

# Economic Overview

05



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**Economic**  
Overview

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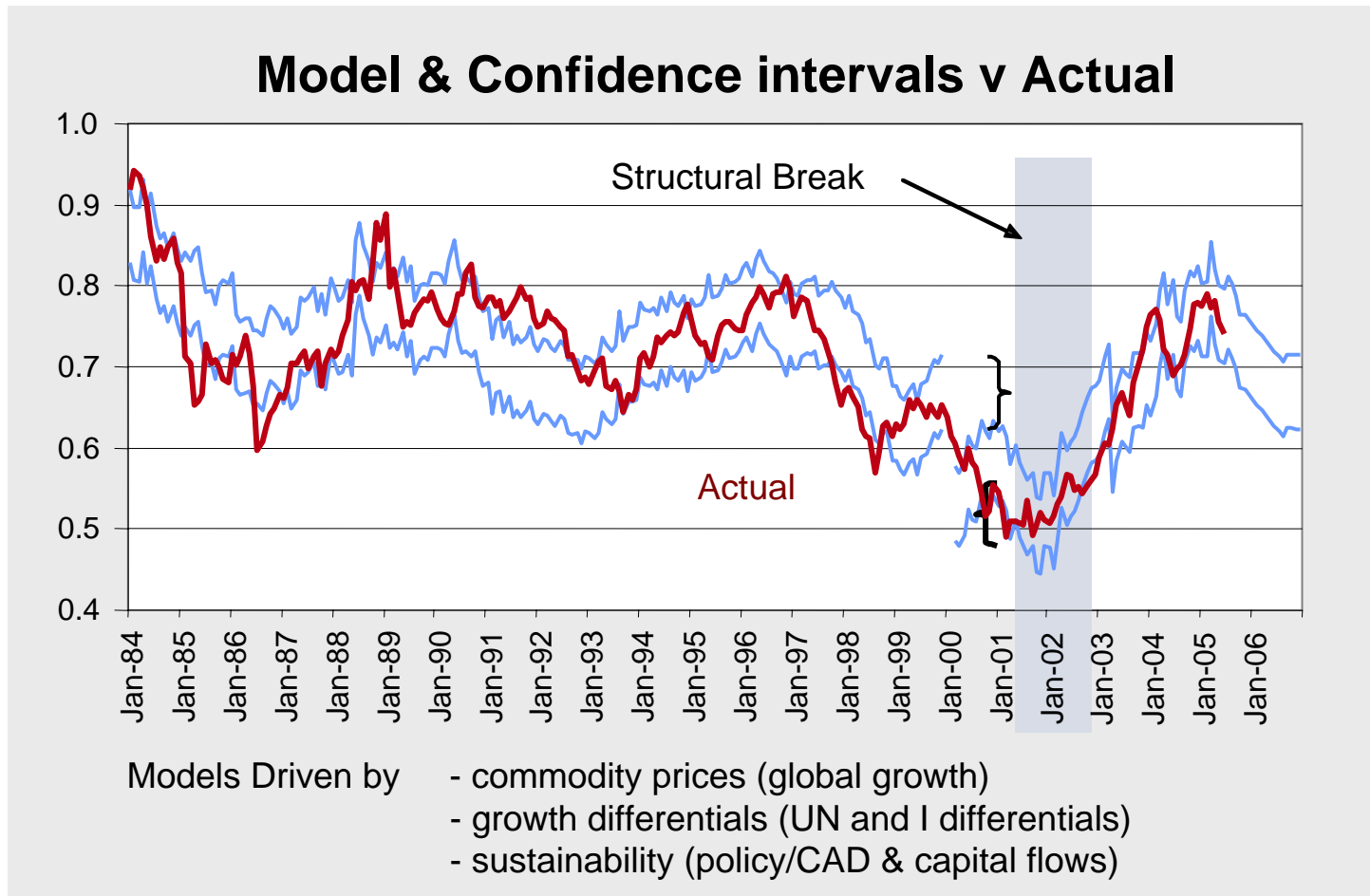
## **Activity & Rates**

Globally we see a slowing still reasonable growth. Albeit very China / US reliant.

