

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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LESS NEED FOR RATE RISE, SAYS CEO

The continuing propensity of commentators to sensationalise interest rate policy by breathlessly trying to link every economic statistic to the outcome of the next Reserve Bank board meeting is pushing them to the brink of professional misconduct.

The Commonwealth Bank Chief Executive David Murray was interviewed last Wednesday night by the ABC's daily radio current affairs programme 'PM'. The reason for his interview seemed to be clear according to the compere's introduction since "Australia's biggest home lender wants your mortgage payments to rise. The Commonwealth Bank is calling for an official interest rate rise of half a per cent by the end of the year".

There was no ambiguity here and it seemed an interview was warranted since a senior banking executive urging monetary policy changes on the central bank so publicly was a departure from the norm. But Mr Murray was saying no such thing.

He began by telling the ABC's business editor that "[t]he Commonwealth Bank's economists, in common with many, feel that interest rates could rise a little further towards the end of the year." Note: "could" rise.

In making the point that "...the Reserve Bank will be looking at many factors in deciding whether to leave interest rates where they are or to raise them", Mr Murray was suggesting that the RBA might actually do nothing. Affronted by the equivocation, the interviewer prodded him along: "What should they be doing then?".

Again Mr Murray was disappointingly reasonable: "Well I think they've got to weigh up a couple of important things." He went on to talk about the housing market. His main message was that market pressures once concerning the RBA were no longer evident according to his own bank's most recent data.

Not daunted, the interviewer pressed on for the scoop: "If the Reserve Bank doesn't act on rates by September or by the end of the year, are we risking another asset bubble....?". Mr Murray's considered response: "No".

The Reserve Bank and the RBA watchers who earn their livings by commenting every day about its likely next move have generally underestimated how much Australia has improved its inflation performance. Consequently, they have the dubious distinction of tipping at least eight of the last four cash rate rises.

Bear in mind it was as long ago as May 2002 when the Governor of the Reserve Bank addressed the House of Representatives Standing Committee on Economics, Finance and Public Administration to draw attention to the need for interest rates to begin rising. There was little doubt in his mind "if monetary policy maintained its present stance for too much longer, there is....a high risk that the economy in time would overheat.... monetary policy should be returned to a more neutral setting."

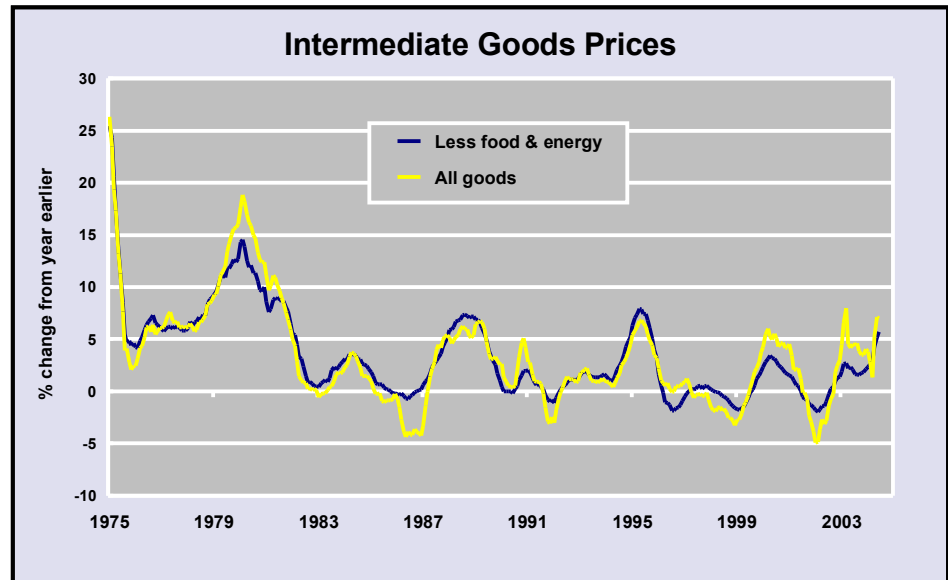
More than two years on overall conditions have only justified a relatively modest 75 point cash rate rise with the need for more monetary tightening to counter overheating hardly compelling.

"In Australia, policy makers have continued an unhealthy pre-occupation with the inflation-prone economy we had in the 1980s. Policy settings have been biased by this experience...."

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THE WEEKLY CHART SPOT

Prices of intermediate goods (excluding food and fuels) in the USA were 5.7% higher over the year to June 2004. However, on a month by month basis the rate of increase seems to have moderated. The June rise was the lowest in five months. The Institute for Supply Management also reported on 2 August that its recent July business survey results showed the rate of intermediate price increase moderating slightly.



Source: US Bureau of Labor Statistics

China: The Odd One Out cont'd

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tous fall in investment activity in the late 1990s. Some recovery is evident but there, too, scars have not healed fully.

