

AUSTRALIA & NEW ZEALAND WEEKLY

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The RBA board meets

Early rate rise can't be ruled out

According to our figuring, the Reserve Bank board meeting Tuesday takes place on the fourth day of the sixteenth year of uninterrupted expansion of the Australian economy. In the fifteen years of expansion since the third quarter of 1991 Australia has experienced a wide range of economic circumstances, from the “jobless recovery” of the early nineties through the slowdown of the mid nineties, the economic collapse of some trading partners during the Asia crisis, the global recession at the beginning of this decade, and then a prolonged drought, a housing boom and housing bust, and today's commodity price boom. The expansion has survived them all. In 1995 Opposition Leader John Howard dismissed the upswing as “five minutes of economic sunshine”. More than a decade later it shows no sign of ending. On the contrary, if the RBA board has a problem to ponder tomorrow, it is that things are a little too good.

The Australian economy itself is expanding a little under the trend of the last fifteen years, because growth has been slow in NSW and Victoria, and export volumes are yet to substantially accelerate. But the rest of the world is very strong indeed. US output increased 3.7% in the four quarters to March, compared to 3.1% in Australia. China expanded over 10% in roughly the same period. Japan, the rest of East Asia, South America, Russia, Eastern Europe, the Middle East and Western Europe have joined in the upswing. The powerful global expansion suggests that Australian commodity prices will stay higher for longer, and that demand for minerals, metals and energy will be robust. That in turn suggests that Australian export volumes will indeed accelerate over the course of this year. It also suggests that the inevitable downturn in business investment, which is now at a half century high as a share of GDP, will be later and milder than previously expected. Beginning this month, income tax cuts will support consumption. The downturn in residential construction, one of the influences constraining growth in the big industrial states, is flattening out. The May 3 25 bp rate increase has evidently had little impact.

Unlike the Reserve Bank of New Zealand the RBA does not go in for measures of potential output, or compute an output gap which might guide policy. It thinks the purported precision of these measures is phoney, and it is right. But RBA Governor Ian Macfarlane has repeatedly said over the last year or so that he thinks the Australian economy is operating very close to capacity. Unemployment was just under 5% in May, employment growth remains been quite firm, and while there is no doubt the investment boom will add substantial capacity in coming years there are certainly output constraints now in coal, iron ore, and farm products. Headline inflation is at

the top of the RBA's target band. Wages growth is a long way from being a problem, but it has crept up. The Australian dollar has decisively broken any link to commodity prices and sits below its level a year ago. These are circumstances in which the RBA will be more than usually wary. Given the strength of the global economy and the depreciation of the Australian dollar another rate increase poses no great risk to growth in exports and investment, while it will help to moderate household consumption and prolong the downturn in building construction. The RBA is not entirely responsible for fifteen years of continuous expansion, but in critical episodes it has made sensible decisions which have allowed the upswing to continue. We think it will wait for the July 26 third quarter CPI, before deciding its next move at the August board meeting. But a rate increase announced Wednesday wouldn't be a bad idea and can't be ruled out.

China boom untroubled by economic theory

Australia, NZ negotiating closer integration

Stock markets the world over may be dubious but visiting there last week for a conference on the proposed free trade agreement between China and Australia, there was no doubt at all on the robustness of China's economic expansion. Though the economic facts are not so very different, the mood among Beijing policy makers today sharply contrasts with the mood two years ago. In the first half of 2004 policy makers were worried that output growth was too fast. They were particularly concerned about the rapid pace of investment in real estate, motor vehicles, steel and cement, especially since most of the investment was by state owned enterprises financed by state owned banks. They were concerned about the leadership's reluctance to open up the capital account and allow a more flexible exchange rate, changes which would permit interest rate changes to influence growth. Two years on the pace of investment growth has slowed from 40% in 2003 and into 2004, but it is still 30%. The currency is more flexible, but the actual movement has been exceedingly small and it remains tightly controlled. Capital movements have been liberalised, but only at the margin. The official interest rate has been increased, but only a little. At 10% overall GDP growth is the same as it was in 2004, the current account surplus has doubled, foreign reserves are much bigger, and while private businesses are now contributing more than they did state owned enterprises and state owned banks continue to play much the same role in overall growth as they did two years ago. This is soberly described by one Chinese policy adviser as a "successful soft landing", which in a strange sort of way it is.

