

1 AUSTRALIA

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2004 IN SUMMARY

Real GDP in 2004 grew by 3.6%, following an increase in 2003 of 3.3%. The economy grew strongly despite a deterioration in the balance between export and import volumes. Australia recorded a current-account deficit in 2004 equal to around 6% of GDP, reinforcing concerns about rapidly growing international debt. A major factor underlying the weak external accounts in 2004 was the strong Australian dollar which rose by 10% against a trade-weighted basket of foreign currencies.

Reflecting strong growth in GDP, the unemployment rate fell from an average of 6% in 2003 to 5.6% in 2004. This was achieved with little change in core inflation. Policy debate in 2004 focussed on a variety of issues, including: the appropriateness of monetary policy settings, and the challenges arising from a strong exchange rate. Also subject to debate have been issues relating to the environment, especially water quality/availability and greenhouse gas emissions.

2004 IN DETAIL

Stimulated partly by tax cuts, real private consumption in 2004 grew by 5.5%, up from 4.4% in 2003. In addition to tax cuts, consumption has been stimulated by strong growth in household wealth fuelled by rises in housing prices: the household savings rate has now turned negative with consumers apparently content to be net borrowers on the strength of their capital gains. Dwelling investment in 2004 increased by 1.4% after rising by almost

7% in 2003. Dwelling construction surged in 2002 and 2003, driven by low mortgage rates, supplemented by the effects of a top-up to the First Home Owners Grant scheme. In 2004, without the one-off effects of the top-up, the path of dwelling investment has returned to its cyclical pattern with slowing growth from a historically-high level. Forward indicators suggest that dwelling construction in the first two months of 2005 fell, with signs that the fall off will continue for some time. Real business investment in 2004 rose strongly (up 8%) for the third successive year. The major positive factors being low real interest rates, high rates of profitability, and tightening capacity.

Public final demand is dominated by government consumer spending – wages of public servants and current spending on goods and services. Government consumption in 2004 grew faster than the economy as a whole, boosted by a large-spending program on defence, border protection and airport security.

Export volumes in 2004 rose by 4.6% after falling by 2.2% in 2003. In each of these years import volumes rose by over 10%. There have been a number of factors underlying Australia's poor export performance in recent years. Some are transitory – such as drought-related shortfalls in agricultural exports in 2003 – while some are medium term, such as the decline in tourism growth. Though these special factors are important, together they account for only a small part of the story. The main influence on export growth have been adverse changes in the real exchange rate.

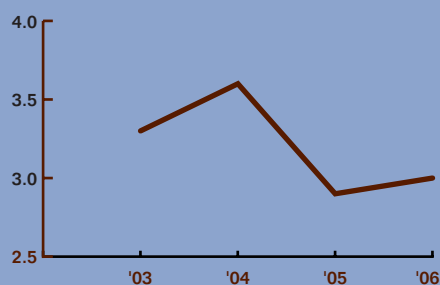
Over the past three years, Australia's currency has steadily appreciated against a trade-weighted basket of currencies. With inflation rates steady, the nominal appreciation has been translated into a real appreciation, reducing considerably the international competitiveness of Australia's export industries. Real appreciation has also been a factor underlying the strong growth in imports.

Somewhat surprisingly, the deterioration in the balance between export and import volumes in 2004 had little impact on the trade-account balance. In 2003, Australia had a trade deficit equal to around 2.2% of GDP. In 2004, that had fallen slightly to a deficit of 2.1% of GDP. The offsetting factor was a sharp improvement of 9.4% in the terms of trade. Reflecting little change in the trade-account balance, the deficit on current account in 2004 averaged around 6% of GDP, little changed year-on-year from the average level in 2003.

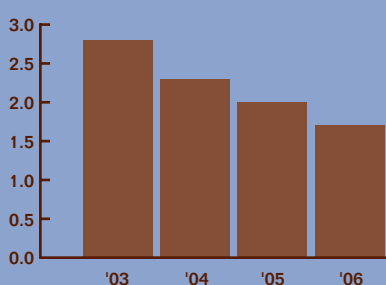
Employment in 2004 increased by 1.9%, precipitating a further fall in the average unemployment rate from 6.0% in 2003 to 5.6% in 2004. Headline CPI-inflation in 2004 was 2.3%, compared with 2.8% in 2003. Some of the moderation can be attributed to a reduction in housing prices and to the rising nominal value of the Australian dollar which has seen prices of imported consumption goods fall.