Perhaps, also, China managed to steal a march as it was poised for growth at a critical time and, able to take advantage of its relative stability, siphoned away at least some of the investment flows which might have otherwise gone in the direction of south east Asia.

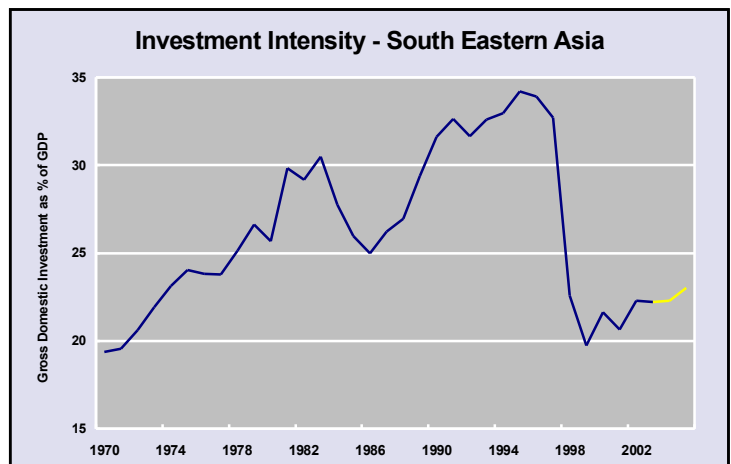
The trend in India is slightly less strong than in China but still impressive in a world averse to taking investment decisions.

Without China and India, the world would be a sorrier place for resource companies. Of that there is little doubt. However, the relative weakness in investment spending elsewhere has made this cycle a weak one by historical standards.

That relative weakness has also meant policy makers have had little cause for concern about the inflationary impact of this cycle. In fact, one of the peculiar features of this cycle is not the strength of China - the point of more general focus - but the weakness elsewhere. That has at

least two implications for investment markets.

- It will be easier for commodity producing industries to adjust supply to China's needs (because the pressures from elsewhere will not be causing as much supply side panic as they might



otherwise).

- There might be another occasion, in years ahead, when the strength of Chinese demand coincides with an upturn in the investment cycle elsewhere to drive a more rapid appreciation of commodity prices.

This latter eventuality will also be the signal that policy makers will have to become more aggressive on the interest rate front to prevent a more deep-seated change in inflationary expectations.

Less Need For A Rate Rise, Says CEO cont'd

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Australia's cash rate remains some three percentage points above the recently reported rise in consumer prices for the year to June. This compares with an average difference over the prior ten years of 3.2 percentage points. And this is amid some signs that economic growth is now moderating.

Compared to the USA where there is scope for monetary conditions to return to "a more neutral setting", Australia's monetary policy has been far more conservative over the past six years.

In the USA during the 1990s, productivity growth accelerated with continuing beneficial effects on inflation which have been

recognised by the Federal Reserve as it has gone about setting interest rate policy.

In Australia, policy makers have continued an unhealthy preoccupation with the inflation-prone economy we had in the 1980s. Policy settings have been biased by this experience despite some similar structural changes to those in the USA evident here as well.

The psychological impact of having 18% interest rates seems to have been long lasting. Anything better, it seems, is to be discounted. The 'take' from the David Murray interview should have been "less need for rate rise, says CBA CEO" but that would have been too much of a leap from the prevailing mindset.

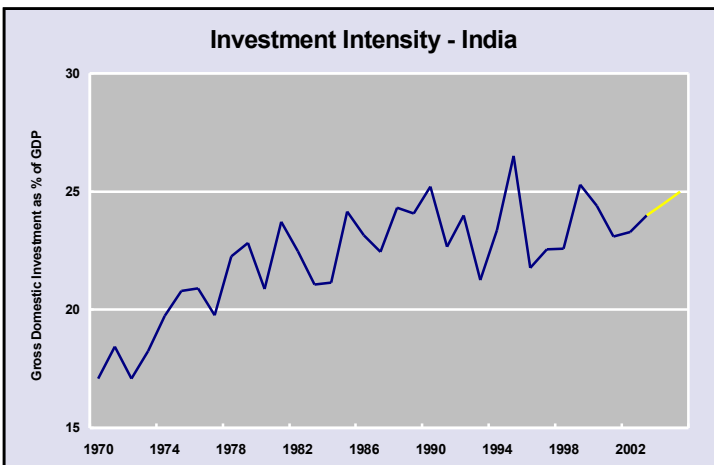
China: The Odd One Out cont'd

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cycles, the corresponding resource market cycle measured as the change in Australian resource sector equity values. In the

China is the odd one out on this occasion. The charts in the earlier article in **thebigpicture** illustrating the extent of the investment weakness in the USA and Australia contrast starkly with what is happening in China.

