The Australian Economy in 2002

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Australia’s economy has once again defied a major global slowdown.

Real GDP growth

- In 1974-75, 1981-82 and 1990-92, world economic growth dropped below 2½% - and each time Australia experienced negative growth.
- However during the Asian crisis, and again during 2001, world growth of less than 2½% did not send Australia into recession.
- Australia’s economy slowed sharply in the second half of 2000 - ahead of the downturn in the global economy - but last year strengthened as the world economy slowed sharply.

Note: World GDP based on weighted averages for 51 countries, excluding Russia and Eastern Europe before 1991. Shaded areas denote periods of sub-2½% world growth.
Leading indicators pointing to a further pick up in Australian economic growth in the current half

Job advertisements and economic growth

Slope of the yield curve and economic growth

Note: 'Slope of the yield curve' is the spread between long (10-year) and short (90-day) interest rates. Job Ads and yield curve are shown as 3-month moving averages. Sources: ABS; ANZ; Datastream.
Australia withstood the 2001 global slowdown via a combination of good luck & good management

- The past 20 years' of economic reforms have strengthened Australia's ability to withstand external shocks, and reduced its propensity to generate internal ones
- The Reserve Bank was quick to unwind its 1999-2000 tightening of monetary policy, cutting rates to 30-year lows by late 2001
- The weak A$ (not engineered by policy :) shielded Australian exporters from the worst effects of the global slowdown
- An dramatic upturn in housing - after the policy-induced slump in the second half of 2000, but aided by interest rate cuts and subsidies to first-home buyers - provided a substantial boost to overall growth in the second half of 2001
- The easier stance of fiscal policy, though overwhelmingly driven by political considerations, lent some support to economic growth
- Not having an IT sector meant Australia's only exposure to the global IT bust was a positive (through falling prices for IT imports)
- More generally, Australia avoided the financial imbalances and investment boom associated with the IT boom-bust cycle
The US asset price and investment ‘bubbles’ were not replicated in Australia

Stock prices

Dec 1990 = 100

US (Wilshire 5000)

Australia

Personal saving rate

% of disposable income (4-qtr moving average)

Australia

US

Household net worth

Multiple of (annualized) disposable income

Australia

US

Business investment

% of GDP (4-qtr moving average)

Australia

US

Sources: Datastream; ABS; Economics@ANZ; US Federal Reserve; US Bureau of Economic Analysis.
Exchange rates have been another key difference - although that effect is now starting to fade a bit

A$ vs US$

Real effective exchange rates
Dec 1990 = 100

Trade balance

Net trade contribution to GDP
% pt contribution to ch. in GDP from year earlier

Sources: Datastream; JP Morgan; ABS; Commerce Department.
The export boom is over: net exports will subtract 1¼ pc points from reported Dec qtr GDP growth

Exports of goods and services by volume and value

Value of goods exports to selected trading partners

Note: Exports exclude naval frigates and non-monetary gold. Sources: ABS; Austrade.
The dwelling construction cycle will peak around the middle of this year

- Housing has rebounded strongly from its GST-induced slump, providing vital support to growth while exports have slowed
- Building approvals and other leading indicators of housing activity peaked in the December quarter
- Dwelling construction will continue to boost overall growth until around mid-year
- After that, however, the housing cycle will turn down, with starts falling to 123,000 in 2003-04 (compared with 115,000 in 2000-01)

**Graph:**

Building approvals and dwelling investment

- '000 (3-mth mvg avge; annual rate)
- 1999-00 $ bn annual rate)

- Private dwelling approvals (left scale)
- Housing investment (right scale)

**Sources:** ABS; Economics@ANZ
Tax cuts, benefit increases, lower interest rates and petrol prices boosted consumer spending

Net income tax payments

% change from year earlier

Interest payments

% change from year earlier

Social security benefit payments

% change from year earlier

Spending on 'motor vehicle operation'

% change from year earlier

Sources: ABS: Economics@ANZ.
Consumer spending will ease back during 2002 as last year’s sources of stimulus fade

- Consumer spending strengthened through 2001, helped by ‘voter-friendly’ tax and spending initiatives, falling interest rates and petrol prices, and flow-on effects of the housing and rural booms.

- However consumer spending is likely to ease back somewhat this year as some of these stimuli wear off - and as the interest rate cycle begins to turn.

