Country Report Australia

Country Report
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Economic growth in Australia is slowing due to lower mining investments and lower commodity prices. This also negatively affects the government budget. Meanwhile, private consumption is still backed by rising house prices.

Strengths (+) and weaknesses (-)

(+) Strong public institutions

Governance, rule of law and transparency indicators confirm the stability of the government. The central bank is highly credible in its inflation mandate and its supervisory role.

(+/-) Dependent on China for exports

In 2013, 36% of Australian exports went to China. Although Australia profited in the past from the fast growing Chinese market and its demand for commodities, this also makes the country vulnerable to a hard Chinese landing via both export volumes and prices.

(-) High amount of external debt

Since 1974, Australia had a current account deficit of on average 4% of GDP, resulting in a large negative international investment position (-49.5% of GDP). The net external debt in 2013 was 55% of GDP.

(-) Banking sector is concentrated and still dependent on foreign funding

The four largest banks account for 92% of the total banking system assets and have very similar business models. Residential mortgages (mainly fully amortizing, with variable interest rates) are the biggest asset class. Net foreign borrowing declined to 16% of total liabilities (from 26% in 2006).

Key developments

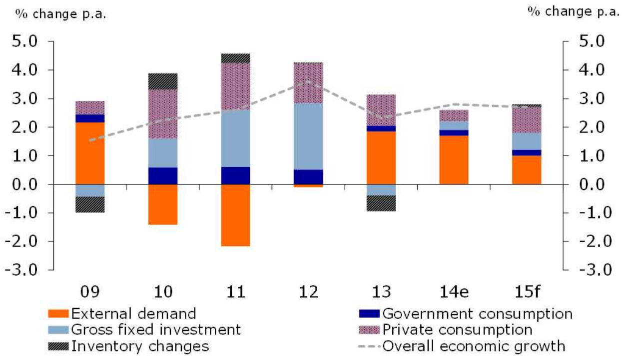
1. Economy is moving from a mining investment towards a mining extraction phase

The Australian economy outperformed other advanced countries during the past years, thanks to the investment boom in the natural resources sector. The economy grew 2.3% in 2013 and, according to the IMF, real GDP growth is expected to accelerate to 2.8% in 2014 and 2.9% in 2015 (figure 1). Currently, the economy is moving from the mining investment phase towards the extraction phase. Going forward, this will result in an improvement in net exports, since most investment projects will reach the production stage and imports of capital goods for the mining industry will decline. This, however, coincides with a lower amount of employment, since the extraction phase is less labour intensive than the investment phase. The unemployment rate increased to 6.1% (Dec-2014), which is the highest unemployment level since 2002. The soft labour market conditions resulted in a slowing nominal wage growth (2.5% y-o-y 2014Q3 compared to an average 3.3% y-o-y over the last 5 years) though it still outpaces consumer price inflation (2.2% 2014Q3). Together with the support from the strong housing market and the low interest rates, private consumption has been robust and is expected to remain so.

2. Natural resources sector: higher volumes, lower prices

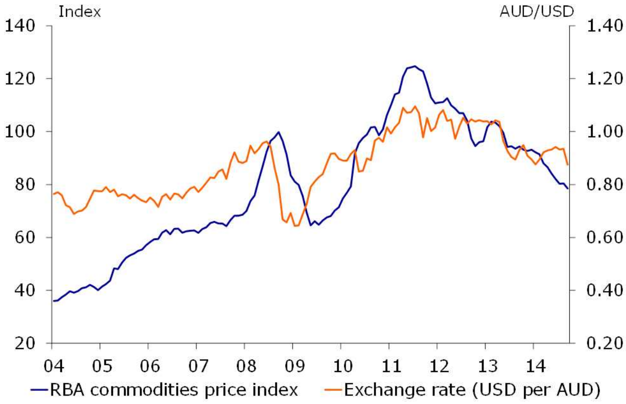
Australia has become very dependent on the natural resources sector for its exports. In 2013, 65% of its export volume consisted of crude materials and fuels. Going forward, the natural resources export volume will likely increase on the back of the large amount of investment in the sector over the last couple of years. At the same time, the commodity prices have decreased significantly (figure 2), e.g. iron ore prices dropped by about 35% over the last year. BREE, the Bureau of Resource and Energy Economics of the Australian government, expects prices to remain low due to reduced demand from China and increased production capacity worldwide. Given the high labour cost in the Australian mining sector, this leads to lower revenues for the mining companies and therefore to lower tax revenues. The budgets of the states of Western Australia and Queensland heavily depend on mining royalties that are determined both by the volume and price of the commodities. Also the budget at the federal level will likely be significantly impacted by the lower commodity prices.

