

Global outlook

➤ An de-synchronisation of the global growth cycle over the past six months is expected to shift to a broad based slowdown in the world economy by the end of 2008.

- The effects of a global tightening of financial conditions will eventually mean slower growth in all the world's major economies.
- Evidence of a US economic recession has become more compelling.
- Pressure on bank balance sheets and wide credit spreads will also dull the impact of monetary easing on the underlying economy.
- The key uncertainty remains the emerging economies, although our base case remains for a moderate slowdown.

➤ A key concern is that the full magnitude of the global credit squeeze is yet to be seen. One interpretation of recent financial disruptions is that we are experiencing the initial fall-out from a significant household balance sheet adjustment in many industrialised economies that follows an extended period of debt accumulation and asset price appreciation.

- Repairing household balance sheets will take an extended period, unlike a standard corporate balance sheet event. This could fundamentally change the global economic landscape given the important role of the Western consumer in driving global growth over the past decade.
- While economic recession in this instance may not be deep, it could be prolonged.

IMF estimates potential losses at US\$945bn, of which banks' losses are reckoned to be US\$440-510bn...

Estimated losses on unsecuritized loans

Type of loan	US\$bn	
	Out-standing	Estimated losses
Sub-prime	300	45
'Alt-A'	600	30
Prime	3 800	40
Commercial real estate	2 400	30
Consumer loans	1 400	20
Corporate loans	3 700	50
Leveraged loans	170	10
Total	12 370	225
of which, banks		100-130

Estimated mark-to-market losses on securities

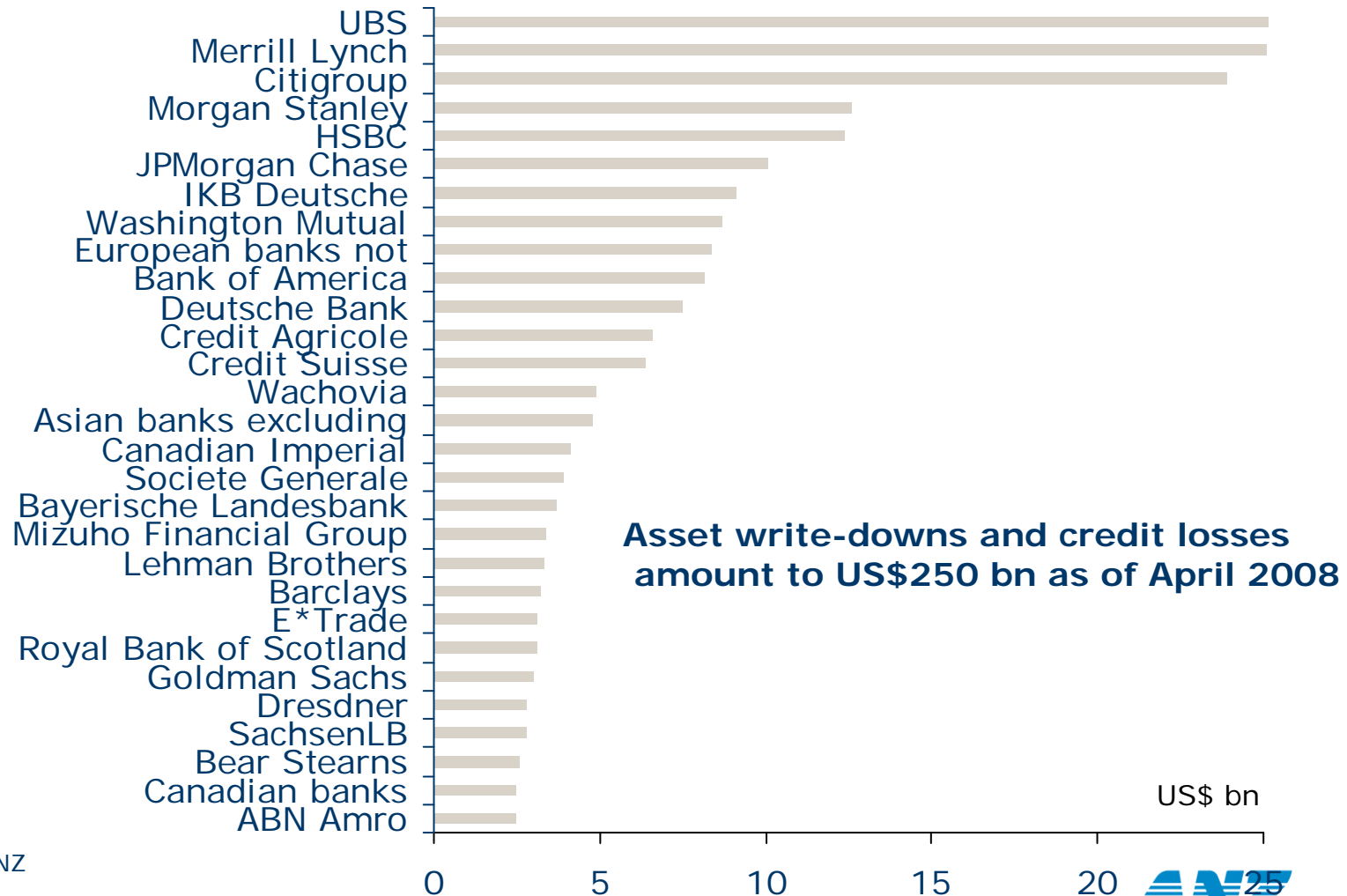
Type of security	US\$bn	
	Out-standing	Estimated losses
ABS	1 100	210
CDOs	400	240
Prime MBS	3 800	0
Commercial MBS	940	210
Consumer ABS	650	0
High-grade corporate	3 000	0
High-yield corporate	600	30
CLOs	350	30
Total	10 840	720
of which, banks		340-380

Notes: 'Alt-A' means 'low-doc' or 'no-doc' mortgage loans. ABS = asset-backed securities; CDOs = collateralized debt Obligations; MBS = mortgage-backed securities; CLOs = collateralized loan obligations.

Source: IMF Global Financial Stability Report April 2008, p. 12

... \$250bn of which has been announced so far

The largest losses have been felt primarily by US-based banks

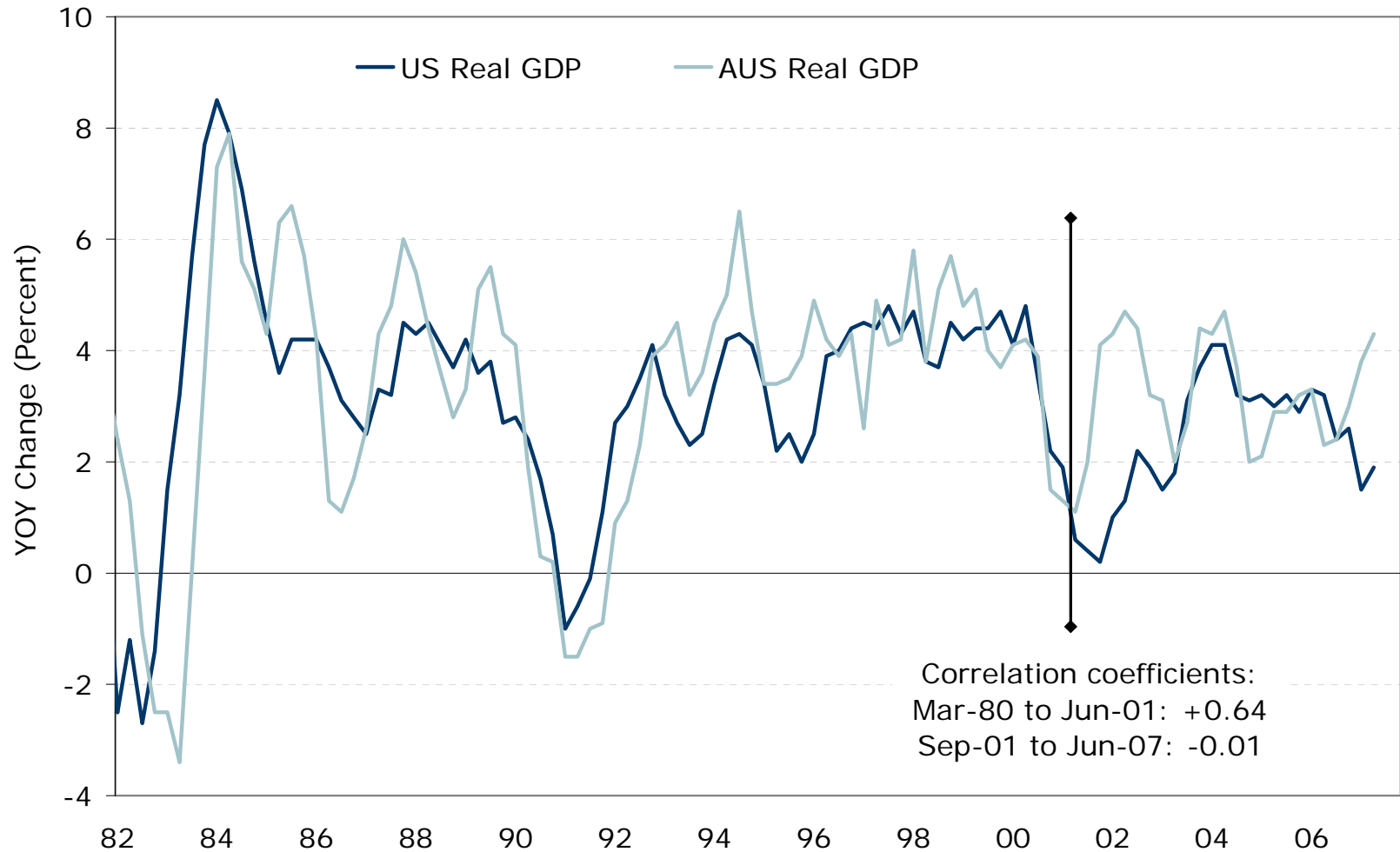


Sources: Bloomberg; ANZ

The outlook for Australia

- Although the Australian and US business cycles are no longer well correlated, the latest shock has been transmitted to Australia through highly globalised financial markets. There is little doubt that the combination of rising official interest rates and tighter financing conditions in wholesale financial markets will impact the underlying economy.
 - As the commercial banks become an increasingly important source of funding for the Australian economy, their cost and terms of the provision of credit will be an important factor in the economic outlook.
- The Australian economy now appears to be approaching, or may have even reached, a 'tipping point', where the impact of tighter financial conditions outweighs the stimulus coming from higher commodity prices.
- In the short-term, the risks to policy are skewed to the upside. But over a longer-time frame, our expectations of a slowdown in domestic and global growth should provide the economic environment for a reduction in official interest rates from cyclically high levels.
- The Rudd Government remains committed to delivering the large income tax cuts which it promised during last year's election campaign. Other Budgetary measures should be more contractionary, although are likely to be smaller in magnitude.
 - the Treasurer has indicated that the Government will 'bank' any additional windfall revenue gains accruing from further increases in commodity prices.

The Australian and US business cycles are no longer well correlated ...



