

ANZ Economic Outlook

Inside

International outlook

- Global economic growth has accelerated swiftly since the middle of last year, and is expected to average 4½% in 2004 – the best outcome since 2000. The persistence of large current account imbalances among the world's major economic regions does pose some risks to the outlook for 2005. *page 2*

Asian outlook

- While a number of countries were badly affected in the first half of 2003 by SARS and weakness in export demand, a significant strengthening in growth was evident in the second half of the year. Providing the global economy performs as expected, the region should perform more strongly in 2004. *page 8*

Australian outlook

- The domestic economy has started 2004 with some momentum behind it, although GDP growth is expected to slow in the second half of the year as higher interest rates take effect. Despite stronger world growth and a near record grain harvest, exporters are under pressure from the strong A\$. *page 12*

New Zealand outlook

- Ongoing strength in the domestic economy creates some upside risks to growth during the first half of 2004. Weaker export incomes, higher interest rates and slowing population growth are expected to increasingly undermine domestic growth during the second half of 2004 and into 2005. *page 16*

Financial markets

- The RBA is expected to move further on the monetary policy front to lift the cash rate into the neutral zone. A cash rate of around 5½% is expected in the months ahead. While the US\$ now looks much closer to what could be regarded as fair value in a historical sense, further depreciation is forecast. *page 19*

State economic outlook

- There are many challenges facing Australian States, including the higher A\$, ongoing drought in some regions and the prospective downturn in the national dwelling cycle. Nevertheless, the impact of stronger global demand should see growth in most States pick up this year. *page 23*

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Gross Domestic Product

% ch	2001	2002	2003(e)	2004(f)	2005(f)
North America	0.6	2.2	3	4¼	3¼
Western Europe	1.7	1.1	¾	2	2½
Japan	0.4	-0.3	2¼	2½	2
Australia	2.6	3.6	2¾	4	3¼
New Zealand	2.5	4.4	3½	2¾	2¼
China	7.3	8.0	9	8½	7½
Other East Asia	2.0	4.6	4	5½	5
South Asia	5.0	4.3	7	6¼	6
South America	0.8	-0.9	1¼	3¾	3¾
E.Europe & Russia	4.0	3.5	5	4¼	3¾
World	2.2	2.7	3½	4½	4

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Asian outlook

Growth momentum building across Asia

The past year has seen patchy economic growth, with a number of countries badly affected in the first half of 2003 by SARS and continued weakness in export demand, particularly for electronics goods. However, by the second half, a significant strengthening in growth was evident, and providing the global economy performs as expected, the region should perform more strongly in 2004. In particular, South Korea, Taiwan, Hong Kong, Singapore and Malaysia are expected to turn in much stronger growth this year. In contrast, China, which provided the growth backbone in 2003 but which is facing supply bottlenecks and rising inflation, is taking steps to cool domestic demand, and should see moderately slower growth this year.

Economic growth in Asia

% ch.	2003 (e)	2004 (f)	2005 (f)
China	9.1	8½	7½
Hong Kong	2.5	4	3
Indonesia	4.0	4½	4¾
Malaysia	5.0	6¼	6
Philippines	4.5	4	4
Singapore	0.8	5¾	4¾
South Korea	2.9	6	5½
Taiwan	2.8	4¾	3
Thailand	6.3	7	6
Vietnam	7.2	7½	7
East Asia*	7.3	7.5	6.6
(ex China)	3.9	5.4	4.9

* weighted GDP at PPP exchange rates

Democracy on show in Asia

The practice and institutions of democracy vary enormously across the east Asian region. In some countries the institutions are well established, in some they are still evolving, in others virtually non-existent. In some countries there is vigorous popular participation, both through the ballot box and in the streets, while in others the processes are orchestrated by dominant political parties. This year will see an unusual coincidence of elections in a number of countries, and there could be some changes in leadership.

- In Indonesia, elections for the legislature will be held on 5 April and the first round of the country's first-ever direct presidential election is scheduled for 5 July with a run-off, if necessary, in September. The period ahead of the presidential election is likely to be characterised by political manoeuvring and strategic alliance-building, as the country treads new ground in selecting its leader.

