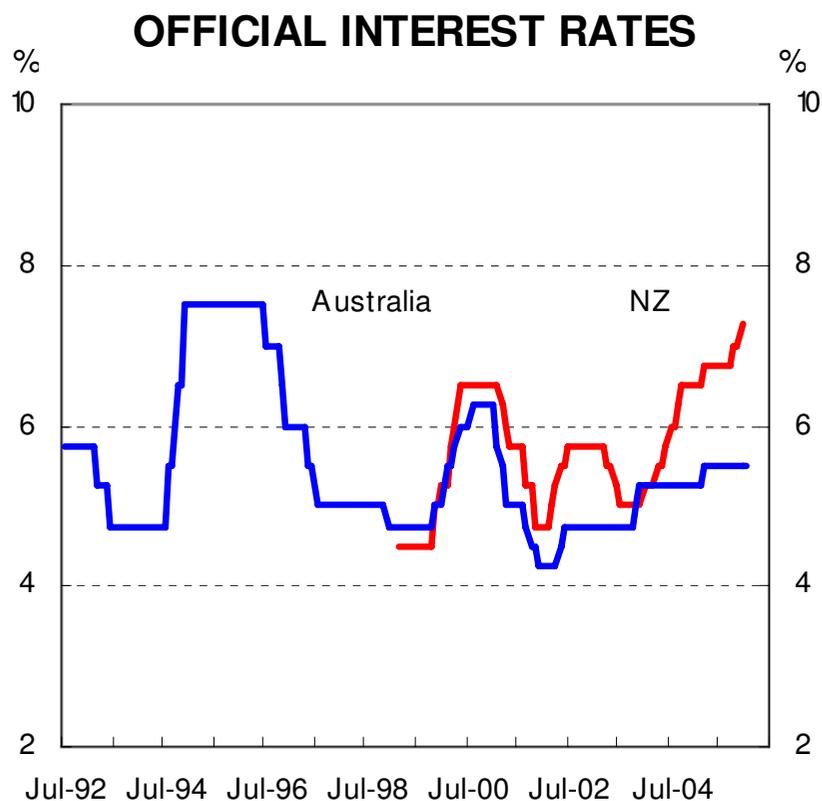


- **Capacity issues are contributing to domestic price pressures.**
- **The benefits from a rising currency are used up.**



Monetary Policy

Game over?