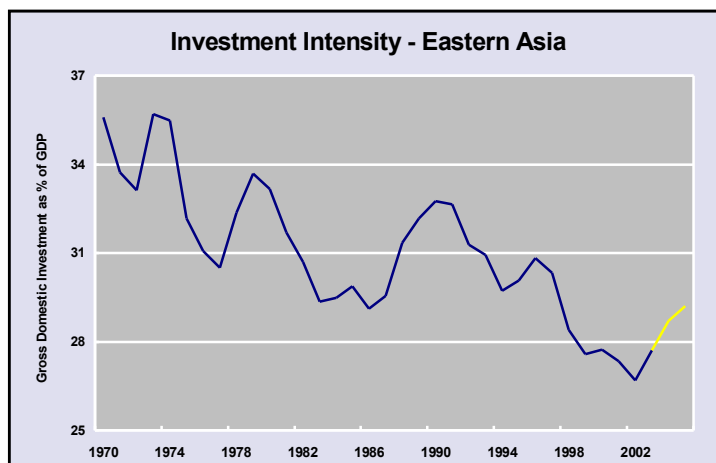
Meanwhile, the overall east Asia picture is also one of relative weakness. The east Asian cycles have been part of an unambiguous down-trend reflecting the declining potency as industrial powers of Japan, Taiwan and, to a lesser extent, Hong Kong over this period of time.



earlier years, the change refers to the All Resources index and, most recently, to the resources component of the ASX 200.

This, albeit rough, empirical analysis suggests that the most recent cycle has been the weakest both in terms of magnitude of change and how long it has taken from the beginning of the China upswing to there being an equity price effect.

One of the reasons for this more tepid performance might be that



The trend in south east Asia is split into two phases by the precipi-

“China having an impact on global commodity markets is not a new phenomenon. Each of the four investment cycles since 1977 has been associated with... relatively rapid appreciation of equity values among resource producing companies.”

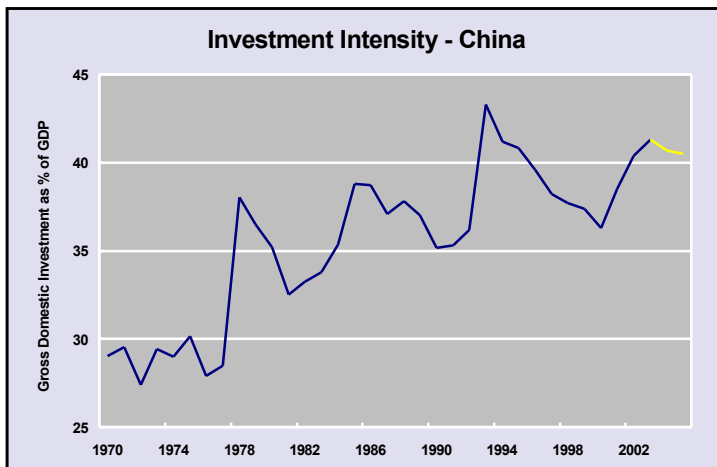
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CHINA: THE ODD ONE OUT

Across the world there is a cleavage in corporate investment performance. In some countries, investment is very weak; in a minority of others quite strong. The cleavage partly explains why inflation pressures are relatively subdued.

In a recent edition (week commencing 14 June 2004), *thebigpicture* noted the weakness in business investment in the USA and Australia. This we ascribed to:

- continuing excess capacity attributable in part to disappointing outcomes from the last round of investment in plant and equipment;
- anxiety about the business regulatory



- environment making managers and directors more risk averse; and,
- some global relocation of industry brought about by relative cost changes.

In contrast, Chinese economic growth seems to have become more self-sustaining (and less dependent on the cycle of activity in developed economies). The importance of investment in the overall spending mix remains high with gross domestic investment set to exceed 40% of GDP in 2004. As the chart illustrates, the out-

come is likely to be lower than at its 1993 peak but still consistent with an upward trend in the investment intensity of the Chinese economy since the early 1970s.

The investment intensity of activity is an important driver of global demand for raw materials and hence commodity price outcomes and the export performance of Australia's mining houses.

The chart also highlights the extent to which there have been investment surges over the past 30 years driving the investment contribution higher during each of the four cycles over the period covered by the chart.

The Chinese and other Asian data shown in the charts have been drawn from the databases of the United Nations and combined with forecasts (shown in the yellow line extensions) from the Asian Development Bank.

There are some cogent reasons to look at China with a newfound sense of awe at its size and industrial potential. However, China having an impact on global commodity markets is not a new phenome-

non.

Each of the four investment cycles since 1977 has been associated with an upturn in commodity markets and a relatively rapid appreciation of equity values among resource producing companies.

The table shows, for each of the Chinese

China and Resource Equity Prices		
China Cycle	Resource Cycle	Resource Equities
1977-78	Jan 78 - Oct 80	+320%
1983-85	Jan 83 - Jan 86	+75%
1992-93	Jan 93 - Jan 94	+66%
2000-03	Jan 03 -	+43%

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“There might be another occasion, in years ahead, when the strength of Chinese demand might coincide with an upturn in the investment cycle elsewhere to drive a more rapid appreciation of commodity prices.”