Economics
Australia

# Australia in 2014

## Still in second gear

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HSBC Global Research

- **Mining investment has peaked and the sector is expected to contribute less to growth than previously**
- **Outside of mining, a further pick-up is needed, with low interest rates, a lower AUD and looser fiscal policy expected to support rebalancing of growth**
- **Policymakers should focus on productivity-enhancing reform to best take advantage of new trading opportunities with Asia**

## More rebalancing needed

The mining boom is now past its peak and resources sector investment is set to fall this year and the next, so other parts of the economy need to take over as drivers of growth. So far, this rebalancing has been slow, leaving Australian GDP growth below trend in 2013 (+2.4%). Rebalancing was hindered by a stubbornly high AUD and tight fiscal settings.

With the AUD now at more comfortable levels, RBA interest rates still at an historical low and fiscal policy less of a drag, we expect Australia's growth to rebalance further in 2014. We expect Australia's housing price boom to continue and housing construction to pick up pace. Household spending should edge higher. All the while, Australia's GDP should be supported by strong growth in resources exports, as new capacity comes on line. We expect GDP growth to remain below average, but to lift modestly in 2014 to +2.8%. Growth is forecast to pick up more solidly in H2 2014.

But with the mining boom now in the past, policymakers and businesses need to focus on new opportunities. Policymakers should remain focused on productivity-enhancing reform to make Australia more competitive and better able to prosper from trading opportunities offered by the expanding Asian middle classes.

Local risks are more prominent in 2014 and 2015. A stymied reform agenda or fiscal missteps are key risks. As always, risks to Australia also come from the international environment, particularly developments in China, Japan and the US and with commodity prices.

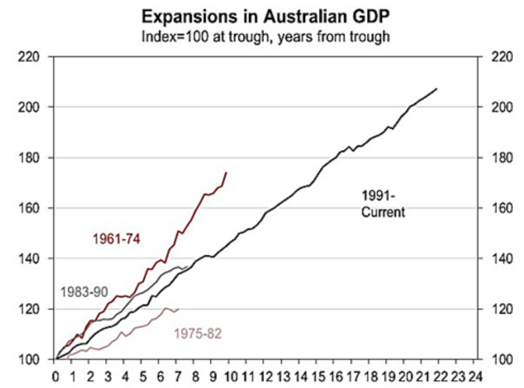
# Australia's long boom and its challenges

- Australia's economy has just completed its 22nd year of continuous growth, a feat unmatched in its history and by its peers
- Growth has been supported by two booms: a housing price and credit boom (1993-2003) and a mining boom (2003-2013)
- The mining boom is now at its end, which makes growing the economy more challenging than in recent years

## No recession in 22 years

Australia's economy has done very well in recent years, having not seen a technical recession in over 22 years (Chart 1). Australia is now entering its 23rd year of continuous annual GDP growth, a feat unmatched in its history and impressive compared to peers.

**1. Australia has had the longest expansion in its history**




Source: ABS

Luck and good management have both played a role. When major negative global shocks have come along, Australia has managed to avoid significant downturns. During the Asian Financial Crisis of the late 1990s the AUD depreciated significantly and exports were redirected from Asia to Western markets. When the IT bubble burst in 2001, Australia was fortunate that it was a large commodity-producer and not a big IT producer. When the Global Financial Crisis arrived in 2008, Australia's strong ties to China and the mainland's massive fiscal stimulus meant that the mining investment boom barely skipped a beat.

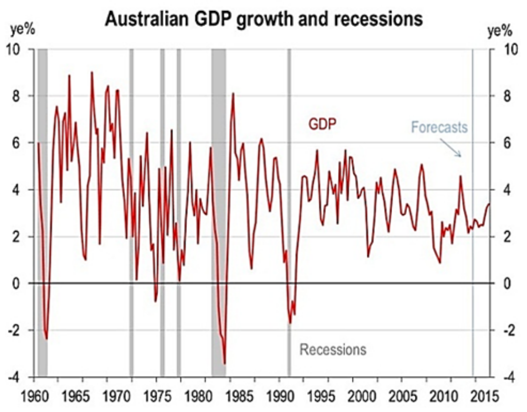
Indeed, the most impressive outperformance has been in recent years. Since 2008, Australia's economy has done significantly better than its global peers, having grown by +14% since the beginning of 2008, compared with +6% in the US, +7% in Canada and falls in GDP of -2% in the UK and euro area. Australia was helped by the rapid loosening of local monetary and fiscal policy settings after the global financial crisis, but the single biggest factor was Australia's strong ties to China and its insatiable demand for commodities. China's economy grew by +60% over this period.