- The positive effects on consumer spending of stronger employment growth in 2003 will be partly offset by higher debt servicing burdens as interest rates rise from late this year onwards.

Sources: ABS; Economics@ANZ
Growth in aggregate household debt is less of a problem than implied by the debt-income ratio ...

Household debt as a pc of disposable income

Household assets as a pc of disposable income

Sources: RBA; ABS; Economics@ANZ. Includes unincorporated enterprises.
... but households are nonetheless much more sensitive to movements in interest rates

Household debt as a pc of household assets

Net interest payments as a pc of disposable income

Sources: RBA; ABS; Economics@ANZ. Includes unincorporated enterprises.
Job prospects are improving, although returning job-seekers may delay the fall in unemployment.

Job ads and employment growth

Unemployment rate

Sources: Economics@ANZ; ABS.
Business profitability has begun to improve after an unexpectedly tough 2000-01

**Company profits**

- % ch. from year earlier (4-qtr mvg avge)

**Prices and costs**

- % ch. from year earlier (4-qtr mvg avge)

**Labour productivity**

- % ch. from year earlier (4-qtr mvg avge)

**Profit perceptions**

- Net balance better (%)

(a) Non-farm GDP deflator, (roughly) adjusted for GST impact in 2000-01

Sources: ABS; Commonwealth Treasury website; NAB Quarterly Business Survey.
The acceleration in productivity growth has been less sustained in Australia than in the US

- Productivity growth slowed more markedly in Australia during 2000-01 than it did during the US last year.
- Although there's no denying that trend productivity growth has accelerated in Australia during the past decade, productivity growth seems to have been more cyclical than in the US ...
- ... and more clearly attributable to structural economic reforms (including those which permitted the greater use of IT).
- It remains to be seen whether Australia will be able to repeat its late 1990s productivity performance.

Nor is Australia’s strong growth helping the A$; rather, the A$ seems to be tracking the euro.

**A$ and economic growth**

<table>
<thead>
<tr>
<th>Year</th>
<th>A$/US$ (left scale)</th>
<th>Expected Australian minus expected US real GDP growth over coming year (right scale)</th>
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**A$ and € vs US$**

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<th>A$/US$ (left scale)</th>
<th>€ / US$ (right scale)</th>
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<td>02</td>
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**Sources:** Consensus Economics Datastream. **Note:** synthetic euro before January 1999.
Improving profitability should see an upturn in business investment

Non-residential building

% change from year earlier

Approvals (18-mths forward)

Real value of work done

Plant & equipment investment

% ch. from year earlier

Machinery & equipment spending

Imports of capital goods

Engineering construction

% change from year earlier

Commencements (6-mths forward)

Real value of work done

Business investment

% ch. from year earlier

(Forecast)

Sources: ABS; Economics@ANZ. Approvals/commencements shown as 6-mth moving averages.
The government needs to wind back last year's vote-driven spending spree

- The Government's re-election drive saw it erase some $23bn from the budget surpluses in prospect over the four years to 2003-04
- Stronger economic growth than envisaged in October means that the cash surplus for 2001-02 will probably be bigger than the forecast $500mn - even allowing for increased spending on defence and asylum seekers
- However, the electoral cycle dictates that this year's Budget is likely to be much 'tougher' than the past two years'
- The burden of spending cuts is likely to fall on the States

The key issue for 2002’s growth profile is the transition from housing to other sources of growth

- The peak in the housing cycle is neatly co-incident with the trough in the export cycle.
- Together with the strength in consumer spending, this has enabled Australia to ‘ride out’ the global downturn.
- However with housing set to turn down from around mid-year, and with little reason to expect any acceleration in consumer spending, sustaining growth above 3½% will require a pick up in business investment and exports.
- There are signs that investment will pick up (though heavily skewed towards mining), while an export revival depends on the world.

Sources: ABS; Economics@ANZ
Inflation is now running at above the Reserve Bank’s 2-3% target

- The CPI rose 0.9% in the December quarter, taking the annual inflation rate to 3.1%
- Some of the ‘one-off’ factors contributing to the December quarter increase will spill over into the current quarter
- There’s some evidence that ‘survivors’ in sectors where corporate collapses occurred last year now have greater power to set prices
- With ‘upstream’ inflationary pressures falling and moderate growth in labour costs, inflation should fall back into the Reserve Bank’s 2-3% target band later this year

Sources: ABS; Economics@ANZ.
The Reserve Bank will start raising interest rates later this year, but by less than markets expect.