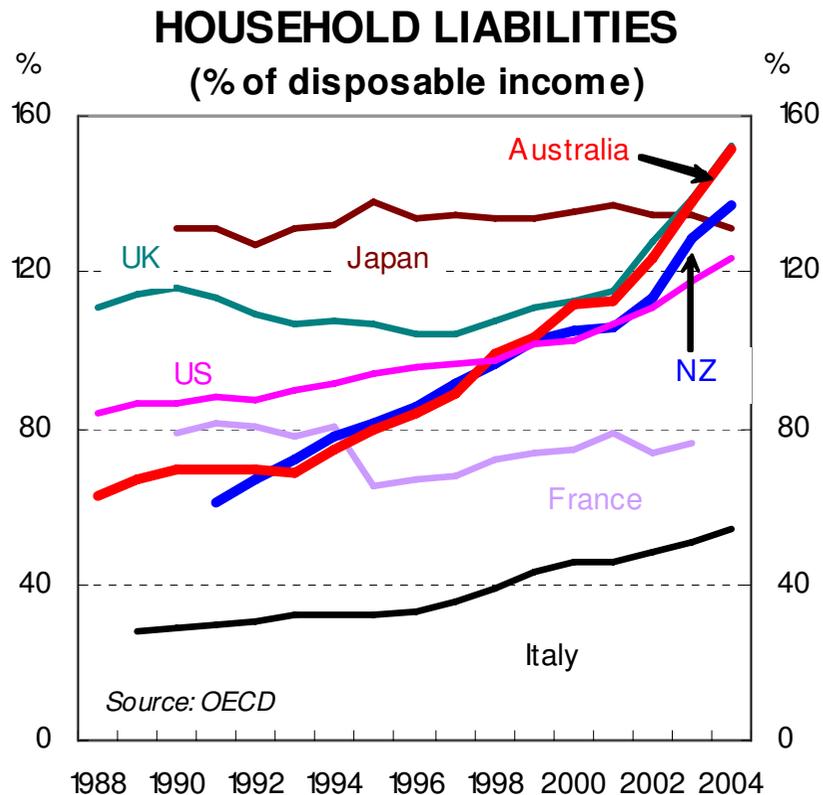


- **RBA: background conditions/macro stability requirements/inflation risks will probably require a rate rise at some point.**
 - toleration of inflation risks lower if inflation is already at 3%pa.
- **RBNZ: odds on further rate rises have fallen after Q4 CPI.**
 - rate cuts in 2007?
- **The long end: the economic fundamentals also favour a rise in longer-term interest rates.**



Housing Issues

The dark side

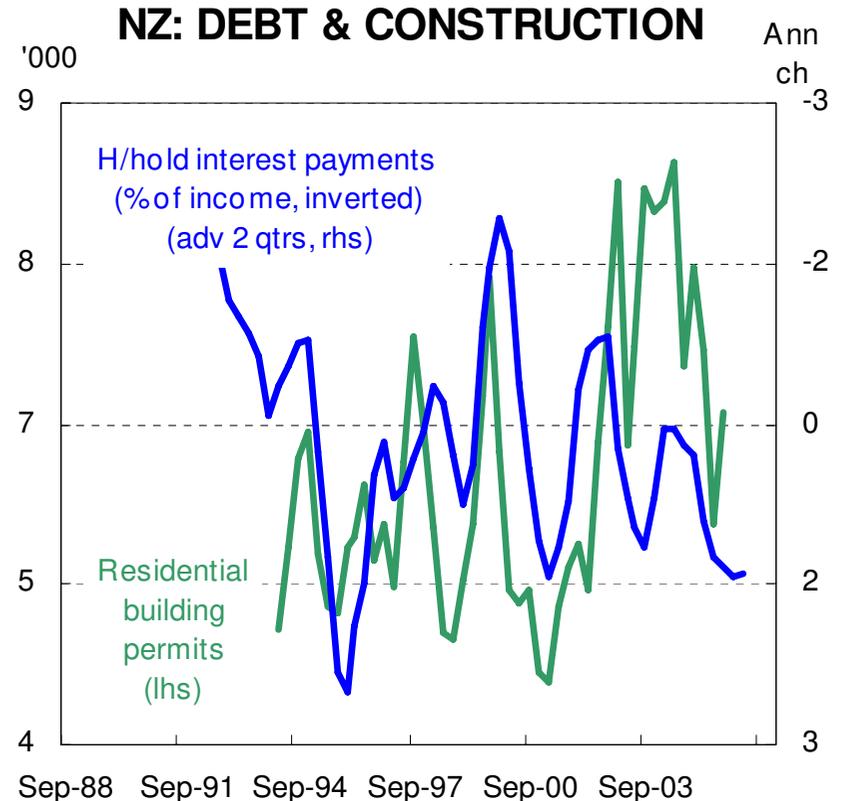
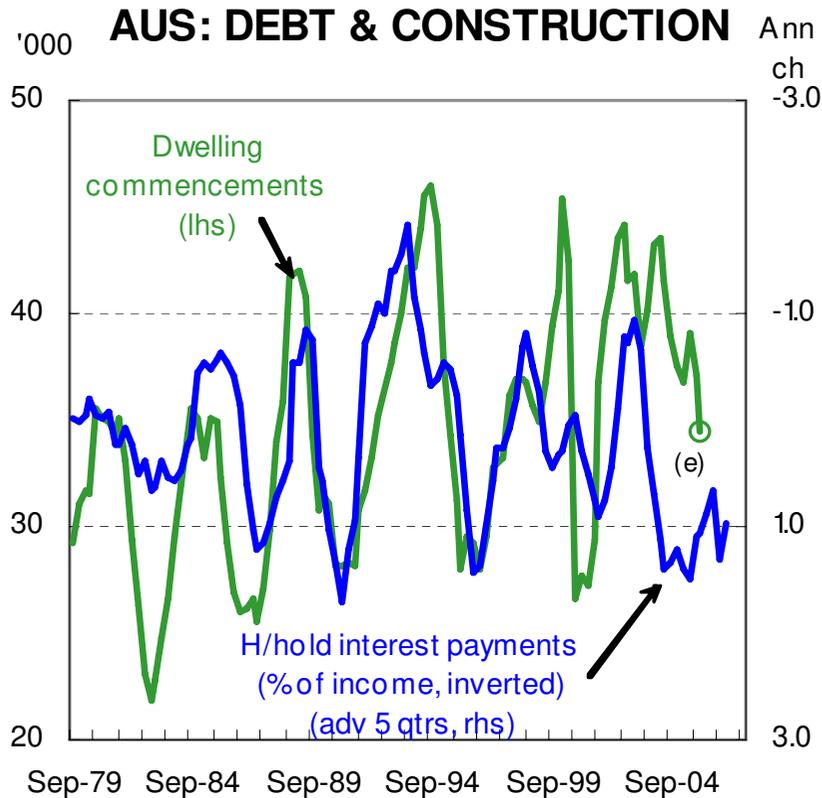


