What's up and what's down Down Under?

Spiros Papadopoulos of National Australian Bank examines an extraordinary year for the Australian economy and outlines the prospects for 2001.

It has not been a normal year for the Australian economy. Following the Y2K-related expenditure boom in late 1999, economic activity in 2000 had to withstand the introduction of a new taxation system and the staging of the Olympic Games in Sydney in September. The depreciation of the Australian dollar to record lows also had to be endured. Although these factors made it more difficult to interpret economic trends in Australia than in previous months, the Australian economy remained robust throughout 2000, although it appears that economic activity has begun to slow and will continue to do so. The main uncertainty is the extent of the possible slowdown in global growth in 2001, which will reduce the potential export gains for the economy, although this will be offset somewhat by the weak state of the Australian dollar.

Solid growth maintained in 2000

Australian GDP grew by 4.7% over the year to the June quarter, continuing a remarkable run in which the economy has now grown at an annual pace of over 4% a year for 13 continuous quarters. Although the second half of 1999 was boosted by strong pre-Y2K investment and strong consumption growth, there is little doubt that the first half of 2000 was influenced by the anticipated introduction of the 10% goods and services tax (GST) on 1 July. In particular, the housing industry was a key beneficiary, with dwelling construction growing at over 12% in the 1999-00 financial year, although that will be reversed as the industry heads for a severe downturn.

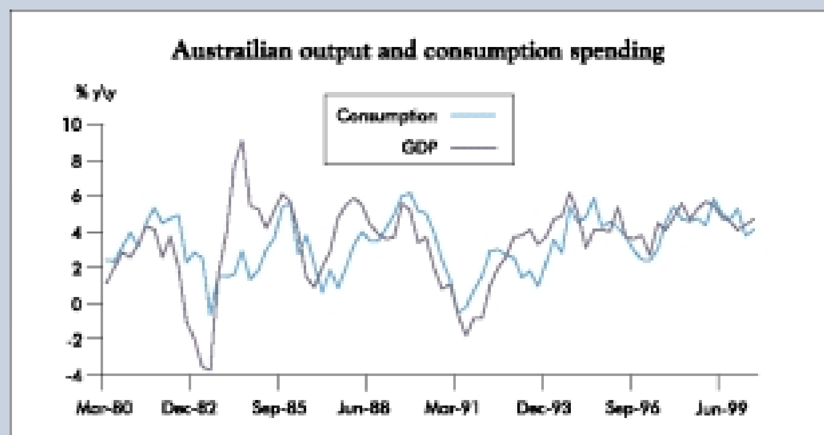
The Olympics also distorted the data readings in 2000. With most of the Olympic-related capital works programmes carried out in 1997-99, the economic impact in the second half of 2000 was estimated at about $1bn. That largely consisted of significant increases in consumption and exports (mainly TV rights and tourism), although total consumption in the September quarter was partly offset by less spending by domestic residents, as many sport-loving Australians chose to stay at home during the games to watch the proceedings on television.

Growth is expected to slow to about 3% in annual average terms in 2001 and the mix is likely to change. Dwelling investment will slump, household consumption will soften and business investment will be flat. This is expected to be partially offset by stronger net exports, despite the slowing in growth of Australia's major trading partners and some softening in commodity prices, with key competitive benefits imparted by the weak Australian dollar.

Slower global growth in 2001?

Through the course of 2000 the resynchronisation of world economic growth has been a remarkable development.