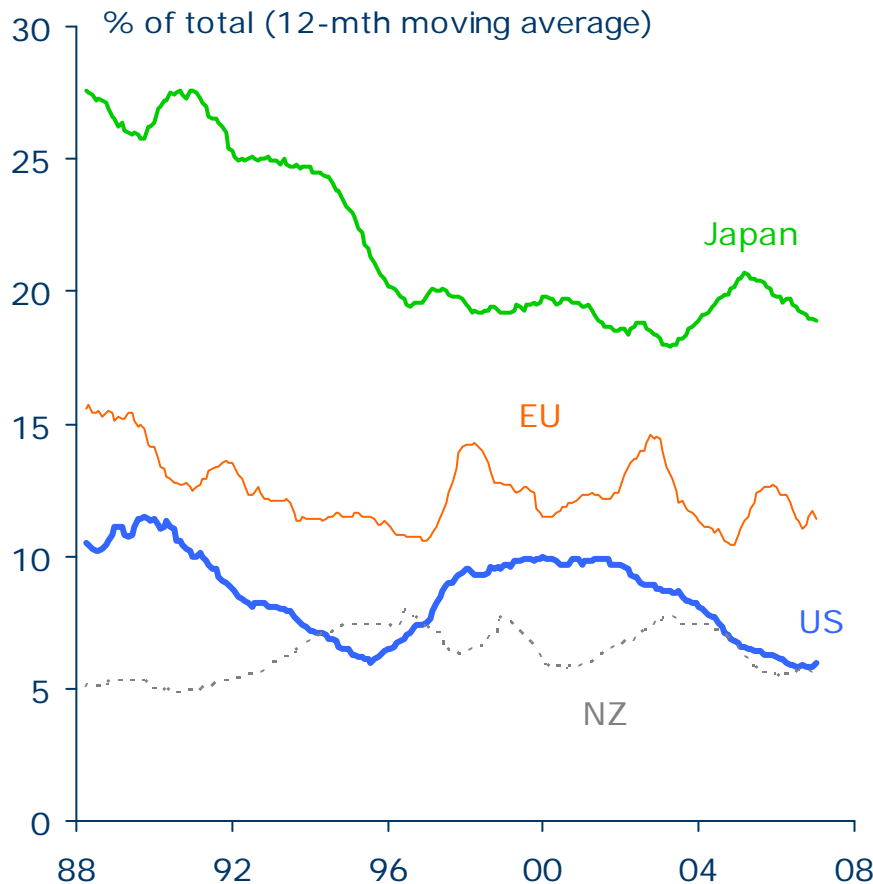
Source: ANZ and Bloomberg



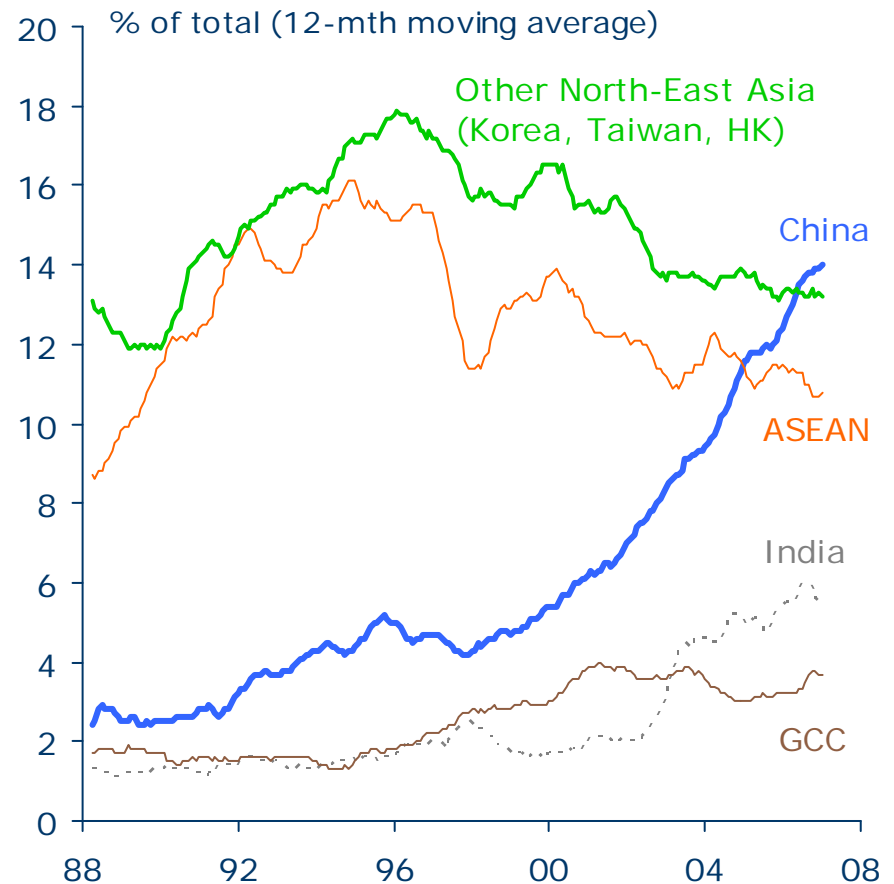
Australia is much less directly dependent on the US and other OECD export markets than it used to be

Australia's major export markets

Advanced economies



Developing economies

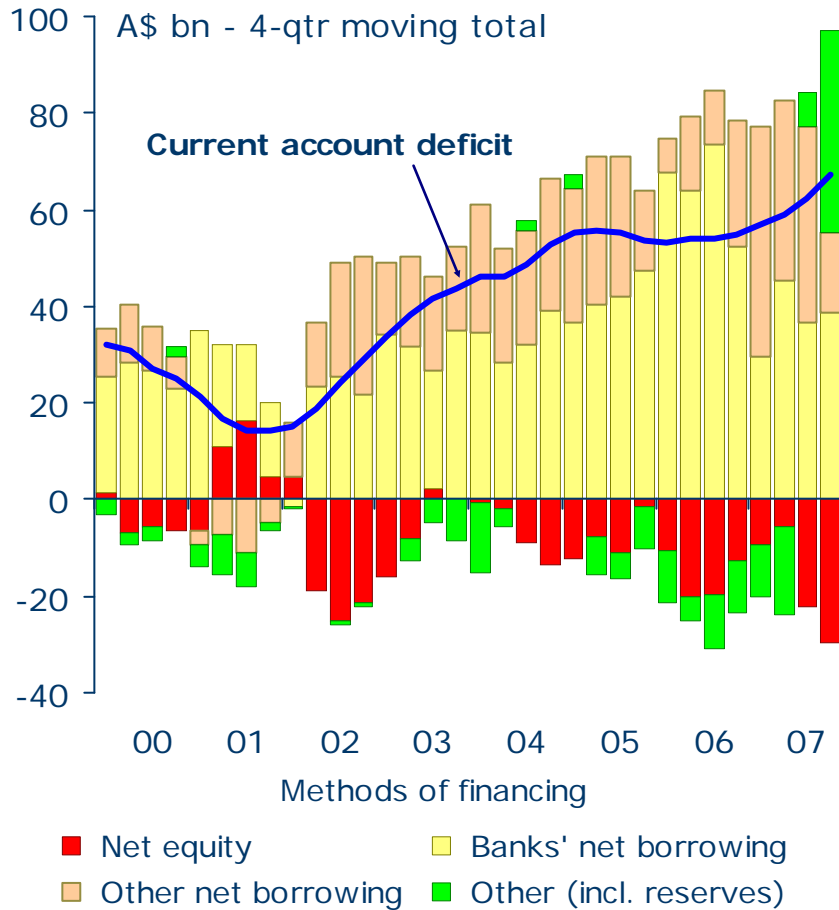


Sources: Australian Bureau of Statistics.

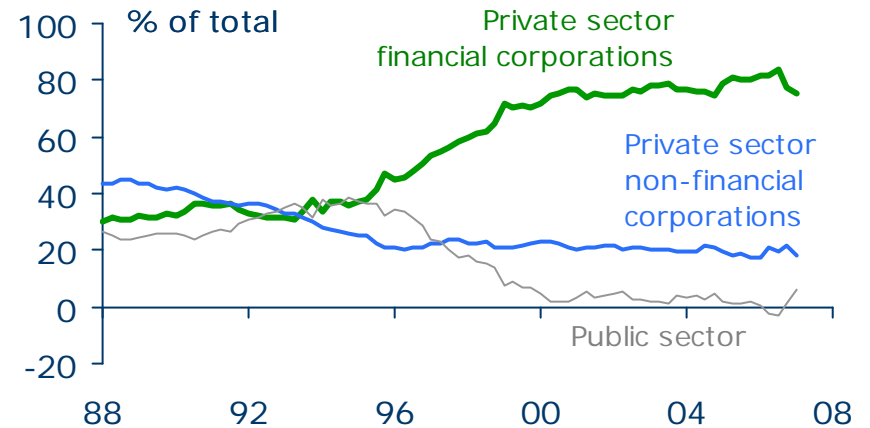


...and Australia is exposed to the global credit crunch as a result of the way it has financed its large current account deficit

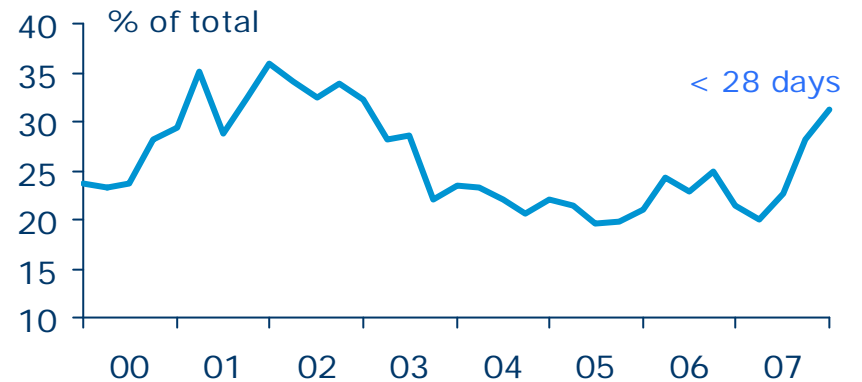
Financing Australia's current account deficit



Net foreign debt, by borrower



Maturity structure of net foreign debt

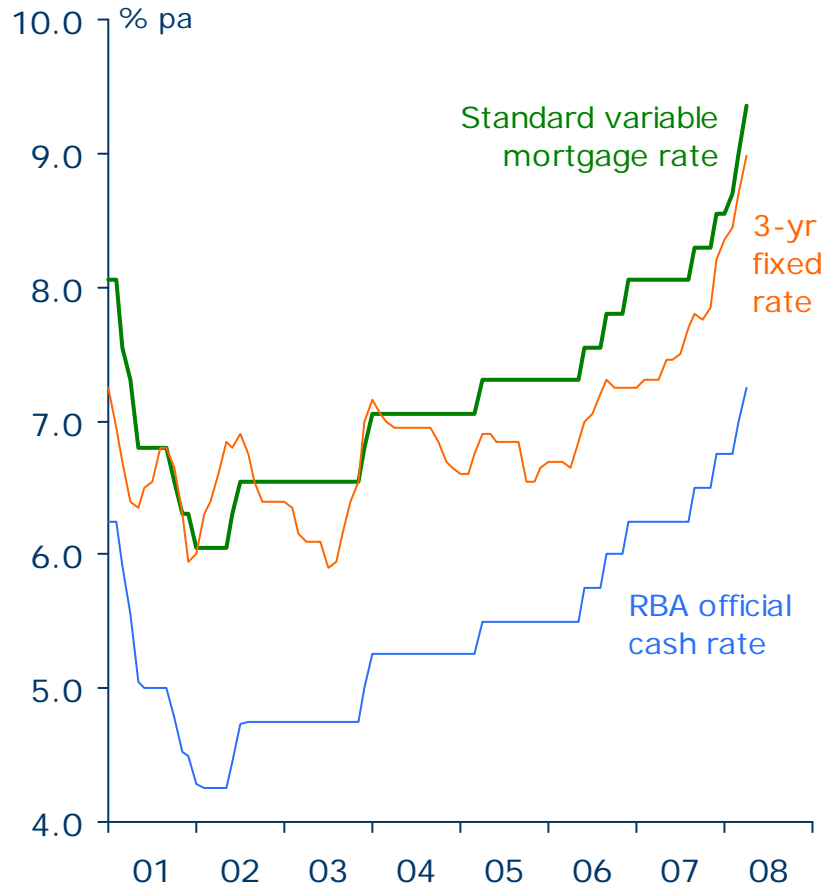


Sources: Australian Bureau of Statistics; ANZ.