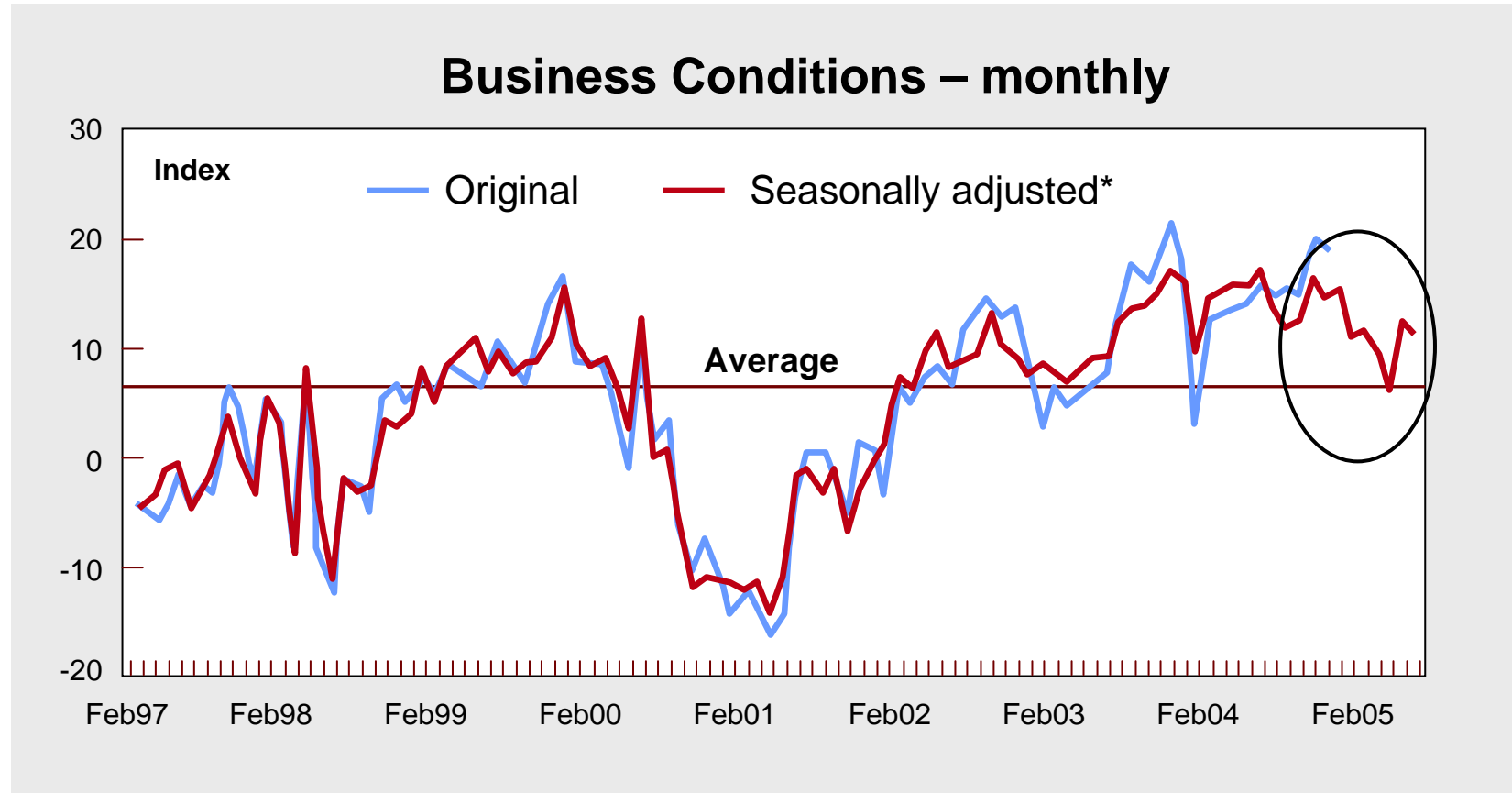
## Global GDP Forecasts

December year Annual ave. % change	2000	2001	2002	2003	2004	2005(f)	2006(f)
US	3.7	0.8	1.9	3.0	4.4	3¾	3.5
Japan	2.4	0.2	-0.3	1.4	2.7	1.5	1.5
UK	4.0	2.2	2.0	2.5	3.2	2.0	2¼
Euro-zone	3.8	1.8	0.9	0.7	1.7	1.5	2.0
Canada	5.2	1.8	3.4	2.0	2.8	2.7	3.0
Australia	3.1	2.2	4.1	3.5	3.2	2.0	3¼
New Zealand	3.5	2.6	4.7	3.4	4.8	2.5	2.5
China	8.0	7.5	8.1	9.3	9.5	9¼	8.5
<b>World</b>	<b>4.7</b>	<b>2.1</b>	<b>2.6</b>	<b>3.4</b>	<b>4.7</b>	<b>4.0</b>	<b>3¾</b>
Non-Japan Asia	7.7	4.2	6.1	6.3	7.5	6.5	6.5
Latin America	4.0	-0.3	-1.0	2.4	5.7	5.0	3¾

Exchange Rate Models used to do well.  
But unable to cope in 2000-2002 ( very much a \$US story). Now working reasonably well – or at least as per pre 2000.



Business Conditions have slowed significantly from late 2004. Continued into 2005. But May saw a surprising improvement which was maintained in June.

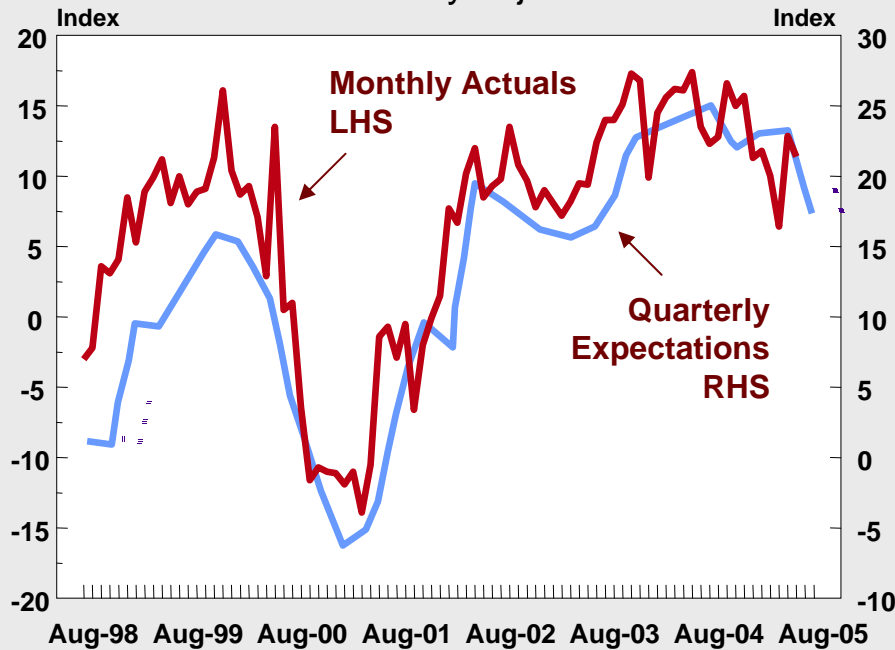


\* Seasonally adjusted by National using x12

But expectations for the next 3 months revised down and confidence still low..