Reform continues, and the direction continues to be along the lines applauded by the World Bank and the IMF, but the pace remains glacially deliberate. What has changed is the evaluation by foreign analysts. This was particularly apparent in the World Bank's most recent quarterly update on economic developments in China. The Bank now argues that there is little evidence of over capacity in Chinese industry, the concerns about investment by state owned enterprises were not highlighted, and "sustained rapid growth" is forecast for several years to come. Importantly, the Bank now argues *against* a punishing slowdown in credit growth or in administrative measures to slow investment, pointing out that major slowdown now is not justified by over-capacity or by inflation, and that it would likely increase the trade surplus by restricting imports and encouraging exports at a time when other countries were already bothered by China's impact on their own manufacturing industry.

This is a sensible adjustment, because China's growth has been untroubled by the predictions of economic theory. The increase in bank liquidity which matches the accumulation of foreign reserves should, for example, have led to an explosive growth of lending and increasing inflation. In fact, lending growth is only now picking up and inflation has fallen. Rapid growth in output should have caused a sharp increase in wages, but while there is some evidence that wages for skilled labour in the coastal areas have increased there hasn't been much change in the going rate for unskilled labour. If a large part of investment by state owned enterprises had been misdirected it ought now to begin to be apparent in substantial overcapacity or falling profits or output exceeding sales growth, and it isn't. As one perceptive analyst of China's economy remarked, conventionally trained economists from the developed world have troubled coming to grips with an economy which is year after year adding roughly one tenth to the output of goods and services and to productive capacity.

The expansion will keep going because while exports are important to China, they are not nearly as important as is commonly thought. It's true exports are roughly 39% of GDP but imports are roughly 36%. Exports are often finally-assembled imports. As another foreign official analyst remarks, China's growth is actually driven by the migration of millions of people from rural to urban life, and by the hundreds of whole new cities, factories, offices, houses, roads and services their migration requires. It depends on domestic demand rather than exports, and on investment by state owned enterprises for the internal market rather than foreign investment for export manufacturing. It depends on domestic saving rather than foreign saving. It will continue as long as urbanisation and industrialisation continues.

Chinese authorities are again responding to the pickup in trend investment, the blowout in the current account surplus and rising real estate prices, but not with major changes. Real estate investment is again discouraged, and commercial bank required reserves have risen. The bank lending rate has been increased, and the exchange rate will certainly continue to appreciate, but China intends a quite slow pace of change. In the year to June China appreciated 3% against the US dollar. The consensus is settling around a steady but persistent 3%, which would take the exchange rate against the US dollar to 7.5 by the June 2008 and 7 in three years. This pace is unlikely to pacify the US.

The high level of bank liquidity remains a risk, as the World Bank points out - but a risk is not quite the same as a problem. So too China's huge current account surpluses attract foreign

criticism, but this year's surplus is likely to be higher than last year's and China will be running surpluses for decades to come.

In the end the difference in view between what China is actually doing and what foreign authorities like the World Bank and the IMF want it to do is mostly a question of pace. The World Bank for example recommends that China liberalise its financial system and have a more flexible exchange rate, improve corporate governance, encourage service sector development and consumption growth, spend more on health and education, address inequalities, and permit increased migration from the country to the city. The central committee of the Chinese Communist party agrees. Editorials in the English language *China Daily* read like World Bank executive summaries. The CCP's 11th Five Year Plan adopted earlier this year adopts most of these goals. There is no dispute over economic direction, but there is over the speed.

While there is some concern about the medium term sustainability of China's growth, there is a good deal more concern about some of the consequences of its style of growth. In a series of important papers World Bank Beijing economist Louis Kuijs has developed a persuasive critique of China's economic development. He began by showing that most of its growth over the last decade (in contrast with the previous decade) is accounted by increased productivity of the workforce, rather than by increased employment. Indeed the rate of growth of employment in China in the last decade has been well under Australia's. Of the growth in labour productivity or output per hour work, more than half is accounted for by increased capital rather than by increased efficiency in using either capital or labour. China's growth is based on more capital rather than more labour. Since the price of capital is well under the global price, it is a story as much about cheap capital as cheap labour. One consequence has been an enormous increase in inequality, because worker productivity is so much higher in manufacturing than in farming. The difference is persistent, because the service sector has lagged behind as a source of employment, and migration from the country to the city has been constrained.