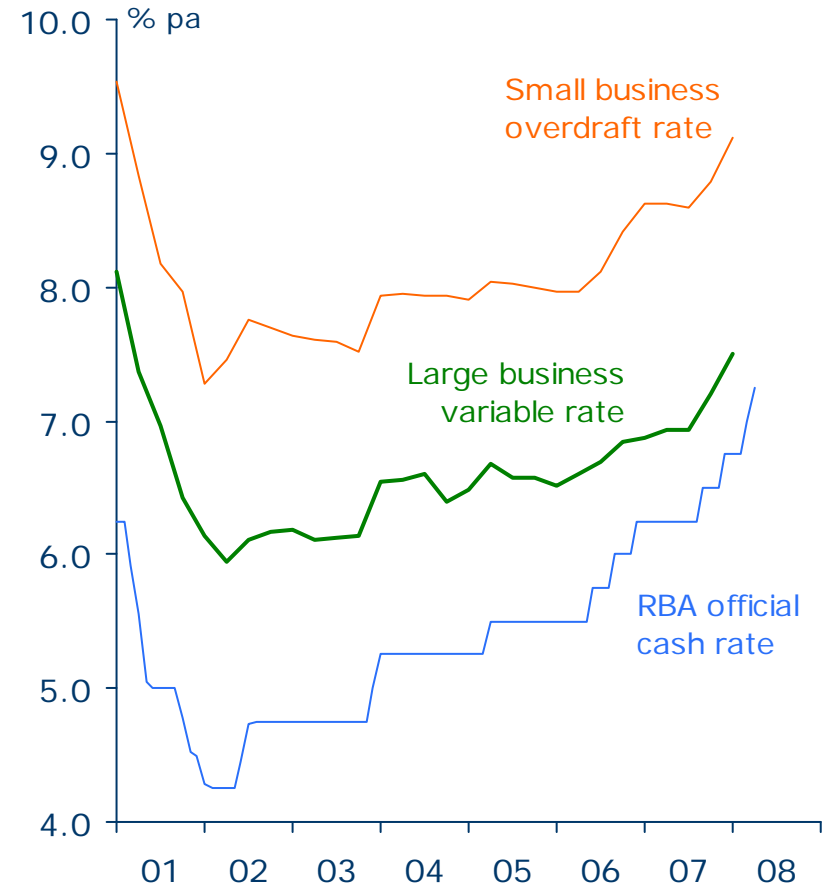


Interest rates actually paid by borrowers have risen by a lot more than official interest rates set by the RBA

Mortgage rates



Business loan rates

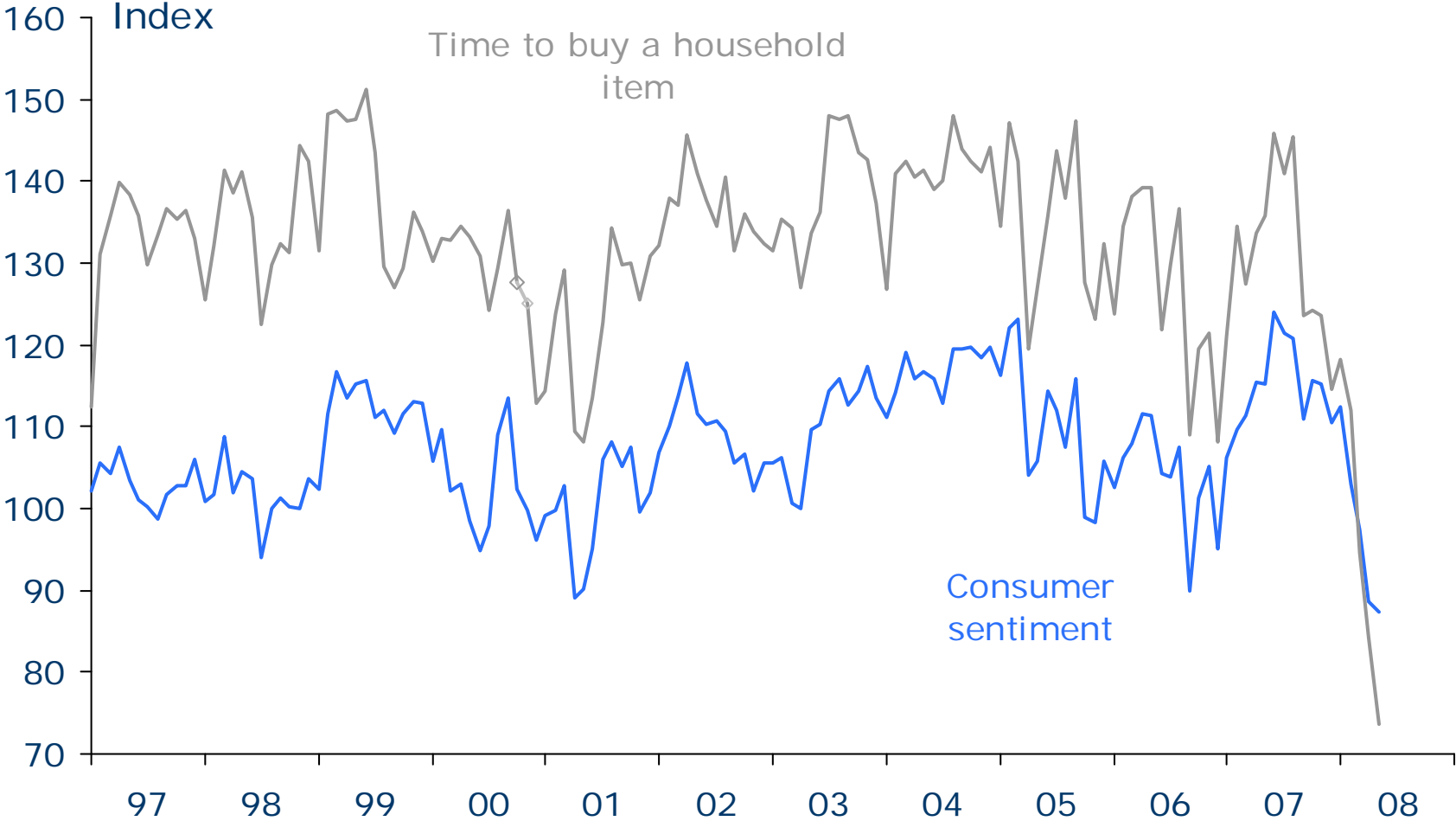


Note: Business lending rates are quarterly averages of rates actually paid, as calculated by the RBA, up to the December quarter 2007. Sources: RBA; ANZ.



Consumer confidence impacted heavily by recent events

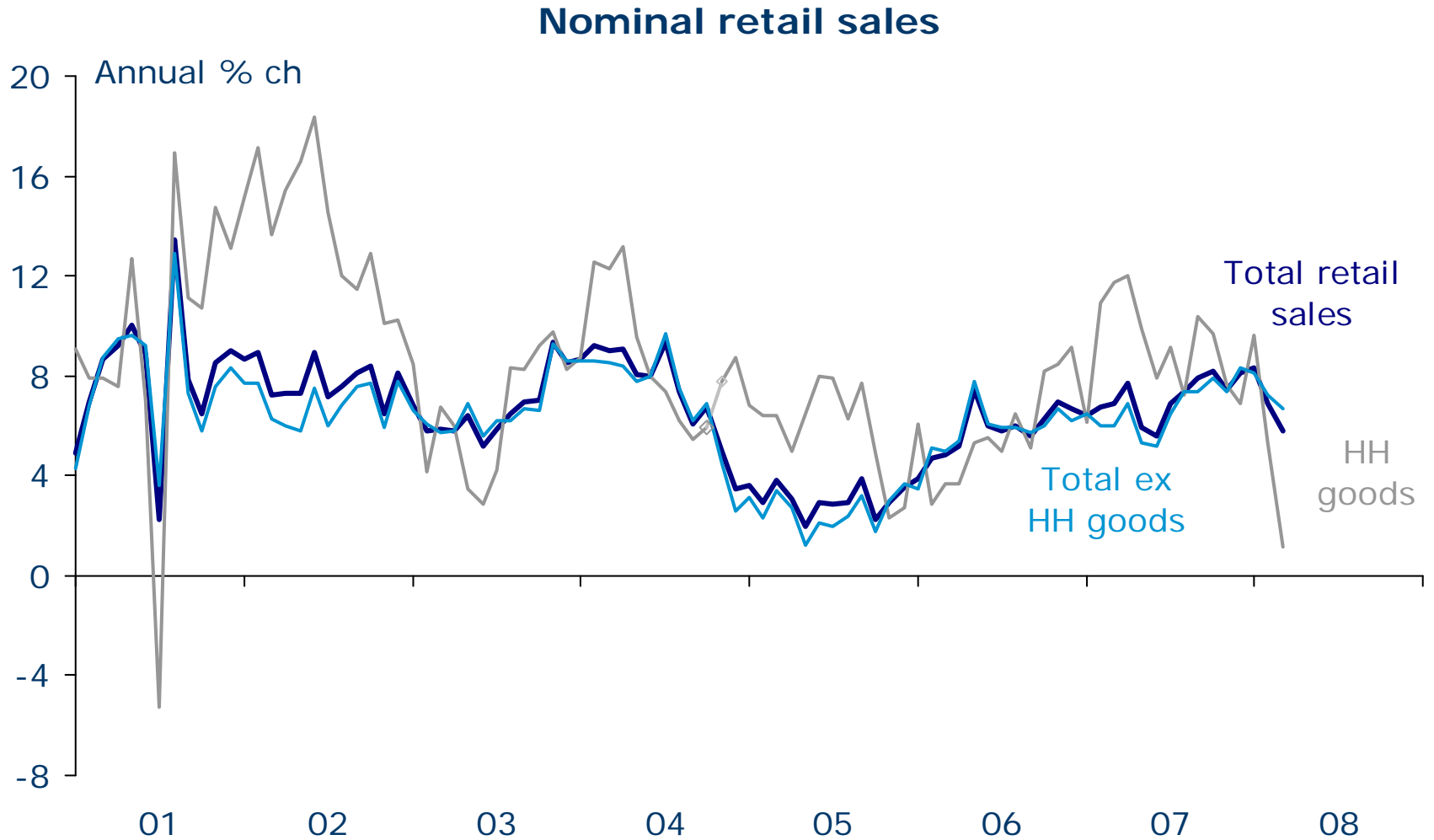
Consumer sentiment index



Source: WBC-MI



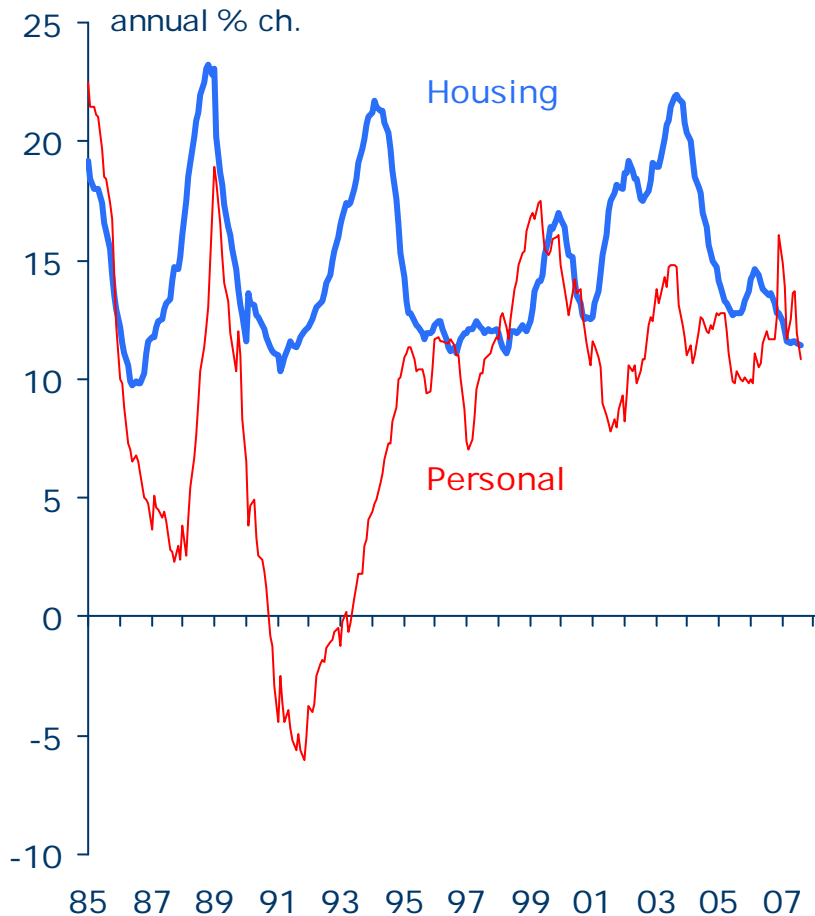
Retail sales down for two consecutive months