With downside risks from the global economy lessening, and the Australian economy continuing to grow strongly, the Reserve Bank is now clearly contemplating removing some of the monetary stimulus it provided last year.

- We expect the RBA will raise the cash rate by ½ pc point in August, and then by a further 1 pc point during 2003.
- This would be below the peak in the 1999-2000 interest rate cycle.
- Financial markets are expecting rates to start rising earlier, and by rather more in total (around 2 pc points) by the end of next year.

**Short-term interest rates**

- 90-day bills
- Bill futures as at 21 Feb
- ANZ forecasts

**Sources:** Reserve Bank; Datastream; Reuters; Economics@ANZ.
Neither firm commodity prices nor relatively high interest rates are helping the A$ like they used to.

**A$ and commodity prices**

**A$ and interest rate spreads**

- **RBA index of Australian export commodity prices in US$ (right scale)**
- **A$/US$ (left scale)**
- **Spread b/w Australian & US 90-day interest rates (right scale)**
- **Basis points**

**Sources:** Reserve Bank; Datastream.
Exchange rate movements are increasingly dictated by capital flows

The US$ has been strong - despite an enormous US current account deficit - because the US has been able to finance that deficit through net foreign purchases of stocks and corporate bonds.

- These inflows are (typically) unhedged (in contrast to purchases of government bonds or bank financing transactions) and thus generate net demand for US$ to offset the net supply arising from the current account deficit.

- The great unknown is, how long will this appetite for US$ continue?

Sources: US Commerce Department; Economics@ANZ. 'Net equity' investment into the US includes corporate bonds.
Weakness in the A$ reflects Australia’s inability to attract net equity capital inflows from abroad

- Over the past two years, Australia has become a net exporter of equity capital...
- ... which means that Australia has had to borrow more offshore (even though the current account deficit has been declining) to finance both the deficit and the equity outflow.
- Most of that borrowing is done through the banking system, which hedges or swaps the currency exposure - so that these transactions create no net demand for the A$ (in marked contrast to the way the US finances its deficit).

Sources: ABS; Economics@ANZ.
A$ still unable to sustain levels above US52¢ but still looking for higher levels later this year

A$-US$ outlook

- Traditional fundamentals - incl. commodity prices, interest rate spreads and prospective growth rate differentials - are starting to turn more positive for the A$
- However the A$ is still suffering from the 'pull' of capital to the US (apparently - since no hard data beyond last September)
- At some point, corporate and investor thirst for US$ assets will fail short of the US' requirement for external financing (which will widen again this year)
- When that happens, the US$ will turn - and so will the € and the A$
Summary

- Australia’s economy has - through a combination of good management and good luck - once again defied the global slowdown
- Housing, which is currently providing the major impetus for growth, will turn down from around mid-year onwards, while growth in consumer spending is also likely to ease back a bit as some of last year’s supports fade
- Sustained overall growth will therefore require a pick up in business investment and exports in the second half of the year: both seem likely to occur, but probably not enough to prevent a temporary slowing in growth below 3%
- Interest rates will shortly start on an upward trend, although the peak in late 2003 will be lower than that of mid-2000
- The A$ will continue to struggle against the US$ for as long as the US absorbs the bulk of international capital flows; but the A$ will likely appreciate further against the yen
Summary of forecasts

<table>
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<th>Calendar years</th>
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<tbody>
<tr>
<td></td>
<td>2000</td>
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<tr>
<td>Real GDP growth</td>
<td>3.1</td>
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<tr>
<td>Inflation</td>
<td>4.5</td>
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<tr>
<td>Unemployment (Dec)</td>
<td>6.2</td>
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<tr>
<td>Current account deficit (% GDP)</td>
<td>4.0</td>
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<tr>
<td>Official cash rate (% pa, Dec)</td>
<td>6.25</td>
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<tr>
<td>10-yr bond yield (% pa, Dec)</td>
<td>5.55</td>
</tr>
<tr>
<td>A$ (US cents, Dec)</td>
<td>56</td>
</tr>
</tbody>
</table>

Sources: ABS; RBA; Economics@ANZ.
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Presentation to the Australian Industry Group’s Economy 2002 - Forecasting Industry Prospects

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