

AUSTRALIA & NEW ZEALAND WEEKLY

John Edwards
Chief Economist

Phone: +612 9255 2744
john.k.edwards@hsbc.com.au

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available online at:-

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RBA, RBNZ diverge

Australia will tighten, NZ now doubtful

The case for a 25bp tightening at next week's RBA board meeting is now open and shut. Core inflation in the year to September was running a little over 3%. The third quarter core increase at 0.8% was only slightly less than the 0.9% for the second quarter, and the annualised rate is again over 3%. The headline rate fell, but even so the annual headline rate is 3.9% and the annualised headline rate for the quarter well over 3%. These numbers would not matter if the economy was slowing, but it's not. Dwelling construction has bottomed out and will be rising next year, exports are beginning to pick up, and household consumption will be sustained by strong jobs growth and rising incomes. Business investment will be slowing, but not enough to offset to growth of other components of demand. We think the global economy will be sufficiently robust next year to support Australia's expansion, and more importantly RBA Governor Glen Stevens thinks so too. At 6% today's cash rate is solid but far from punitive, and this is evident in the growth of mortgage lending and other credit in the last six months. Given that Mr. Stevens said recently that tackling higher inflation is his first priority, it would now be astonishing if an increase was not agreed November 7 for announcement November 8.

We are very reluctant, however, to join the clamour for more increases next year. The RBA does not know at this point if any further increase will be required. Headline inflation in quarterly terms will fall again this quarter, perhaps quite a lot. We will probably see some moderation in the core rate. Surveys of business investment plans show a marked decline in capital spending next year, and the last two quarters have shown only very modest increases. The somewhat higher cash rate will slow consumer spending increases, and the threat of more rate increases may well discourage Treasurer Peter Costello from offering another big round of tax cuts in the May budget. There are plenty of reasons to think 6.25% may be the top in cash.

RBNZ Governor Alan Bollard's decision to leave the cash rate unchanged at 7.25% surprised us last week. He is evidently more convinced that NZ domestic demand growth is fading than we are. There was much in his statement that might have rationalised a rate increase. He rightly deprecated the relevance of the fall in the headline rate in the September quarter consumer price index, and also the relevance of the further headline fall expected for the current quarter. He noted that the housing market was stronger than he would wish, with house prices still quite firm and the decline in housing construction bottoming out. He reiterated that a further tightening might have to be considered. The key message, however, was that inflation pressures in NZ were abating. This is a new thought. There was some sign it may be so in the quarterly weighted median of the consumer price index for the September

quarter, which rose only 0.4% - half the increase of the equivalent Australian measure. The RBNZ does not seem to attach any significance to this core measure, however, and it was not referred to by Dr Bollard. He instead instanced the decline in domestic demand evident in the second quarter. Our conviction that Dr Bollard would increase cash 25bp was not based on a view that the NZ economy requires the increase. It was based on the view that only a rate rise would reconcile the sharp fall in domestic demand required by the RBNZ economic projections with what we think is actually happening in the NZ economy. At the beginning of this year Dr Bollard declared the tightening episode over, in the September 14 Monetary Policy Statement he warned that he was no longer confident he would not need to tighten again, and last week we learned that inflation pressures were abating. We aren't confident that we will see the continued decline in domestic demand called for in the RBNZ projections, and accordingly we aren't sure that 7.25% is indeed the top. But we are confident that if there is a rate increase it will be very reluctant indeed and we are no longer expecting one. By the December 7 MPS the trajectory of the NZ economy will be clearer. Meanwhile Dr Bollard would have been well pleased with the September merchandise trade numbers out Friday. Export values were up 20% compared to the previous September, imports 3%.

IMF easy on Australian current account

Real issues ignored

As last week's staff report by the IMF usefully shows, over the last few years business investment in Australia has been markedly higher as a share of GDP than in the UK, the US, Germany or Japan. In real terms it is also higher than Australia's own experience over the last half century. Exports by contrast have been quite weak. Though widely believed to be in a mining boom, Australia has actually been experiencing an investment boom. The critical question for 2007 is whether the growth of exports will be sufficiently strong to make up for the inevitable fall in investment growth.