### Business Conditions

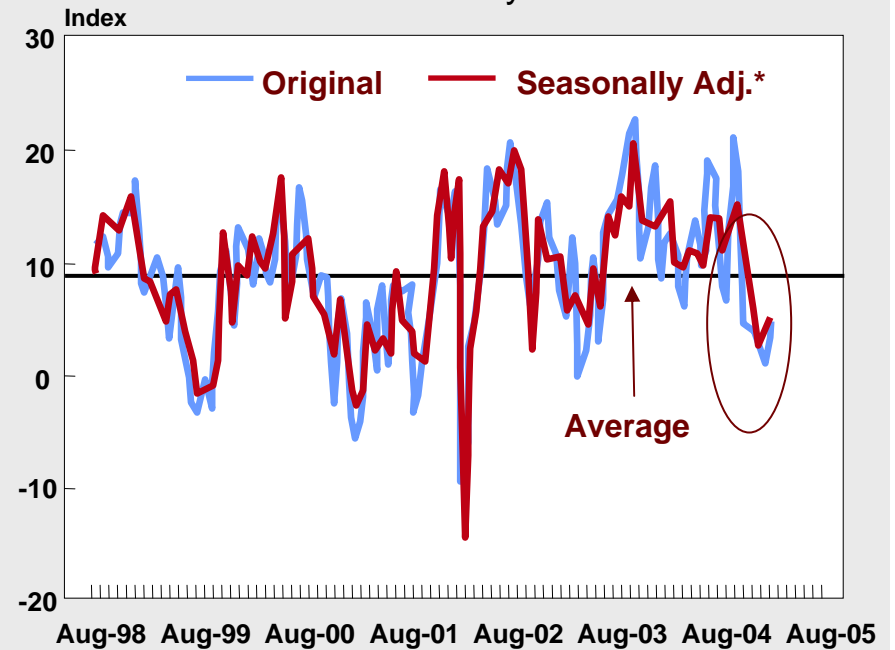
Seasonally adjusted



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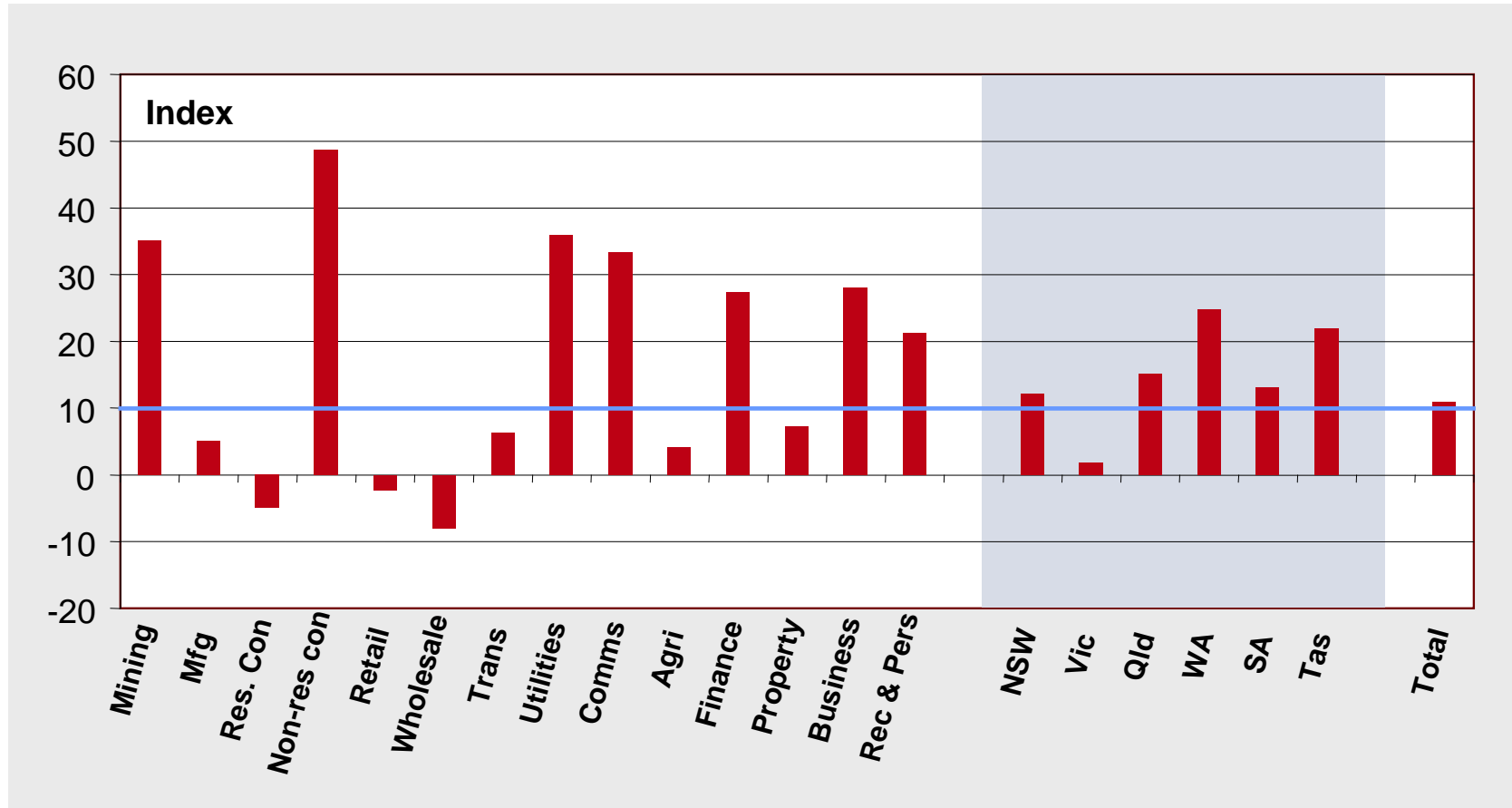
### Business Confidence

Monthly

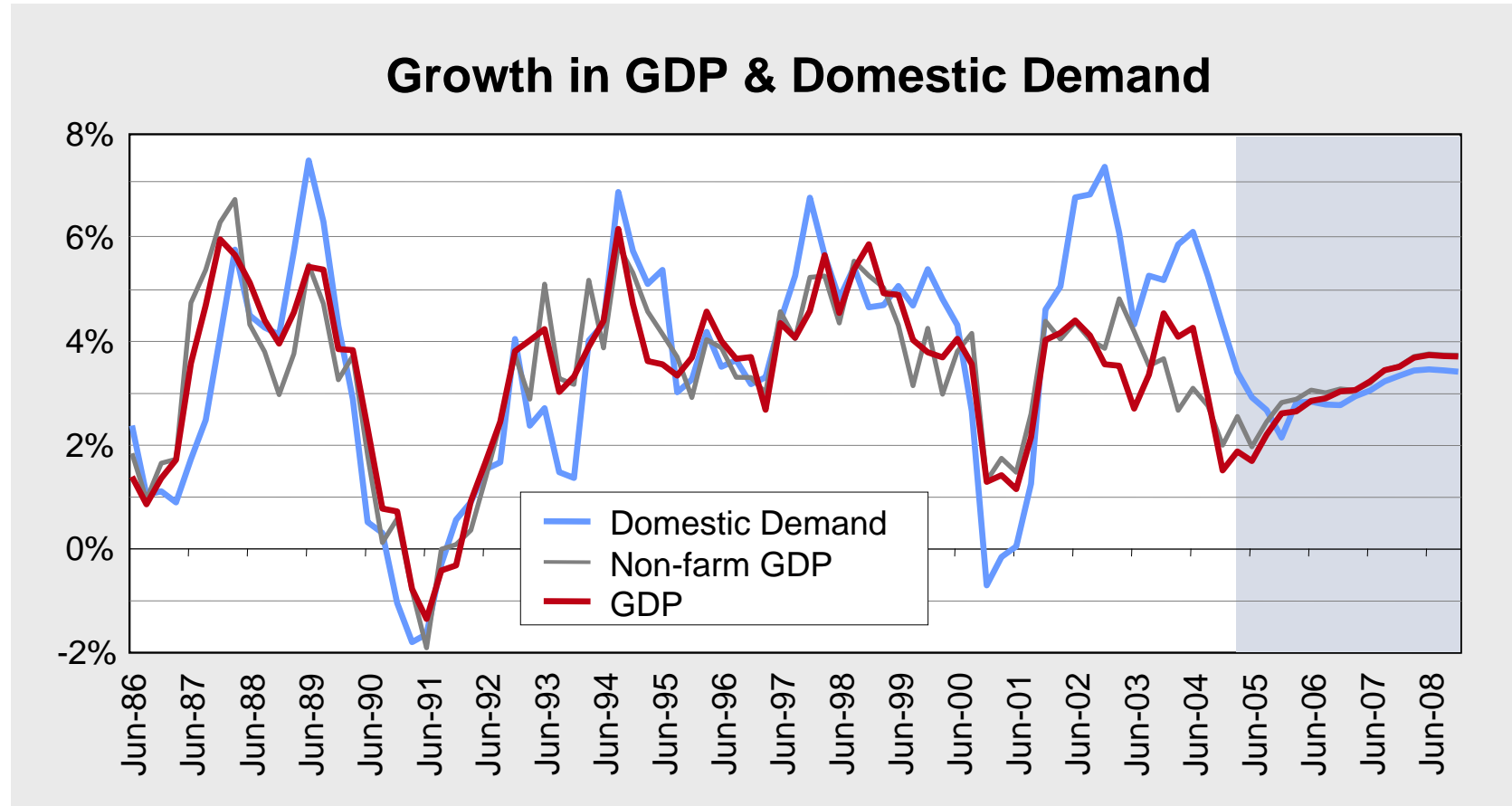


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Looking at latest data (June Qtr) you can see the industry impacts across states...



