

# AUSTRALIA & NEW ZEALAND WEEKLY

John Edwards  
Chief Economist

Phone: +612 9255 2744  
[john.k.edwards@hsbc.com.au](mailto:john.k.edwards@hsbc.com.au)

Australia & New Zealand research is  
available online at:-

[www.hsbc.com.au](http://www.hsbc.com.au)

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## In this week's issue

**Australia and the  
Dutch Disease** See page 2

Three decades on, things  
have changed

**Looking on the bright  
side in NZ** See page 4

Recession dodged, and  
formidable deficit drives  
currency down

**Weekly Calendar** See page 6

**Monthly Calendar** See page 8

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# Australia and the Dutch Disease

## Three decades on, things have changed

The trade weighted value of the Australian dollar has appreciated roughly one third in the last five years, and over the same period Australian commodity prices have nearly doubled. That conjunction seems to lend support to the Commonwealth Treasury's recent interest in the Gregory Thesis, in which resource booms crowd out manufacturing and services exports (and perhaps farm exports as well) by raising the exchange rate. So too the wide growth divergence between areas where resources are concentrated and areas where they are not suggests a Gregory effect may be at work. In the year to March, for example, the coal-rich Australian state of Queensland expanded at three times the national GDP growth rate. The volume of business investment in Queensland for the year to March increased by over one third, convincingly ahead of China's business investment growth for roughly the same period. Queensland's growth rate was eight times faster than the biggest industrial state, New South Wales.

If the currency does indeed follow commodity prices, Australia has a policy problem of the first magnitude. As we have pointed out, the mining sector directly accounts for only 4% of output and 1% of employment. The association between rising commodity prices and a rising dollar is however, more apparent than real. The real trade weighted exchange rate certainly appreciated by nearly 30% in the two years to March 2004, but most of that was due to the decline of the US dollar over the same period and the correction of the Australian dollar from its all time low of under USD0.50 at the beginning of the decade. The commodity price boom did not get underway for Australia until the end of 2003. In the two years to the middle of 2006 Australian commodity prices measured in SDR's (an IMF currency basket) nearly doubled. But in March 2006, after those two years of dramatically increasing commodity prices, the real trade weighted exchange rate was actually a little weaker than it had been two years before. The same pattern is true of the nominal trade weighted exchange rate, which peaked in February 2004. Two and half years later it was somewhat lower, despite the increase in commodity prices. Not surprisingly the same pattern is also true of the Australian dollar exchange rate against the US dollar. It was USD0.79 in February 2004, as the commodity price boom got underway. In June 2006 it was USD0.74. In all these measures Australia's exchange rate is lower after the commodity price increase than it was before.

It is 30 years since the ANU's Professor Bob Gregory published his argument that an improvement in Australia's terms of trade would likely crowd out manufacturing. His pioneering work preceded by several years the formalisation of the similar Dutch Disease by another brilliant

Australian economist, Max Corden. In those thirty years capital flows around the world have vastly increased, even compared to the growth of trade in goods and services. In 1976 Australia's current account deficit was a little under 2% of GDP. In 2005 it was close to 6% of GDP. The corresponding net capital inflow had increased to match, and with increasing Australian investment offshore, gross capital flows have increased more than the net flow. In 1980, the earliest data easily calculated, gross foreign liabilities were equivalent to less than 30% Australian GDP. Last year they were equivalent to 130% of GDP. The associated cross border capital flows are more influenced by interest rate differences than by commodity prices, which may be one reason the relationship between commodity prices and the Australian dollar has broken down. (It has also broken down for Canada, South Africa, and Norway and for much the same reasons)

Regional divergence in Australia is certainly real, but it is hard to believe that growth in the resource rich states is at the expense of growth in Victoria and NSW. The residential construction and house price boom began in NSW and then spread to Victoria before moving on the Queensland and the rest of the country. Part of the downturn in NSW and Victoria now is the earlier termination of those booms. Part is also no doubt the stagnation of manufacturing output, which is related both to the persistent pressure of cheaper imports and also to the downturn in household demand growth as the housing boom cools and interest rates increase. But not much of the manufacturing downturn is related to the exchange rate itself. At USD0.74 the Australian dollar is above its post float average of USD0.70 but about where it was on average during the years from 1984 to 1999, when manufacturing exports did very well. The big downturn in manufacturing exports earlier this decade was not due to the exchange rate but to the global economic downturn of 2001-2003. The growth rate of manufacturing exports has since picked up, though it remains below the growth of exports as a whole.