## The cycle is dead: long live the cycle

It may be tempting to suggest that Australia seems to have tamed the business cycle, but this would be foolhardy. Policymakers are not omnipotent and economies are notoriously difficult to forecast. The cycle is not dead. As we noted last year, there is always a risk of recession, which is worth bearing in mind (see Bloxham, P and Richardson A. (2013) '*Australia's R-word: Rebalancing not recession*', 10 July).

Assessing the probability of recession is very difficult, so we adopt a simple approach as a benchmark. Quite simply, given that Australia has had ten years when it was in technical recession in the past 52 years (Chart 2), an unconditional probability would suggest that in any one year there is around a 20% chance of being in a recession. While a significant downturn (or recession) is not our central case, it should never be ruled out and it is fair to say that the local risks are more prominent in 2014 and 2015 than previously.

**2. Australia's has had six technical recession in 52 years**




Source: ABS; HSBC estimates

## The two booms story

A key risk that Australia faces is how to deal with the end of the mining boom. In its history, Australia has never come to end of a mining boom and had a soft landing. The challenge of a managing a soft landing this time is also complicated by the fact that the driving economic force in the years just prior to the mining boom was a housing price and credit boom, the size of which is unlikely to be repeated in coming years.

Australia's long boom can, arguably, be thought of as having been supported by two booms. The first was the housing price and credit boom of the 1990s and early 2000s. This was driven by earlier deregulation which granted households greater access to credit, lower interest rates and greater local bank access to global financial markets. This process came to its end around the middle of the first decade of the 2000s. The peak in housing price growth was in 2003 and rapid housing credit growth slowed significantly around 2007.

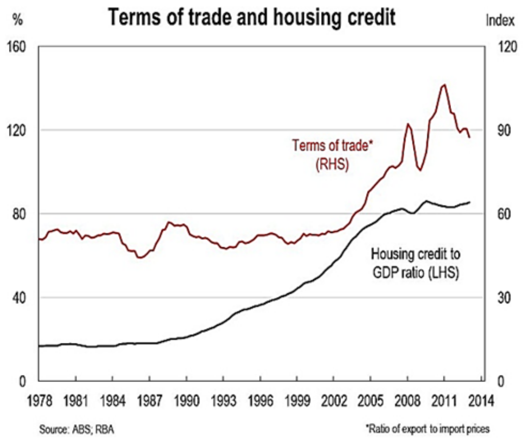
Just as the housing and credit boom ended, the mining boom arrived, largely driven by a pick-up in demand for commodities from China and a long period of global underinvestment in capacity to produce commodities.

This fairly smooth transition from housing to mining boom was probably more luck than good management, although it is fair to say that the RBA did recognise the growing excesses in the housing market and began to lean against them in 2002. Policymakers were less adept at responding to the mining boom, with fiscal authorities largely treating the run-up in mining boom-related revenues as permanent (as discussed below).

The mining boom came in three stages: first, commodity prices skyrocketed; then, mining investment ramped up; and, finally, resources exports grew strongly. The first stage began in 2003, just after the housing price boom ended. Commodity prices ramped up and, looking through a small hiccup during the global financial crisis in 2008, they ultimately peaked in 2011. The investment stage ramped up from 2005 and has run for a bit longer, as many of the projects were very large and are taking a significant amount of time to complete. The investment boom is likely to have peaked in 2013. While the export ramp up is expected to run for many years yet, the biggest positive impact of the mining boom is now likely to be behind us.

The two booms are illustrated in Chart 3. Australia's terms of trade – which is the ratio of exports prices (mainly commodities) to import prices (mainly manufactured goods prices) peaked in 2011 at +106% above its 1980/90s average and has fallen since then to now be +71% higher than its 1980/90s average. Importantly, the terms of trade are still well above historical average levels. Australia's housing credit to GDP ratio levelled out from 2007, after having ramped up from the early 1990s.

3. Growth has been driven by two booms




Source: ABS; RBA

With global resources supply coming on-line to meet demand, particularly from China, commodity prices seem unlikely to return to their 2011 peaks.

Importantly though, we still expect mining GDP to continue to grow – we do not expect the sector to be an outright drag on GDP. This is because the ramp up in exports is expected to more than offset the fall investment over the next two years (discussed further in Chapter 2).