- There was a smooth leadership handover in Malaysia at end-October 2003 when Abdullah Ahmad Badawi succeeded Dr Mahathir Mohamad as prime minister. He is expected to seek to consolidate his political authority by calling a general election within a few months.
- Hong Kong is due to hold Legislative Council elections in September, which could provide a further test for the chief executive, Tung Chee-hwa, after his support group, the Democratic Alliance for Betterment of Hong Kong, lost ground at council elections last November.
- The Philippines will hold elections in May for the presidency, the House of Representatives and half the Senate. The president is elected for a single six-year term, but as the incumbent, President Gloria Arroyo, was elected Vice-President in 1998 and took over mid-term, she is eligible to run this year. Four other candidates will be contesting the presidency.
- In South Korea, parliamentary elections are due in April 2004. Whatever the outcome, there is likely to be a difficult working relationship with President Roh, whose term in office is due to end in February 2008, and whose leadership has been undermined by a series of political scandals and diminished support base.
- Of all the elections to be held, most tension will surround Taiwan's presidential election to be held on 10 March, and the referendum on the same day. The issue of independence for Taiwan is seen as a vote-winner, but China has indicated disapproval of any discussion on the matter. As the campaign proceeds, there is a risk that antagonism across the straits could intensify.

China starts to apply the brakes

China's economy expanded by 9.9% in the final quarter of 2003 with full-year growth reaching 9.1%, the strongest since 1996. Strong demand is exposing supply constraints in sectors such as power, transport, coal and grains. In recent years, demand has been boosted by public spending and foreign investment. In 2003, these drivers were supplemented by a rapid expansion of domestic credit. The authorities initial response, in July, was to tighten the rules on lending for apartments, which were escalating in price. More recently, in September, the bank reserve requirement was raised from 6% to 7% to restrict credit generally. Extra-budgetary public spending, which has been used in the past four years to boost demand, is likely to be scaled down in 2004.

Inflation has risen to reach 3.2% in December, but the CPI in China is not a good gauge of overheating. With the prices of many goods and services fixed by the state, excess demand may be reflected in shortages rather than rising prices. Manufacturers with excess capacity and facing rising input costs may be unable to raise their product prices, and forced to take the impact on their profits.

A strong rise in imports is both a symptom of, and a safety valve for, overheating. China's imports rose 40% in 2003, while exports grew 35%. Imports from the rest of Asia were particularly strong, providing a boost to the region.

Despite strong economic growth and its large trade surplus with the US, the authorities will continue to resist pressures for a revaluation of the renminbi. However, the prospect of a currency regime change, such as broader trading bands or pegging to a currency basket, is growing.

Rebound in Hong Kong – but deflation persists

The economy has rebounded strongly after the severe SARS-induced dip in April and May, and growth for the full year is expected to have been around 2½%. Business and consumer sentiment have been boosted by the free trade agreement with China, effective from January 2004, and the sharp rise in share prices (which rose 50% between the low in April 2003 and end-December), and significantly stronger growth is expected this year. The unemployment rate reached 8.7% over the three months to July - the highest level in 30 years. It has subsequently eased to 7.3%, measured over the three months to December.

The collapse in demand during the SARS epidemic triggered aggressive discounting and pushed the CPI down sharply in May, June and July. There has been a minor recovery in prices since then, in line with a rebound in retail sales volume which was up 5.2% over the year to November. Nevertheless, annual inflation is still negative at -1.9% over the 12 months to December.

Brighter prospects for Singapore

Advance estimates indicate that the Singapore economy expanded by a slower-than-expected 3.7% over the year to Q4 2003. This brought growth for 2003 to 0.8%, the slowest among the East Asian economies. Nevertheless, economic activity in the second half of 2003 recovered strongly after the steep SARS-induced decline and sluggish external demand in the first half.

Brighter global economic prospects are expected to lift the manufacturing and services sectors in 2004.

After three years of weak economic growth, real GDP is forecast to rebound to around 5¾% in 2004. Average annual inflation is likely to edge up in 2004 to around 1% from an estimated 0.5% in 2003, partly reflecting a one-percentage point increase in the GST to 5% from 1 January.

Singapore was able to draw a respectable level of investment in 2003 despite a lacklustre global economic environment with S\$7.5bn worth of net investment commitments in manufacturing (the bulk of which constitutes foreign commitments), just S\$500mn short of the 2003 target. This underscores the country's pro-business climate, well-established infrastructure, domestic political stability and benefits related to a series of bilateral free trade agreements, with the latest to come into force being the US-Singapore free trade agreement on 1 January. The challenge remains to maintain a conducive and competitive business environment to sustain these levels of investment, which underpin manufacturing activity, in the face of intense competition from China and Malaysia.

Taiwan's recovery driven by exports ...

After slumping in the SARS-affected second quarter, the economy is recovering and is expected to have grown by around 2.8% in 2003. Among partial indicators, the composite leading indicator has turned decisively upwards, but is still well below previous peaks. Exports rose 9.5% in 2003, but this statistic obscures the way exports have built momentum through the year, and were running at an annual growth rate of 21% by December. A high level of export orders bodes well for sustained growth next year. Despite the improving economy, unemployment remains stubbornly high. The latest reading (November) was 4.7%, down from a peak level of 5.35% seen in August 2002. Annual inflation continues to hover around or below zero.