Where the IMF staff report is less convincing is in its analysis of Australian current account and external liabilities. It rightly makes the point that the expansion of Australia's current account deficit is the consequence of higher investment rather than lower saving. Australian gross saving has been roughly 20% of GDP for the last decade – a markedly higher share than the UK or the US, and not very much less than Germany or France. It also makes the point that foreign liabilities will not indefinitely grow faster than GDP (and the means to service them) if the current account deficit does not continue to grow faster than GDP. But the report does not mention a key implication. This is that Australia must run a persistent trade surplus if it wants to slow the rate of growth of foreign liabilities to the rate of growth of GDP. The IMF projects that in five years time Australian foreign liabilities will be 70% of GDP. If the average rate of return on those liabilities is 6%, this implies a net income deficit of 4.2% of GDP. The net income deficit is of course a component of the current account deficit, and these days the biggest component. If nominal GDP is increasing at 5% in five years time a current account deficit of 4.2% of GDP would still see external liabilities still rising a little faster than GDP. The critical size of the current account deficit would be a little under 4%. That deficit could only be achieved by running a surplus on the trade balance, which is the other component of the current account balance. The trade deficit is presently around 2% of GDP. Australia has not run a persistent trade surplus for many decades. The IMF does not identify this issue and consequently has no advice to offer on how Australia might shift around 3% of GDP into exports, or how the corresponding increase in saving or decrease in investment might occur. The assumption no doubt is that the exchange rate will take care of it, but we now know that the counterpart of the easy toleration of large current account imbalances in the global economy is that exchange rates no longer move to reduce them. Australians need to decide the optimal level of foreign liabilities; the global economy won't decide for them.

The IMF also squibs on the issue of financing the current account deficit. It notes that most of the deficit is now financed by relatively short term offshore borrowing by Australian banks. They hedge their offshore liabilities into Australian dollar liabilities, minimising the exchange rate mismatch on their balance sheet. No issues there. But the staff report does not go on to canvas the more delicate issue, which is that from the point of view of ratings agencies (which Moody's at least has publicly acknowledged) and probably from the point of view of lenders, the debt of the major Australian banks has a sort of quasi government guarantee. As a result Australia may be running a larger current account and financing it in cheaper but more vulnerable ways than it would if the risks were properly priced.

John Edwards

Weekly Calendar

Week commencing Monday October 30, 2006

Country/ Region	Event or Economic Release	Period	HSBC	Market F'casts Cons	Range	Actual Previous	
Monday October 30, 2006							
NZ	Building Permits	Sep	1.0%	-	-	3.6%	
NZ	NBNZ Business Confidence		-	-	-	-28.9	
UK	Consumer credit & mortgages (09:30 BST)	Consumer credit (GBPbn)	Sep	0.7	0.8	-	0.8
		New mortgages ('000s)	Sep	119.0	119.5	-	119.0
US	Personal income and spending (13:30 BST)	Personal income	Sep	0.3%	0.3%	-	0.3%
		Personal spending	Sep	0.2%	0.3%	-	0.1%
		Core PCE deflator					
		Month	Sep	0.2%	0.2%	-	0.2%
		Year	Sep	2.4%	2.4%	-	2.5%
JN	Industrial production (23:50 BST)	Month	Sep	-0.7%	-0.8%	-	1.9%
		Year	Sep	5.0%	4.8%	-	6.0%
Tuesday October 31, 2006							
AU	Private Sector Credit	Sep	1.0%	1.0%	-	0.9%	
AU	Housing Industry Association New Home Sales	Sep					
UK	Gfk consumer confidence (10:30 BST)	Balance	Oct	-6	-7	-	-7
UK	CBI distributive trades report (11:00 BST)	% net balance Reported sales	Oct	+12	+13	-	+14
US	Employment cost index (13:30 BST)	% Qtr ECI	Q3	1.0%	0.9%	-	0.9%
		Wages & salaries	Q3	0.9%	-	-	0.9%
		Benefits	Q3	1.1%	-	-	0.8%
US	Consumer confidence (15:00 BST)	Month	Oct	108.0	107.8	-	104.5
US	Chicago PMI (15:00 BST)	Month	Oct	57.0	58.0	-	62.1
JN	Overall household spending (23:30 BST)	Year – nominal	Sep	-1.5%	-	-	-3.3%
		Year – Real	Sep	-2.1%	-2.1%	-	-4.3%
JN	Housing starts (05:00 BST)	Year	Sep	2.0%	-	-	1.8%
JN	BoJ rate announcement		Oct				
JN	Unemployment (23:30 BST)	Unemployment rate, sa	Sep	4.1%	4.1%	-	4.1%
		Offer to applicants ratio, sa	Sep	1.09	1.09	-	1.08
EM	CPI (flash estimate) (10:00 BST)	Year	Oct	1.7%	1.7%	-	1.7%
Wednesday November 1, 2006							
AU	Building Approvals	Sep	2.0%	2.2%	-	-12.6%	
AU	AiG Performance of Mfg Index	Oct					
UK	PMI manufacturing (09:30 BST)	Index	Oct	53.5	54.0	-	54.4
US	Construction spending (15:00 BST)	Month	Sep	-0.3%	0.1%	-	0.3%
US	ISM manufacturing (15:00 BST)	Month	Oct	52.0	53.1	-	52.9
		Prices paid	Oct	58.0	58.0	-	61.0
US	Pending home sales (15:00 BST)	Month	Sep	-1.0%	-0.9%	-	4.3%
NW	Norges Bank rate announcement (13:00 BST)		Nov				