We also expect commodity prices to remain 'structurally high' which should mean Australia's terms of trade cycles around a much higher level than the 1980/90s average. This should support continued profitability of resources projects that have already been built. But, without a further rise commodity prices, there will be less of a boost to local incomes than occurred over the past decade. The period of outperformance of Australia's mining sector seems likely to be in the past.

The big structural shift in levels of household debt has also already occurred. With higher levels of debt, households now appear to be more cautious in their spending and borrowing behaviour. While there is some scope for a further modest increase in household leverage, it seems likely that the pace of this will be slower in the future than it was in the 1990s and the first half of the 2000s.

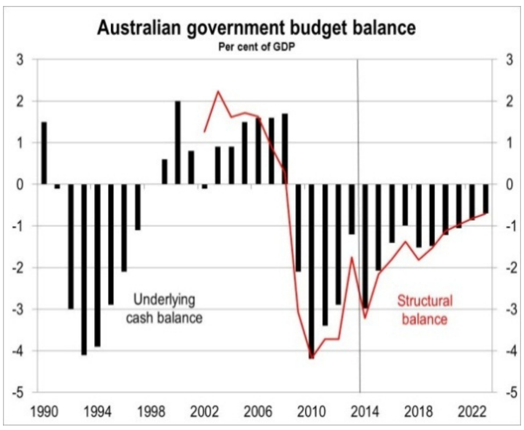
## Resources curses

Australia faces another challenge. The long boom has, itself, affected economic behaviour.

### Lack of public saving

Governments have largely treated the ramp up in incomes as though they were permanent and are now left with a structural fiscal deficit (Chart 4). Even a small fall in commodity prices has left the government with less ability to support the economy following the mining boom.

4. The structural budget deficit is a policy challenge

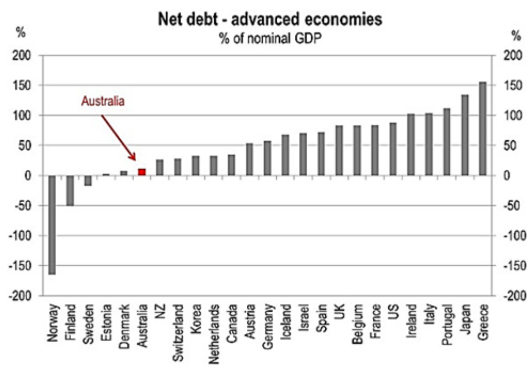



Source: Australian Treasury

Australia's fiscal position should be in better shape, given the long boom and the run-up in commodity prices. But tax cuts, that were made early in the mining boom, the failed attempt to introduce a decent-sized mining tax, and an increase in spending after the global financial crisis all contributed to a structural budget deficit.

If Australia had been able to collect more tax revenue, the fiscal position may have been more comparable to the Nordic states, where the governments have net asset positions (Chart 5). Australia also had a net asset position before the global financial crisis. Nonetheless, while Australia's fiscal position could have been better, it is still strong when compared with most advanced economies – supporting Australia's triple-A sovereign rating.

**5. Public debt could be lower but still low by world standards**




Source: IMF

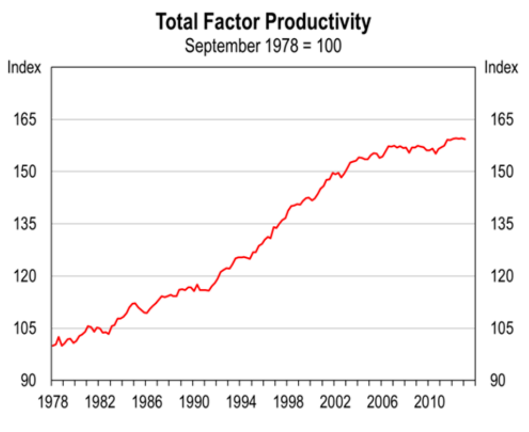
## Stymied reform

The long boom has also had an impact on the broader policy agenda. Australia's reform agenda, which had great momentum in the 1980s and 1990s, has stalled over the past decade. Tax reform, regulatory reform and investment in infrastructure all took a backseat as Australia rode the mining boom wave.

In our view, this is partly the result of the mining boom itself. The 'gift' of high commodity prices and the resulting strong income growth stymied the reform agenda, as policymakers did not have to make hard choices in order to achieve growth. Back in 2011 we referred to this stymied reform agenda as one of the resources curses (Bloxham, P. (2011) '*Does Australia have a resources curse? The challenges of managing a mining boom*', 18 August).