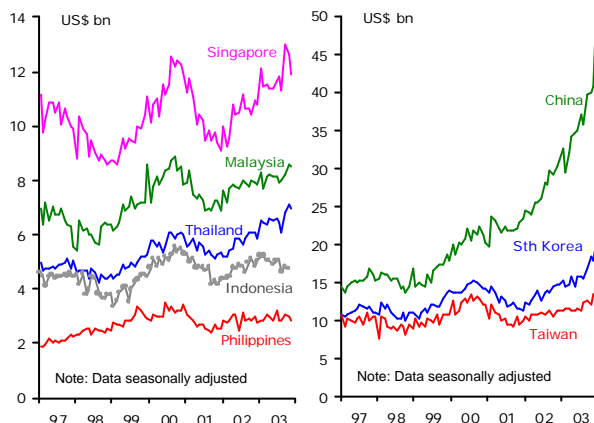
Perhaps with an eye to the upcoming elections, the government has announced plans for 10 major infrastructure projects costing some US\$14bn. The programme is unlikely to give an early boost to the economy, as funding will need to be approved by the opposition-dominated legislature.

... and so is South Korea's

The Korean economy is estimated to have grown at a faster pace of 3.6% over the year to Q4 2003, bringing growth for 2003 to 2.9%. Growth is expected to rise to around 6% in 2004, underpinned by external demand. With exports to China growing at a rapid pace (average annual growth of 50% in the second half of 2003), China has overtaken the US to become South Korea's largest export market. Domestic demand, which has put a drag on the economy, is likely to recover only gradually as high

levels of household debt discourage growth in private consumption. While investment is expected to respond to improved export demand, labour unrest and political uncertainty are likely to be mitigating factors. Interest rates are expected to remain steady in the first half of the year to support the domestic recovery. The key overnight call rate was left unchanged at 3.75% at the central bank's January meeting.

Exports driving recovery in East Asia



Sources: National statistical agencies; Datastream.

Fears of economic overheating in Thailand

Full-year growth is expected to have been around 6.3% in 2003, up from 5.4% in 2002 and the strongest annual increase since 1995. The strong performance of exports provided a basis for the improvement in 2003, but a 1.6% quarter-on-quarter GDP rise in the third quarter was mainly due to a surge in inventories.

Prime Minister Thaksin expects even faster economic growth over coming years and projects that real GDP will rise by 8% and 10% respectively in 2004 and 2005. With the stock market rising by 117% in 2003 and significantly out-performing other Asian markets, and real estate prices also rising strongly, such ambitious forecasts are exacerbating fears of economic overheating and the development of speculative bubbles in financial markets. The Bank of Thailand's benchmark 14-day repo rate has been held at a record low of 1.25% since the last reduction in June 2003.

Global economic recovery and continued strong growth in China are positive for Thai exports in 2004. The authorities are, however, becoming increasingly concerned about the impact of the strong currency (up by almost 9% against the depreciating US dollar in 2003 and at a 3½-year high in January 2004) on export competitiveness. With the baht's recent rise against the US dollar exceeding that of most other Asian currencies, the central bank has placed limits on short-term

deposits from non-residents at commercial banks and has also intervened on the foreign exchange market to curb its rise.

New economic objectives in Malaysia

One of main priorities of the new prime minister, Abdullah Badawi, is to shift from 'crony capitalism' to a business environment that is transparent, accountable and based on an open-tendering system, a move that would strengthen Malaysia's attractions to foreign investors. He has also expressed scepticism about large infrastructure projects; an ambitious railway construction project has been postponed and the government is considering scaling-back the large Bakun Dam hydroelectric project.

Real GDP growth is now expected to have been around 5% in 2003 following a strong performance in the third quarter. Malaysia has an open economy and economic growth prospects are being bolstered by stronger-than-expected growth in its major export markets, and by the boost to export competitiveness provided by the depreciation of the ringgit which is pegged to the US dollar. Real GDP growth is expected to rise to around 6¼% in 2004.

The government intends to retain the fixed ringgit peg to the US dollar for the time being. However, the fixed peg restricts the flexibility of economic policy, and the prospect that Malaysia will adopt a managed float by, say, end-2005 now seems quite high. The probability of any change to the exchange rate regime will increase if the recent rapid depreciation of the US dollar continues or if China adopts a more flexible exchange rate policy.

The improved outlook for economic growth should allow Malaysia to significantly reduce its budget deficit and there are good prospects that a balanced federal budget will be achieved ahead of the government's 2006 target.