- Consumers reacted rationally to falling unemployment and low interest rates by gearing up.
- Housing booms were one outcome. Stretched household balance sheets are another.
- Household sensitivity to interest rate changes has increased.



Housing Issues

Will debt bite?

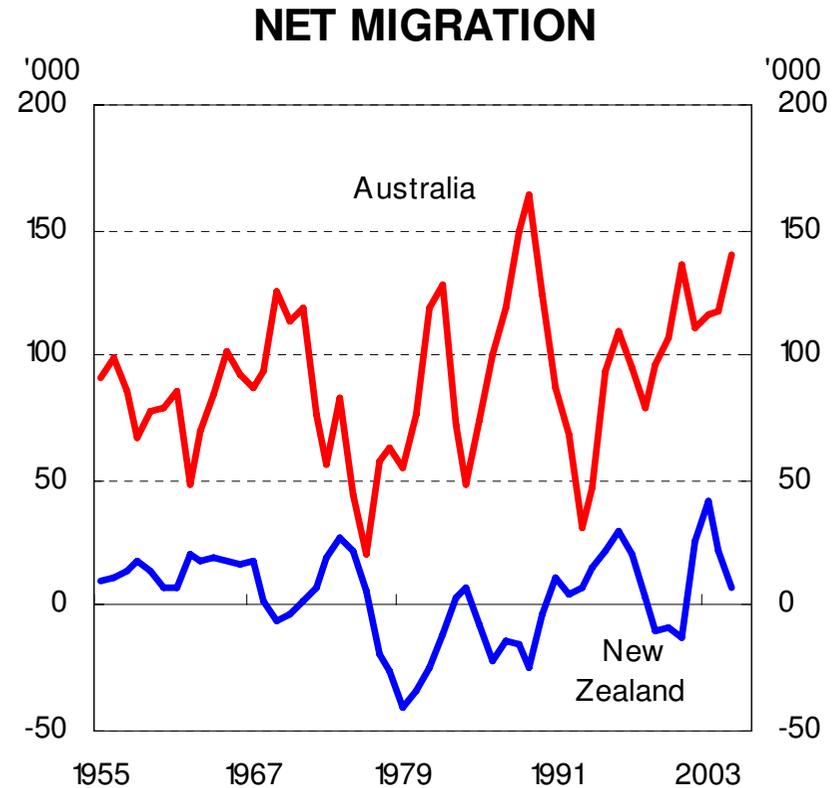
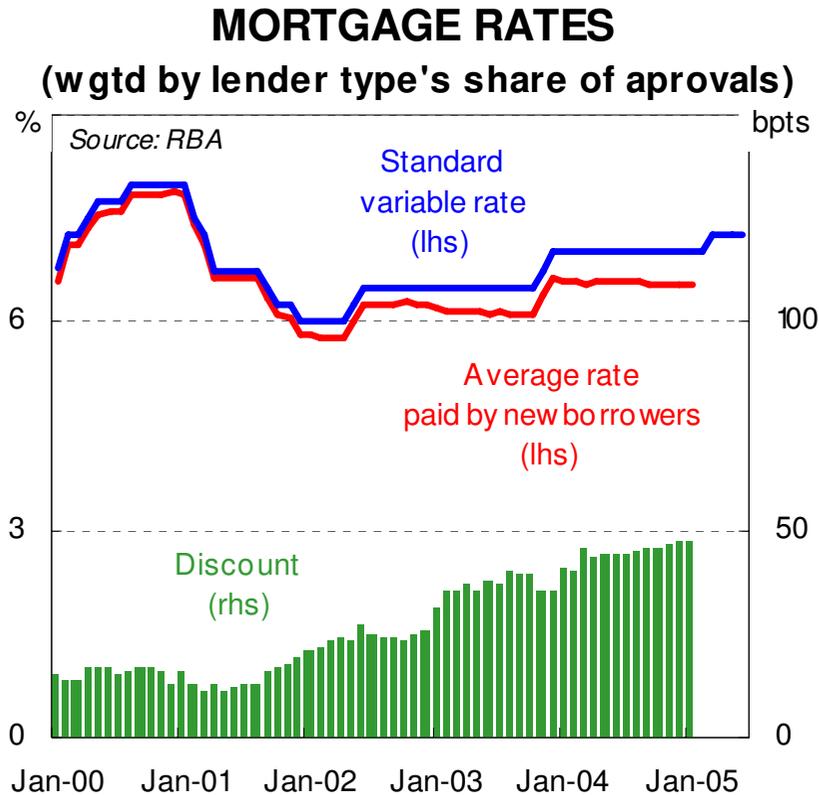