Thursday November 2, 2006

AU	Treasury Secretary Ken Henry speaks Melbourne						
AU	Trade Balance		Sep	zero	-\$200m	-	-\$208m
AU	Retail Sales		Sep	0.8%	0.5%	-	0.3%
US	Non-farm productivity (13:30 BST)	% Qtr Ann	Q3	0.4%	1.5%	-	1.6%
		Nonfarm productivity	prelim				
		Unit labour costs	Q3	2.1%	3.4%	-	4.9%
			prelim				
US	Jobless claims (13:30 BST)	Week ('000s)	Oct	310	-	-	308
			wk 28				
US	Factory orders (15:00 BST)	Month	Sep	2.9%	1.2%	-	0.0%
EM	PMI manufacturing (09:00 BST)	Index	Oct	56.9	56.7	-	56.6
EM	ECB meeting and press conference (12:45 BST)		Nov				

Friday November 3, 2006

AU	AiG Performance of Service Idx		Oct				
UK	PMI services (09:30 BST)	Index	Oct	56.7	56.7	-	57.0
US	Non-farm payrolls (13:30 BST)	Nonfarm payrolls	Oct	140k	125k	-	51k
		Unemployment rate	Oct	4.6%	4.6%	-	4.6%
		Month	Oct	0.3%	0.3%	-	0.2%
		Year	Oct	3.8%	-	-	4.0%
EM	Retail sales (10:00 BST)	Month	Sep	-0.3%	-0.4%	-	0.7%
		Year	Sep	2.1%	2.2%	-	2.4%