It may be that a commodity boom changes the economy in ways not captured by volume measures. In that case we would surely expect to see it in the nominal measures. In the three years to 2005 the value of exports rose markedly less than value of output (both in nominal dollars) and contributed less than one sixth of the gain to the dollar value of output. Exports of metals, metal ores and minerals, coal and other mineral fuels, grew faster than GDP over the three years, but even so by 2005 they had only returned to the same share on nominal GDP (8%) they had in 2001. The entire increase in the value of exports of those products in the three years accounted for one eighth of the increase in nominal GDP over the period. Even with very large increases in commodity prices over the period, and even looking only at that sector and only in a big upswing, the contribution to the economy as a whole was not overwhelmingly large.

## Looking on the bright side in NZ

### Recession dodged, and formidable deficit drives currency down

At around USD0.61 the New Zealand dollar is nearly 20% off its last year highs, reason enough for the Reserve Bank of New Zealand to maintain its 7.25% cash rate all through this year and into next. But RBNZ Governor Alan Bollard would be very far from being alarmed over the exchange rate. It is after all still above its twenty year average of USD0.58 and at 63 the trade weighted index value is significantly stronger than the twenty year average of 59. Given the whopping first quarter current account deficit of \$4.1 billion that took the whole year number to a formidable 9.3% of GDP, it's surprising the New Zealand dollar didn't fall further. The financing of New Zealand's deficit ultimately depends on the willingness of retail investors in Japan to buy New Zealand dollar denominated financial assets, and the gain they are making on the interest rate premium has long been overwhelmed by the loss on the exchange rate.

With a 0.7% increase in first quarter GDP lifting four quarter growth to 2.2% from under 2% for the year to December, New Zealand has dodged recession. The components of growth, however, would not have delighted the Reserve Bank. Business investment was down, confirming that the decline in the previous quarter was not just a blip. Export volumes were down 2.6%, mainly because of flagging dairy exports and tourism. Household consumption was up 0.8%, and inventory accumulation made a substantial contribution to growth. Government spending was up. Residential construction was flat, and down 5.1% for the four quarters. The increase in GDP came after two flat successive quarters which raised the risk that the Reserve Bank of New Zealand had overdone tightening. We expect growth to slow to under 2% from the 2.2% four quarter rate, and rebalancing towards exports and away from private consumption to become more apparent. The weakness in business investment is troubling. It comes after several years of firm growth, and suggests the current growth slowdown will also circumscribe future potential growth.

The first quarter current account deficit was easily the highest ever and well ahead of the seasonally adjusted \$3.4bn recorded for the December quarter last year. Higher oil prices and higher dividend and interest payments abroad contributed to the increase. At what Statistics NZ calculated as 9.3% of GDP, the NZ current account deficit is keeping company with Iceland and Spain and is now well ahead of Australia and the United States. With net liabilities already around 85% of GDP, New Zealand is testing the limits of global tolerance of current account deficits. The Reserve Bank of New Zealand does not directly or indirectly target the current account, and in any case the effect of monetary policy on the balance of payments is quite ambivalent. But the

yawning deficit will weigh on the New Zealand dollar and consequently on the speed with which inflation can be brought back within the target band. The current account deficit will narrow over 2006 as trend exports pick up and import growth slows but the sagging NZ dollar probably now rules out a rate cut in 2006 - unless demand and output growth slow much more rapidly than we now expect.

The bright side is that the combination of high interest rates bearing down on domestic demand while a cheap dollar encourages exports is exactly the prescription for New Zealand's current circumstances. Australia and the United States will likely move in the same direction.

