Political overview

2004 in retrospect

The 2004 federal election marked John Howard's ascension to the role of Liberal Party great. He turned around poor early-year polls and expertly exploited Labor vulnerabilities. He proved the appeal both of Coalition themes such as choice, self-reliance and mutual obligation, and of his own personal traits of steadiness and consistency. His victory was the first time that an incumbent prime minister has improved his party's vote at two successive elections, and the first time since 1977 that a government has won control of the Senate.

Labor, by contrast, must regroup in tough circumstances. Mark Latham, once seen as the face of "New Labor", has taken the party to a huge defeat. Yet neither an alternative leader nor alternative policies lie close at hand.

2005 in prospect

The Coalition's first priorities will be changes which have previously stalled in the Senate: industrial relations, small business and the privatisation of Telstra. Each of these also offers the Coalition an attractive opportunity to harry the bewildered Labor Party.

Beyond this agenda, however, lies another agenda traditionally less comfortable for the Coalition. That agenda covers issues such as education, health and aged care, infrastructure and the distribution of funds to the states. Here the federal government can either rebuild its relationship with the states or, as seems increasingly likely, attempt to bend them to its will. More broadly, it can either seize a historic opportunity for change or let it slip.

Industrial relations overview

2004 in retrospect

Individual Coalition government changes have not transformed the landscape overnight, but over eight years they have gradually shifted the course of events. Union membership reached a new low of 23 per cent of the workforce in 2004. But all the players spent much of the year awaiting the election outcome.

2005 in prospect

The government's leaders are long-term champions of industrial relations reform. That, along with the Coalition's surprise triumph in the 2004 Senate vote, ensures continued change. But at what pace? If it chooses a big-bang, the government could go so far as to make pre-strike ballots compulsory and strikes themselves illegal in some industry segments. A more cautious path would nevertheless further unwind union influence. Either way, a waterfront-style showdown with building unions is possible.

Photo: istockphoto.com

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A long-time CEDA contributor, Dr Caton has built a reputation as one of Australia's liveliest and most engaging writers and presenters on economic matters. He reports that he is kept youthful by his two young children.

CHRIS CATON

economic overview

2004 in retrospect

"If you're not confused about the state of the Australian economy, then you clearly don't understand what's going on."

We'll come back to that quote later. It was certainly an interesting year. Globally, it was the strongest year of economic growth for a quarter of a century, with most of the world in synchronised, if moderate, recovery. World economic growth probably came in at a little below 5 per cent. The big international stories included oil prices, the first interest rate rises in the United States for four years, and the continued surge in growth in China.

The oil gusher has peaked

The price[1] of a barrel of oil, which had been as low as $12 in 1998, hit an all-time record high of more than $55 in late October. Many analysts have noted that every recession in the US in the past 40 years has been preceded by a spike in oil prices, so at least a few speculated that the US economy was once again at risk of such an outcome. This is very unlikely to happen. First, we appear to be well past the peak in the oil price. Second, while it is true that every recession has been preceded by a spike, there have been other spikes that have not been followed by recessions. Third, there was something very different about the 2004 spike. Each of the previous ones that clearly did contribute to a US recession had been associated with a sudden and severe contraction in the supply of oil. Except for when the hurricanes passed through the Gulf of Mexico, there was no restriction of supply in 2004. Rather, the price was driven up primarily because of strong demand – the increase in the demand for oil in 2004 was the biggest ever recorded – itself caused by strong economic growth. The US and China led the way.

In addition to strong demand, a premium of between $10 and $15 was added to the price because of concern that future supply may be restricted. There is no shortage of candidates here: destabilisation of the Saudi regime, a nasty event that closes the main port in Saudi Arabia, even lower output from Iraq, Yukos in Russia, civil unrest in Nigeria and labour unrest in Norway are the most obvious. If, as time goes on, these concerns remain but none of them actually leads to a significant reduction in supply, then the oil price should continue to fall as the hoarders and speculators cut back their purchases. Of course, should one of these concerns lead to a reduction in supply, particularly if Saudi Arabia is involved, then the price could shoot sharply higher. Without this, however, the oil-price story is fading. It has cut into world growth, but this effect should also fade over 2005.

Figure 1: Oil shock … Oil prices (West Texas) in $US/bbl SOURCE: DATASTREAM

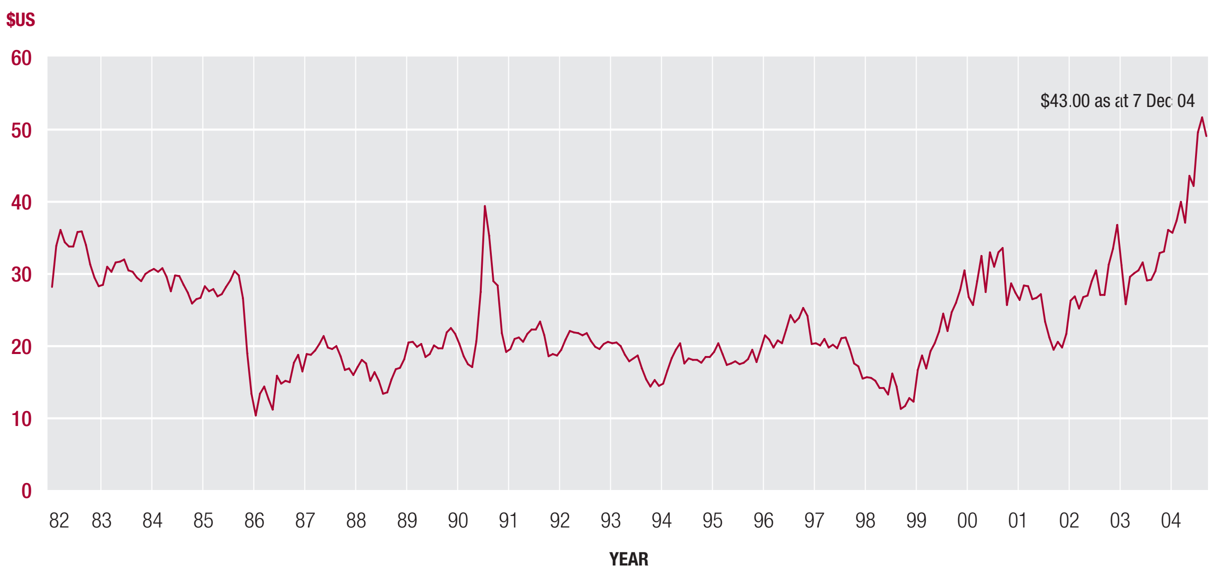
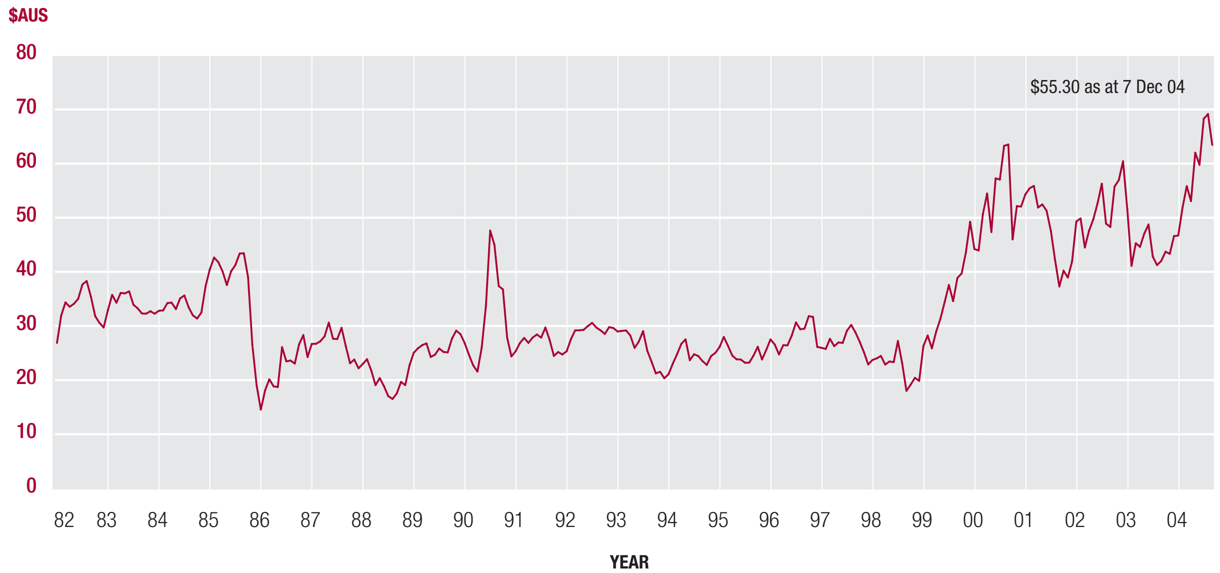


