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Country report **AUSTRALIA**

Summary

The Australian economy has quickly shaken off the economic disruption caused by the Queensland floods of late December 2010 and early 2011. Growth in Chinese demand for commodities and the rise in commodity prices have been very important facets of Australia's economic strength. The sharp increase in the reliance on both the exports to China and the price of commodities means that the Australian economy has become more vulnerable to adverse developments on these fronts. Household deleveraging, a modest fall in house prices and reduced reliance of banks on short term foreign funding are positive developments. The reduction of the budget deficit is slower than expected, but given the very low level of government debt this is no cause for concern. We do think it is important to use the period of solid economic growth and high commodity prices to build large budget surpluses to cope with possible adverse economic.

Things to watch:

- Household indebtedness and house prices
- Economic developments in China and international commodity price developments
- The need to use commodity price windfall revenue to build even bigger fiscal buffers

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Australia

National facts	
Type of government	Parliamentary democracy
Capital	Canberra
Surface area (thousand sq km)	7,682
Population (millions)	22.9
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)	Julia Eileen Gillard
Monetary unit	AUD

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	1445	2.09
Nominal GDP at PPP	927	1.17
Export value of goods and services	321	1.47
IMF quotum (in mln SDR)	3236	1.49
Economic structure	*1905*	*5-year av.*
Real GDP growth	1.7	2.8
Agriculture (% of GDP)	4	4
Industry (% of GDP)	25	27
Services (% of GDP)	71	70
Standards of living	*USD*	*% world av.*
Nominal GDP per head	64137	595
Nominal GDP per head at PPP	41127	333
Real GDP per head	37856	466

Social and governance indicators	rank / total
Human Development Index (rank)	2 / 187
Ease of Doing Business Index (rank)	15 / 183
Index of Economic Freedom (rank)	3 / 179
Corruption Perceptions Index (rank)	8 / 183
Press Freedom Index (rank)	30 / 178
Gini index (income distribution)	35.19
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
China	25	China	21
Japan	19	US	12
South Korea	9	Japan	10
India	7	Thailand	6

Main export products (%) 2011	
Coal	20
Meat & meat products	4
Wheat	3
Greasy Wool	1
Main import products (%) 2011	
Intermediate & other goods	51
Consumption goods	27
Capital goods	21
Openness of the economy 2011	
Export value of G&S (% of GDP)	22
Import value of G&S (% of GDP)	20
Inward FDI (% of GDP)	2.4

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Shaking off a flooding induced slowdown

The Australian economy has quickly shaken off the economic disruption caused by the Queensland floods. After contracting 0.3% q-o-q in the first quarter of 2011, GDP rebounded by 1.4% in the second quarter and continued to expand in the second half of the year. Because of the quick recovery, average quarterly GDP growth was slightly higher in 2011 compared to 2010. But the disruption in production halted the rise in employment seen in the year before. As a result, the unemployment rate rose from 4.9% in December 2010 to 5.3% in September 2011. With the onset of the recovery, the unemployment rate has stabilized and averaged 5.2% in the six months to March 2012. We expect economic growth to strengthen somewhat this year. Exports should be able to continue to grow while investment in mining capacity is set to remain strong. Household spending growth will probably be constrained by a persistently high saving rate, but should still be able to expand as it did last year. Continued economic growth will ensure that the slight pickup in employment seen in the first quarter of the year will continue, leading to a stable or slightly falling unemployment rate.

Although the unemployment rate at over 5% is still higher than the 4% low reached in early 2007, it is still very low both in an international and historical context. Unemployment probably cannot fall significantly below current levels without causing inflationary pressures that the central bank will want to prevent. As such, Australia's economy is probably operating not that far from its potential level of output. For now though, the previous rise in unemployment, the rise in the exchange rate of the Australian Dollar and the waning of the price pressures created by the floods has kept

inflation in check. In response to the uncertain economic outlook created by renewed financial market tensions arising from the intensification of the European debt crisis in the second half of 2011, the Reserve Bank of Australia cut its cash target rate twice, by 25 basis points in November and December, to 4.25%. If growth disappoints and inflation remains within the 2%-3% target band, the policy interest rate may well be lowered further. Given the relatively high level of the policy rate relative to other industrialized countries, Australia has quite some room to support the economy in this manner.