- Debt servicing ratios consistent with further slowing in housing activity.



Housing Issues

Dragging the anchor

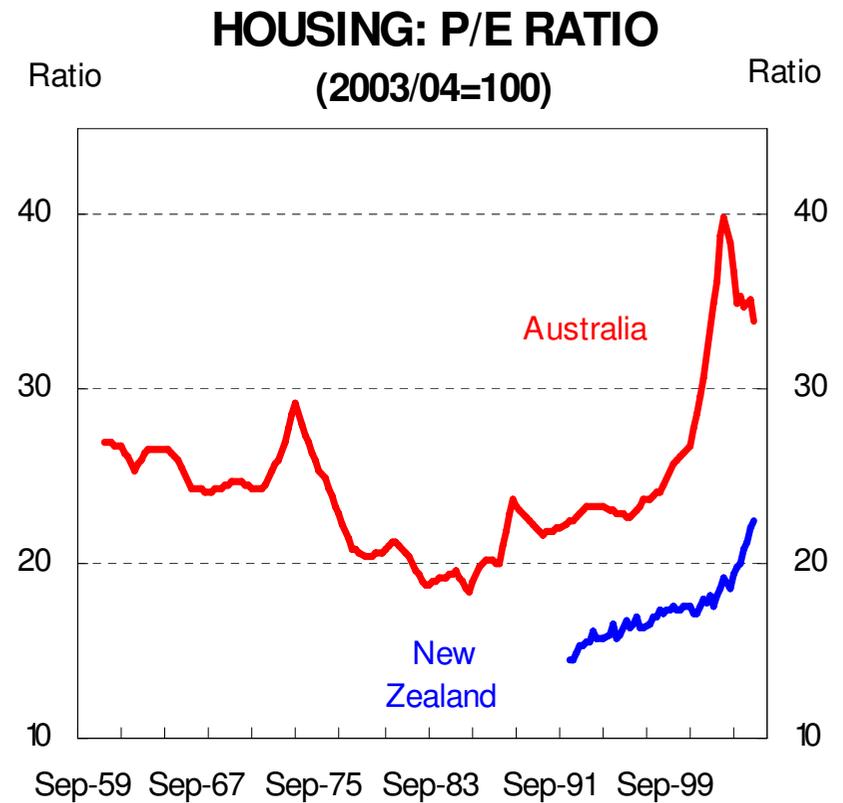


- Competition keeping a lid on mortgage rates.
- Migration trends moderating Aust housing cycle, accentuating NZ cycle.



Housing Issues

Rushing for the door?