Figure 2: What oil shock? Oil prices (West Texas) in $A/bbl SOURCE: DATASTREAM



Mainly because that's the way everyone does it, so far we have looked at everything in US dollars. Figure 2 shows the oil price in Australian dollars. It hit $75 in late October, but has come down significantly already. Note that the price has been close to its current levels twice in the past few years, with no marked unfavourable effects.

US rate rise won't hurt Australia

As mentioned, interest rates are on the rise in the US. Between January 2001 and mid-2003, the Federal funds rate (equivalent to our short-term cash rate) fell from 6.25 per cent to a Japanese-like 1 per cent. In mid-2003, employment in the US had been falling for two and a half years, something that had never happened before in the postwar period. Inflation was low and falling, and there was genuine concern about the prospect of deflation. By mid-2004, employment was growing and inflation was on the rise. Accordingly, the Federal Reserve made a decision to begin to normalise interest rates. The Federal funds rate has so far moved from 1 per cent to 2.25 per cent, with the expectation that it will hit 3 per cent by mid-2005. This should not choke off growth in the US – indeed, if growth does slow too much, the Fed will simply stop raising rates – and it won't put upward pressure on Australia's interest rates.

China's 9 per cent economy

China was again a big story in 2004. In late April, the Chinese premier made an important speech in which he instructed the banks to diminish the flow of credit to certain key industries – steel, cement, aluminium and construction – that were regarded as overheating. His words had a major short-term effect on commodity prices and Asian share markets, but the Chinese economy has continued to grow strongly, so much so that interest rates were raised for the first time in many years in October. Of course, raising interest rates in an economy with a fixed exchange rate may not help – higher rates with no exchange rate risk simply attract more money to the economy, and the liquidity effects may outweigh the effects of the higher cost of money. It is likely that China's GDP grew by more than 9 per cent in 2004.

Australia survives the housing bubble

Against this background, the Australian economy fared reasonably well. For the year as a whole, GDP appears to have grown by about 3.4 per cent, just a touch below the forecast in last year's *Economic and Political Overview*. We also said a year ago that year-to growth would peak in mid-year, at about 4 per cent, and then fade to 3 per cent by the end of the year. Remarkably, this was also close to correct. Current data suggest that year-to growth peaked at 4.5 per cent

in the June quarter, but will be only 2.5 per cent in the year to the December quarter.

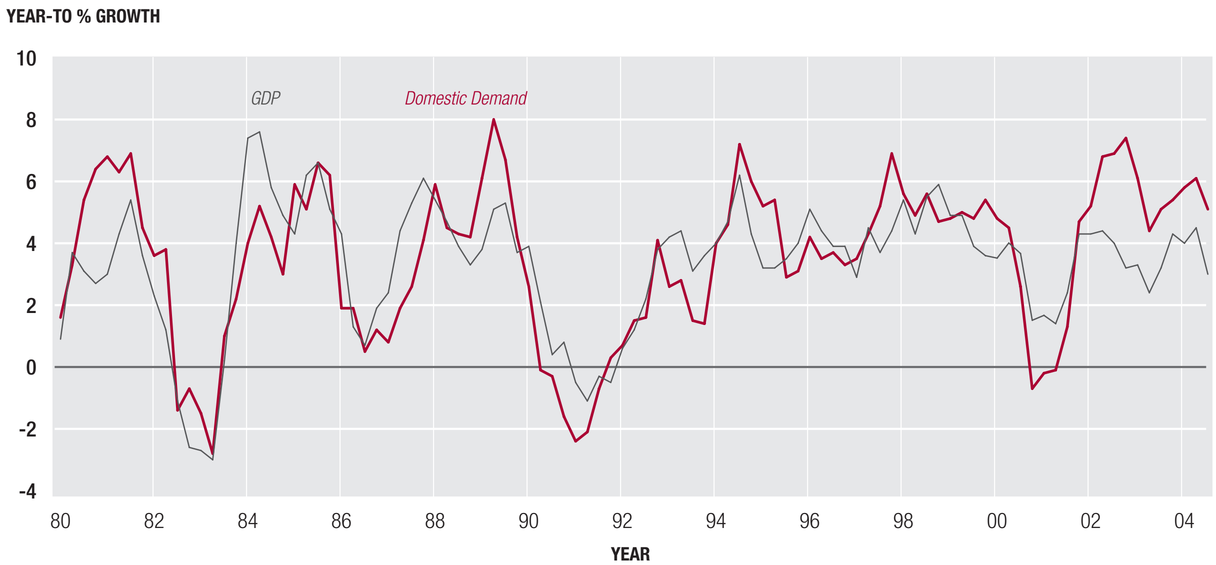
Although the air has clearly been coming out of the housing bubble all year, residential construction has actually held up better than forecast a year ago. Consumer spending has also been remarkably strong, driven by the extraordinary fiscal stimulus in the May 2004 budget, as well as the unprecedented willingness of Australian homeowners to run up their mortgages.

Growth has been held down by a poorer-than-expected performance of our trade sector. A year ago, given that the drought had effectively ended and the rest of the world was looking significantly stronger, it seemed reasonable to forecast strong growth in exports in 2004. Although the prices of our exports have risen nicely, the growth in volume has been disappointing. One reason for this is that we have literally been unable to get enough of the "stuff" out of the ground, to the port, and onto a ship. In the year to the September quarter, the volume of our exports grew by 4.7 per cent, which seems healthy until one compares it with import growth of 13.5 per cent. As a result, the current account deficit blew out to a record quarterly reading of $13.7 billion in the September quarter. Figure 3 shows that spending growth of 4.3 per cent has been translated into product growth of just 3 per cent in the year to the September quarter, primarily because "net exports" have been so weak.