The Reserve Bank held its official cash rate steady at 5.25% throughout 2004. This and the fact that inflationary expectations changed little during the year meant that interest rates

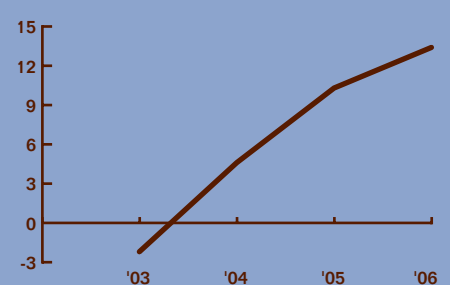
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)





across the board changed little. The story for 2005, however, will be quite different. The official cash rate rose 0.25 percentage points at the start of March with the Reserve Bank reacting to concerns about inflationary pressure building up due to local supply-side constraints.

THE STRONGER AUSTRALIAN DOLLAR

Historically, the value of the Australian dollar has been determined by economic fundamentals: interest rate differential, the strength of the world economy and the position on the commodity price cycle. However, between the start of 1999 and the middle of 2002, the traditional rules seemed not to apply: the Australian dollar fell when the global economy grew strongly and then remained low when the global economy weakened even though commodity prices were relatively strong. The major factor influencing the Australian dollar during this period appeared to be the strength of the US dollar: regardless of the fundamentals, the Australian dollar was out of favour.

Since the middle of 2002 the situation has been reversed. Now the Australian dollar is moving in line with commodity prices and investors appear to be taking notice of the fact that Australian interest rates are well above most international rates. As a consequence, the Australian dollar has increased significantly in value. Against the trade weighted index, the Australian dollar rose in value by almost 19% between the middle of 2002 and the end of 2004, while against the US dollar the increase has been almost 50%. In real terms, the increases have been of a similar magnitude, implying a significant deterioration in competitiveness for Australia's traded goods industries. This is a key risk for Australia's trade

balance, and is likely to slow the improvement in the current-account deficit which would otherwise come with a general pick-up in world demand. On the positive side, though, a stronger currency reduces inflationary pressures, which will ease the pressure on the Reserve Bank to further raise interest rates.

OUTLOOK FOR 2005 AND 2006

Key assumptions underlying the forecast for 2005:

- (a) Interest rates, on average, a little higher than in 2004 reflecting a 0.25 percentage point increase in the official cash rate in March and a further 0.25 percentage point increase around the middle of the year;
- (b) A significant cyclical decline in housing investment through the year resulting in a year-on-year decline of 8.9%;
- (c) An increase of 6.2% in real private business investment (in line with the latest data from the Australian Bureau of Statistics' survey of business investment intentions);
- (d) Growth in real public final demand of 4.5% (the spending increase reflects, in part, some of the promises announced in the run-up to the 2004 Federal election);
- (e) Little change in Australia's terms of trade following the sharp increases in 2003 and 2004;
- (f) A strong pick-up in Australian exports, with a robust rural rebound coupled with a strong increase in mining exports;
- (g) No change in the high level of oil prices; and
- (h) Little change in the value of the currency from levels at the start of the year (TWI = 62 and A\$/US\$ = 0.78).

Overall, GDP growth will likely weaken to 2.9% in 2005. Underpinning this decline will be falls in growth in real private consumption (-3.8%, compared with 5.5%) and in real private dwelling investment (-8.9%, compared with 1.4%).

The volume of net trade in 2005 is expected to deteriorate again, but at a much slower pace than in 2004, thus partly arresting the rate of deterioration in the current-account balance.

In 2005, we are forecasting a current account-deficit at 6% of GDP. Our forecast for CPI-inflation in 2005 is 2%.

For 2006, we are forecasting real GDP growth to be about the same as in 2005 (3% c.f. 2.9%), with a worsening in the current-account deficit as a share of GDP.

UNCERTAINTIES

Global imbalances. Strong global growth seems to be in place at the start of 2005, but there are considerable risks for later in the year and beyond. Currently many countries face large structural budget deficits and have unsustainable current-account balances (surpluses or deficits). The adjustments necessary to correct these imbalances may put at risk most of our forecasts. For example, in correcting the US current-account deficit, we may see a further dive in the value of the US dollar. If this were to translate into real appreciation for the Australian dollar, it would adversely affect the global competitiveness of Australian industries beyond that currently assumed, and make the forecast for the Australian current-account balance too optimistic.

6% FOR FOUR YEARS!

Australia's current-account deficit rose to 6% of GDP in 2003 and 2004, and is likely to remain at about this level through to 2006. Reducing the deficit and curtailing growth in the stock of net foreign liabilities by encouraging saving and by easing supply-side impediments is a major challenge facing Australian policy makers.

CURRENT ACCOUNT DEFICIT (% OF GDP)