**John Edwards**

# Weekly Calendar

Week commencing Monday June 26, 2006

Country/ Region	Event or Economic Release		Period	HSBC	Market Fcasts Cons	Range	Actual Previous
<b>Monday June 26, 2006</b>							
US	New home sales (15:00 BST)	Month ('000s)	May	1130	1150	-	1198
<b>Tuesday June 27, 2006</b>							
GER	Ifo business climate (09:00 BST)	Index	Jun	104.7	105.2	-	105.6
		Current conditions		107.6	107.5	-	107.3
		Business expectations		101.8	103.0	-	104.0
US	Consumer confidence (15:00 BST)	Month	Jun	105.0	103.0	-	103.2
US	Existing home sales (15:00 BST)	Month (mn)	May	6.65	6.64	-	6.76
<b>Wednesday June 28, 2006</b>							
JPN	Retail sales (00:50 BST)	Large stores	May prelim	-1.2%	-	-	-0.9%
		Retail Trade		-0.5%	-	-	-0.8%
UK	HSBC consumer index (09:30 BST)	Reported sales	Jun	12%	10%	-	9%
UK	CBI distributive trades report (11:00 BST)	(net balance)	Jun				
<b>Thursday June 29, 2006</b>							
JPN	Industrial production (00:50 BST)	Month	May prelim	0.0%	-	-	1.5%
		Year		5.4%	-	-	3.8%
GER	Unemployment (08:55 BST)	S.A ('000s)	Jun	-41	-33	-	-93
		N.S.A		-120	-	-	-255
EMU	M3 (09:00 BST)	M3	May	8.9%	8.9%	-	8.8%
		Private sector loans		11.5%	-	-	11.3%
UK	Consumer credit & mortgages (09:30 BST)	Consumer credit GBPbn	May	1.1	-	-	0.8
		New mortgages ('000s)		112	-	-	106
NOR	Norges Bank interest rate announcement (13:00 BST)						
US	GDP (13:30 BST)	Quarter	Q1 - final	5.6%	5.6%	-	5.3%
		GDP price index		3.3%	3.3%	-	3.3%
US	Initial jobless claims (13:30 BST)	Week ('000s)	Wk 24 Jun	305	-	-	308
US	FOMC decision (19:15 BST)	Fed funds		5.25%	5.25%	-	5.00%

# Weekly Calendar (continued...)

Week commencing Monday June 26, 2006

Country/ Region	Event or Economic Release	Period	HSBC	Market F'casts Cons	Range	Actual Previous
<b>Friday June 30, 2006</b>						
AU	Private Sector Credit	May	1.1%	1.1%	-	1.3%
JPN	Consumer price index (00:30 BST)	Total month May / Jun	0.1%	-	-	0.1%
JPN	Unemployment (00:30 BST)	Total year Unemployment rate	0.4%	-	-	0.4%
JPN	Unemployment (00:30 BST)	May	4.0%	-	-	15.0%
JPN	All household spending (00:30 BST)	Job offers Nominal	1.05	-	-	1.04
JPN	All household spending (00:30 BST)	Real	-1.1%	-	-	-1.6%
JPN	Housing starts (06:00 BST)	Year	-1.5%	-	-	-2.0%
JPN	Construction orders (06:00 BST)	Year	7.2%	-	-	15.0%
UK	GDP (09:30 BST)	Quarter	3.0%	-	-	0.5%
UK	GDP (09:30 BST)	Q1, final	0.6%	0.6%	-	0.6%
UK	Current account (09:30 BST)	Year Current account (GBPbn)	2.2%	2.2%	-	2.2%
UK	Current account (09:30 BST)	Q1	-12.8	-10.3	-	-11.0
EMU	Confidence indicators (10:00 BST)	Consumer confidence	-8	-8	-	-9
EMU	Confidence indicators (10:00 BST)	Business climate	0.0	-	-	1.0
EMU	CPI (10:00 BST)	Year	2.3%	2.5%	-	2.5%
UK	Gfk Consumer confidence (10:30 BST)	Balance	-3	-4	-	-5
US	Personal income & spending (13:30 BST)	Personal income	0.1%	0.2%	-	0.5%
US	Personal income & spending (13:30 BST)	Personal spending	0.4%	0.4%	-	0.6%
US	Personal income & spending (13:30 BST)	Core PCE deflator				
US	Personal income & spending (13:30 BST)	Month	0.2%	0.2%	-	0.2%
US	Personal income & spending (13:30 BST)	Year	2.1%	2.1%	-	2.1%
US	Michigan sentiment (14:45 BST)	Month	82.5	82.3	-	82.4
US	Michigan sentiment (14:45 BST)	Jun, final				
US	Chicago PMI (15:00 BST)	Month	59.5	59	-	61.5

Source:- Dow Jones, Reuters, Bloomberg

Notes:- p=preliminary, r=revised, n.f.=not forecast, n.s.a.=not seasonally adjusted, ann.=annualised, bn=billion, m=million