For most of the year, the RBA and others toyed with the idea that interest rates were likely to rise further, but we ended 2004 with the cash rate unchanged all year. The case for higher rates began from the view that rates were low, and thus must rise eventually. Talk of rate rises presumably helped to keep the air seeping out of the housing bubble. Of course, officially, any rate rise must be justified in terms of concern about (future) inflation, and it's still hard to make that case convincingly. In the year to September, the CPI rose by just 2.3 per cent. While it is true that the unemployment rate sits at a 27-year low (and the continued good performance of the labour market was one of the pleasant surprises of 2004), so far there has been no sign of any systematic pickup in wage inflation.

Incidentally, one of the current puzzles about the Australian economy is the apparent contradiction between the improving labour market along with high levels of both consumer and business confidence, and the marked slowing in GDP growth. This is the reason for the opening quotation. The strength of business confidence despite slowing output growth almost certainly reflects the extraordinary profit boom in Australia. This, in turn, is primarily responsible for the strong performance of the Australian share market.

Figure 3: Demand runs ahead – Gross Domestic Product and domestic demand SOURCE: AUSTRALIAN BUREAU OF STATISTICS



The $A decouples from commodities

One reason for continued low inflation is the exchange rate, which continued to be a big story in 2004. It began the year at 75 cents, rose to 80 cents for a nanosecond in mid-February, fell back below 70 cents, and then flirted again with 80 cents late in the year. The strength of the currency is one of the reasons the volume of exports has not done better than it has, but please don't feel sorry for our mineral exporters. Figure 4 shows the relationship between the RBA's index of non-rural commodity prices and the $A. As can be seen, for years this was one of the great regularities of economics. When the world price of our mineral exports rose, the $A (then considered to be a "commodity currency") tended to rise also, and vice versa when mineral prices fell. That relationship no longer holds tightly – if it did, the $A would now be worth 92 US cents. The gap between this and the value of the currency can be thought of as the exporter happiness index.

There are two reasons why commodity prices have been so strong. One is the strength of world economic growth, and the concentration of this growth in commodity-intensive economies, particularly, of course, China. The second is the weakness of the $US. While analysts frequently make the point that commodity prices are quoted in $US, these prices are not impervious to weakness in that currency, and will tend to drift up as the $US falls.

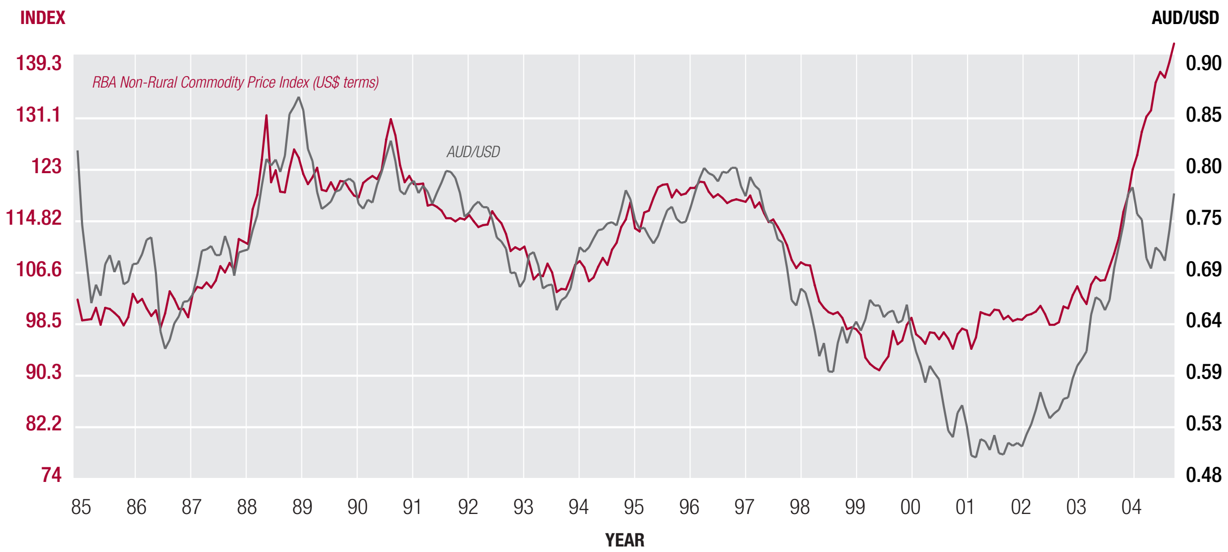
2005 in prospect

World economic growth this year should be slower than in 2004, but still quite good. Early in the year, growth may continue to be held down slightly by the lingering effects of the oil price peak. It is likely that oil prices will continue to fall, possibly to as low as $US35 per barrel in the second half of the year. The demand for oil will, of course, continue to grow, but the continuation of high prices will lead to an eventual supply response (OPEC will invest more, and there will be more use of unconventional sources such as tar sands and shale oil).

Outside Australia, slower growth

The most important question mark hangs over the US. In recent weeks, there has been more focus on that economy's clear imbalances, particularly its "twin" federal and current account deficits. One of the side-effects of George Bush's election has been a realisation that neither of these deficits is going away quickly. Box 1, overleaf, examines this issue in more detail. It is possible that at some stage in 2005 this issue will become so important to financial markets that a major dislocative adjustment will take place. But it is more likely that the problem will be fixed only slowly and that the economic recovery continues, albeit at a more gradual pace. Consensus forecasts see 2005 growth of about 3.5 per cent in the US, down by a percentage point from 2004.

Figure 4: End of an era – RBA Non-Rural Commodity Price Index and the AUD/USD SOURCE: RESERVE BANK OF AUSTRALIA, DATASTREAM



BOX 1:

Bush's second term: The greenback keeps retreating

As the whole world knows, US president George W. Bush has been elected to serve for a further four years. In one sense, this is status quo ante. But he has outlined some key economic objectives for his second term, and these are likely to have financial market effects.

First, a brief look back. President Bush inherited a federal budget surplus of more than $US230 billion, and converted it to a deficit of more than $US410 billion in just four years. This came about because the US economy was weak (hence driving down tax receipts) because of a seemingly endless round of tax cuts and because there was little if any restraint on spending. Defence spending, of course, grew enormously, but so too did discretionary non-defence spending. President Bush is the first president in 176 years not to veto a single spending bill in his term of office. The tax cuts were huge – large enough to take the share of federal taxes in GDP from a record high to a 50-year low.

My personal view is that a large part of this swing in fiscal policy was justified by the weakness of the US economy. The tax cuts were clearly driven by ideology rather than by concern about the economy, but as one of George Bush's Yale professors said, "I have to give him a pass even though he doesn't seem to have studied much". The problem, however, is that there is no exit strategy. The US seems likely to run large federal deficits indefinitely.

In his post-election speech, President Bush mentioned two areas of reform – the tax system and social security. In the case of taxes, the first thing he is likely to do is to make the existing tax cuts permanent. Because of the vagaries of US budget law, some of the tax cuts (those on dividends and capital gains, for example) are set to expire in about five years. The other thing he will address is the "alternative minimum tax" (AMT). This was originally intended to catch those relatively wealthy taxpayers who were clearly engaging excessively in tax minimisation strategies. For technical reasons, progressively more middle-income earners are finding themselves caught by this AMT (up to 20 million by 2010 under current legislation), and this is not politically acceptable.