Figure 1: Growth performance



Source: EIU

Figure 2: Commodity prices are decreasing



Source: Macrobond

3. Free trade agreements with China, Japan and South Korea provide new long-term growth opportunities

During 2014, Australia concluded free-trade agreements with its three main trade partners, namely China, Japan and Korea. Together, these three countries make up 61% of total Australian exports. These treaties include a reduction of many tariffs (including the ones on commodities, food and agricultural products) the removal of several barriers to market access for services and an improved access to capital markets. In exchange, Australian tariffs on manufactured goods from these countries will be abolished, which will be good for Australian consumers. These agreements will likely increase the trade flows between Australia and the

Asian countries, and improve the cost-competitiveness of Australian exports, especially since most other exporting countries of agricultural goods do not yet have such an agreement in place.

4. House prices are bubbling along

House prices in the capital cities rose by 10.1% y-o-y in 14Q2, of which the increases were the biggest in Sydney and Melbourne. In Perth, on the other hand, the prices declined slightly (-0.2% q-o-q), probably due to decreasing mining income. Compared to its long-term average, the Australian housing market is overvalued both in affordability (price-to-income ratio, 37%) and profitability (price-to-rent ratio, 21%) terms. Part of the demand can be attributed to the low interest rate environment. The investor share of housing loan approvals is rising quickly, of which the majority of the loans taken out is interest-only. This is induced by the tax-deductibility of interest expenses for investment purposes only (and not for owner-occupiers). To fully exploit this tax advantage, a significant part of the investor market is geared negatively (interest costs higher than rent incomes) that indicates speculation. In its latest financial stability review, the RBA stated its concern about the role of these investors in the housing market. Even though the impact of a sharp drop of the house prices on the banking sector is low, as mortgages with an LTV above 80% are almost fully insured, it will have a negative impact on households and, thus, on domestic demand.

Factsheet of Australia

Australia

National facts		
Type of government	Parliamentary democracy	
Capital	Canberra	
Surface area (thousand sq km)	7,682	
Population (millions)	23.9	
Main languages	English (78.5%)	
	Chinese (2.5%)	
Main religions	Protestant (27.4%)	
	Catholic (25.8%)	
	Other Christian (7.9%)	
Head of State	Queen Elizabeth II	
Head of Government (prime-minister)	Tony Abbott	
Monetary unit	AUD	
Economy		**2014**
Economic size	*bn USD*	*% world total*
Nominal GDP	1,447	1.89
Nominal GDP at PPP	1,076	1.01
Export value of goods and services	289	1.24
IMF quotum (in m SDR)	3,236	1.49
Economic structure	*2014*	*5-year av.*
Real GDP growth	2.9	2.5
Agriculture (% of GDP)	4	4
Industry (% of GDP)	29	28
Services (% of GDP)	67	68
Standards of living	*USD*	*% world av.*
Nominal GDP per head	61,314	531
Nominal GDP per head at PPP	45,593	283
Real GDP per head in 2005 prices	39,856	457

Social and governance indicators	rank / total
Human Development Index (rank)	2 / 187
Ease of Doing Business Index (rank)	11 / 189
WEF Global Competitiveness Index (rank)	22 / 144
Corruption Perceptions Index (rank)	11 / 175
Press Freedom Index (rank)	28 / 180
Gini index (income distribution)	34
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2013
Main export partners (%)		*Main import partners (%)*	
China	36	China	22
Japan	18	US	12
South Korea	7	Japan	9
India	4	Singapore	6
Main export products (%)			
Crude materials			38
Fuels			29
Food			10
Manufactured goods			7
Main import products (%)			
Machinery & transport equipment			40
Mineral fuels			17
Miscellaneous manufactured articles			12
Openness of the economy			
Export value of G&S (% of GDP)			20
Import value of G&S (% of GDP)			21
Inward FDI (% of GDP)			3.7

Source: EIU, CIA World Factbook, UN, World Economic Forum, Transparency International, Reporters Without Borders, World Bank.

Background information

Australia is one of the wealthiest economies in the world with GDP per head at PPP being 22% above the OECD average. The country implemented a large number of reforms in the 1980s and 1990s, making the country more internationally focused, more diverse and more competitive. In the 2000s, economic growth is mainly driven by the natural resources investment boom and the increase in the terms-of-trade as a result of the rise of China. The last economic recession dates from 1991. The Australian economy was able to withstand the Global

Financial Crisis relatively well, since the fiscal position of the government enabled a major stimulus program.