In a subsequent paper looking at the savings investment balance in China, Kuijs found that while household savings were not unusually high for China's stage of development, enterprise and government saving were extremely high. The source of China's unusually high saving rate even compared to its unusually high investment rate is not so much China's households as China's state owned enterprises. This in turn reflects a policy of not paying economic dividends on capital to the government, while government saving reflects a policy of capital injections to industry at the expense of health and education spending. In his most recent paper* Kuijs has asks if the excess of

savings over investment will change. The excess of saving over investment is equal to the current account surplus, which will persist so long as the excess of saving over investment persists. He finds that given existing trends the excess of saving over investment won't seriously narrow. Without very big changes in policy there will be "no significant decline" in the excess of savings over investment and therefore of the matching current account surplus for the next two decades.

The probability of China's current account surplus continuing for many decades to come has powerful implications for China and the rest of the world. Last year the excess of savings over investment and the corresponding current account surplus was 7% of GDP. China's surplus last year matched Japan's, hitherto the biggest in the global economy. If China continues to grow at 8% a year, if the surplus narrows to 4% of GDP but persists, then within a few decades China will be supplying far more capital to the rest of the world than any nation in history. It will be the biggest national economy in the world, and unlike the US today it will still be a net exporter of capital. Since China like the US will increasingly prefer foreign direct investment over holdings of foreign governments bonds, it will by the middle of this century begin to match the US in its direct ownership of foreign business assets.

Chinese policy makers and foreign analysts share plenty of concerns about the balance of growth, the long term distributional, environmental and global consequences of the current style of growth, the slow pace of reform in industrial organization, capital markets and the monetary system. There are plenty of people bothered by corruption, political repression and startling inequality. But no one now seriously questions the sustainability of China's expansion for many years to come. Australia and New Zealand are the only developed economies now negotiating free trade agreements with China, initiatives which are of considerable interest among trade officials in Europe, Japan and North America. What is achieved in those agreements will be the first evidence on whether and how China is prepared to move beyond the World Trade Organisation commitments it made six years ago. Australian goods exports to China increased by 40% in the year to April compared to the previous twelve months, twice the growth rate of export values overall. In just five years the share of Australian goods exports going to China has doubled to 12%, and there is little doubt it will continue to increase in the next few years as natural gas is added to the major commodity exports of iron ore, wool, copper, and bauxite. For New Zealand the China story has been less dramatic, but still influential. The share of New Zealand exports going to China has doubled to 5% since the beginning of the decade, and at 7% in the year to May the rate of growth of exports to China was nearly double the rate of growth of goods exports overall.

Last week's conference registered the slow but perceptible progress towards a useful free trade agreement between Australia and China. At the highest level of Australian government there is a total insistence that whatever is agreed be genuinely helpful – that is, it covers trade in agriculture, services and manufacturing and also covers investment, and that it improves upon the current levels of tariffs and restrictions. Australia is not in a hurry, and there may well be another three years of negotiation. The indications so far suggest that agreement on reducing or eliminating tariffs on manufacturing and on metals and minerals will be difficult but achievable, that any agreement on services trade will be complicated, reluctant and only marginally helpful. On the Chinese side agricultural trade will be hard fought but may be useful. The area of least interest to China is any liberalisation of investment rules. Given the likelihood that China itself will within a few years be the biggest provider of foreign direct investment to the rest of the world, this lack of interest is puzzling.

* *How will China's saving-investment balance evolve?* Kuijs, Louis China Research Working Paper No5 World Bank Beijing Office.

