

AUSTRALIA

2002: STRONG PERFORMANCE

The Australian economy performed strongly in 2002 despite the early impacts of a severe drought and weak growth in the world economy. Real GDP increased by 3.8 per cent, real private consumption increased by 4.1 per cent, real private investment rose by around 12 per cent and real public demand was up 5 per cent. Underpinning growth in domestic demand was strong growth in consumer wealth (fuelled partly by substantial rises in housing prices), leading, in part, to significant increases in consumer spending on housing and housing-related durables. Other positive factors were a cyclical upturn in business investment and stimulatory fiscal policy (mainly reflecting a large program of spending on defence, border protection and airport security). Unemployment averaged 6.3 per cent of the labour force and core inflation was moderate. The main negative in 2002 was a sharp deterioration in the balance between export and import volumes, resulting in a doubling in the current account deficit.

Policy debate through the year focused on a variety of issues, including strategies for supporting drought-affected rural Australia, the appropriateness of monetary policy settings, and the challenges arising from the increased risk of terrorism.

Trade and the balance on current account. Export volumes fell by 0.5 per cent in 2002, while imports grew by 10.2 per cent. That exports did not fall by more is an achievement given the global downturn, the problems affecting

tourism, and the early impacts of drought on agricultural exports. Exports in 2002 were supported by the low real value of the Australian dollar, which has maintained a high level of competitiveness for Australia's export industries. In 2001, Australia had a trade surplus of around 0.5 per cent of GDP. In 2002, that became a deficit of about 1.5 per cent of GDP. Reflecting the deterioration in the trade account balance, the deficit on current account rose from 2.4 per cent of GDP in 2001 to 4.1 per cent in 2002.

Employment and inflation. Total employment increased by 2.2 per cent in 2002, following a rise of 1.1 per cent in 2002, precipitating a fall in the average unemployment rate from 6.8 per cent in 2001 to 6.3 per cent in 2002. Headline CPI-inflation was 3.0 per cent in 2002, down from 4.4 per cent in 2001. In 2002, much of the inflation has come from increased prices for housing and for imported consumption goods.

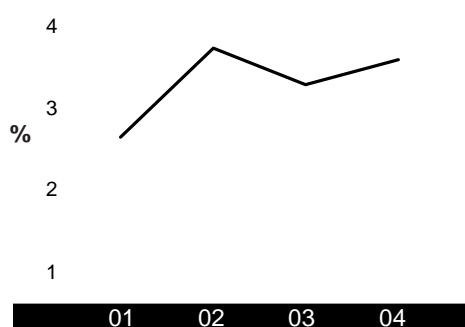
Monetary policy. The official cash rate has been held steady at 4.75 per cent since June 2002—the lowest level in 35 years, and in real terms it has never been lower.

Impact of the drought. Australia is experiencing one of the most severe and widespread droughts on record. Current estimates indicate agricultural output will fall on average by almost 30 per cent in 2002–03 (July to June). The fall in agricultural output itself is expected to remove 1.0 percentage point from Australia's GDP growth rate. Flow-on effects to the rest of the economy are expected to lower real GDP growth by a further 0.6 percentage points.