FIGURE 1



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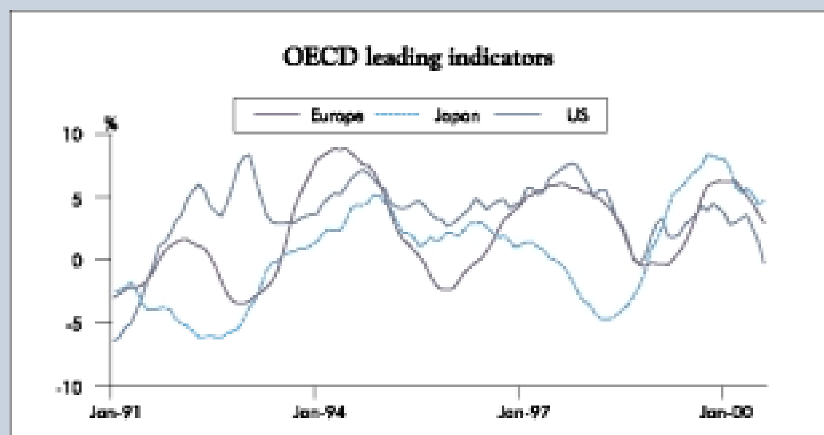


After a decade of different performance across the key economic regions, a clear common trend of slower growth has emerged. This broad-based slowdown seen in the big-picture economic indicators (leading indexes, regional industrial production) has important implications for Australia.

For some time, markets and forecasters have expected that the necessary slowdown in the US would be at least offset by accelerating growth in Europe, Japan and non-Japan Asia. At present, that looks unlikely to happen and global growth in 2001 is shaping up to be slower than in 2000.

In turn, this suggests that the stimulus to the Australian economy from exports may not be as strong as previously thought. More by accident than design, the potential negative of a weaker global economy will be significantly offset by the extraordinarily weak Australian dollar.

Inflation: following the script so far

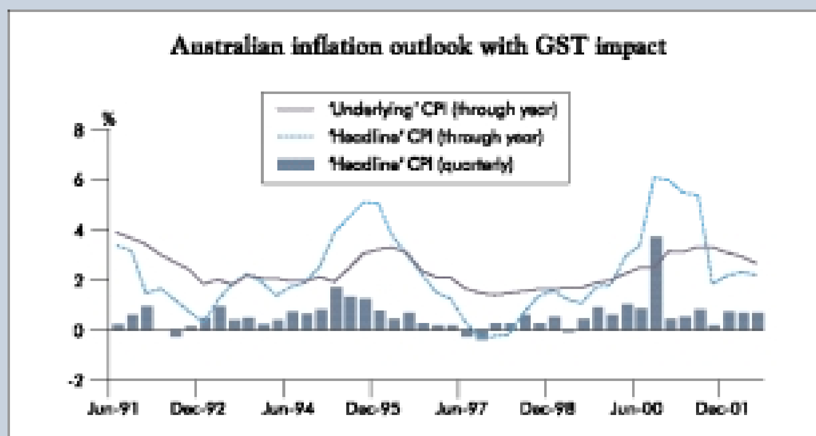
Despite fears that the introduction of the 10% GST on 1 July 2000 would seriously impact on inflation, the September quarter CPI rose by a much less than expected 3.7%, to 6.1% over the year. The outcome prompted calls from the market that interest rates had peaked, but concerns remain – mainly that the September rise understated the full impact of the GST, and that a second (smaller) installment will appear in the December quarter. Possibly, but the more important issue is that there is little evidence of 'second round' profit rebuilding happening under a GST smokescreen.

The risks to inflation from GST-linked wage claims are also muted. The union movement has turned up the heat – or at least the volume – but once again, a slowing economy plus the lack of union clout in many of the labour-intensive sectors makes large broad-based pay rises unlikely.

So the inflationary impact of the GST looks to be on track to be quarantined to the first couple of quarters of its life.

There still remains the risk of the weaker Australian dollar and higher oil prices. A belated, but substantial, rise in prices driven by higher import prices cannot be ruled out. But the lack of flowthrough when the economy was growing strongly and the mounting evidence that the domestic economy is slowing may mean that the importers will end up absorbing more of the latest Australian dollar depreciation than they have in the past.

