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NAB report predict significant rate cuts in early 2009

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National Australia Bank forecasts significant rate cuts in early 2009, as the Australian economy appears to be slowing faster than expected.

Moreover, NAB's monthly business confidence survey for April released this week forecasts Australian GDP to remain unchanged at 2.75% in 2008 and 2009 and GDP discounting farm and mining to fall below 2% during 2009.

House price increases would ease to about 4% as a result of tighter financial conditions and associated lower growth in asset prices.

But the report predicts the Reserve Bank of Australia (RBA)'s core inflation measures to stay around 4% for all of 2008, which could mean rate rises later in the year.

"With oil prices and upstream pressures very high, the RBA will be on aggressive inflation watch for some time with a clear upside bias," it warns. "Any signs of accelerating wages, a stronger economy or labour market could well see the RBA in action again.

"We still see downside risks to demand and expect core inflation to be back into the target range by mid 2009."

The report notes RBA's core inflation was more pessimistic than NAB's, both short-term and into 2009, but the increased NAB headline inflation forecasts reflected continued higher oil prices.

The report warns the disruption in financial markets is far from over. "Indeed additional costs on banks' near term funding costs (above that imposed by central banks) remain substantial," it says.

"Similar increases in banks' longer term funding costs are also apparent. That combination, together with increased demand for corporate funding could well see Australian banks moving to ration credit – as is already the case in the USA and Europe – in late 2008, potentially hampering growth even further."

NAB says the results from its latest survey strongly reinforced the view that a significant slowing had already occurred and was occurring faster than it and business had expected.

The report notes there are now more pessimists than optimists in all sectors of the economy, except mining, and warns sustained falling confidence could have a detrimental psychological affect on business and negatively impact business hiring and investing intentions.

The survey showed business confidence fell sharply in April from already the lowest level since September 2001– down four points to minus eight points as more forward orders fell sharply – down five points to minus five points – the lowest level since

October 2001.

Profits and trading conditions alike fell by four points and three points, to plus 10 points and plus two points, respectively – the lowest reading since early 2002.

Business conditions remained unchanged at plus seven index points – also the lowest reading since December 2002, reflecting a still tight labor market, while employment rose five points to plus nine points;

The exception to the rule was the mining sector, where conditions and confidence improved. There was also some improvement in finance confidence, while most other sectors suffered falls in confidence, particularly retail and transportation.

But conditions fell sharply in finance, retail and personal and recreational services, and of concern to RBA, a picture arose of sharply rising purchase costs, further acceleration in inflation and marginally higher wages despite a still strong labor market.

Overall, the survey remains consistent with domestic demand, slowing to around 3.5% in April – well down from about 5.5% in late 2007.

However, of concern is the wages growth, which accelerated in April, increasing marginally to 5.2% in the year ended April.

Purchase costs – including oil – jumped sharply while overall and retail prices accelerated further as retail prices rose to 2.9% at an annual rate.

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