# Monthly Economic Calendar

Week commencing June 26, 2006

Monday July 03, 06	Tuesday July 04, 06	Wednesday July 05, 06	Thursday July 06, 06	Friday July 07, 06
AU Retail Sales (May) AU Building Approvals (May) EC PMI Manufacturing (survey) (Jun) UK PMI Manufacturing (survey) (Jun)	AU Reserve Bank July Policy-Setting Meeting US ISM Manufacturing (Jun)	AU RBA Cash Target (Jun) UK Bank of England's Monetary Policy Committee Meets	US Factory Orders (May) UK Industrial Production (May) US Initial Jobless Claims (Jul 2) UK BoE Announces Rates (July 7) EC ECB Announces Interest Rates (Jul)	US ISM Non-Manufacturing (Jun) US Nonfarm Payrolls (Jun)
Monday July 10, 06	Tuesday July 11, 06	Wednesday July 12, 06	Thursday July 13, 06	Friday July 14, 06
AU ANZ Job Advertisements (Jun) JPN Money Supply (Jun) JPN Machine Orders (May) GER Trade Balance (May) GER Current Account (May) GER Exports (May) UK PPI (Jun)	AU National Australia Bank's June Business Survey AU Home Loans (May) AU Investment Lending (May) US Consumer Credit (May) UK BRC June Retail Sales Monitor JPN Consumer Confidence (Jun) JPN Consumer Confidence Households (Jun) UK Visible Trade Balance GBP/Mn (May) UK Trade Balance Non EU25 GBP/Mn (May)	AU Westpac July Consumer Confidence UK Claimant Count Rate (Jun) UK Jobless Claims Change (Jun) UK ILO Unemployment Rate (May) EC Euro-Zone GDP s.a (Q1F) EC European Commission GDP US MBA Mortgage Applications (Jul 8) US Trade Balance (May)	AU Consumer Inflation Expectations for July AU Employment change (Jun) AU Unemployment Rate (Jun) AU Participation Rate (Jun) JPN Current Account Total (May) JPN Trade Balance – BOP Basis (May) JPN BoJ Monetary Policy Meeting JPN Industrial Production JPN Capacity Utilization US Initial Jobless Claims (Jul 9) US Continuing Claims (Jul 2)	AU Trade Balance (May) AU Exports (May) AU Imports (May) JPN BoJ Monetary Policy Announcement JPN BoJ Monthly Report US Import Price Index (Jun) US Retail Sales Less Autos (Jun) US U. of Michigan Confidence (Jul P)
Monday July 17, 06	Tuesday July 18, 06	Wednesday July 19, 06	Thursday July 20, 06	Friday July 21, 06
NZ Consumer Price Index (Q2) US Empire Manufacturing (Jul) US Industrial Production (Jun)	US Producer Price Index (Jun)	NZ Migration (June) US Consumer Price Index (Jun)	US Initial Jobless Claims (Jul 16)	AU International Trade Price (Q2) US Minutes of Jun 29 FOMC Meeting
Monday July 24, 06	Tuesday July 25, 06	Wednesday July 26, 06	Thursday July 27, 06	Friday July 28, 06
AU Producer Price Index (2Q)		AU Consumer Prices (2Q) NZ Trade Balance (Jun) US Existing Home Sales (June) US Richmond Fed Manufact. Index (Jul) JPN Mercnd's Trade Balance Total (Jun) UK CBI July Industrial Trends  26-31 July UK Nationwide House Prices (Jul)	NZ RBNZ Official Cash Rate (Jul 27) US Fed's Beige Book US Durable Goods Orders (Jun) US Initial Jobless Claims (Jul 23)	US New Home Sales (Jun) US GDP Price Index (2Q A) US Personal Consumption (2Q A) US Employment Cost Index (2Q) US U. of Michigan Confidence (Jul F) JPN National Consumer Prices (Jun) JPN Retail Trade (Jun P)

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#### HSBC Bank Australia Limited

HSBC Centre  
580 George Street  
Sydney, NSW 2000  
Australia  
Telephone: +61 2 9006 5888  
Fax: +61 2 9255 2205  
Website: [www.hsbc.com.au](http://www.hsbc.com.au)

#### The Hongkong and Shanghai Banking Corporation Limited

1 Queen Street  
Auckland  
New Zealand  
Telephone: +64 9 308 8888  
Fax: +64 9 918 8699  
Website: [www.markets.hsbc.com](http://www.markets.hsbc.com)