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 November 6, 2006

Monday November 6, 06	Tuesday November 7, 06	Wednesday November 8, 06	Thursday November 9, 06	Friday November 10, 06
AU TD Securities Inflation (OCT) AU ANZ Job Advertisements (OCT) NZ Labor Cost Private Sector (3Q) UK HBOS Plc house prices (OCT) UK Industrial Production (SEP) EC Euro-Zone PPI (SEP)	AU Reserve Bank November Policy-Setting Meeting UK Land Registry House Price (3Q) UK BRC October Retail Sales Monitor	AU RBA Cash Target (NOV) AU AiG Perf of Construction Index (OCT) AU Home Loans (SEP) AU Investment Lending (SEP) UK Bank of England's Monetary Policy Committee Meets UK BRC October Shop Price Index US Consumer Credit (SEP) US ABC Consumer Confidence (NOV 6) US MBA Mortgage Applications (NOV 4)	AU Employment Change (OCT) NZ Unemployment Rate (3Q) UK BOE Announces Rates (NOV 10) JN Machine Tool Orders (OCT P) EC ECB Publishes Nov Monthly Report	US Trade Balance (SEP) US Import Price Index (OCT) US Initial Jobless Claims (NOV 5) US Continuing Claims (OCT 29) US U. of Michigan Confidence (NOV P) JN Machine Orders (SEP) EC ECB's Stark, Noyer, Others Speak at Conference on Monetarism
Monday November 13, 06	Tuesday November 14, 06	Wednesday November 15, 06	Thursday November 16, 06	Friday November 17, 06
AU Reserve Bank Quarterly Monetary Policy Statement NZ ANZ Job Vacancies (3Q) UK PPI (OCT) JN Domestic CGPI (OCT) JN Export Price Index (OCT) JN Import Price Index (OCT) JN Current Account Total (SEP) JN Industrial Production (SEP F) JN Capacity Utilization (SEP F) JN Consumer Confidence (OCT)	NZ Producer Prices - (3Q) UK CPI (OCT) JN Gross Domestic Product (3Q P) EC Euro-Zone GDP (3Q A) EC ZEW Survey (Econ. Sentiment) (NOV)	AU Westpac November Consumer Confidence AU Wage Price Index (3Q) AU Australia House Price (3Q) NZ Retail Sales (SEP) US Producer Price Index (OCT) US Advance Retail Sales (OCT) US Business Inventories (SEP) US Fed's Poole Speaks to CFA Society in Wilmington, Delaware US Minutes of Oct. 24 FOMC Meeting US ABC Consumer Confidence (NOV 13) US MBA Mortgage Applications (NOV 11) JN BoJ Monetary Policy Meeting	AU Australia's November Consumer Inflation Expectations UK RICS House Price Balance (OCT) UK Retail Sales (OCT) US Empire Manufacturing (NOV) JN BOJ Target Rate (Nov 16) JN Machine Tool Orders (OCT F) EC Euro-Zone CPI (OCT)	US Consumer Price Index (OCT) US Initial Jobless Claims (NOV 12) US Continuing Claims (NOV 5) US Industrial Production (OCT) US Capacity Utilization (OCT) US Fed's Poole Speaks at Cato Institute Monetary Conference US Philadelphia Fed. (NOV) US NAHB Housing Market Index (NOV) EC Euro-Zone Ind. Prod (SEP)

Weekly Calendar (continued)

Week commencing Monday November 6, 2006

Monday November 20, 06	Tuesday November 21, 06	Wednesday November 22, 06	Thursday November 23, 06	Friday November 24, 06
	AU New Motor Vehicle Sales (OCT) NZ Visitor Arrivals (OCT) UK U.K. CBI November Industrial Trends Survey US Fed's Fisher Speaks in Berlin on German Economy's Prospects JN BoJ Monetary Policy Meeting Minutes for October	AU DEWR Skilled Vacancies (NOV) AU Westpac MI September Leading Index UK Bank of England Minutes US Fed's Lacker Speaks to Richmond Economists' Group JN Merchnds Trade Balance Total (OCT) EC Industrial New Orders SA (SEP)	UK Total Business Investment (3Q P) US Initial Jobless Claims (NOV 19) US U. of Michigan Confidence (NOV F) EC ECB Euro-Zone Current Account (SEP)	NZ Trade Balance (OCT) UK GDP (3Q P)
Monday November 27, 06	Tuesday November 28, 06	Wednesday November 29, 06	Thursday November 30, 06	Friday December 1, 06
AU Housing Industry Association New Home Sales (OCT) NZ NBNZ Business Confidence (NOV) UK Nat'wide House prices sa (NOV)	JN Retail Trade SA (OCT)	AU Trade Balance (OCT) NZ Building Permits (OCT) US ABC Consumer Confidence (NOV 27) UK Mortgage Approvals (OCT) US MBA Mortgage Applications (NOV 25) US Durable Goods Orders (OCT) US Consumer Confidence (NOV) US Existing Home Sales (OCT) US Richmond Fed Manufact. Index (NOV) US S&P/ CaseShiller Home Price (SEP) JN Industrial Production (OCT P)	AU Retail Sales (OCT) AU Private Sector Credit (OCT) AU Private Capital Expenditure (3Q) US New Home Sales (OCT) US Fed's Beige Book JN Housing Starts (OCT) EC Euro-Zone Indust. Confidence (NOV) EC Euro-Zone CPI Estimate (NOV)	AU AiG Performance of Mfg Index (NOV) UK PMI Manufacturing (survey) (NOV) US Personal Income (OCT) US Personal Spending (OCT) US PCE Core (OCT) US Initial Jobless Claims (NOV 26) US Continuing Claims (NOV 19) US Chicago Purchasing Manager (NOV) JN Jobless Rate (OCT) EC PMI Manufacturing (survey) (NOV)

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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

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