We see 2005 at a around 2% (and in 2004/05). For 2005/06 around 2 ¾ % Note: The big change in drivers of growth.



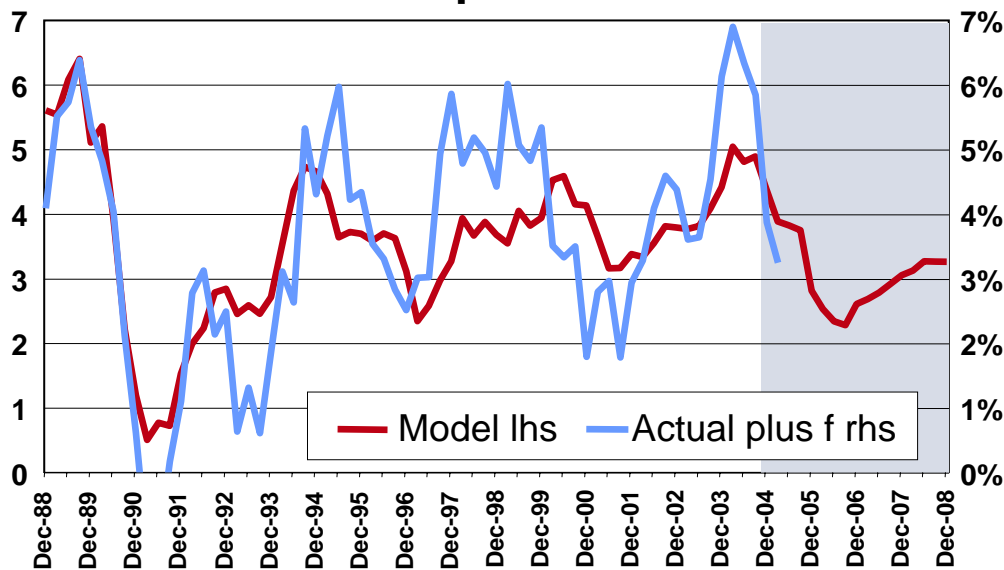
## Key drivers in 2005/06.....

- We expect **consumption** to slow moderately from very fast pace
- In year to March 31/2 % - mid last year was around 6%
  - We expect that it will slow to around 2 ¾ % through 2005 & 2006
- That slowing reflects
  - slower growth in employment as domestic economy (and housing) slows
  - wealth effects
    - Mainly through house price wealth effects

# Housing wealth effects...

- To put this in perspective our research suggests that elasticities on consumer spending to house prices are around 0.10% - with the effects taking up to 12 mths to come through
- That is the move from house price growth of around 22% at end 2002 to 10% in mid 2004 to zero at present. That could be expected to lower consumption by the best part of 2.4% and GDP by around 1½%. We are half way through the adjustment

**Consumption model**

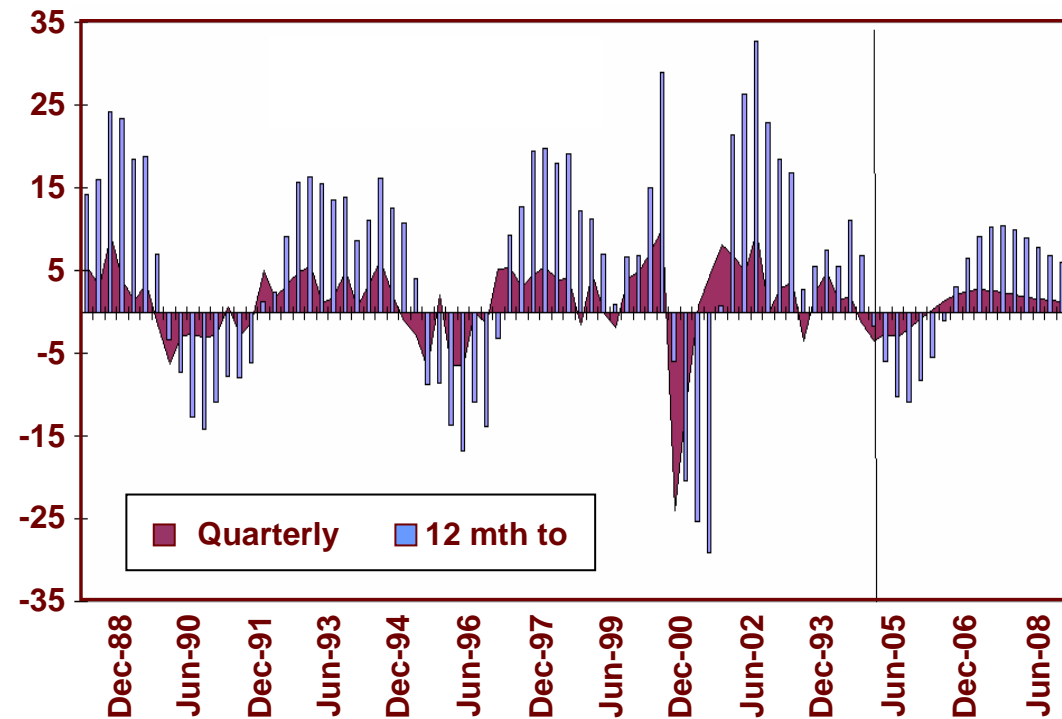


Also helps explain  
NSW & Vic  
vis a vis the rest

# Building Activity to reduce....

- **Dwelling investment** to fall but not as far as past cycles.
- **Activity forecasts**
  - 2002 24.8 %
  - 2003 7.9 %
  - 2004 5.2 %
  - 2005 - 8 <sup>3</sup>/<sub>4</sub> %
  - 2006 + 1/2 %
- **Essentially forecasts are for 10% fall in construction activity from late 2004 to late 2005.**