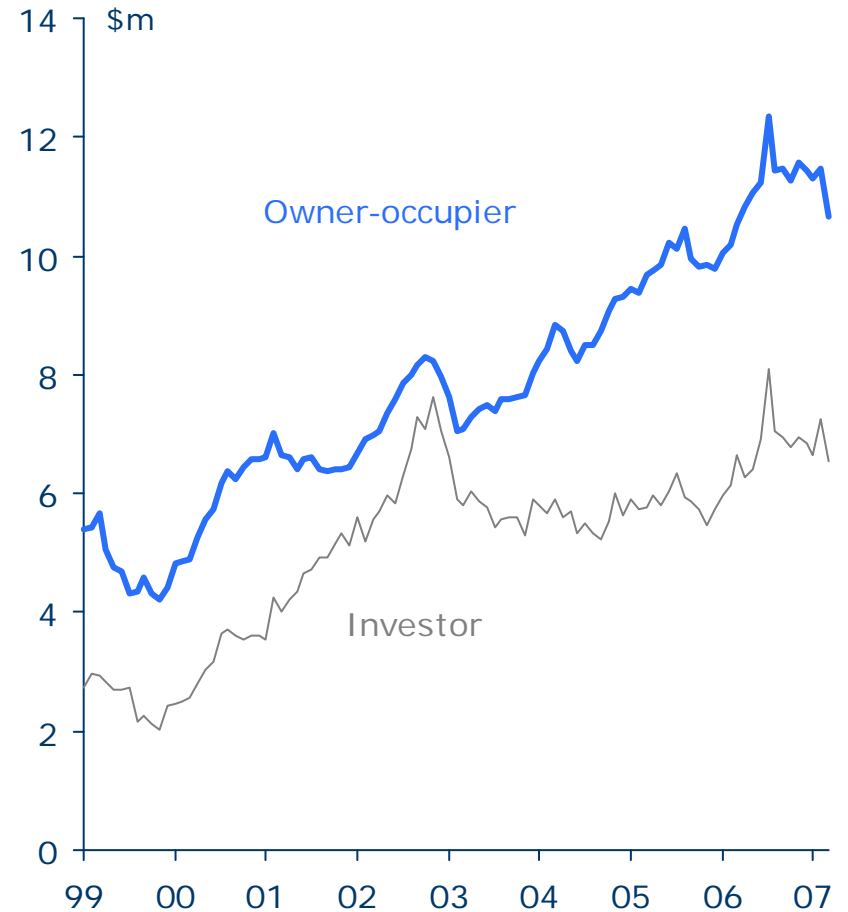
Source: WBC-MI

Demand for household credit has also softened

Household credit growth



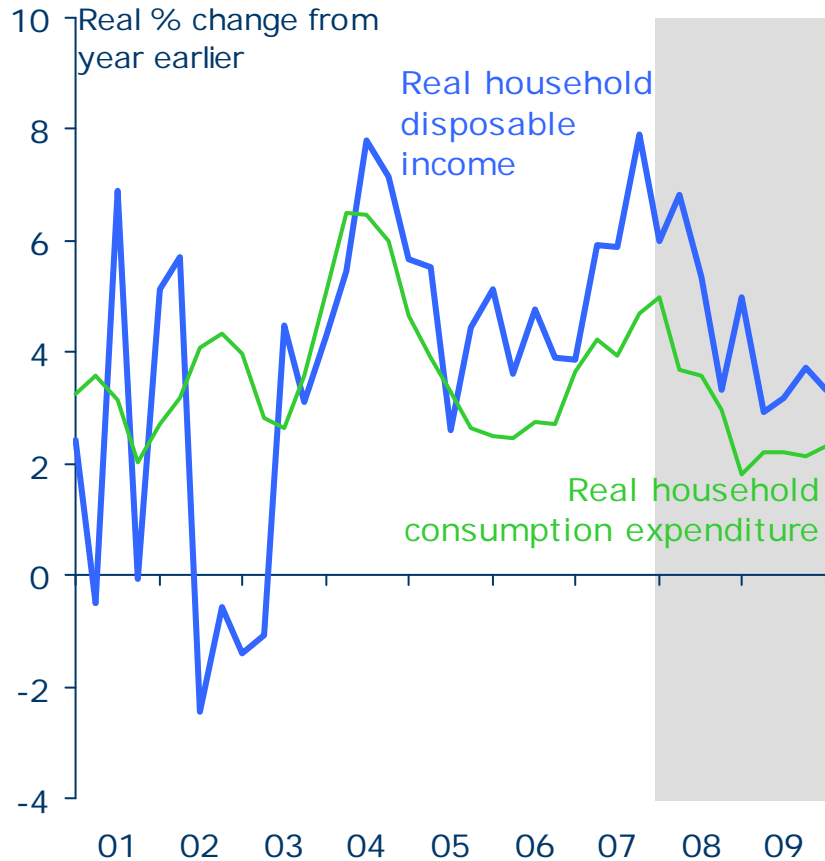
Housing finance approvals*



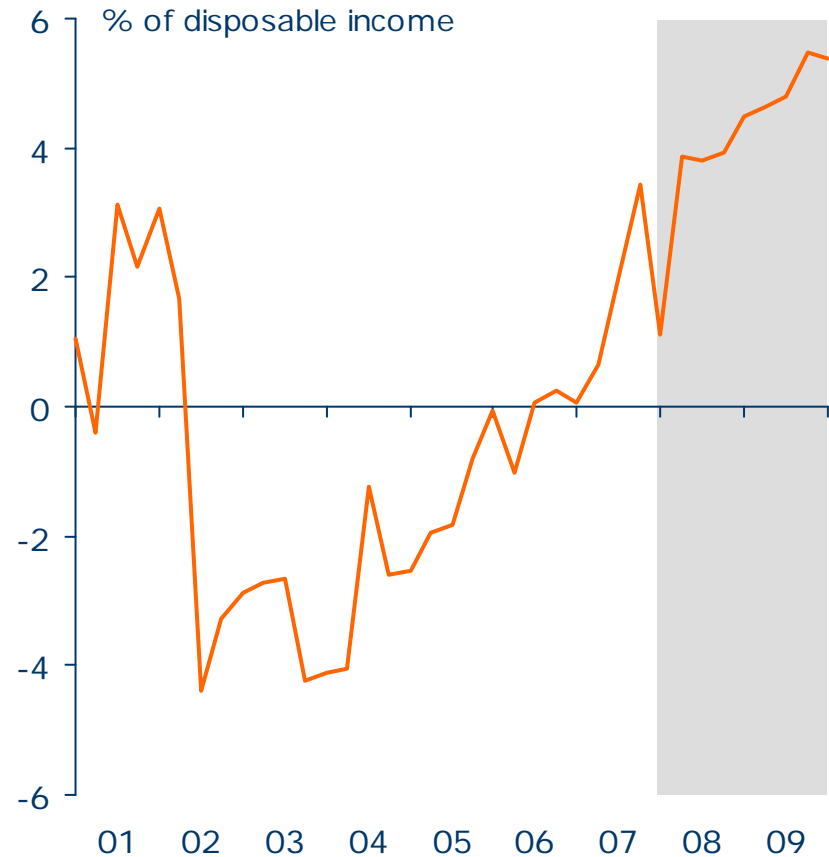
*Excluding refinancing
Source: ANZ and RBA

Household income and spending growth are likely to slow significantly in response to tighter monetary and fiscal policy

Household income and spending



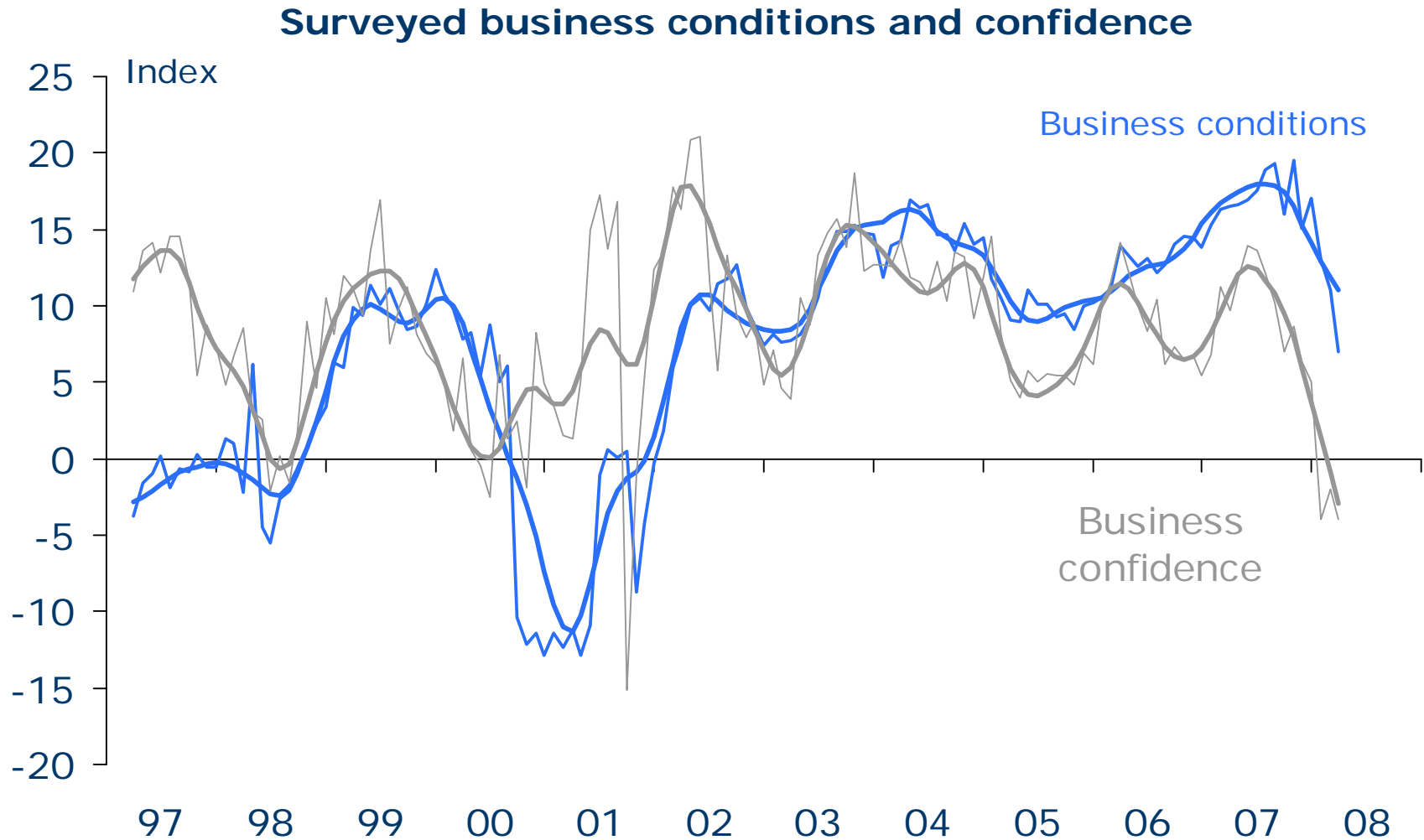
Household saving rate



Sources: Australian Bureau of Statistics; ANZ.