Flipsides and risks arising from the mining boom

The performance of the Australian economy in the face of both the global recession in 2008/09 and the domestic flooding has been very solid and is rather enviable from the perspective of most of the rest of the advanced economies. It has been much helped by ample policy flexibility due to a high starting point for the central bank policy rate, the very low level of government debt and a floating exchange rate. But apart from the policy response, growth in Chinese demand for commodities and the rise in commodity prices have been very important facets of Australia's economic strength, creating a boom in investment to increase mining capacity and increasing national income due to a sharp rise in the terms-of-trade. At the same time, the sharp increase in the reliance on both the exports to China and the price of commodities means that the Australian economy has become more vulnerable to adverse developments on these fronts. The share of exports going to China has increased from about 5% in 2000 to 25% in 2010. The good performance of the Australian economy and high demand for its commodities has driven up the value of the Australian dollar. This is leading to symptoms of Dutch disease, in which the success of the commodity sector is undermining the non-commodity tradable goods and services producing firms. Crucially also, there are risks inherent in this development. High investment in mining capacity around the world will increase supply going forward. In case of a sharp decline in prices some of these investments may turn out not be profitable. Apart from the supply response, since demand from China is a major driver of commodity prices, a sharp slowdown of Chinese growth would lead to a double negative whammy for Australia, with both the volume of exports declining and the terms of trade deteriorating sharply. To the extent that government revenue is being boosted by income from the commodity sector, this will have a negative impact on the government budget balance that comes on top of the automatic deterioration due to a likely slowdown in economic growth. It is very hard to predict why and for what reason either China will experience a severe growth slowdown or commodity prices would drop sharply. But it is important to acknowledge the increased vulnerability of the Australian economy to such developments.

Existing vulnerabilities

A sharp fall in the saving rate of households from the late 1980's to the early 2000's coupled with a sharp increase in investment has resulted in years of current account deficits and a rise in the net international debtor position of the country. Related to this are the relatively high level of household indebtedness and banks being reliant on foreign wholesale funding. Coupled with the assessment of the IMF that house prices are probably some 10%-15% overvalued, this is cause for concern. If the unemployment rate were to rise sharply and house prices would fall, banks would be confronted with rising non performing mortgage loans and a declining value of the collateral. This may well prompt disruptions in foreign funding, leaving banks vulnerable to funding problems. For now though, Australia is well placed as one of the world's safe havens for capital flows. In the meantime, risks are being moderated with house prices having declined somewhat and households having shifted firmly into saving mode.

We see the decline in house prices over the past year (prices falling 4.8% from the last quarter of 2010 to the last quarter of 2011) as a positive development. Affordability is stretched, partly because of the lack of adequate supply. The lack of supply meanwhile mitigates the risk of a very sizeable correction in house prices. An orderly fall in house prices will both improve affordability and reduce leverage relative to income for new loans. Importantly, the lack of a building and real estate development boom in Australia reduces the potential risk of elevated house prices to the banks considerably. In Ireland and Spain, unsustainable house prices were joined by a development and building boom. When that boom went to bust, the damage to the economy from sharply falling residential investment was a major force in the subsequent recession and the deterioration of government finances. Losses on commercial real estate loans were the biggest problem for the banks, much less than household mortgages have been. Since Australian banks are heavily exposed to household mortgages but less to commercial real estate (being around 10 percent of total loans compared to 31 percent in Ireland), any further sharp decline in house prices will have much less adverse effects on the banks. This is helped by relatively conservative lending standards, with loan-to-value (LTV) ratio's on average being 50% and with LTV's that are higher than 80% at the start of the loan having mandatory insurance. Moreover, the Australian Prudential Regulatory Authority sets relatively high standards for the amount of capital that banks have to hold for residential mortgages when compared to other countries. With the onset of the global recession, the Australian household saving rate has shot up sharply. From an average 1.5% in 1999-2006, net saving reached 10.2% of disposable income in 2009 and remained close to 9% in 2010 and 2011. As a result, over the past three years, households have been building up financial assets or have reduced financial liabilities. Given the high level of household debt, we see this as a positive development. Moreover, the increase in corporate deposits and a fall in corporate lending have reduced banks needs for foreign wholesale finance. Then again, with the onset of economic recovery pushing corporate loan demand back up, it remains to be seen whether this development will be sustained.

