

AUSTRALIAN ECONOMIC UPDATE



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Australian Economic Update

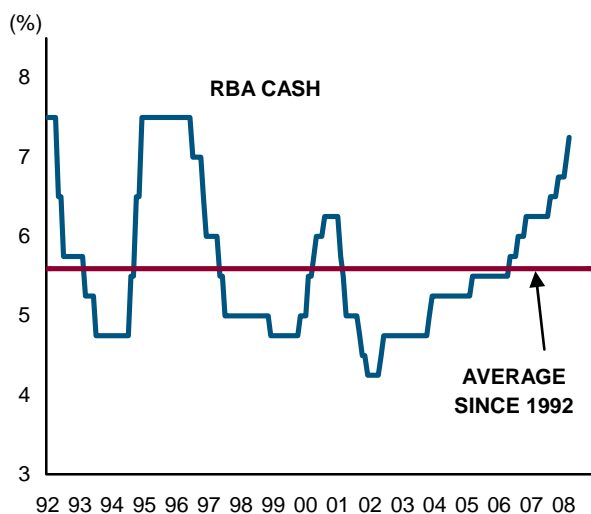
Consumer Confidence Cracks as RBA's Rate Tightenings Hit Home

Has Australia's monetary tightening cycle peaked?

As widely expected, the Reserve Bank of Australia (RBA) increased rates after its policy meeting earlier this month. The official cash rate has now risen by 100 basis points since the latest, and most aggressive, phase of this tightening cycle began in August last year (**Display 1**).

At 7.25%, the cash rate is at its highest level in more than a decade. Australia's major banks duly passed the latest rise on to households and businesses, adding another 10 to 15 basis points to cover recent increases in their funding costs. With standard variable mortgage rates approaching 9.5%, and with nonbank lenders experiencing funding difficulties, there is no doubt that, in the words of the RBA, a "substantial" tightening in financial conditions has occurred.

Display 1: Cash Rate Is Highest in a Decade RBA Cash Target Rate



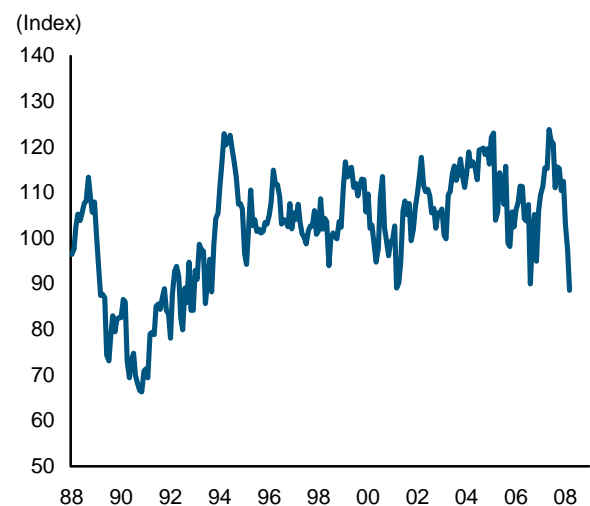
Source: Reserve Bank of Australia

Consumer Sentiment Plummets

The monetary policy action was again accompanied by hawkish rhetoric, leaving few in doubt that the RBA wants the economy to slow significantly. Judging by the latest consumer confidence readings, that message has filtered through to households.

Consumer sentiment fell 9% in March, taking the series¹ to the lowest level since 1993, when unemployment was above 10% and the economy was crawling out of the early 1990s recession (**Display 2**). Over the last three months sentiment has dropped by 21%, marking the largest three-month decline since the survey's inception in 1974. Consumer confidence has not always been a reliable guide to spending trends. But in our view, the latest moves are too large to be ignored and we expect to see a pronounced slowing in consumer spending in the coming months. The index's current level is consistent with consumption growth of around 2%—well below the 5% recorded year over year to fourth-quarter 2007.

Display 2: Consumer Sentiment Plunges Consumer Confidence



Source: Datastream

¹ The Westpac-Melbourne Institute Index of Consumer Sentiment

The sub-indices within the sentiment index reinforce this point. The degree of pessimism in responses to the question, “Is this a good time to buy a household item?” plumbs recession-like depths. Sentiment towards housing has also plunged, to levels comparable with late 2003 when Australia’s (relatively short-lived) house-price correction began. Against that backdrop, it is not surprising that auction activity in housing markets in recent weeks has become more subdued.

Watch the Leads and Lags

Not all the data point in the same direction. Employment growth was again very strong in February, and the unemployment rate (**Display 3**) dropped to its lowest in more than 30 years at 4.0%. The economic backdrop, then, continues to appear sound. In part, however, this reflects inevitable lags between economic developments and business decisions. Given strong growth through 2007, robust labour market figures come as no surprise. But as economic activity slows through 2008, we should expect to see weaker readings on this front, too. There are already tentative signs of such weakness as advertised job vacancies have softened since the turn of the year.

The RBA, too, is aware of these lags. With policy settings now substantially tighter, and with

mounting evidence that they are biting, we believe the RBA should be content to sit on its hands. In our view, 7.25% should represent the peak in cash rates in this cycle.

Display 3: Unemployment Continues to Fall Unemployment Rate



Source: Australian Bureau of Statistics

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