Business confidence and conditions trending downwards

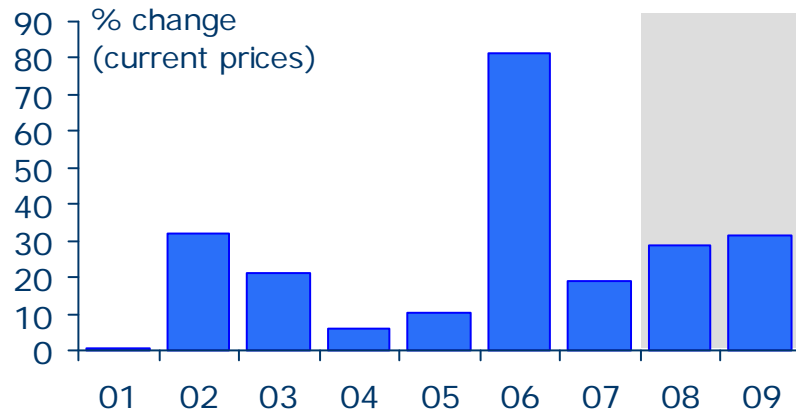


Source: NAB

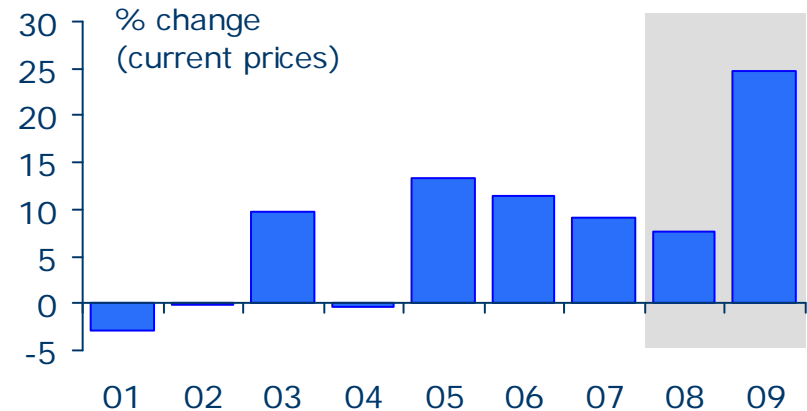
Business investment expectations likely to be scaled back

Actual and projected capital expenditure

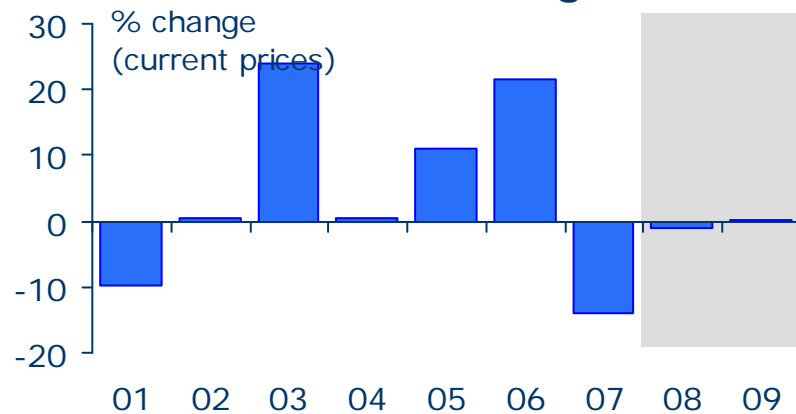
Mining



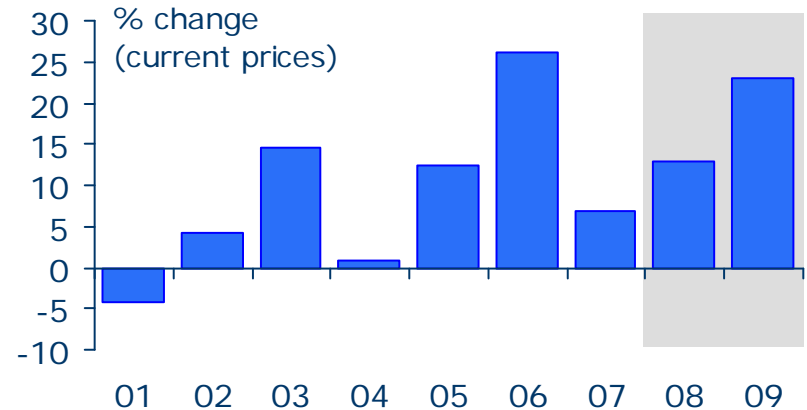
Other industries



Manufacturing

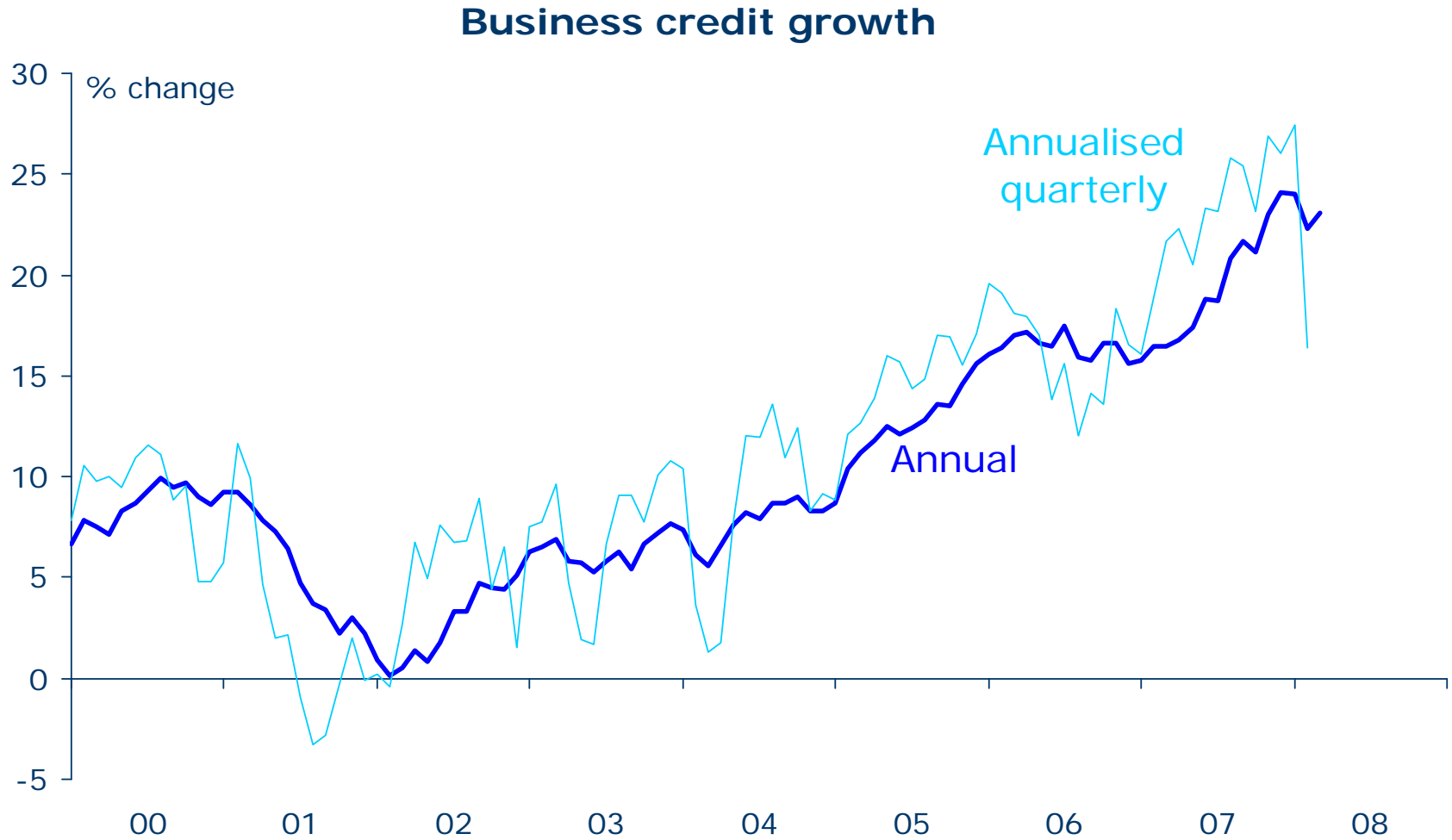


Total excl. farm and finance



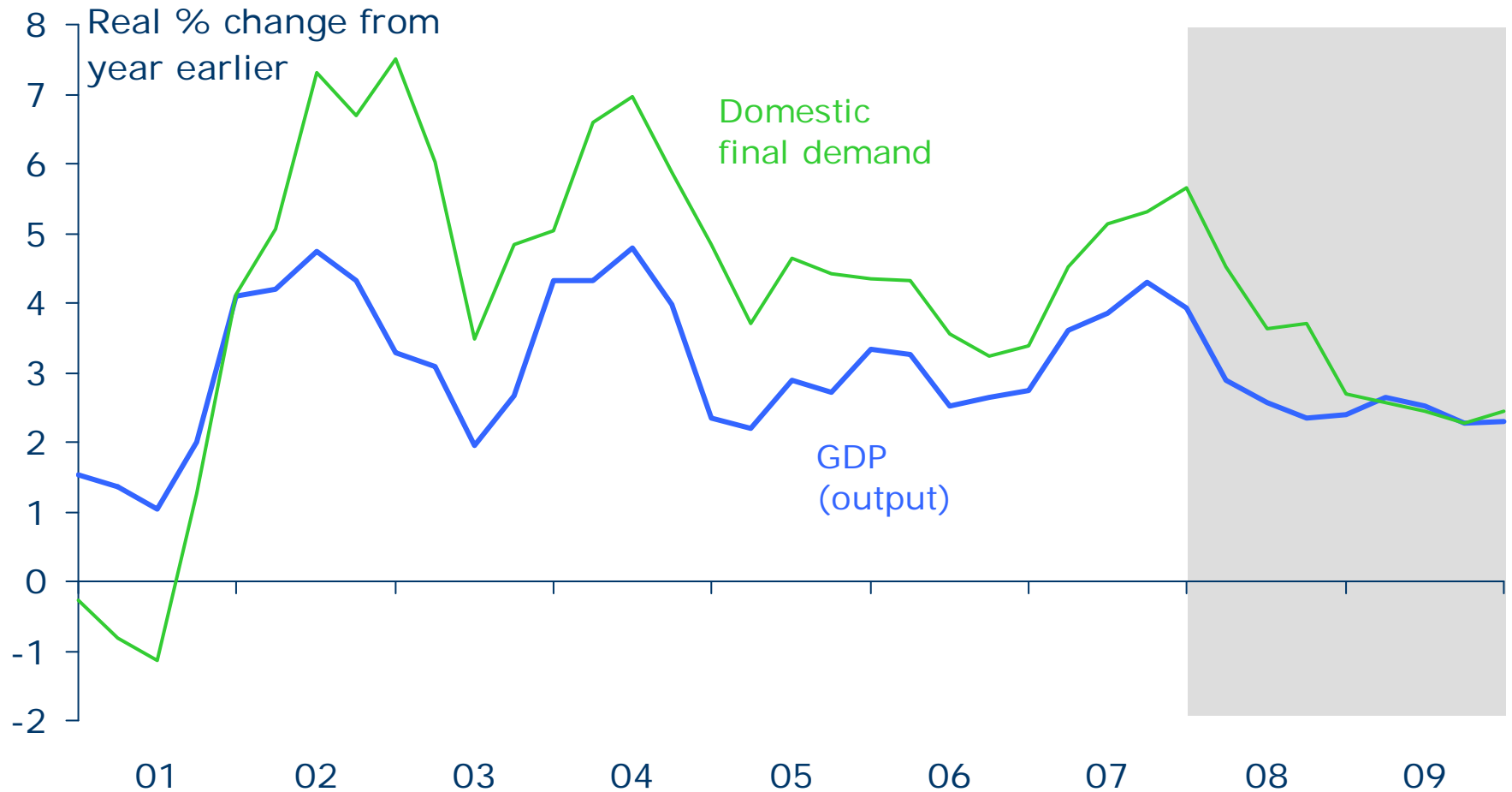
Note: Data are for financial years ended 30 June. Projections for 2007-08 and 2008-09 are based on expected levels of capital expenditure reported to the ABS in its January-February 2008 survey, adjusted for the extent to which expectations in this survey have been realized over the five years to 2006-07. *Sources:* ABS; ANZ.

Business credit growth eases: is this due to easing demand or supply?



Tighter financial conditions will likely see a significant slowing in domestic demand over the next eighteen months ¹⁶

Spending and output



Sources: Australian Bureau of Statistics; ANZ.