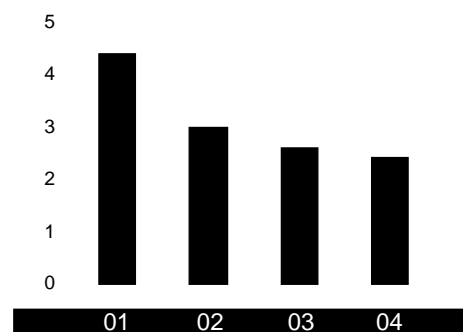
PHILIP D. ADAMS

Centre for Policy Studies,
Monash University

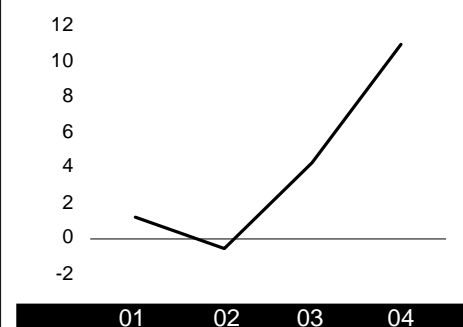
GDP growth



CPI inflation



Export growth



Increased risk of terrorism and the policy response. The most obvious impact effect on the Australian economy of the September 11 tragedy and the Bali bombing, and the attendant concerns about terrorism, was a downturn in international tourism. In the final quarter of 2001, Australia's tourism exports fell by 13 per cent. Tourism numbers continued to fall in each of the next 3 quarters, with only a small rise being recorded in the final quarter of 2002. In year-average terms, visitor numbers in 2002 were down nearly 4 per cent. It is likely that the tourism downturn has taken around 0.4 percentage points from average growth between the financial years 2001–02 and 2002–03.

The policy response to the terrorism risk has led to increased Federal Government expenditure on defence and security. This has contributed to concerns of a budget blow-out, and is likely to result in a tightening of all new spending outside of defence and security, including spending on capital items.

Impact of the war with Iraq. Increased oil prices were the most obvious direct impact effect on the Australian economy of the war with Iraq. Retail petrol prices have risen by around 15 per cent and this, combined with food price rises due to the drought, put strong upward pressure on expenditure-price deflators in first-quarter 2003.

Indirect effects of the war include

- a re-alignment of currency values against the US dollar. Since the start of 2003 the Australian dollar has increased in value against the US dollar by around 17 per cent
- a slowdown in world recovery

- increased government expenditure on defence over and above that noted above.

OUTLOOK FOR 2003 AND 2004

The key assumptions underlying our forecasts for 2003 are

- continued low real interest rates
- a steady cyclical decline in housing investment through the year resulting in little change year-on-year, coupled with strong growth in aggregate business investment (consistent with the latest data from the Australian Bureau of Statistics' survey of business investment intentions)
- continued strong growth in government spending, fuelled by increased current and capital expenditures on defence and security and by drought relief payments
- improvement in Australia's terms of trade, in line with the 2.3 per cent improvement in 2002, coupled with a pick up in Australian exports starting late in the year
- little change in the value of the currency from May 2003 levels.

Overall, we think that GDP growth will fall to 3.3 per cent in 2003. This will be supported by a fall in the growth in real private consumption (growth of 3.2 per cent, compared with 4.1 per cent in 2002) and a fall in the growth in dwelling investment (2.9 per cent, compared with 20.7 per cent). We expect that this will be partly offset by an improvement in the balance between export and import volumes. Little change is expected in the growth rates of real private business investment and real public final demand.

The forecast improvements in net trade volumes are expected to arrest to

some extent the rate of deterioration in the current account balance. In 2003, we are forecasting a current account deficit of 4.4 per cent of GDP. Our forecast for CPI inflation in 2003 is 2.6 per cent.

For 2004, we are forecasting real GDP growth to be higher than in 2002 at 3.6 per cent, compared to 3.3 per cent in 2002, an improvement in the current account deficit as a share of GDP, and little change in the rate of CPI inflation.

UNCERTAINTIES

Drought. In our current forecasts we assume that the main effects of the drought will have dissipated by the middle of the year. But there is a chance of continued, or back-to-back, droughts. History suggests that this is unlikely, but if it were to occur its effects would be catastrophic for the farm sector and for many non-urban regions. At the macroeconomic level, continued drought will result in reduced exports, reduced GDP, higher retail prices, a worsening in the current account deficit and may necessitate interest rate increases to keep CPI inflation in control.

Household vulnerability. Growth in Australia's real GDP is being driven by strong growth in domestic demand. There are, however, significant downside risks facing domestic final users, the most significant of which is to household spending. Over the past 10 years, the ratio of household debt to income has risen from 56 per cent to nearly 130 per cent. Moreover, the average household-gearing ratio (debts relative to assets) has risen from the historical norm of around 10 per cent to over 15 per cent. This suggests that household spending on current and capital items is highly vulnerable to an interest rate rise (currently not factored into our forecasts).

Household debt (share of disposable income)

Household debt has risen sharply over the past 10 years due to low interest rates, the First Home Owners' Grant scheme, and other factors such as financial deregulation and the consequent increase in competition among mortgage lenders. This suggests that household spending has become more vulnerable to interest rate rises.