If that was all that was done, it's clear that the deficit would be even bigger. This alone may limit more grandiose plans to further reduce taxes on saving and investment, or to move towards a flat tax, or to replace (partially) the income tax with a spending tax (sound familiar?).

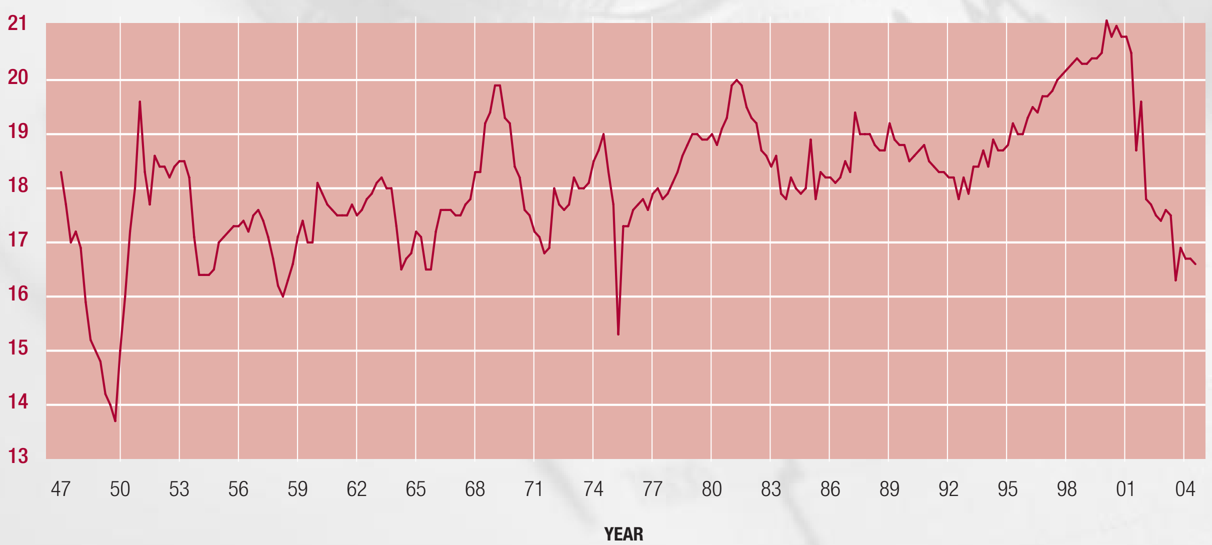
In the area of social security reform, President Bush has previously expressed enthusiasm for privatising the system. At the moment, the contributions of current workers go to pay the pensions of retirees. Any surplus is invested in government securities – safe, but not exactly high return. A privatised system would presumably lead to more money being invested in the share market. *Ceteris paribus*, this would be good for equities. But not so fast.

The current system relies on participants willingly paying for others now on the assumption that future workers will be willing to pay for them later. If you move from this system towards an individual account system (which would have to happen under privatisation), then the government has to keep paying for the current retirees. Message: the transition effects of this would add significantly to the deficit for several years. It's difficult to see this being good for financial markets.

Current private-sector estimates of the federal deficit suggest that it will total more than $5 trillion, and perhaps as much as $7 trillion, in the next ten years.

One side-effect of the large budget deficit has been increased pressure on the current account deficit. One day, foreigners may decide that they are no longer willing to fund the latter, in which case the only way to bring the CAD down would be via a significant correction in the $US. Given the current state of other world economies, much of this correction may eventually have to be against the Asian currencies, a process that could only begin with a re-pegging of the Chinese currency. If it happens this way, the $A won't necessarily appreciate significantly against the $US. Any such appreciation would, of course, be of concern for Australian investors with money overseas.

Figure 5: Over the cliff – US federal government receipts as a percentage of GDP SOURCE: DATASTREAM



Elsewhere, Europe will probably do what it usually does: totter along at close to 2 per cent growth. Japan, which performed relatively well in early 2004, should grow only moderately. China is likely to slow, but still to record growth (perhaps 8 per cent) that other countries can only envy. That said, there is a risk that, in seeking to slow that economy the authorities will overdo it. But even if China softens significantly this year, it will be just a speed bump in the strong growth story, which probably has decades yet to run.

Inside Australia: The trade brake released

It is possible that 2005 will be the weakest year for Australian economic growth since 2001, when output was buffeted by the aftermath of the introduction of the GST. At any one time, what will happen next to overall growth will generally be determined by the outcome of conflicting forces. Some parts of the economy will be getting stronger, while others will fade. In 2005, the potential weak links appear to be residential construction and consumer spending, while growth should be supported, in a rather odd sense, by the trade sector. Exports are likely to grow more rapidly as some of the capacity constraints ease. The growth in imports is likely to slow, in part because of the slowdown in consumer spending, as discussed below. As a result, trade will be less of a brake on overall growth.

Housing: Investors retreat

In 2003, we suggested that residential construction would fall in 2004. As Table 1 shows, it grew for the year as a whole, although it was falling at the time of writing, and appears likely to show a significant decline for all of 2005. The housing sector clearly