Forward looking indicators are already pointing to slower employment growth

Job vacancies and employment



Sources: Australian Bureau of Statistics; ANZ.

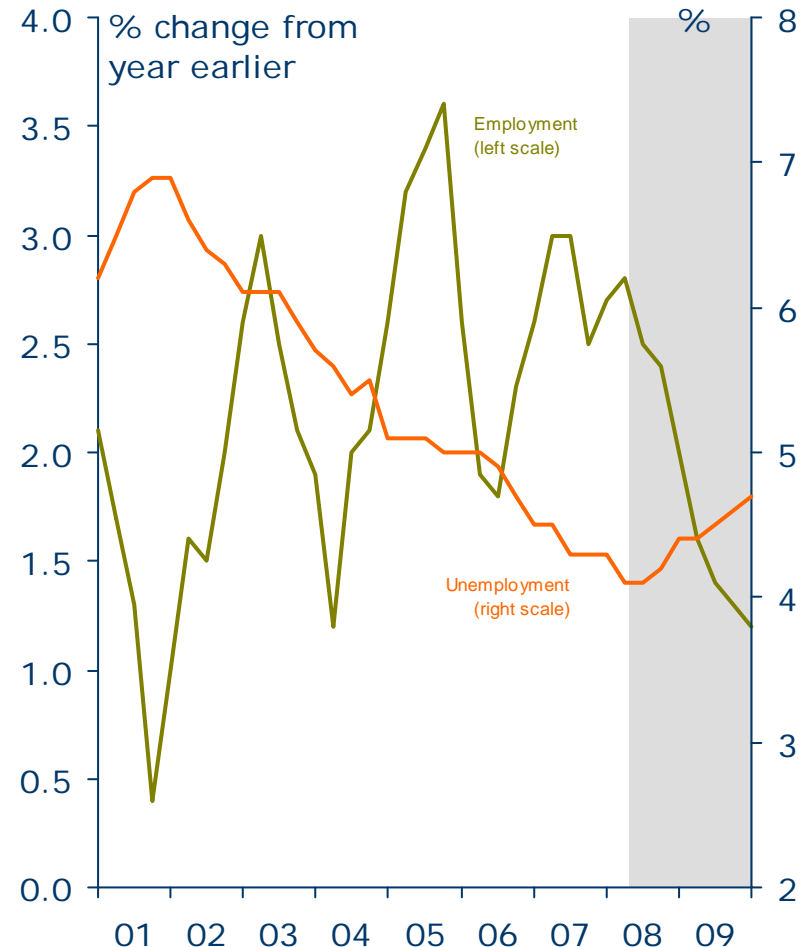


... but the deterioration in labour market conditions will be gradual¹⁸
in the presence of skill shortages and labour hoarding

Businesses reporting labour shortages

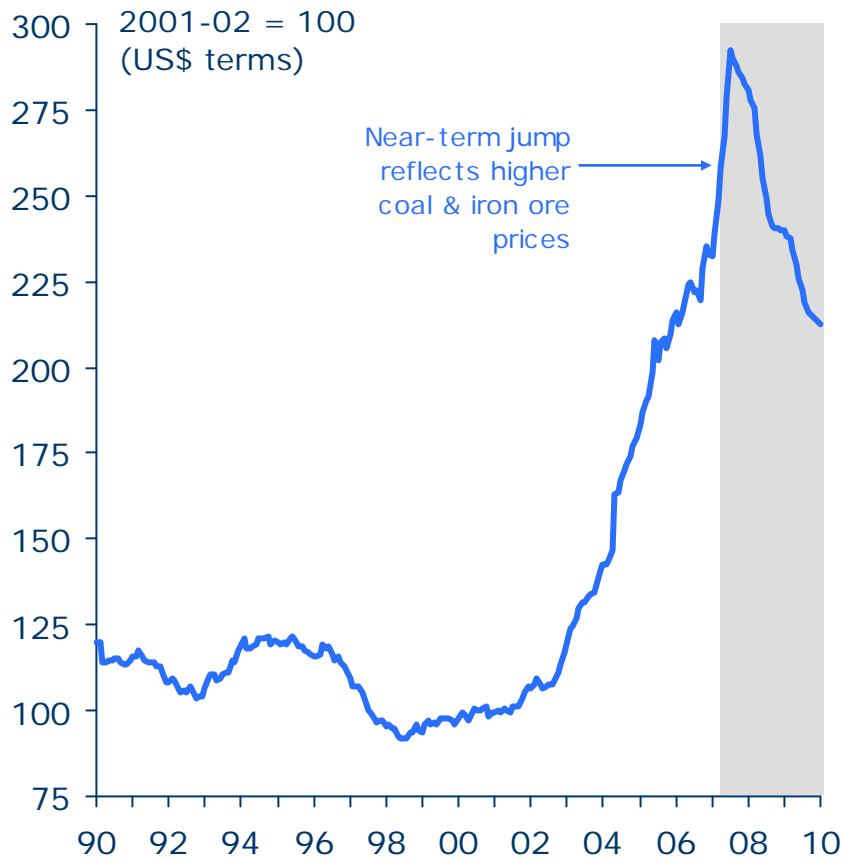


Employment and unemployment



Rises in coal and iron ore export prices will deliver a further leg upwards in Australia's commodity price cycle in 2008-09 ¹⁹

Australian export commodity prices



Australia's "terms of trade"



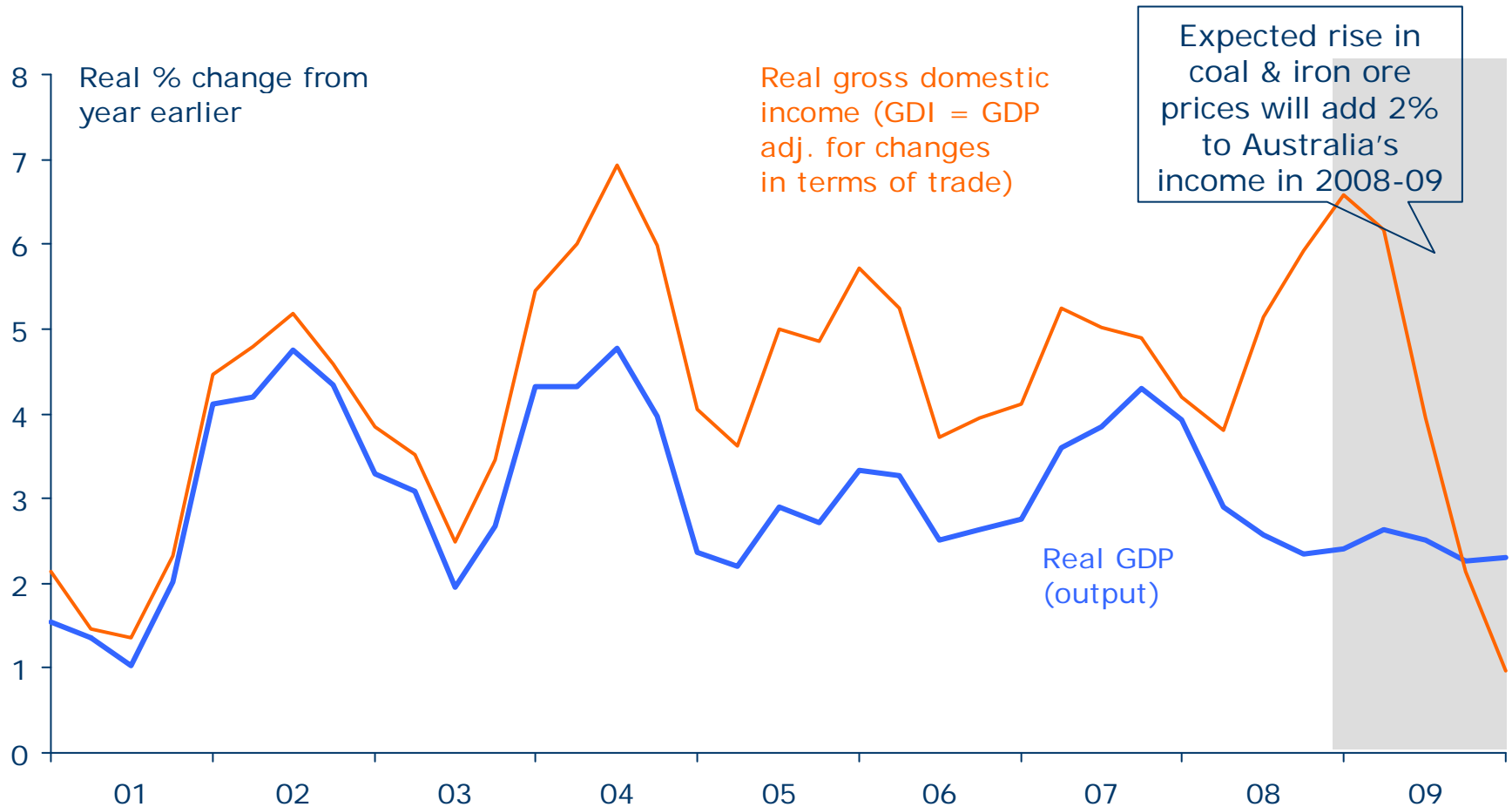
Note: "terms of trade" is the ratio of average export to average import prices.

Sources: Reserve Bank of Australia; ABS; ANZ.



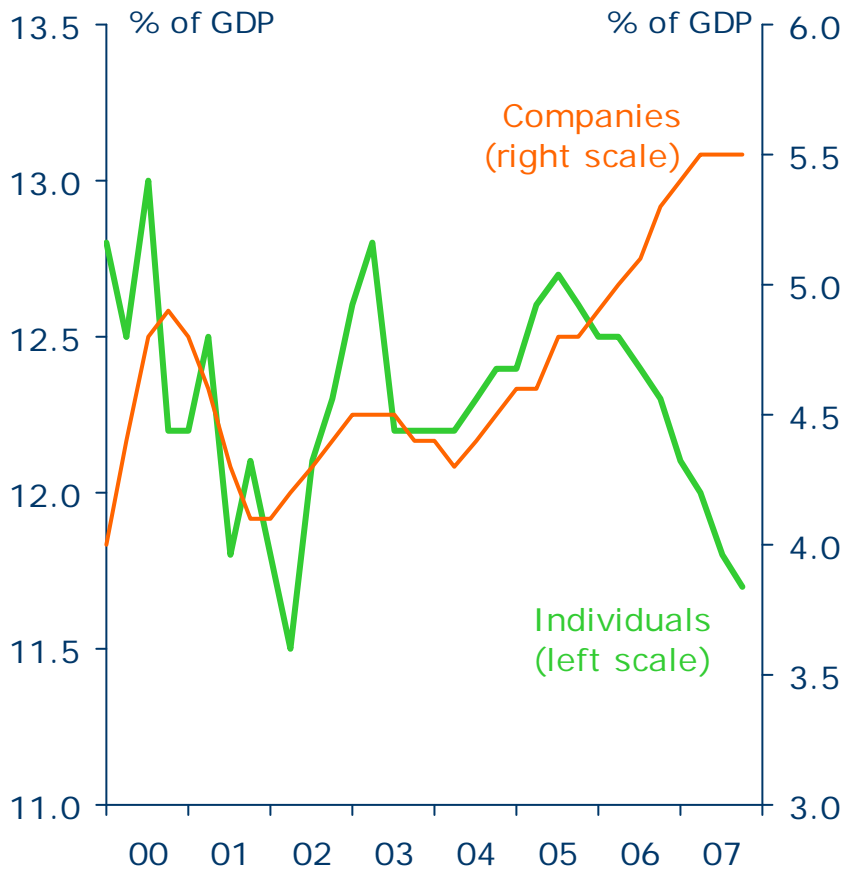
This will boost Australia's income by another 2% in 2008-09, on top of 11% from terms of trade gains already so far this decade ²⁰