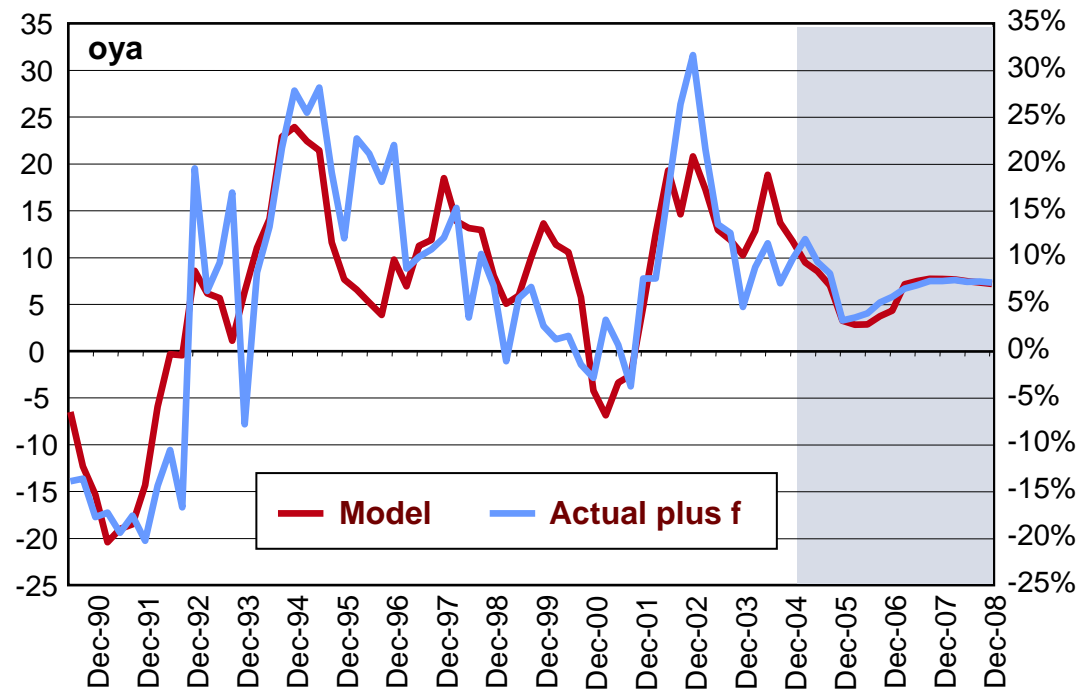
**Investment in Housing –**  
Qtrly & 12 Mth to %



## And business investment to slow...

- **Business investment** has remained strong – reflecting profitability and domestic demand.
- But as demand slows and confidence erodes business investment will slow – to around 5% over the next few years.

### Underlying Business Investment and Model Forecasts



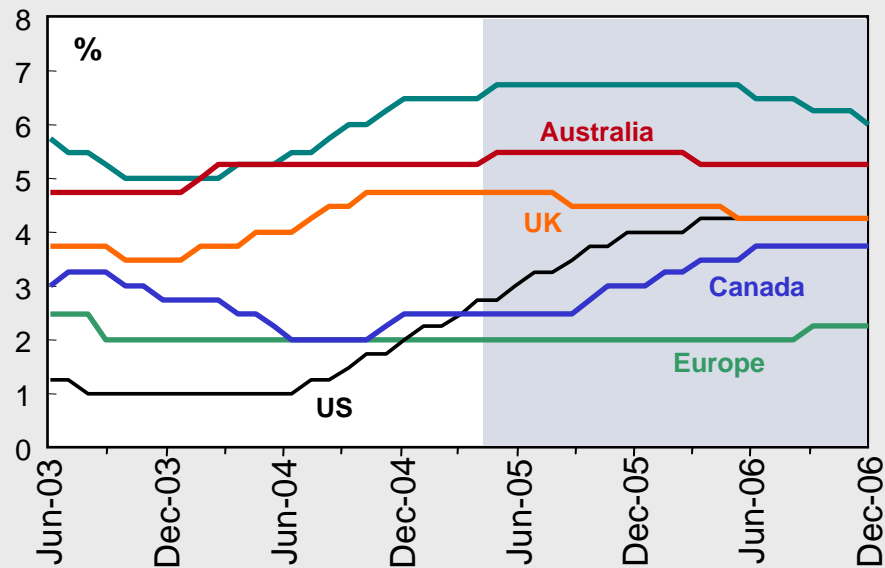
Model Based on Domestic demand, Cap Utilisation & Confidence (T+2)

## Rates.....Our view is

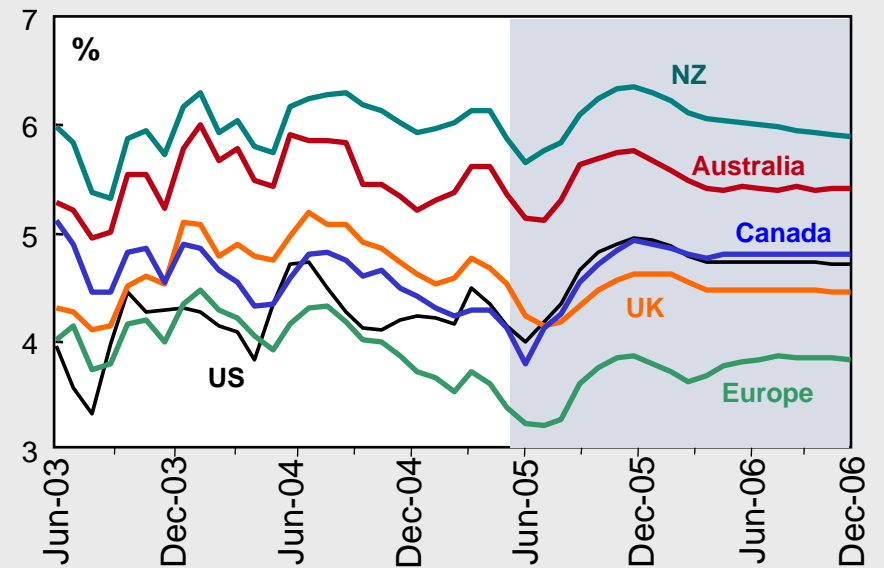
- Our GDP forecasts of 2 ¾ % in 2005/06 have unemployment increasing to around 6% by early 2006
- Expect RBA to cut rates by 25 points at that stage (i.e. early 2006)
- Recent strength in survey and labour market needs to be watched carefully. That plus rain puts some upside risks to forecasts. Not yet in camp of increases. But some doubts over whether a cut will be needed.
- Long end still dominated by US which still looks too low. We expect a US sell-off. Will have some impact on Australian long rates. But Australia is less at risk given where we are in the relevant rate cycle.

Interest Rates – We expect no more action this year on Cash Rates in Australia this year. With likelihood of a cut in early 2006. Longer run rates effected by bond market rally in early/mid 05. Moderate Sell off in late 2005 then easing back...