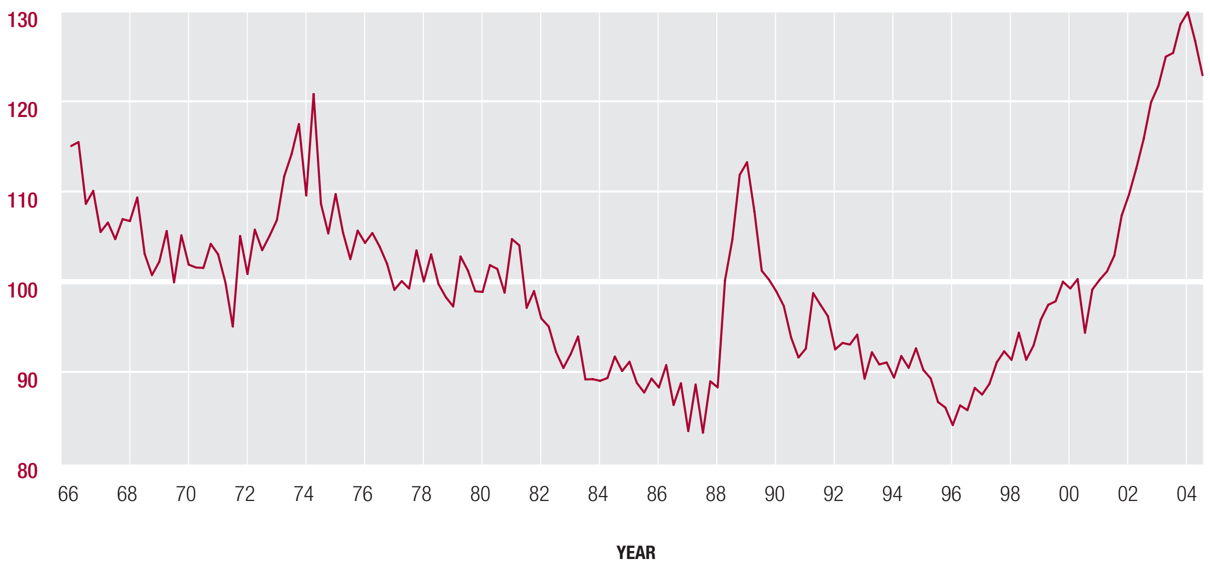
TABLE 1: AUSTRALIAN GROWTH CATCHES ITS BREATH

	CALENDAR YEARS (YEAR AVERAGE % CHANGE)					
	2001	2002	2003	2004	2005	2006
				(e)	(f)	(f)
GDP	2.6	3.8	3.5	3.4	2.9	3.7
Non-farm GDP	2.6	4.1	4.1	2.8	2.9	3.5
Farm product	1.4	–9.2	–9.0	22.6	3.4	9.3
Private consumption	2.8	4.0	4.4	5.5	3.7	3.2
Residential construction	–11.1	24.8	7.9	5.9	–7.1	2.7
Business investment	0.3	14.9	12.4	7.4	7.4	6.2
Private final demand	1.6	7.1	5.7	5.5	3.4	3.8
Public final demand	1.0	4.4	3.9	4.2	4.9	3.5
GNE	1.3	6.4	6.0	5.3	4.1	3.9
Exports	1.6	0.1	–2.2	4.7	6.4	8.0
Imports	–4.2	11.0	10.5	13.9	8.6	6.1
Unemployment rate	6.8	6.4	6.1	5.6	5.4	5.8
CPI inflation	4.4	3.0	2.8	2.3	2.4	2.7
Current account deficit ($bn)	16.6	31.4	46.2	49.9	45.1	36.6
Exchange rate (USD/AUD)	0.51	0.55	0.66	0.74	0.75	0.75

(e) estimate
(f) forecast

SOURCE: AUSTRALIAN BUREAU OF STATISTICS, BT FINANCIAL GROUP

Figure 6: Unsustainable – Ratio of Australian house prices to GDP SOURCE: UBS



cooled in 2004, with all key indicators – approvals for new construction, lending to owner-occupiers and to investors, auction clearance rates and prices – softening considerably.

In the early 1990s investors were responsible for less than 20 per cent of all residential purchases. That share has now more than doubled.

To understand what will happen next to housing, one has to focus on the investors. It may be thought that this is always the case, but they have become much more important. In the early 1990s investors were responsible for less than 20 per cent of all residential purchases. That share has now more than doubled. It can't be the 3 per cent rental yields that have been attracting them. Rather it has been the prospect of 15 per cent capital gains year after year, with the value of these gains obviously considerably enhanced since the change to the CGT in 1999. How will these people react when they realise that these gains are no longer automatic, and may not be so for several years? Figure 6 shows the relationship between the Australian median house price series and nominal GDP, that is, the overall size of the economy. It suggests that prices will fall further in 2005, and it may be at least two more years before they return to their recent peaks.

Spending: The end of equity withdrawals

The changed housing story will have other implications for growth. In recent years, Australians have done something they have never done before. Instead of paying off their mortgages over time, they have, in aggregate, been running them up. Presumably, they have been doing this because they feel themselves to be wealthier as a result of house price appreciation. It may also be happening because it is now so much easier to do it. For example, it is entirely possible for a wage slave to faithfully make the monthly payments on his or her mortgage, only to have his or her spouse get on the Net and pull the money back the other way. (This hasn't happened to me, but it has happened to a close friend of mine.)

BOX 2:

The rising tide of household debt

There is no question that Australians have embraced the concept of debt. Since the early 1990s, the ratio of debt to yearly household income has gone from 50 per cent to 140 per cent.

Most of this increase is simply rational consumer behaviour. When something is cheaper, it is customary to buy more of it. And over the past decade debt has become considerably cheaper, simply because interest rates have fallen. It took a while for consumers to begin to treat the fall in interest rates as permanent.

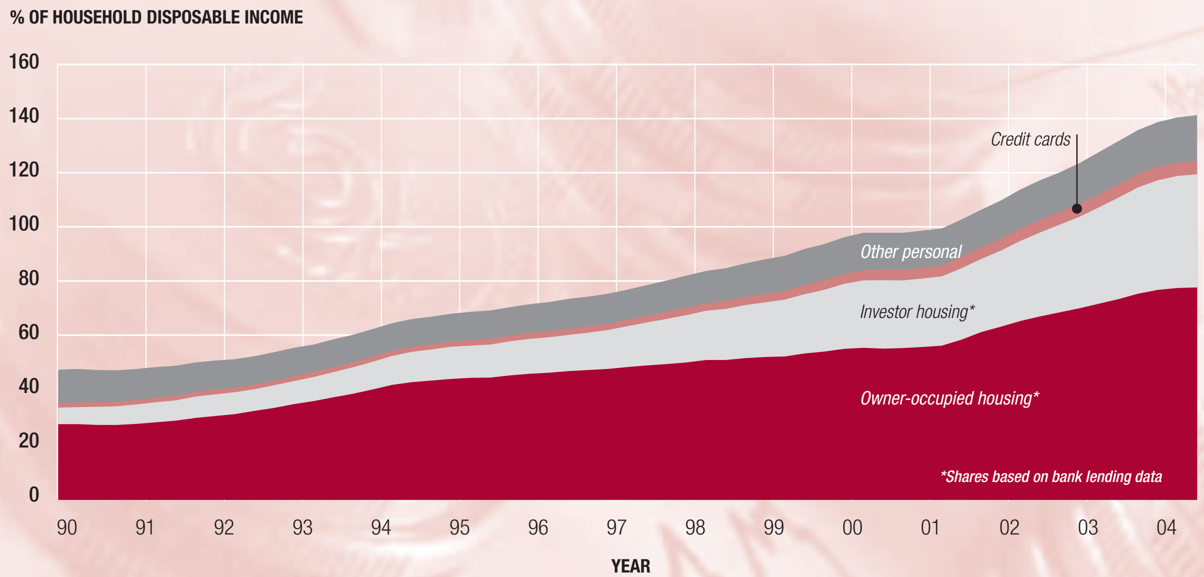
The changed behaviour of financial institutions has clearly contributed. The margin between the standard mortgage rate and the cost of funds to these institutions has been forced down by competition. Also, as the governor of the RBA recently reminded CEDA and the nation, lenders have aggressively lowered their credit standards in their zeal to increase market share.

In addition, even when standards have not been lowered, it is easier for borrowers to qualify for a (larger) loan when rates are low. Lenders frequently operate on rules of thumb, such as a requirement that standard repayments be less than 30 per cent of the borrower's income at the start of the loan. Obviously, with lower nominal rates, more borrowers will qualify for larger loans on average.

The era of low inflation also keeps the debt/income ratio high, even without this effect via low interest rates. In the bad old days, high inflation (and hence high income growth) used to reduce the ratio of mortgage debt to income for any one borrower substantially in just a few years. This doesn't happen nearly so quickly any more.

The media frequently focuses on credit card debt. As can be seen from Figure 7, this is a very small part of overall consumer debt, and much of its rise merely reflects the increasing use of credit cards as a convenient means of payment, or a source of frequent flyer points etc. Note that even if you pay off your credit card every month, on average your credit card debt is half your monthly balance.