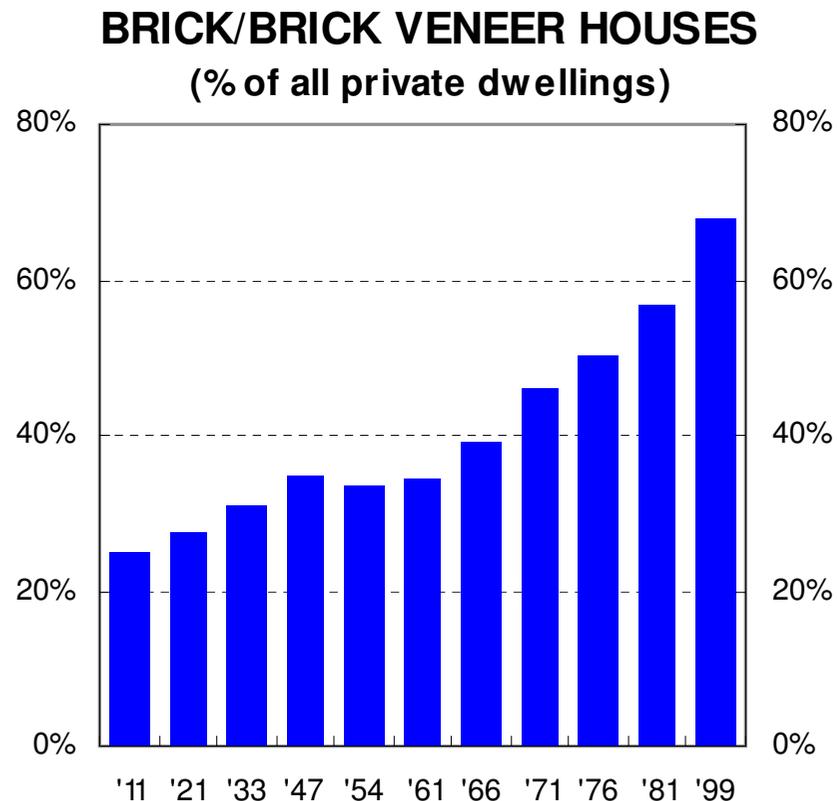
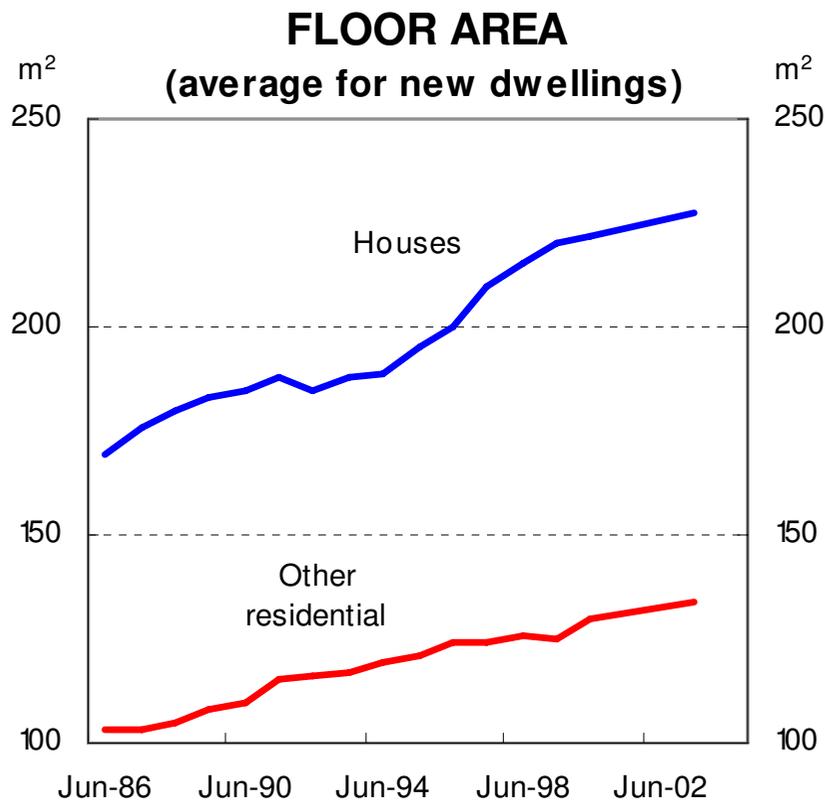


- Housing “overvalued” on some criteria.
- Applying investment valuation criteria to housing may be misleading.