### Movements in Official Rates



### Movements in Long Bonds



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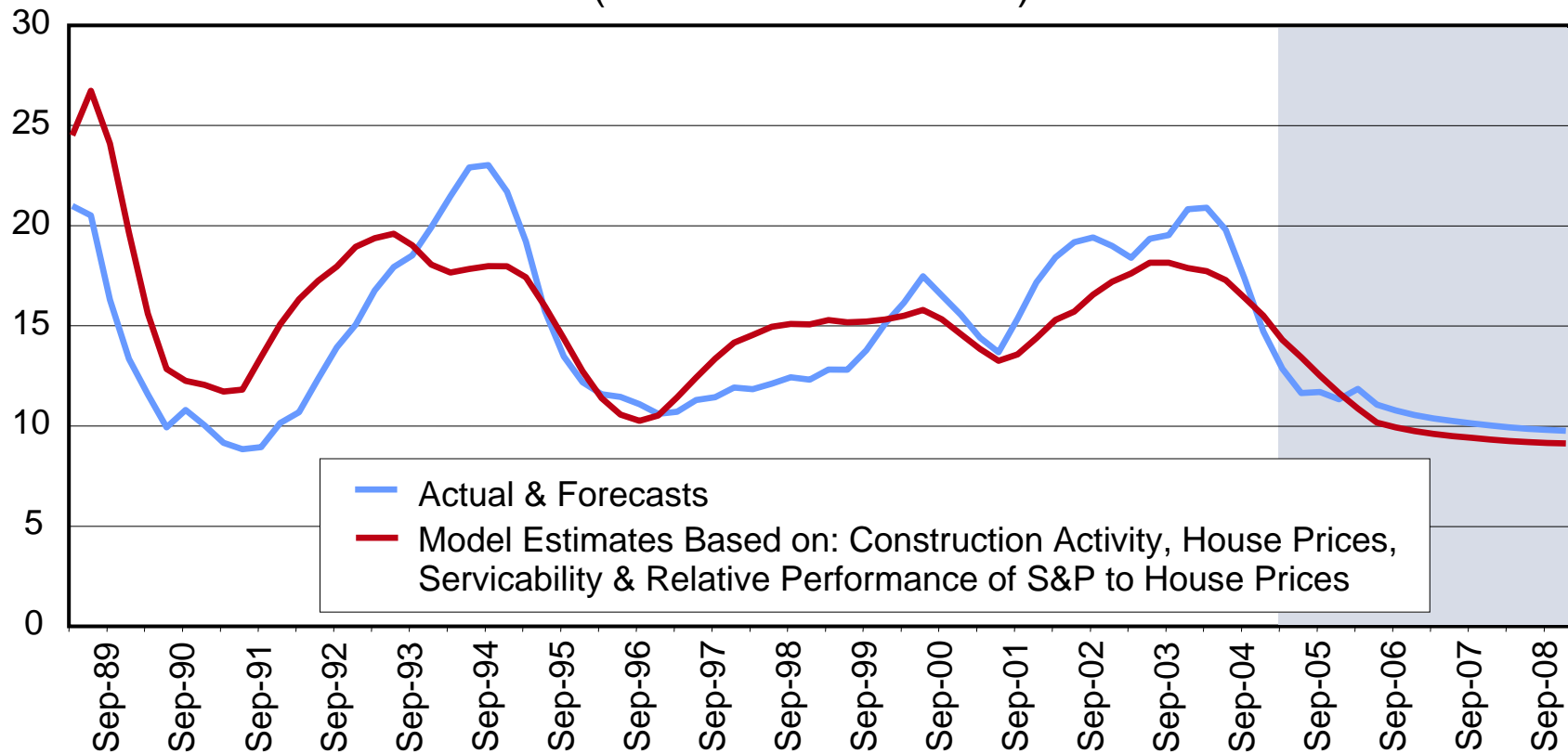
# Credit & Deposits

# Housing Credit

- Look at lots of variables but
- Can use models based on
  - Housing construction cycle (assume falls of 10% this year)
  - House prices (assume no change)
  - Interest serviceability (rates unchanged)
  - House prices to Share Market (assume equity market out performs by 10%)
- Results are as follows....

# Housing Credit Forecast v Model. Tracking a touch below but accelerating in recent months

## Model Estimates & Growth in Housing Credit (Estimated from 1986)

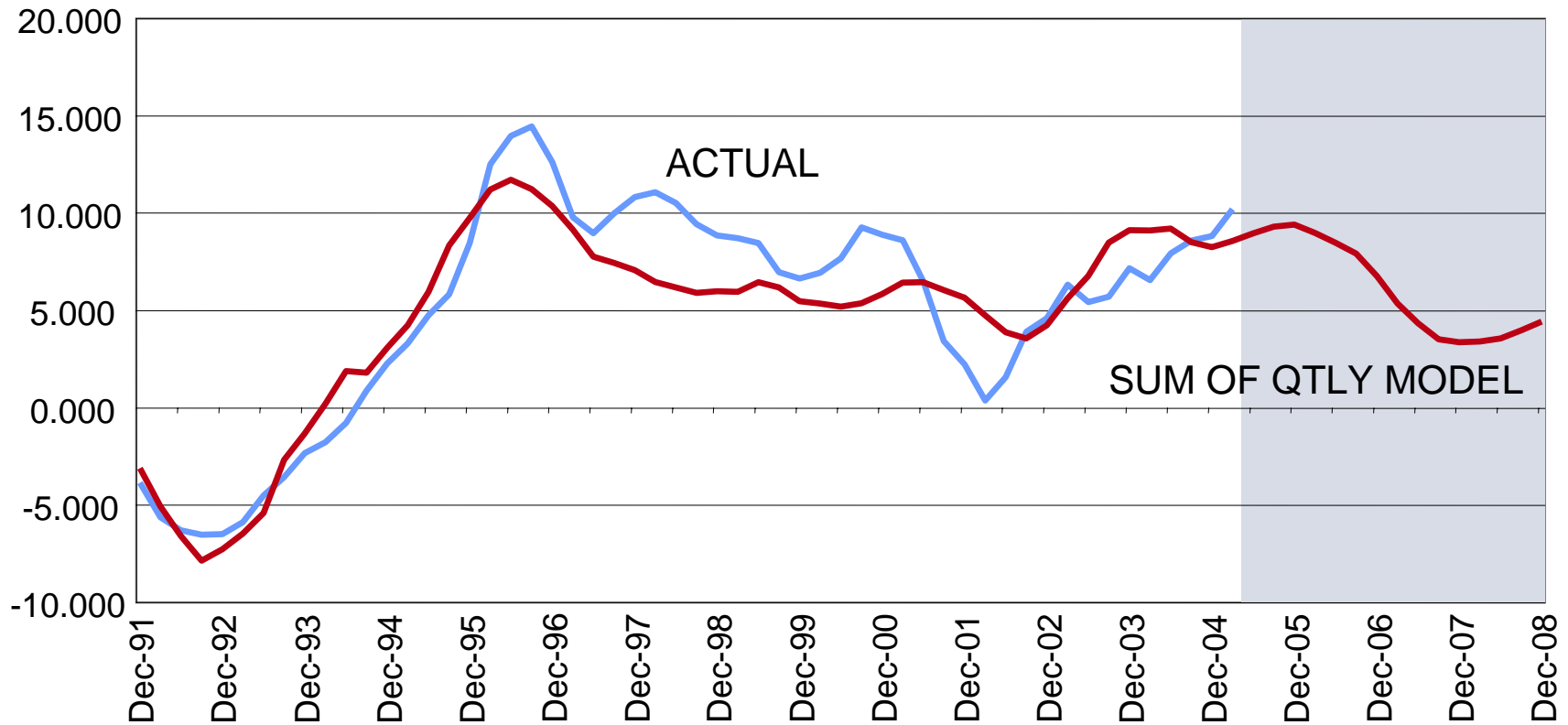


# Business Credit...

- Basically our research points to key drivers of business credit
  - Lagged investment cycle (i.e. what happens to domestic demand and the level of capacity utilisation)
  - And business confidence (lagged around 6 months)
- When we put in our activity forecasts we get the following