Figure 7: Price curve – Household debt (% of household disposable income) SOURCE: UBS



Of course, far and away the most important growth in debt has been accounted for by mortgages, and within these, investor debt has grown more rapidly than owner-occupier debt. There is a clear link to the house-price story here. If we are all prepared to double the amount of debt we are prepared to carry in relation to our income, what has to happen to the price of the asset that this debt goes to purchase? This means that part of the dramatic upshift in house prices relative to GDP in recent years (see Figure 6) may be sustainable. But since the debt-to-income ratio is not going to double again, it also means that house-price growth in the next decade must be far more moderate than in recent years.

The rise in the debt-to-income ratio is the most important reason why changes in interest rates are now so much smaller than they used to be. Fifteen years ago, when rates were moved it was commonly by a full percentage point, and sometimes more. Now we deal in rate changes of a quarter of a point. But if the level of rates is half what it was, and debt service is a higher proportion of income than it used to be, then a quarter of a point may have about as much effect as three-quarters of a point did 15 years ago. Among other things, this means that mortgage rates are never going back to the high teens recorded in the late 1980s. With future rate rises likely to be so much smaller, it is very unlikely that the high level of consumer debt will become a major macroeconomic problem. That said, any rise in rates will be difficult for those borrowers who have leveraged into poor investment choices!

Figure 8: End of the run-down – Mortgage equity withdrawal (% household disposable income) SOURCE: ABN AMRO

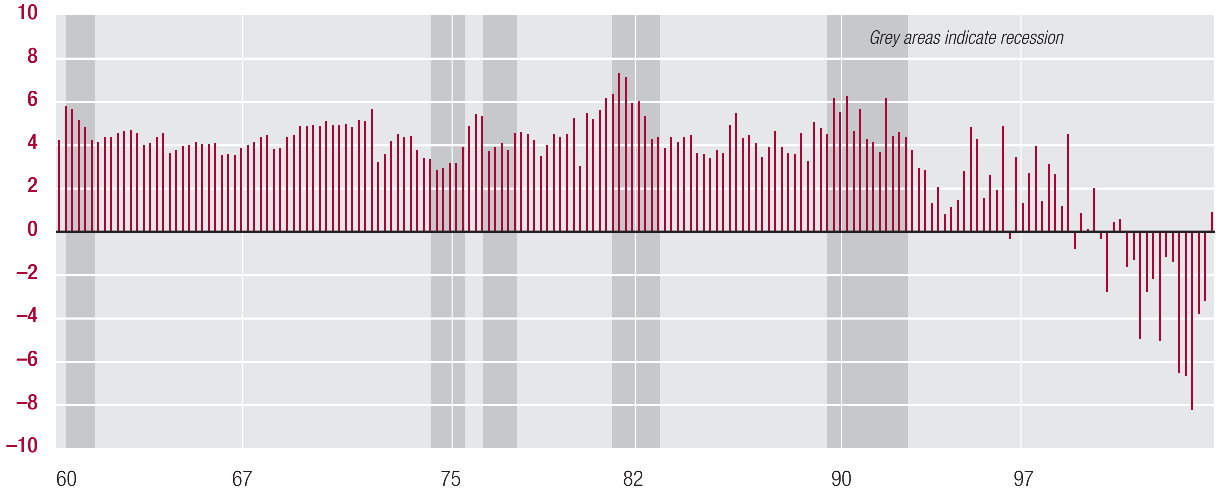


Figure 9: Gross Domestic Product SOURCE: AUSTRALIAN BUREAU OF STATISTICS, BT FINANCIAL GROUP

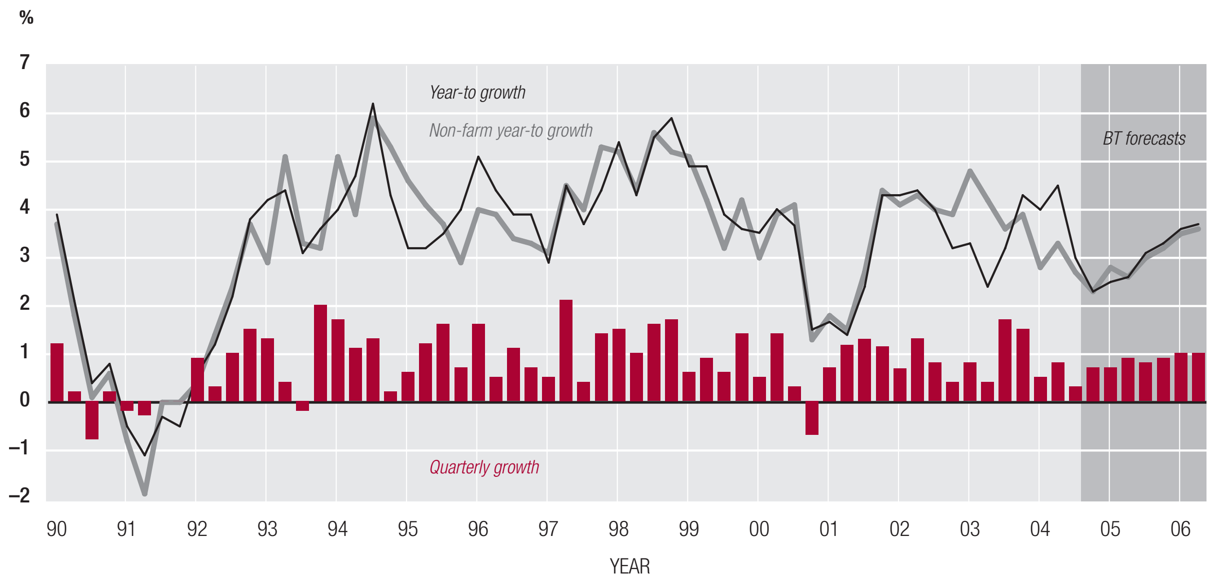


Figure 8 illustrates this phenomenon. When the columns are in positive territory, mortgages are being paid off. When they are below zero, mortgages are being run up, and the extent of this in recent years has been quite large. Some of this may just represent a substitution of mortgage debt for other forms of debt (e.g. by small businesses), but some of it has unquestionably fuelled the boom in consumer spending. A moment's thought suggests that if we continue to withdraw equity from our homes at the same rate over the coming year, consumer-spending growth will slow to that of income growth. That is, in order to maintain the recent rate of growth of consumer spending, we must withdraw even more equity in the next year than in the past year. This is very unlikely to happen, so consumer spending growth will slow, with the only question being by how much. As shown in Table 1 on page 7, GDP growth in 2005 appears likely to be less than 3 per cent, before picking up again in 2006 as the fall in residential construction comes to an end.

free trade

BOX 3:

The Australia–US **Free Trade** Agreement

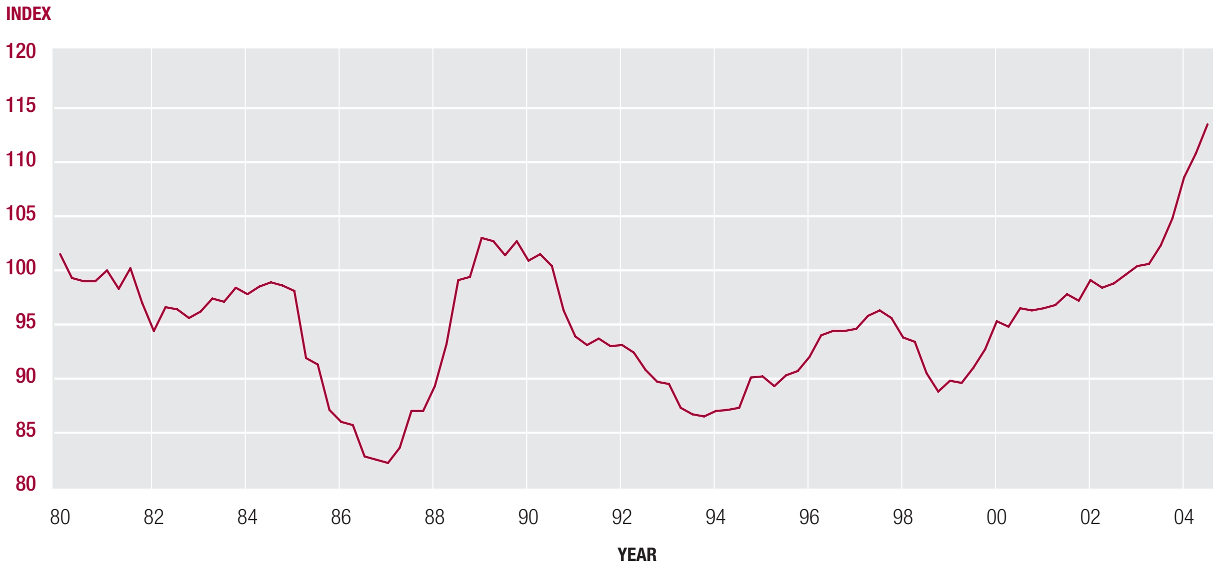
The free trade agreement (FTA) with the US became effective on 1 January. The agreement has been hugely promoted by the politicians, but practising economists have been curiously quiet about it. One of the iron laws of the dismal science is that for every economist there is an equal and opposite economist. That is, on most issues the economics profession will express a range of views. But almost every economist is in favour of free trade. So why the thundering silence on the FTA?

There appear to be a number of reasons. First, trade with the US was not exactly shackled beforehand, and it's still not completely free now, so the FTA is closer to evolution than revolution. Second, the modelling work done before the agreement suggested that the most substantial gains for Australia would be in beef and sugar. Sugar is off the table altogether, while the measures pertaining to beef are to be phased in over 18 years.

Third, and perhaps most importantly, bilateral trade agreements are very much a second-best option. They create trade (good) but they also divert trade (bad). For example, we may now import some goods tariff-free from the US that could be produced more efficiently elsewhere, but would then enter with a tariff. Suppose such a good costs $100 to produce somewhere in Asia, $105 to produce in the US, and that the tariff rate is 10 per cent. Prior to the agreement, we would import this from Asia. Now, we would import it from the US, and the Australian consumer is better off. But Australia isn't, because the tariff revenue forgone is more than the drop in price to the consumer. In addition, it's not hard to imagine that the Asian producer is not particularly pleased by this turn of events.

In all, the FTA has probably improved the structure of trade. The greatest gains may come from the lower impediments to capital flow, and from trade in services. These are notoriously hard to model.

Figure 10: Terms of trade SOURCE: AUSTRALIAN BUREAU OF STATISTICS



Employment and inflation: Both flat

The outcome for residential construction also has major implications for the labour market. In the past two years, construction and related industries accounted for employment growth of 127,000 out of total growth of 337,000. It is inevitable that employment growth will slow. The 27-year low of 5.1 per cent unemployment recorded in December may be the lowest for several years.

> The outcome for residential construction also has major implications for the labour market.

Despite this, it is possible that, with the unemployment rate likely to remain below 6 per cent for most of the year, wage inflation will begin to rise. That said, the best measure of wage costs – the wage price index – was effectively flat-lining at 3.5 per cent growth through 2004. And even if wage inflation were to pick up slightly, the strength of the exchange rate is likely to offset any major effect on price inflation. With growth below trend, and no sign of inflation, it is possible that interest rates will remain right where they are for the second year in a row. If this is wrong, any move in either direction should be relatively small.

Trade deficit: High, but not destabilising

Should we worry about the current account deficit or the exchange rate?

Although imports are expected to continue to grow faster than exports in volume terms, Australia's terms of trade (the ratio between export prices and import prices) are expected to continue to rise. At present, they stand at a 30-year high. We are getting good prices for our exports, but some of the improvement in our terms of trade in recent years also came about because of declining import prices. The rise in our exchange rate is part of this story, but so is the relentless downward pressure, coming from China and elsewhere, on the global price of manufactured goods.

Further improvement in the terms of trade will allow for some decline in the current account deficit, which hit a record high of close to $50 billion in 2004. Remarkably, Australia has the fourth-largest current account deficit in the world behind only the US, the UK and Spain, all of which are significantly larger economies.

So far, our continuing large CAD has had no effect on the value of the $A. As was the case for the previous four years, the value of our currency in 2004 was largely determined by the machinations of the $US. When the latter rose against the currencies of the developed countries in general, we went down against it, and vice versa. Figure 11 shows this relationship.

Figure 11: The Australian dollar and the US trade weighted index SOURCE: DATASTREAM, BT FINANCIAL GROUP