Australia's real gross domestic income and output

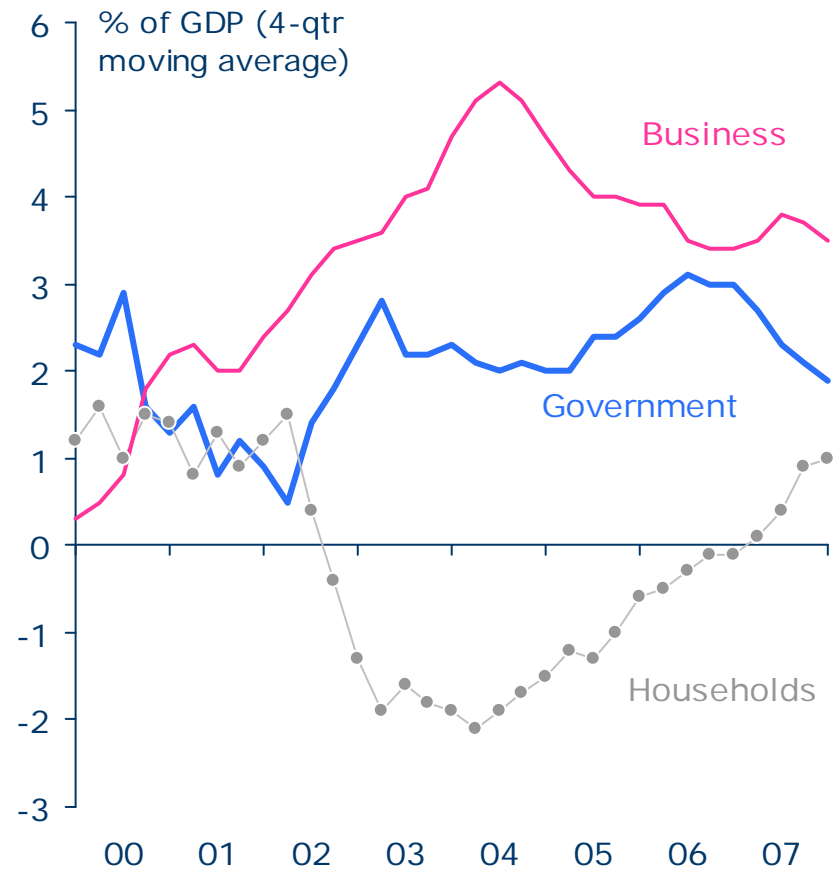


Tax cuts from 1 July mean that fiscal policy will continue to be recycle income from the corporate sector to households

Australian income tax collections



Net saving by sectors of the Australian economy



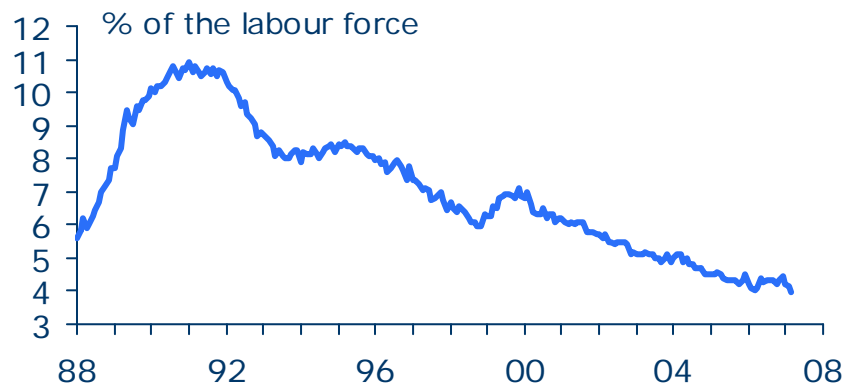
Sources: Australian Bureau of Statistics; ANZ.



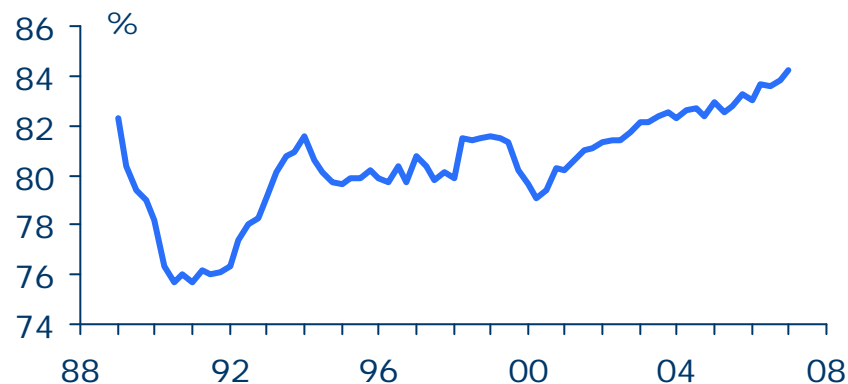
It will take some time for slower growth to help alleviate serious²² capacity constraints

Indicators of 'spare capacity' in the Australian economy

Unemployment rate



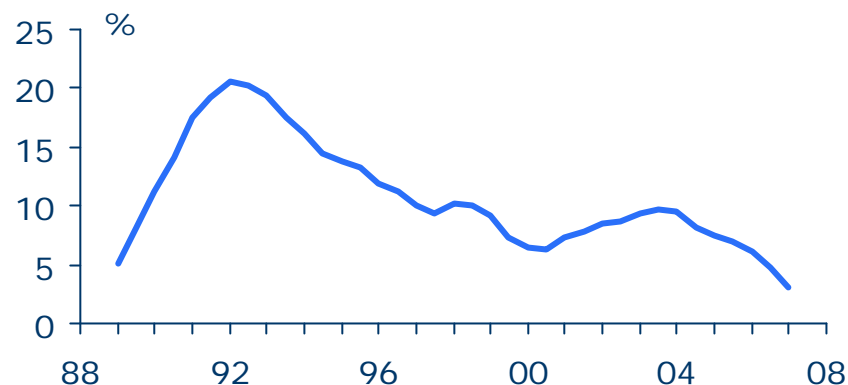
Capacity utilization rate



Businesses reporting labour shortages



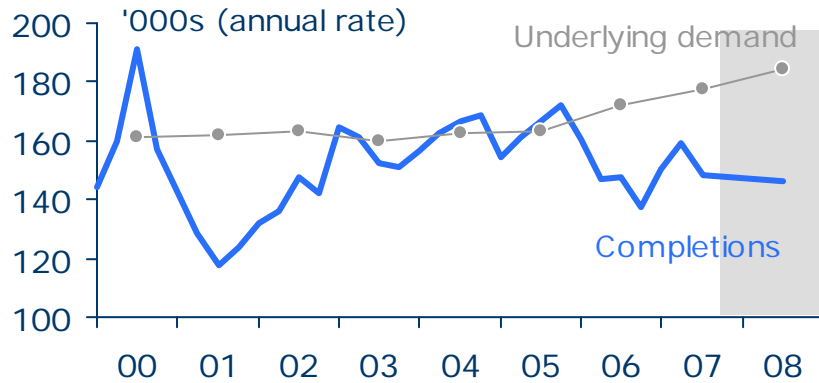
Office vacancy rates



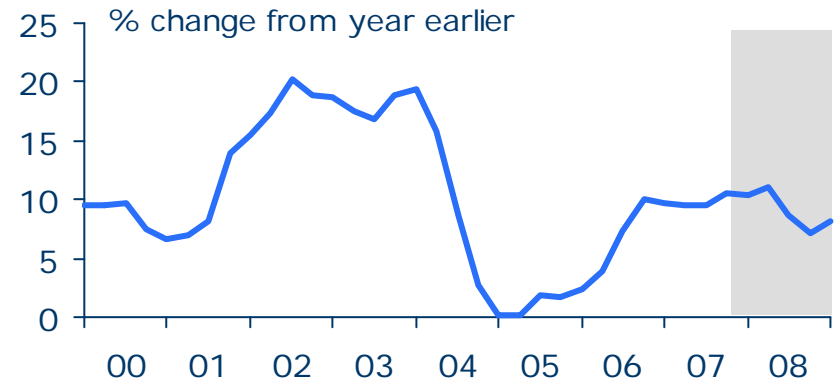
Housing is increasingly in short supply, putting upward pressure on rents ²³

Australian housing market fundamentals

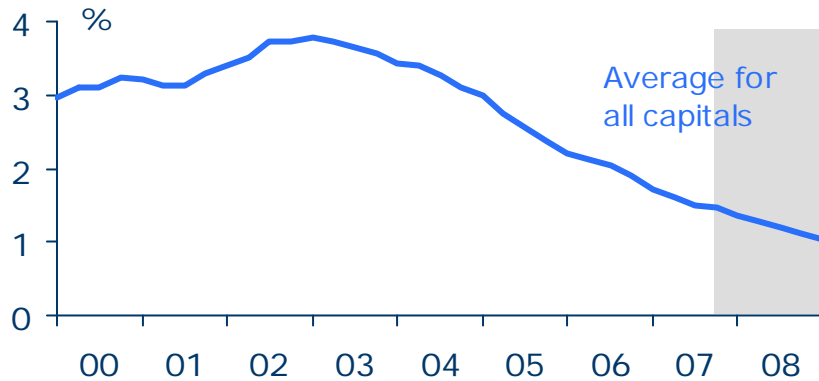
Housing supply and demand



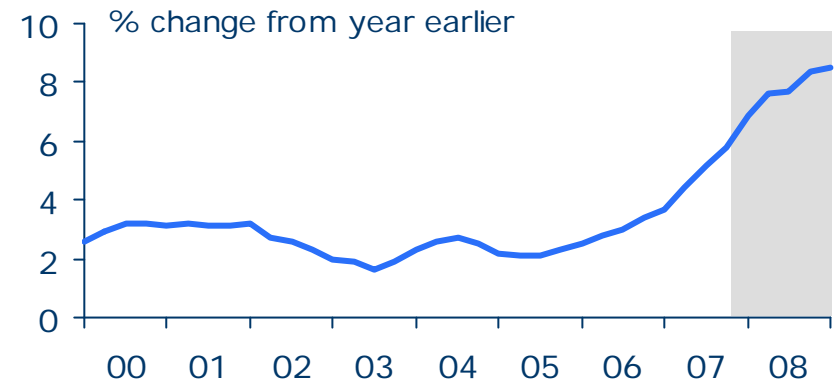
Capital city house prices



Rental vacancy rates

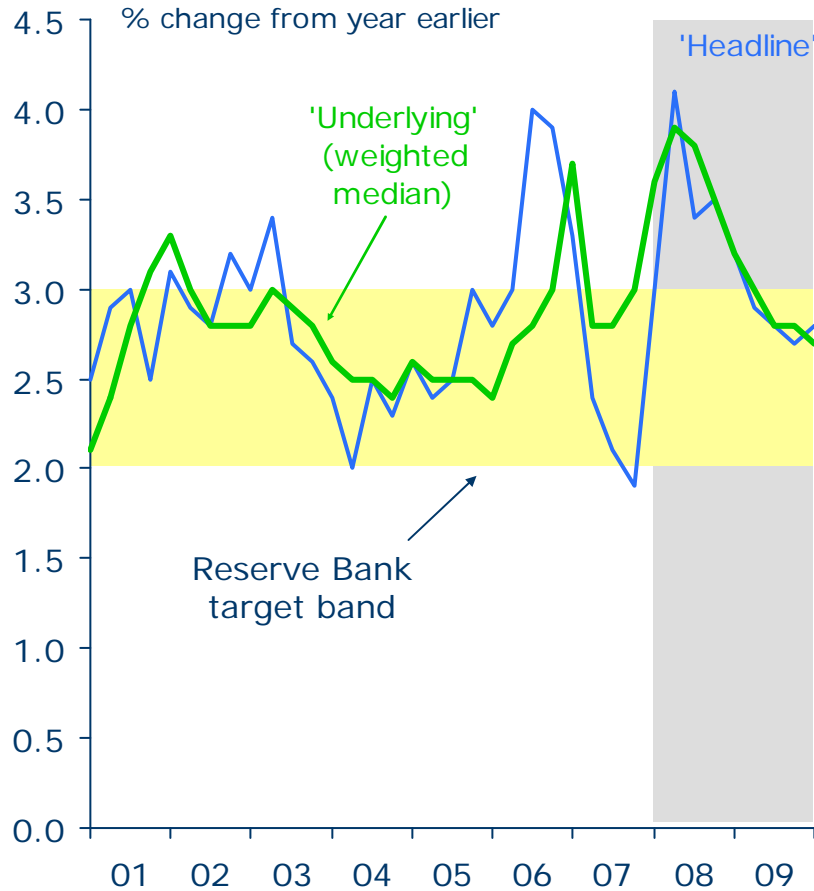


Capital city dwelling rents

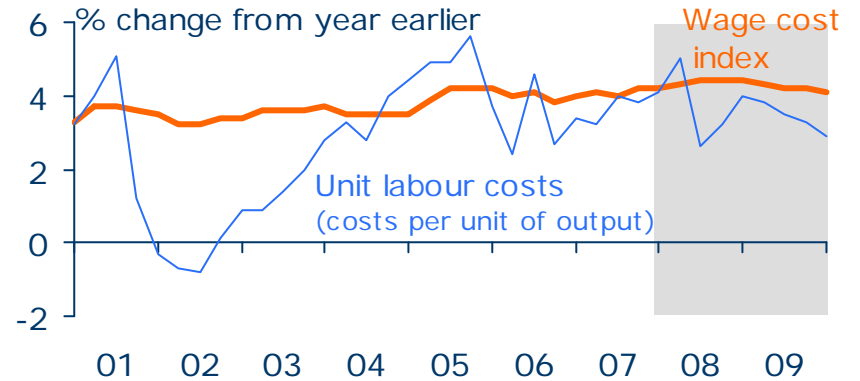


High inflation (reflecting demand growth in excess of supply potential as well as global factors) remains a serious concern