# Business Credit Forecasts. At present still tracking a touch above forecasts.

## Sum Of Quarterly Model v Actual 12 Mth Growth in Business Credit



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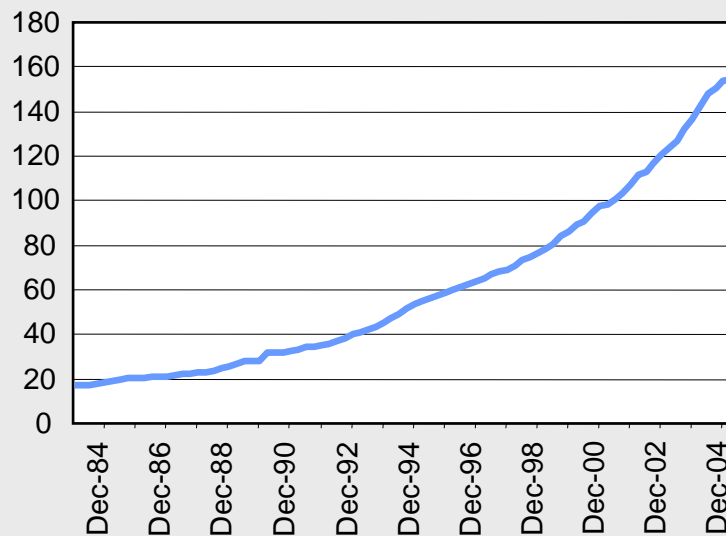


# Household Balance Sheet

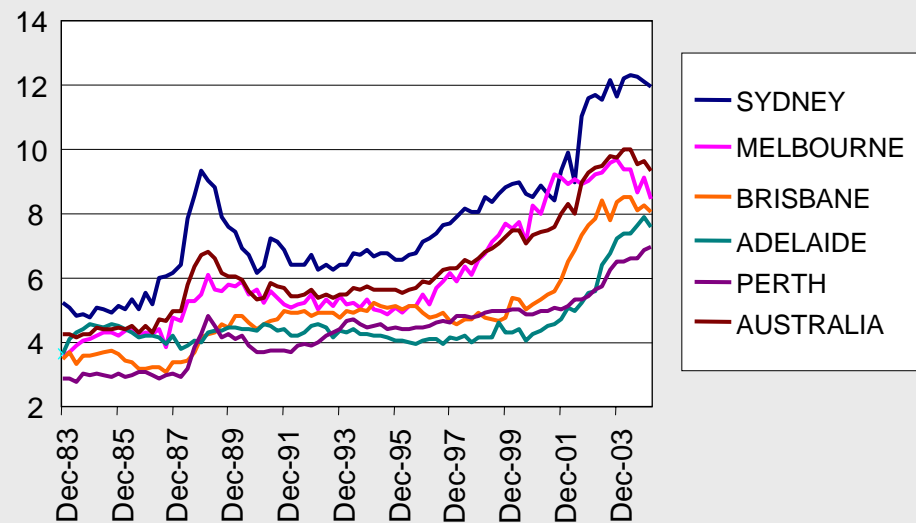
# Household Sector – How stressed.....

- Lots of noise re over gearing and its all going to crash. Typically refer to debt to income or awe to house prices.

### Housing Debt to AWE

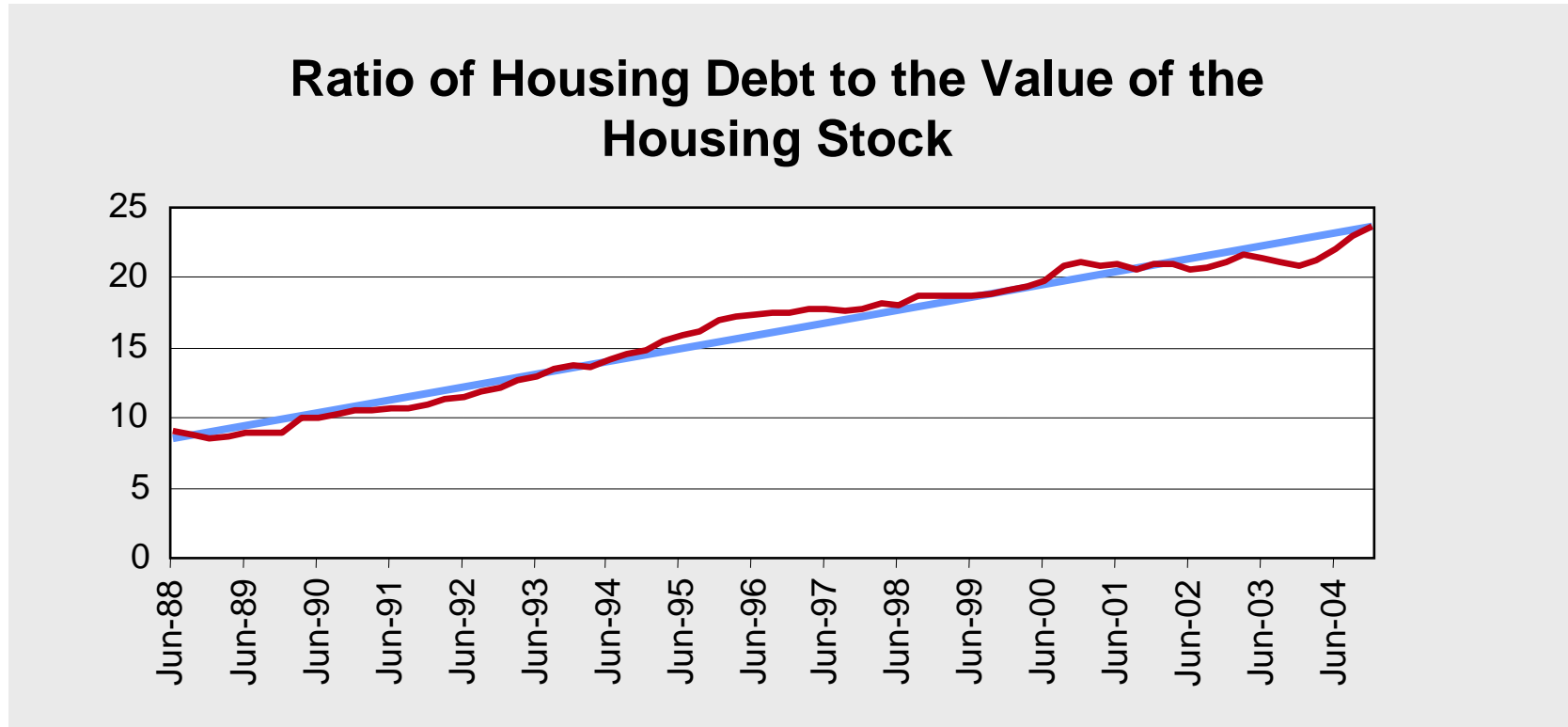


### Australian House Prices to AWE



But these measures misleading – comparing stocks (total debt) to flows (annual income).

