ING investmentweekly

November 8, 2010

Doing Well Down Under: The Australian Economy

Tanweer Akram, Ph.D.
Senior Economist, Global Rates

The prospects for Australia's economy in the coming year are quite enticing. The country experienced only a mild slowdown during the worldwide recession, with real GDP declining for one quarter in late 2008. Since then, the Australian economy has been expanding at sturdy pace — GDP growth for 2010 will be nearly 3.5%.

Consumer confidence has improved, and consumer spending has picked up, causing households' saving rate to decline after rising sharply in late 2008. Retail sales have continued to rise. Vehicle sales are still slightly below peak. The recovery in industrial production has been fairly robust. Business confidence has been rising for the past six quarters. Capacity utilization has been improving and is now a bit above its long-run average.

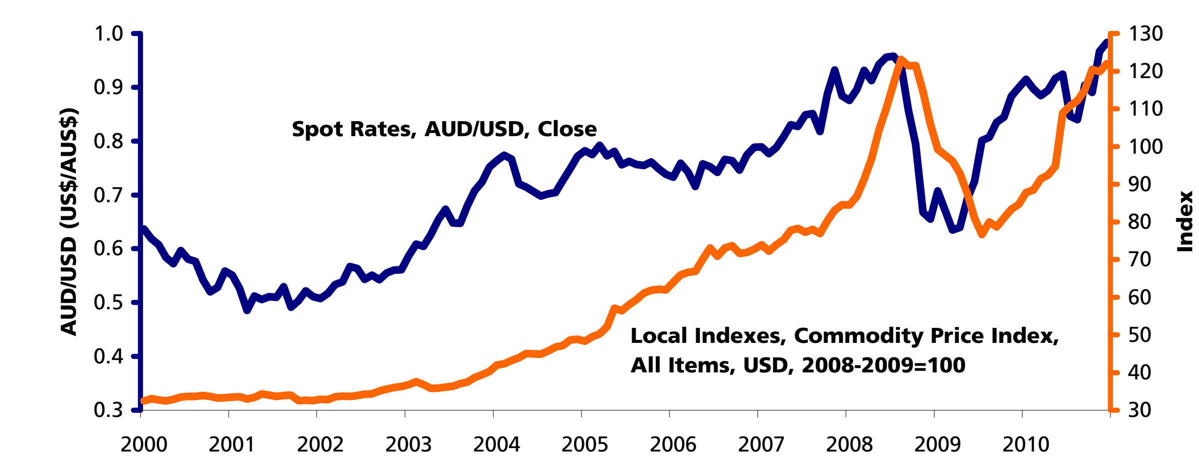
Both nominal exports and imports have been growing for more than a year. Exports — destined primarily for Asia — consist mainly of commodities such as wheat, wool, cotton, aluminum, zinc, iron ore and coal; they constitute nearly 20% of Australia's GDP. The strong growth in non-Japan Asia and higher commodity prices worldwide have fueled Australia's export growth.

Job growth has been strong. The number of jobs has been increasing by more than 3% on a year-ago basis over the past several months, and the unemployment rate has been declining. Wages are gradually rising; prior to the global contraction, wages in Australia had been rising strongly, particularly in the mining and construction sectors.

Financial conditions, which had deteriorated with the global recession, have improved markedly. Since mid-2009 both short-term and long-term rates have risen. The slope of the yield curve, as measured by the difference in the interest rates on ten-year and two-year government securities, has been flattening. Corporate spreads have narrowed, while equity prices have gradually improved in recent months.

Meanwhile, the Aussie dollar has been approaching parity with the U.S. dollar. As you can see in the chart below, the Aussie dollar is highly correlated with commodity prices and has appreciated along with rising commodity prices since the end of the recession. Year to date, the Aussie dollar has appreciated 13% against the U.S. dollar.

The Aussie dollar is highly correlated with commodity prices



Source: Rueters EcoWin

Although economic activity is resilient, some indicators suggest the momentum is slowing. Recently, the manufacturing sector purchasing managers' index, particularly the new orders component, has slowed somewhat. Business credit is declining due to tighter lending standards and corporate de-leveraging, while households' debt-to-assets and debt-to-disposable-income ratios have been rising.

House prices in metro areas outside of Sydney have appreciated sharply in recent years and could be somewhat overvalued. Between first quarter 2004 and third quarter 2010, house prices rose 109% in Perth, 82% in Melbourne, 64% in Adelaide, 51% in Brisbane and 46% in Canberra; Sydney has seen appreciation of a mere 16%. There had been a mild correction of house prices in 2008, but they resumed their upward trajectory in 2009 and in the first half of this year; prices fell slightly in the third quarter in some cities. Building activity is slightly below trend, and housing credit has been growing even though mortgage rates have risen with the overnight cash rate.

Inflation is nearing the upper bound of the 2–3% medium-term headline inflation target range established by the Reserve Bank of Australia (RBA), and producer prices are also rising. Various measures of consumer prices — such as trimmed mean and weighted median, and special index excluding volatile items — show inflationary pressures. But the most recent quarterly inflation report showed a lower rate than expected, leading many investors and analysts to expect that the RBA would stay on hold following its early-November meeting. However, with their hike of the overnight cash rate — a 25 basis point increase to 4.75% — policymakers proved that they are mindful of the looming dangers of higher inflation and an overheated economy. With seven increases since mid-2009, the RBA has hiked the overnight cash rate a total of 175 basis points coming out of the recession.

Prospects

The Australian economy should continue to expand at a strong pace next year; the RBA expects the economy to grow at a 3.8% rate in 2011. Australia — its mining sector, in particular — stands to benefit if the Chinese economy maintains a decent pace of growth. The volume of exports to Asian countries should continue to rise, and consumer spending also appears to be robust.

Given this strength, the central bank is likely to be proactive rather than passive, continuing to raise the overnight cash rate at a gradual pace next year; it's reasonable to expect it may tighten by an additional 100 basis points within the next 12 months. Among the factors that may induce policymakers to continue raising the rate include a tight labor market, inflationary pressures close to the upper bound of the central bank's target range, froth in the housing markets and resilience in the country's mining sector.

Though the prospects for the Australian economy for next year and beyond are sound, the risks to growth are tilted to the downside. There are two main downside risks. First, a slowdown in global and Asian growth would likely stall commodity prices, which could deteriorate Australia's terms of trade. Second, a sharp and unexpected decline in house prices could adversely affect households' balance sheets, contain private consumption and lower growth. Upside risk could arise from strong commodity prices leading to further expansion of the country's mining sector, but this would result in upward pressure on wages and inflation.

Given the healthy prospects for the economy and consideration of various risks, policymakers are likely to become less accommodative in the course of the next year. Nevertheless, the Australian authorities retain substantial leeway and flexibility with policies measures if needed. ■

Copyright © 2010 ING Investment Management. This material may not be reproduced in whole or in part in any form whatsoever without the prior written permission of ING Investment Management. To obtain permission, contact david.chung@inginvestment.com or 212-309-8440. For all other inquiries contact David White, Publishing Manager, david.white@inginvestment.com or 860-275-2056.

Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities.

The opinions, views and information expressed in this commentary regarding holdings are subject to change without notice. The information provided regarding holdings is not a recommendation to buy or sell any security. Portfolio holdings are fluid and are subject to daily change based on market conditions and other factors.