Housing Issues

Bigger is better

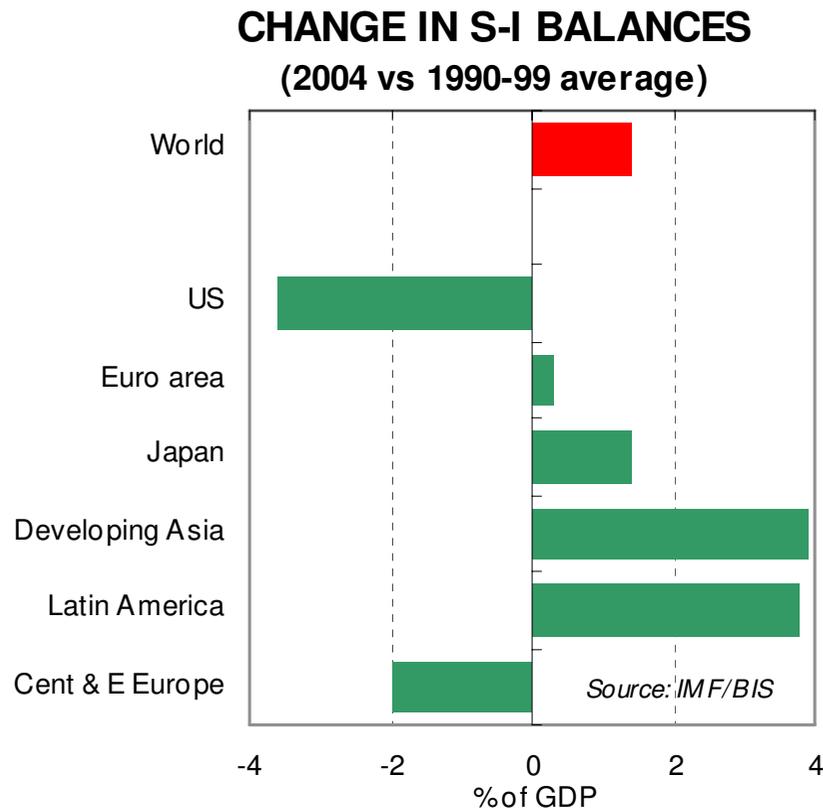


- Spending on “essentials” has fallen - more to spend on housing.
- Rising trend in new dwelling size. Preference for more expensive materials.