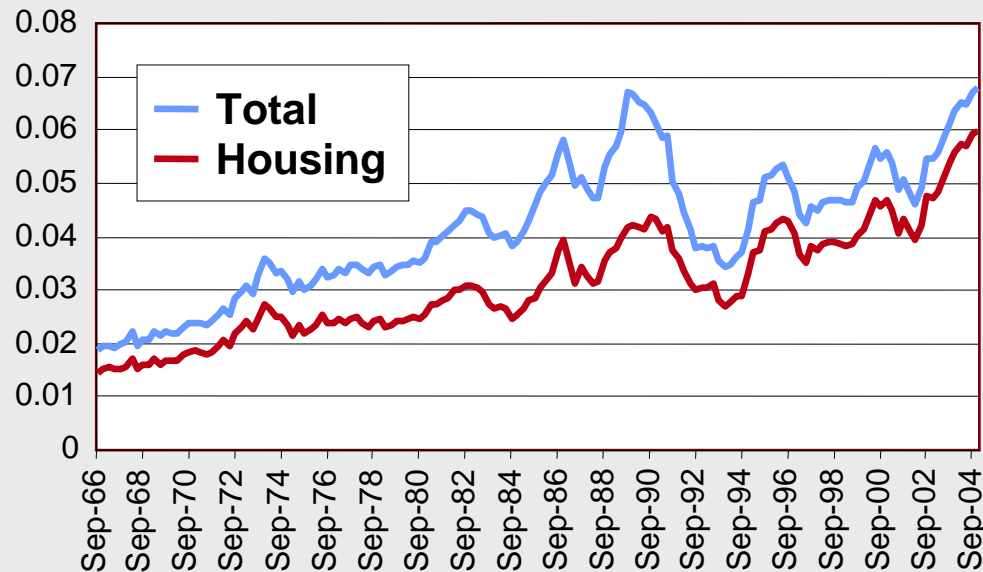
Different story if look at stocks to stocks.



- Yes increasing but nowhere near as dramatic...

## Also flows v flows interesting. Interest paid as % of disposable income

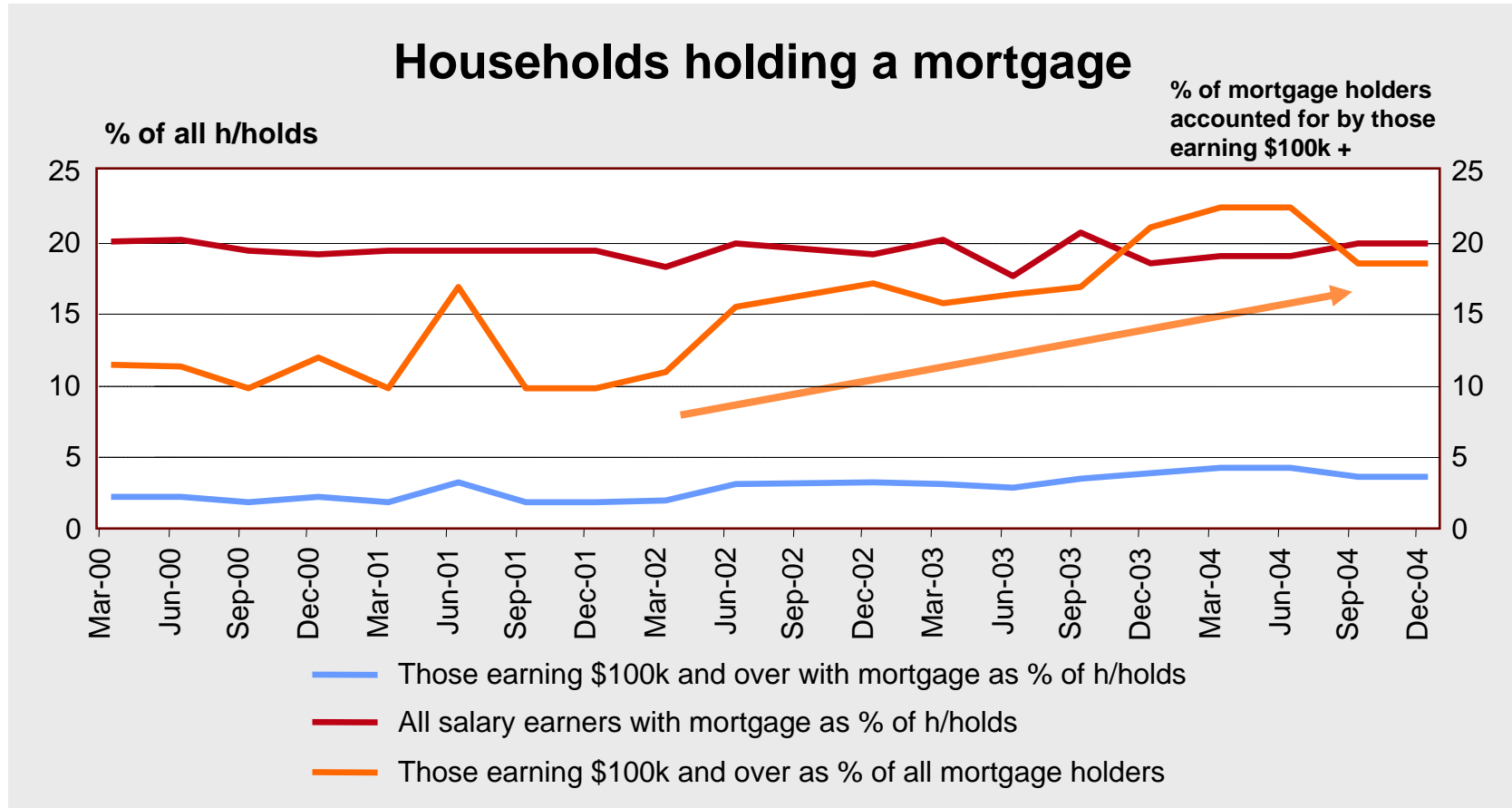
**Interest Paid By Households to Gross Household Income Plus Interest & Depreciation**



### Highlights a few points

- Significant increases reflecting added gearing
- How much more of the debt is against mortgages.
- Impact of higher income earners going into housing in 2000 on "average". That's why the consumer not falling over now.

Can also see signs of top income decile moving into housing in early 2000s (out of equities & super).  
And mainly into investment property...



Source: ING / Melbourne Institute.

## Overall then on Households...

- Not showing signs of stress...
- Be wary of “sensationalist headlines” & “averages” re debt
- But clearly households are much more geared and sensitive to rate movements
- House prices very important both re consumption spending and credit demand. We expect no change HP over next year but no crash....
- We expect further slowing in household spending and lower residential building
- Unemployment a key driver – up marginally but at low levels

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