FIGURE 3



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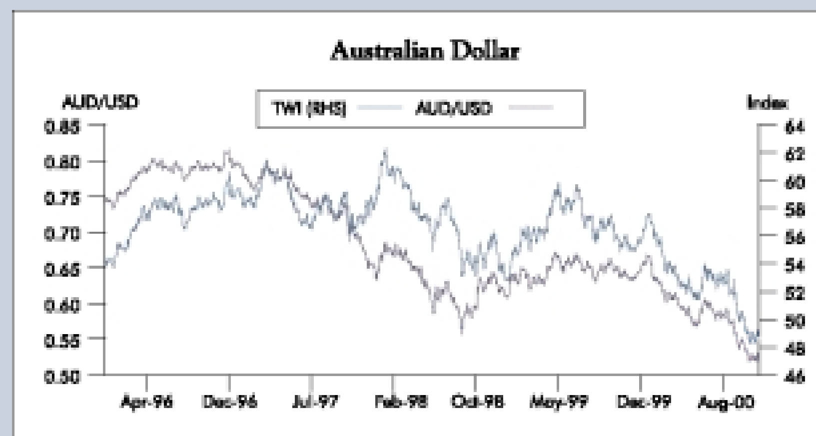

Dollar remains under pressure

During 2000 the Australian dollar neither traded in line with the traditional fundamental drivers of commodity prices, interest rate differentials and net external liabilities, nor with the overall state of the Australian economy.

The core of the problem stemmed from negative investor sentiment towards the Australian dollar because Australian interest rate and equity investments had not offered sufficient outperformance to compensate for the currency risk.

With Australia running a current account deficit of $8bn a quarter, a lack of capital inflows meant it had progressively sagged under its own weight. Investment returns elsewhere, particularly in the US dollar, had been much more attractive. The US dollar was almost the only choice for global investors during 2000, offering good yields, high equity returns on the back of a very strong economy, and, as a result of the capital inflows, an appreciating currency.

Recovery in Australian dollar will require a reduction in Australia's need for capital plus the return of superior investment returns. And these positive factors are likely to become apparent in early 2001. Until then, the Australian dollar will remain weighed down by lack of investor interest.

Interest rate outlook

The RBA has tightened policy in five steps by 150bp to 6.25%, the last increase occurring in August 2000. Key drivers in this tightening cycle have been accelerating credit growth and strengthening world demand.

However, the decision by the RBA not to raise rates at the end of the year was consistent with the state of the economy. The data also suggested that the balance of probabilities had shifted

towards interest rates having peaked. The message from the RBA's preferred economic indicators is that growth abroad is losing some momentum. At home the picture was less clear, in part due to GST and Olympics distortions, but the risks to growth were on the downside.

Although the chances of another rise were declining, the inflation risks remained sufficient to prevent completely ruling out a further rise.

Opportunities for UK and European corporations

From a commercial perspective, the attractiveness of the developing Australian economy is providing high quality investment opportunities for UK and European corporates, further enhanced by the Australian dollar weakness.

Australia has established itself as a consumer-led society, with a strong emphasis on leisure, and the success of the Sydney Olympics has helped to underpin this trait. Additionally, the strong cultural links with the UK and Europe aid the establishment of regional hubs centred around Australia.

The Australian economy has remained robust throughout 2000, although it now appears that economic activity has begun to slow and will continue to do so

As a result it is not only industries with a resource flavour which are investing heavily in Australia – although key global mining concerns have been particularly active in the last 18 months. Increasingly, hotel and leisure businesses are developing their presence as the country continues to benefit from long-haul global tourism expansion. The telecoms, media & technology sector (TMT) is also now well established, with a number of notable global brand names being domiciled in Australia.

Without doubt, UK and European investors benefit from the relatively friendly nature of the Australian legal and financial system, which has many similarities with the UK structure.

While there are some local differences, investing or making an acquisition in Australia would not be dissimilar to embarking upon a similar venture in the UK – a strong commercial incentive.

For many companies Australia is an ideal southern hemisphere base from where key global markets such as China and Japan can be accessed, while also keeping a watching brief upon the recovering Tiger economies of the South East Asia. ■

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