Housing Issues

The global risk

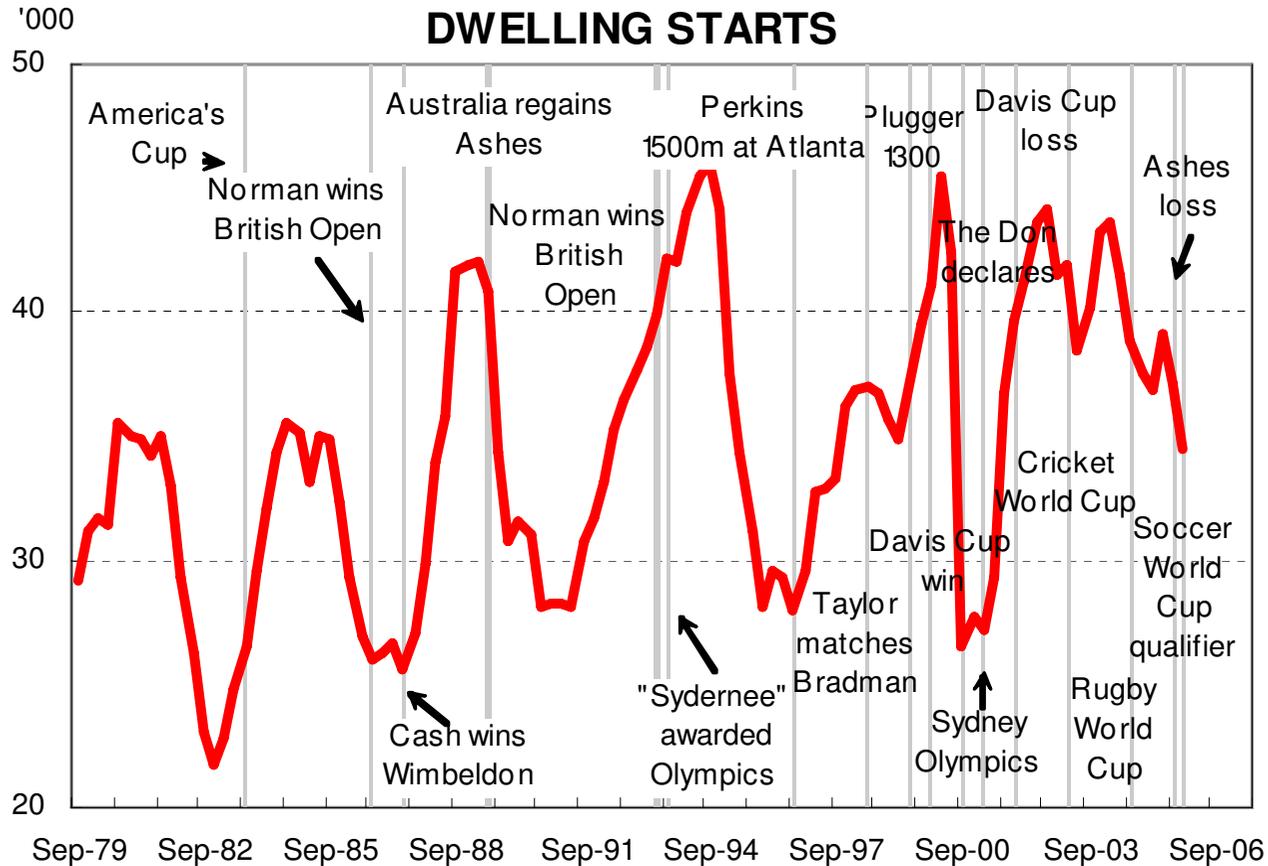


- Global saving has outpaced global investment.
- Excess savings flowing into asset markets.
- Pursuit of capital gain / yield pick-up has essentially pushed down the allowance for risk.
- Markets and real economy exposed to any re-pricing of risk.



Factor X

Sport and housing



- **Greg Norman wins and cricket losses seem to do the most to get the Australian housing market going.**



Our View



Global growth risks

- respectable growth momentum for now - low interest rates and ample global liquidity fuelling imbalances;
- “normalisation” in Japan a potential trigger?

Australia retains momentum but inflation risks lifting

- signs of consumer caution – but economic fundamentals still favourable;
- business capex and export lift are rebalancing growth;
- risks of second-round flow through into inflation.

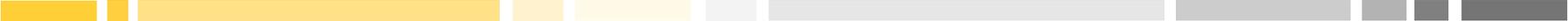
New Zealand inflation risks remain as growth slows

- sub trend growth likely but upside risks in the near term;
- tight product and labour markets generating inflation pressures.

Economic policy and markets

- RBA edging back to a tightening bias;
- RBNZ inflation concerns should see rates hold at high levels.





Produced by Commonwealth Research based on information available at the time of publishing. We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made as at the time of its compilation, but no warranty is made as to accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Bank of Australia ABN 48 123 123 124 - AFSL 234945 - nor any of its subsidiaries accept liability to any person for loss or damage arising from the use of this report. No person should act on the basis of this report without considering and if necessary taking appropriate professional advice upon their own particular circumstances. In the case of certain securities Commonwealth Bank of Australia is or may be the only market maker. This report is approved and distributed by Commonwealth Bank of Australia incorporated in Australia with limited liability. Registered in England No. BR250 and authorised and regulated by the Financial Services Authority (FSA). This report does not purport to be a complete statement or summary. For the purpose of the FSA rules, this report and related services are not intended for private customers and are not available to them. Commonwealth Bank of Australia and its subsidiaries have effected or may effect transactions for their own account in any investments or related investments referred to in this report.

We do not charge any fee for the advice provided. You may be charged fees in relation to the financial products the Bank provides. These are set out in the relevant Product Disclosure Statement. Our employees receive a salary and do not receive any commissions or fees. However, they may be eligible for a bonus payment from us based on a number of factors relating to their overall performance during the year. Our employees may also receive benefits such as tickets to sporting and cultural events, corporate promotional merchandise and other similar benefits. If you have a complaint, the Bank's dispute resolution process can be accessed on 13 2221.

Unless otherwise noted, all data is sourced from Australian Bureau of Statistics material.

