

Addendum – PMI Outlook for the Australian Property Market October 2008 **Tuesday 14th October**

In light of the recent deterioration in global financial markets and the RBA's 100 basis point cut in the official cash rate in October, BIS Shrapnel will be revising its short-to-medium term economic outlook.

The Australian economy has not been immune to the global crisis of confidence, despite not suffering from an overhang of capacity and continuing to benefit from strong income flows as a result of the commodity boom. Credit growth slowed sharply through the first half of 2008 and consumer spending contracted in the second quarter. Employment growth slowed, but the labour market remained tight and disposable incomes continued to post solid growth, despite the rise in interest rates.

The significant pipeline of mining and infrastructure works underway will continue to support investment through 2009. With the US, UK and possibly parts of Europe expected to be in recession through 2009, commodity prices are likely to fall further. But in the absence of a sharp slowdown in Chinese investment growth, many of the planned mining and associated infrastructure projects, particularly oil, gas, coal and iron ore, will remain economically viable. Moreover, the long lead times for projects and their scale means that activity would be slow to adjust down to a drop in demand. Strong government revenues, particularly federal, have also been underpinning a major round of infrastructure investment. The Federal Government has scope to fast-track projects to provide a counter-cyclical boost to activity, but it would still take time for construction activity to ramp up.

While engineering construction activity is expected to remain resilient through the current financial turmoil, discretionary investment spending on machinery and equipment is likely to be scaled back. The current climate of risk aversion has also made it difficult for speculative building projects to attain finance and the deleveraging process is a global phenomenon, with businesses often being required to reduce their gearing levels before they can refinance loans. This has impacted on demand for industrial and commercial property, despite broadly favourable leasing conditions. Therefore the level of non-dwelling building is set to fall significantly once the current round of construction has been completed.

Dwelling approvals also softened as a result of the run up in interest rates. However, the commercial banks passed on 80 basis points of the 100 basis point cut in official interest rates in October and we are now forecasting the standard housing variable rate to fall to 8.1% by June 2009, remaining at 8.1% by December 2009, before declining a further 0.3% to 7.8% by June 2010. In the absence of wholesale job losses and a blow out in unemployment (which we are not anticipating), sharp drops in house prices are unlikely and the undersupply of dwellings will effectively put a floor in construction.

Despite the massive government and central bank intervention programs overseas, the credit crisis has further to run and it will take time for confidence to be restored.

The current pipeline of construction work and the strength of mining incomes will support the Australian economy in the near term. The recent depreciation in the A\$ will also support export volumes, although this will be offset to a large extent by the slowdown in world demand.

However, the resilience of growth largely depends on whether consumer confidence returns sufficiently to prevent a sharply domestically-driven slowdown. On balance, we expect that the economy will sustain growth at 2.5 to 3% through 2008/09, but calendar 2009 will see growth weaken further as a result of a gap in building activity. However this gap will increasingly be filled through 2010 by an upswing in dwelling building as confidence returns and lower interest rates encourage the release of significant pent-up demand for housing.