The country ran a persistent current account deficit since 1973, resulting in a large negative net international investment position (NIIP). Currently, the current account deficit is mainly driven by a large income account deficit. Moreover, since the mid-00's, the country started to consume less and invest more. This increase in investment will increase Australia's capacity to export and to pay back its international liabilities in the future.

Australia has a stable and well capitalised banking system, though it is very concentrated as well. The four biggest banks together have a market share (in assets) of 92% and share the same business model. Historically, the banking sector has been highly reliant on foreign wholesale markets, but due to tighter regulations and increased domestic private savings since the Global Financial Crisis, the banks have reduced this dependence. Moreover, the Australian regulators are forerunners in implementing Basel-III regulations, e.g. they implemented higher capital requirements for the systemically important institutions. In 2012, the IMF concluded that the banking system can withstand a severe economic shock.

Economic indicators of Australia

Australia

Selection of economic indicators	2010	2011	2012	2013	2014e	2015f	2016f
Key country risk indicators							
GDP (% real change pa)	2.2	2.6	3.6	2.3	3.0	2.9	3.1
Consumer prices (average % change pa)	2.9	3.3	1.8	2.5	2.5	2.3	2.5
Current account balance (% of GDP)	-3.6	-3.0	-4.4	-3.3	-3.9	-3.2	-2.6
Total foreign exchange reserves (m USD)	38,659	42,783	44,866	49,745	41,300	45,900	47,300
Economic growth							
GDP (% real change pa)	2.2	2.6	3.6	2.3	3.0	2.9	3.1
Gross fixed investment (% real change pa)	3.9	7.7	8.5	-1.4	-1.0	1.2	2.0
Private consumption (real % change pa)	3.2	3.0	2.6	2.0	2.6	2.1	2.4
Government consumption (% real change pa)	3.4	3.4	2.9	1.1	1.5	1.3	1.5
Exports of G&S (% real change pa)	5.7	-0.3	5.8	6.6	6.9	6.9	6.8
Imports of G&S (% real change pa)	15.2	10.9	6.4	-2.0	0.2	2.1	3.1
Economic policy							
Budget balance (% of GDP)	-5.1	-3.6	-2.9	-1.4	-2.6	-1.9	-1.5
Public debt (% of GDP)	24	27	32	33	35	36	37
Money market interest rate (%)	4.3	4.7	3.7	2.7	2.5	2.3	3.4
M2 growth (% change pa)	6	10	8	7	7	7	9
Consumer prices (average % change pa)	2.9	3.3	1.8	2.5	2.5	2.3	2.5
Exchange rate LCU to USD (average)	1.1	1.0	1.0	1.0	1.1	1.2	1.1
Recorded unemployment (%)	5.2	5.1	5.2	5.6	6.0	5.9	5.8
Balance of payments (m USD)							
Current account balance	-44,714	-44,525	-68,009	-49,558	-56,900	-45,300	-39,900
Trade balance	11,336	22,481	-12,187	4,390	-4,700	-400	8,600
Export value of goods	213,810	271,719	257,950	254,164	237,700	240,500	270,500
Import value of goods	202,470	249,240	270,140	249,770	242,400	240,900	261,800
Services balance	-5,150	-10,243	-12,371	-14,055	-13,900	-13,200	-10,800
Income balance	-49,293	-54,549	-41,087	-37,709	-35,900	-29,500	-35,300
Transfer balance	-1,607	-2,214	-2,364	-2,185	-2,300	-2,200	-2,500
Net direct investment flows	17,142	55,460	50,314	56,208	47,460	47,410	42,330
External position (m USD)							
International investment position	-754,360	-823,240	-873,620	-743,520	n.a.	n.a.	n.a.
Total assets	1,334,550	1,346,010	1,516,100	1,526,730	n.a.	n.a.	n.a.
Total liabilities	2,088,910	2,169,250	2,389,720	2,270,250	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	0.9	1.5	-0.8	0.3	-0.3	0.0	0.6
Current account balance (% of GDP)	-3.6	-3.0	-4.4	-3.3	-3.9	-3.2	-2.6
Inward FDI (% of GDP)	2.8	4.3	3.5	3.5	3.7	4.1	3.6
International investment position (% of GDP)	-60.5	-55.0	-56.2	-49.5	n.a.	n.a.	n.a.

Source: EIU

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