Enviably strong public finances should not lead to complacency

The public finances remain exceptionally strong, with gross government debt to GDP projected by the IMF to peak below 24% in 2012, net government debt remaining below 10% of GDP and the government planning to balance the budget by financial year 2012-13, from a 4.2% deficit in financial year 2009-10. Deficit reduction in the current financial year is proving harder than expected, due to both the economic impact of the floods but also because of deviation from the budget. In the Mid-Year Economic and Fiscal Outlook (MYEFO), the government has indicated that the fiscal balance for 2011-12 would probably be -2.2% of GDP instead of the planned -1.4%. The budgetary outturn for the year to February shows further slippage relative to the MYEFO revision. Even so, strong political commitment to fiscal discipline will ensure further deficit reduction. Although the budget deficit and the debt level are very modest, especially when compared to the rest of the advanced economies, we think it is important for the government to stick to its goal to return the budget to balance. A low debt ratio is sensible given the high net international debtor position for the country as a whole, leading to the risk that private debt migrates to the public balance sheet in case of severe economic shocks. Also, the economy is operating close to potential and national income is very high due to very favorable terms of trade. To provide buffers for economic shocks, it would be a good idea to run sizeable budget surpluses in such favorable economic conditions. That will provide ample room for a deterioration of the budget balance when government revenue dries up due to sizeable economic disruption and the potential drying up of currently high commodity related government revenue. High budget surpluses will become especially important should commodity prices rise further, should the mining boom take on even bigger proportions and

in case the unemployment rate falls much further. If such developments do not translate into large budget surpluses in the years to come, that would weaken the resilience of the government finances even though the headline figures will look good at the surface.

Australia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	4.7	2.5	1.4	2.6	1.7	2.9	2.9
Consumer prices (average % change pa)	2.3	4.4	1.8	2.8	3.4	2.7	3.6
Current account balance (% of GDP)	-6.2	-4.6	-4.5	-2.6	-2.1	-1.9	-2.0
Total foreign exchange reserves (mln USD)	24769	30691	38950	38659	42783	45300	47300
Economic growth							
GDP (% real change pa)	4.7	2.5	1.4	2.6	1.7	2.9	2.9
Gross fixed investment (% real change pa), Cal Adj	9.3	8.2	-3.1	5.1	6.2	6.7	7.5
Private consumption (real % change pa), Cal Adj	5.6	1.9	1.0	2.9	3.0	2.9	2.6
Government consumption (% real change pa), Cal Adj	3.3	3.7	0.7	3.4	1.5	1.3	1.5
Exports of G&S (% real change pa), Cal Adj	3.2	3.8	2.1	5.8	-1.3	9.4	8.7
Imports of G&S (% real change pa), Cal Adj	12.6	11.2	-8.6	14.1	11.7	12.2	11.5
Economic policy							
Budget balance (% of GDP)	2.2	0.5	-4.1	-4.8	-2.6	-0.5	0.1
Public debt (% of GDP)	15	14	19	23	25	25	23
Money market interest rate (%)	6.4	6.7	3.3	4.3	4.7	3.8	4.3
M2 growth (% change pa)	30	14	0	9	11	11	12
Consumer prices (average % change pa)	2.3	4.4	1.8	2.8	3.4	2.7	3.6
Exchange rate LCU to USD (average)	1.2	1.2	1.3	1.1	1.0	1.0	1.0
Recorded unemployment (%)	4.4	4.3	5.6	5.2	5.1	5.3	5.0
Balance of payments (mln USD)							
Current account balance	-58032	-47786	-43890	-31991	-30500	-28100	-30100
Trade balance	-17783	-4915	-4215	18180	36500	37800	36700
Export value of goods	142421	189058	154789	212850	270200	289400	318500
Import value of goods	160210	193970	159000	194670	233700	251700	281800
Services balance	587	-3098	-531	-2978	-9200	-9600	-11400
Income balance	-40547	-39400	-38075	-45803	-56300	-54700	-53800
Transfer balance	-288	-373	-1069	-1387	-1600	-1700	-1700
Net direct investment flows	21110	9170	11530	6049	-7561	-5410	-1660
External position (mln USD)							
International investment position	-574602	-499134	-694970	-794890	n.a.	n.a.	n.a.
Total assets	883738	702956	1045620	1238020	n.a.	n.a.	n.a.
Total liabilities	1458340	1202090	1740590	2032910	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-1.9	-0.5	-0.4	1.5	2.5	2.5	2.5
Current account balance (% of GDP)	-6.2	-4.6	-4.5	-2.6	-2.1	-1.9	-2.0
Inward FDI (% of GDP)	4.4	4.6	2.8	2.5	2.4	3.3	3.7
International investment position (% of GDP)	-60.9	-48.2	-71.2	-63.9	n.a.	n.a.	n.a.

Source: EIU

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