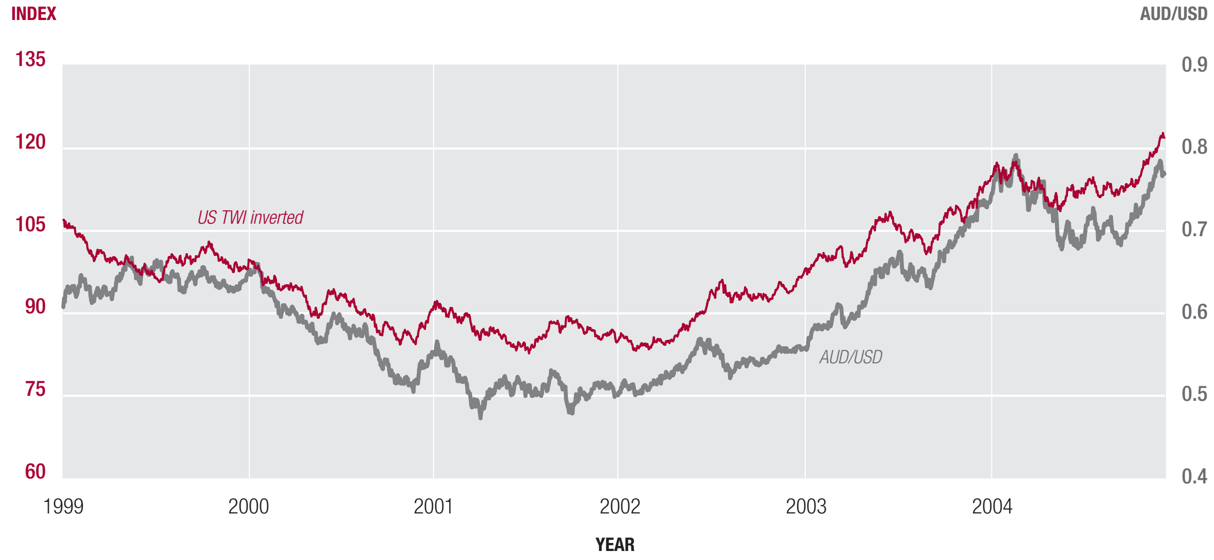


Figure 12: AUD/EURO and AUD/USD SOURCE: DATASTREAM

One line represents the $A in US cents, while the other is the trade-weighted index of the $US against the currencies of all the developed countries with which the US trades. The broad similarity of movement of the two lines means that it's the variation in the $US that is causing most of the variation in the $A. There are two other ways to drive this point home. First, 95 per cent of the net rise in the $A from 48 cents in late 2001 to 80 cents in mid-February 2004, took place in the middle of the night – that is, in overseas markets. Given the paucity of new information about the Australian economy at 3 a.m., this can only mean that the value of our currency is being determined by non-Australian factors. Second, the cross-rate of the $A against the euro, for example, has almost been flat in recent years, as Figure 12 shows.

So if one wishes to forecast the $A over the course of 2005, all one has to do is forecast the $US. The conventional view is that, given the large US current account deficit, the $US must continue to fall. But the Europeans are already complaining about the resulting strength of the euro – the recent adjustment has been described as "brutal" – while the Japanese are unlikely to let the yen appreciate very far. So if the $US is to fall significantly further, which currencies is it going to fall against? The eventual answer presumably must be: the currencies of non-Japan Asia, a process that can really only begin in earnest when the Chinese repeg. An upward movement of the yuan, of the order of at least 10 per cent, appears likely some time in 2005. This, and the flow-on effects on other Asian currencies, may give the US some relief. China is responsible for about one-quarter of the US trade imbalance. Its surplus with the US is equal to about 9 per cent of its own GDP, so obviously it will be aiming for a relatively slow adjustment.

Of course, if the main exchange rate story in 2005 is the fall of the $US against Asian currencies, then it is by no means inevitable that this will push the $A higher against the $US. The "trend is your friend" method of forecasting suggests that our currency could keep rising to the low 80s, but it is also possible that this episode is already over, and that the $A will settle down in the 70s in 2005.

A quick thought on fiscal policy

The overview made the point last year that fiscal policy is driven far more by electoral considerations than economic considerations. And 2004 reinforced this point. It now appears very likely that GDP growth in 2004/05 will be not much more than 2.5 per cent, down considerably from the 3.5 per cent assumed at budget time. There have already been suggestions that, as a result of this lower growth, the federal government may decide that some of its election promises can no longer be afforded. We like to think that sensible economics still plays some role in the budget process. If economic growth disappoints, and if the fiscal stance were appropriate beforehand, then the rational response is to loosen policy in order to assist growth, rather than to tighten policy on the grounds that the slower economy means that promises cannot now be afforded. After all, the budget exists to serve the needs of the economy, and not the other way around.

[1] The price quoted here is that for West Texas Intermediate (WTI), the most commonly quoted price. Until recently, I had thought that West Texas Intermediate was George Bush's last year at high school.

Chris Caton is the chief economist for BT Financial Group. The views expressed here are his own, and should not be otherwise attributed.

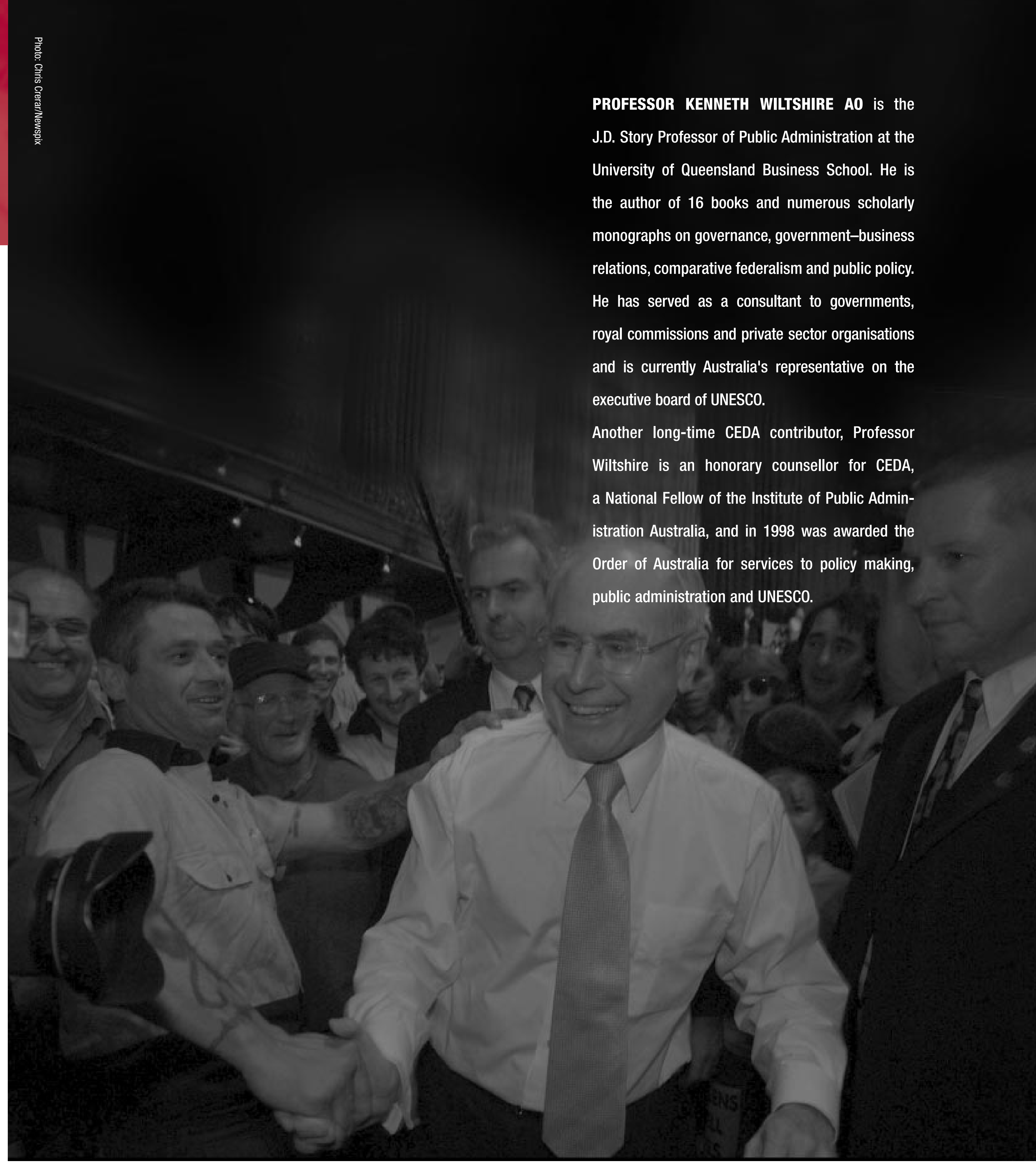


Photo: Chris Crerar/Newspix

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political overview

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