John Edwards

Weekly Calendar

Week commencing Monday July 03, 2006

Country/ Region	Event or Economic Release	Period	HSBC	Market Fcasts		Actual Previous
				Cons	Range	
Monday July 03, 2006						
AU	AU Retail Sales (May)	May	0.8%	1.4%	-	0.8%
AU	AU Building Approvals (May)		1.0%	-3.4%	-	1%
JPN	BoJ Tankan survey (00:50 BST)	Q2				
	<i>Large firms</i>					
	Manufacturers		23	22	-	20
	Non-manufacturers		20	20	-	18
	<i>Small firms</i>					
	Manufacturers		9	-	-	7
	Non-manufacturers		-6	-	-	-9
EMU	PMI manufacturing (09:00 BST)	Index	57.3	57.5	-	57
UK	PMI manufacturing (09:30 BST)	Index	53	52.8	-	53.2
US	Construction spending (15:00 BST)	Month	0.3%	0.2%	-	-0.1%
US	ISM manufacturing (15:00 BST)	Month	57	55	-	54.4
	Prices paid		76	74.5	-	77
Tuesday July 04, 2006						
AU	AU Reserve Bank July Policy-Setting Meeting					
EMU	Unemployment rate (10:00 BST)	Rate	8.0%	8.0%	-	8.0%
EMU	PPI (10:00 BST)	Month	0.3%	0.3%	-	0.8%
		Year	5.9%	6.0%	-	5.4%
Wednesday July 05, 2006						
AU	RBA rate announcement (09:30 Local)					
AU	RBA Cash Rate	July	5.75%	5.75%	-	5.75%
EMU	PMI services (09:00 BST)	Index	59.0	59.0	-	58.7
UK	PMI services (09:30 BST)	Index	58.5	58.9	-	59.2
EMU	Retails sales (10:00 BST)	Month	0.3%	0.2%	-	1.4%
		Year	2.1%	2.1%	-	2.8%
US	Factory orders (15:00 BST)	Month	0.0%	0.0%	-	-1.8%
Thursday July 06, 2006						
UK	Industrial productions (09:30 BST)	Month	0.6%	0.3%	-	-0.6%
		Year	-0.3%	-0.6%	-	-1.0%
GER	Factory orders (11:00 BST)	Month	0.2%	-	-	4.1%
		Year	12.5%	-	-	14.0%
UK	Bank of England rate announcement (12:00 BST)					
EMU	ECB meeting and press conference (12:45 BST)					
US	Jobless claims (13:30 BST)	Week	305	-	-	313
US	ISM non-manufacturing (15:00 BST)	Month	60.0	59.0	-	60.1
US	Pending home sales (15:00 BST)	Month	0.5%	0.0%	-	-3.7%
Friday July 07, 2006						
GER	Industrial production (11:00 BST)	Month	0.7%	0.4%	-	1.6%
		Year	5.5%	4.8%	-	4.8%
US	Non-farm payrolls (13:30 BST)	Non-farm payrolls ('000)	180	168	-	75
		Unemployment	4.6%	4.6%	-	4.6%

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 July 10, 2006

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 Mercnds 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)

Monthly Economic Calendar...(continued)

Week commencing July 10, 2006

Monday July 31, 06	Tuesday August 1, 06	Wednesday August 2, 06	Thursday August 3, 06	Friday August 4, 06
AU TD Securities Inflation (Jul) JPN Industrial Productions (Jun P) UK Net Consumer Credit (Jun) UK Net Lending Sec. on Dwellings (Jun) UK Mortgage Approvals (Jun) EC Euro-Zone Indust. Confidence (Jul) EC Euro-Zone Consumer Confidence (Jul) EC Euro-Zone CPI Estimate (Jul) US Fed's Poole Speaks to Southern Legislative Conference	AU Reserve Bank August Policy-setting meeting AU AiG Performance of Mfg Index (Jul) AU Building Approvals (Jun) UK PMI Manufacturing (survey) (Jul) EC PMI Manufacturing (survey) (Jul) US Chicago Purchasing Manager (Jul) US Personal Income (Jun) US Personal Spending (Jun) US PCE Deflator (Jun)	AU RBA Cash Target (Aug) AU Retail Sales Ex Inflation (2Q) AU Retail Sales (JUN) JPN Monetary Base (Jul) UK Bank of England's Monetary Policy Committee Meets EC Euro-Zone PPI (Jun) US ISM Manufacturing (Jul)	AU AiG Performance of Service Idx (Jul) UK BoE Announces Rates (Aug 4) EC ECB Announces Interest Rates (Aug) EC Euro-zone July Services PMI US Initial Jobless Claims (Jul 30) 3 – 9AUG UK HBOS Plc house prices (Jul)	AU Reserve Bank Quarterly Monetary Policy Statement US Factory Orders (Jun) US ISM Non-Manufacturing (Jul) US Non-farm Payrolls (Jul)

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