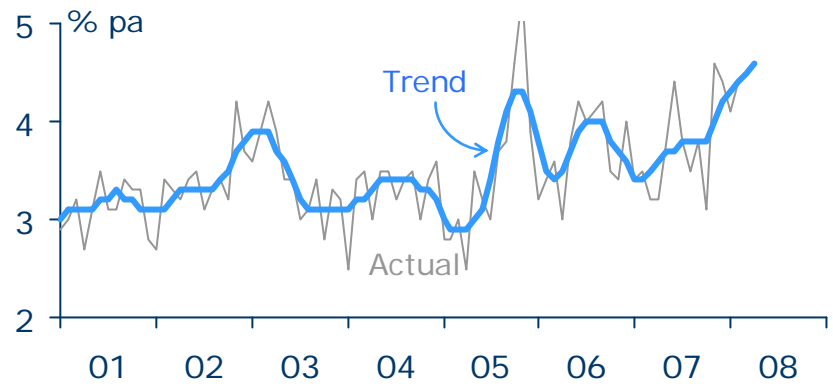
Consumer prices



Measures of labour costs

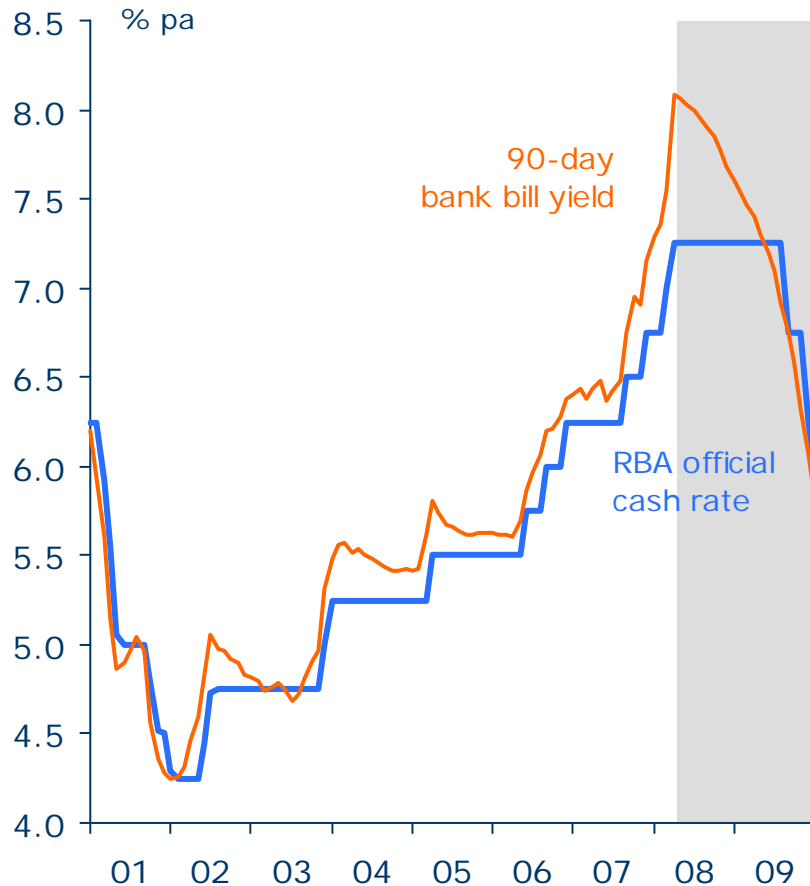


Household inflation expectations



The 1% increase in official rates since August, combined with the effects of the credit crunch, should now be 'enough' for the RBA²⁵

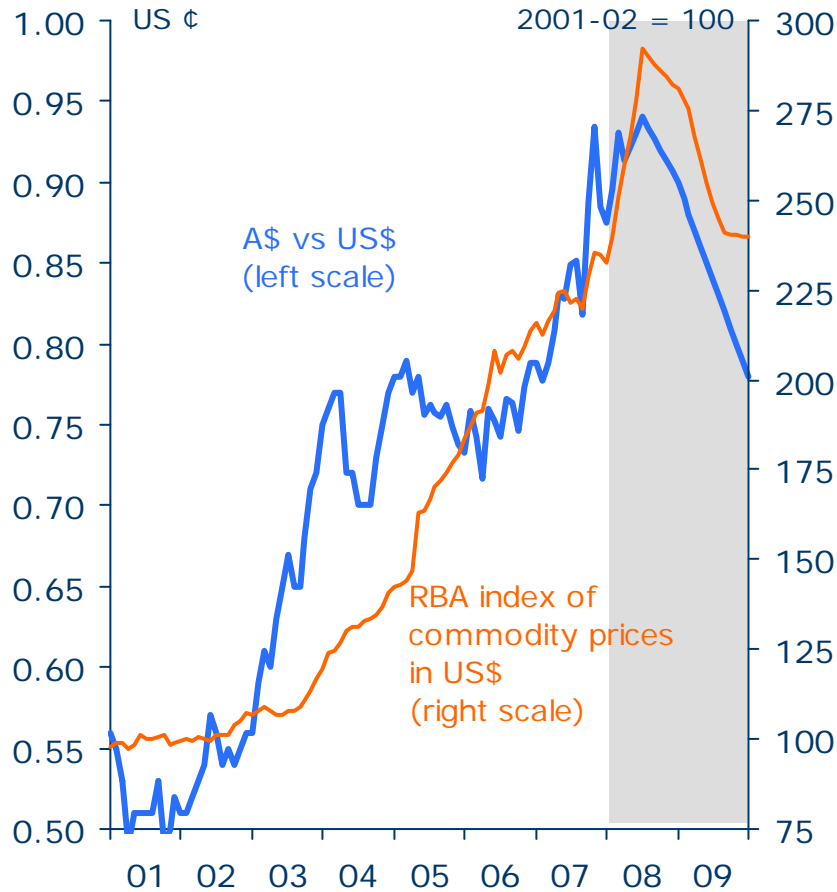
Short-term interest rates



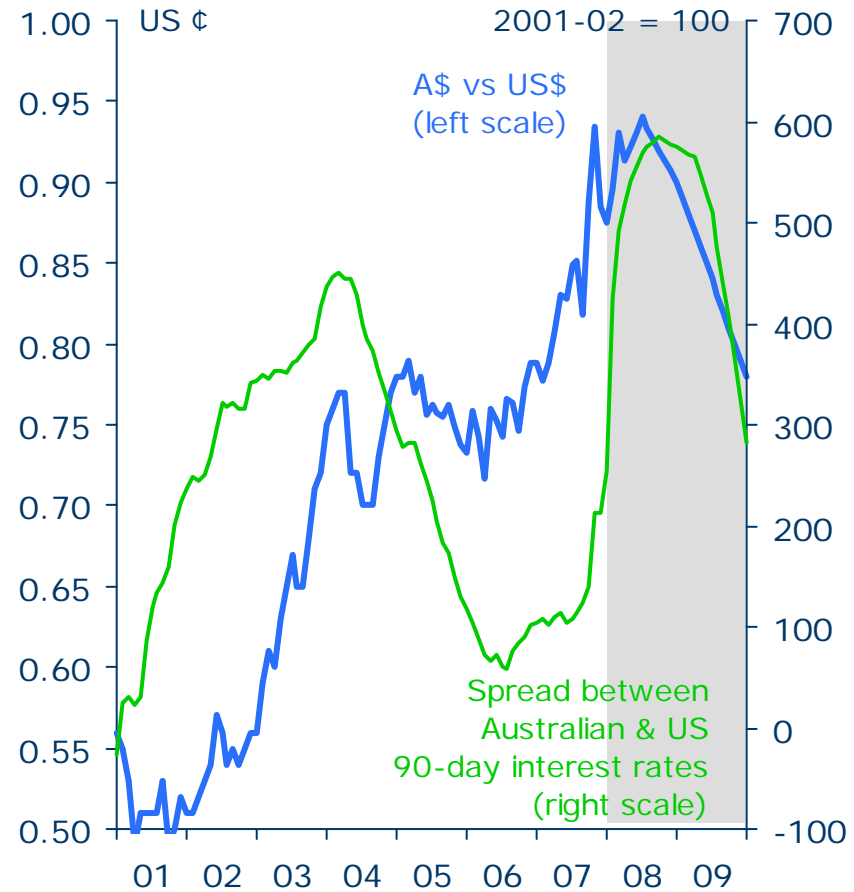
- The RBA tightened monetary policy aggressively in late 2007 and early 2008.
- Mortgage rates have risen by an additional ~0.4 pc points, and business rates by rather more, over and above this increase in official rates
- Combined with the other effects of the credit crunch, a stronger exchange rate and sharply lower share prices this amounts to a substantial tightening of financial conditions
- The RBA is increasingly comfortable that domestic demand is slowing, which will eventually put downward pressure on inflation.
- Official rates have thus peaked, and will fall from mid-to-late 2009 onwards
- Market pricing for rate cuts in 2008 is premature, with the risks to inflation in the short term still to the upside.

Support for the A\$ from commodity prices and interest rate differentials will erode next year

A\$ and commodity prices



A\$ and interest rate spreads



Sources: Thomson Financial; Reserve Bank of Australia; ANZ.



Summary

- The US sub-prime mortgage crisis has morphed into a fully-fledged global credit crunch
 - the US economy may fall into recession (though it probably isn't there yet)
 - Europe and Japan are also likely to experience significantly weaker economic growth
- Developing Asian and other emerging economies are much less reliant on foreign capital than previously and so won't be significantly affected by the credit crunch, although their exports to the US will slow
 - developing country demand will likely keep commodity prices high
 - metallurgical and thermal coal prices both likely to be significantly higher in 2008-09, though this probably represents the peak
- Although Australia will continue to benefit from rapid growth in China and other developing countries, its large current account deficit and reliance on banks' overseas borrowings makes it vulnerable to the credit crunch
- Domestic demand growth will slow sharply from its 2007 pace of nearly 6% to less than 3% by early next year
 - there is some risk of an earlier and sharper slowdown in domestic spending
- This sharp slowdown will allow Australian interest rates to fall from mid-2009 onwards, and the A\$ will also fall significantly as rates come down

The material in this presentation is general background information about the Bank's activities current at the date of the presentation. It is information given in summary form and does not purport to be complete. It is not intended to be relied upon as advice to investors or potential investors and does not take into account the investment objectives, financial situation or needs of any particular investor. These should be considered, with or without professional advice when deciding if an investment is appropriate.

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