A bigger current account deficit in Vietnam

Real GDP rose by 7.2% in 2003 according to official figures, marginally above annual growth of 6.8-7.0% during 2000-2002 despite the adverse impact of SARS in the second quarter. Industry and construction, which account for about 40% of total GDP, grew by 10.3% in 2003, while agriculture and services grew by 3.2% and 6.6% respectively.

Strong economic growth is fuelling demand for imports, which rose by almost 27% in US dollar terms in 2003. This exceeded export growth of 19% and the visible trade deficit widened to US\$5.1bn from US\$2.8bn in 2002. It is estimated that the current account deficit rose from less than 2% of GDP in 2002 to over 5% in 2003.

Vietnam's economic achievements over recent years include a significant reduction in poverty and much greater engagement with the world economy. However, while real GDP growth is expected to be sustained around 7-7½% per annum over the next year or two, concerns are mounting that growth could slow unless economic reform is speeded up. The IMF has reiterated that commercially-based decision-making in the state-owned enterprise and banking sectors is a key requirement to sustain solid growth. Regulatory and transparency issues also continue to impede economic modernisation. Faster reform is also needed to secure WTO membership by 2005, which would be particularly beneficial to the textiles sector and would significantly boost Vietnam's appeal to foreign investors.

Philippines - sluggish exports contribute to underperformance

After recovering sharply in late-2001, exports from the Philippines have been sluggish for almost two years. In the first eleven months of 2003, exports were up by just 2% on the corresponding period of 2002, while most other countries in the region enjoyed a significantly stronger pickup. Reports suggest that Philippines is losing ground to China in global electronics markets.

The mediocre trade performance, combined with a poor image as an investment destination (reflecting concerns over security, governance, corruption, inefficiency etc) have weighed on the peso. In the past two years the peso has continued to drift against a weakening US dollar, in contrast to other regional currencies (excluding those that are pegged), which have been trending upwards. With exports and government spending playing a minor role, the main growth driver in 2003 was private consumption. Full year growth is estimated to have been 4½%, and a similar performance is expected for 2004.

Policy continuity essential in Indonesia

While political uncertainty ahead of the elections is bound to affect business and consumer sentiment, our main case scenario assumes that the election outcomes will not produce a significant shift in macroeconomic policy. Indonesia's political and economic profile has improved in recent years and policy continuity is necessary to maintain it. The expiry of Indonesia's loan arrangement with the IMF in December 2003 makes it essential for the government to deliver on reform commitments in order to lift investor confidence.

Interest rates and inflation have been successfully brought down over the course of 2003 and bode well for economic activity. The benchmark 1-month SBI rate was under 8% in late January from 12.9%

a year ago. Inflation was 5.1% over the year to December 2003, the lowest since July 2000. However, the scope for a further decline in inflation is limited in 2004 given the likelihood of exchange rate weakness amid political uncertainty in this election year. Real GDP is forecast to grow at a slightly higher pace of 4½% in 2004 after an estimated 4% in 2003 as external demand gains momentum. However, relatively weak long-term investment flows continue to impede prospects.

Risks to the outlook

Apart from country-specific risks, there are some factors which could have a broad regional impact. The SARS outbreak last year was an example of something completely unexpected which had a dramatic economic impact. Fortunately, the recent cases of SARS have been quickly identified and contained, but the risk of another serious outbreak cannot be ignored. A more immediate threat is the outbreak of avian flu virus, which is spreading rapidly and by late-January had been detected in birds in ten Asian countries with humans affected in Vietnam and Thailand. There is no evidence, as yet, that the disease is spreading from person-to-person and the World Health Organization has not recommended travel restrictions to the affected countries. Large numbers of chicken have been slaughtered and many countries have banned poultry imports from affected countries.

Another risk arises from the export-driven nature of the recovery in most countries. Unusually, the major export markets of the US and Japan are expanding at the same time, and within the region, China has become a major impetus for its neighbours. China is expected to lose some momentum this year, and if either the US or Japan falters, then the favourable forecasts for East Asia would need downward revision.

The global economy has benefited from low interest rates for some years. Now, bond yields have begun to rise, and the impact will be greater on countries such as Indonesia and Philippines which have significant external and domestic public debt. While the rise in yields is not expected to be dramatic, it could be exacerbated by an increase in emerging market spreads.

Another dampener - at least for the resource-poor countries - could come from commodity prices, especially oil. Against expectations, oil prices have remained high since the end of the war in Iraq, and prices of coal and base metals have risen strongly. This is placing pressure on profits and could contribute to monetary tightening.

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