As a result, productivity growth has slowed down in recent years (Chart 6). Total factor productivity growth averaged an annual rate of +2.2% from 1991 to 2003, but has slowed down to +0.5% a year since then.

**6. Lack of reform has held back productivity growth**




Source: ABS

## Australia needs a 'third boom'

There is a temptation, at this point, to suggest that perhaps Australia's best days are behind it. But this ignores some crucial facts.

First, Asia's demand for commodities is expected to continue to grow strongly as many Asian economies continue to converge to advanced country living standards and this requires better infrastructure and more reliable electricity supplies. Australia has built a massive amount of capital to meet this demand. Despite an expected fall in resources sector investment, the ramp up in Australia's resources exports still has a significant run ahead of it. As a result, we expect that the resources sector is not likely to be an outright drag on GDP, despite growth slowing down. Chapter 2 provides some more details on the resources sector.

Second, the bulk of the Australian economy is outside of the resources sector and policy settings are favourable for a pick-up in these sectors this year. Interest rates are at record lows and have already driven a strong pick up in housing prices. The AUD, which had held back growth in 2013, has also fallen in recent months, which should help to support the traded sectors of the economy. Fiscal policy is also looser than it was last financial year. Chapter 3 explains Australia's progress so far in rebalancing growth, as the mining sector slows down.

Third, Australia's ties to the Asian economies are strong and as Asia's middle classes continue to expand, the types of goods and services they demand will change. Demand for services, such as education, tourism and financial services, is set to continue to rise in coming years, offering Australia opportunities to benefit from Asia's continued emergence. The opportunities presented by Asia's continued emergence are the most likely source of Australia's 'third boom'. Chapter 4 sets out some of these opportunities.

Fourth, Australia's starting point is not that bad. While the fiscal position could be better, government debt is still very low by global standards. The economy is also already fairly flexible, illustrated by the fact that it has just absorbed the largest mining boom in its history, with inflation remaining low and growth comparably steady.

There is, however, no denying that growing Australia's economy in the post-mining boom period is going to be tougher than it has been in recent years. Policymakers need to focus on lifting productivity and improving Australia's competitiveness if a 'third boom' is to get traction. Chapter 5 sets out some of the policy challenges and the implications for the policymakers, including the RBA.

# Resources sector slowing, but not an outright drag

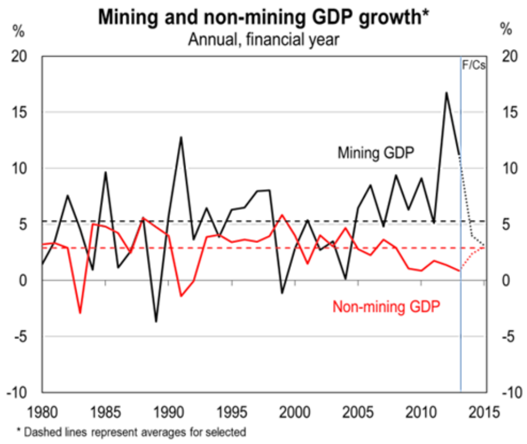
- We see the resources sector slowing significantly, but still continuing to be a positive net contributor to GDP growth
- While the investment boom is now behind us, growth will be supported by an export boom that is set to run for many years
- A sharp fall in commodity prices presents a key risk to the resources sector outlook, but we continue to expect commodity prices to remain 'structurally high'

## Still growing, but more slowly

In late 2012, we argued that 2013 would see mining investment plateau, not plummet, and that the overall mining story was only slowing down, not collapsing. As it turned out, the resources sector was still a strong contributor to growth in 2013, with resources exports ramping up through the year as investment slowed down, rather than fell. On our estimates, mining GDP grew by +11% in the 2012/13 financial year, which is still strong growth, albeit down from +17% the previous financial year (Chart 7).

In 2014 and 2015, we expect mining investment to fall, as far fewer new projects are getting started and some of the larger projects that are currently under construction are completed. Importantly though, the ramp up in the volume of exports is forecast to more than offset the fall investment over the next two years. As a result, we still expect mining GDP to continue to grow.

7. Mining GDP is expected to slow down, not fall




Source: ABS; HSBC estimates

Nonetheless, the period when the mining sector significantly outperforms the rest of the economy is likely to be over. Growth in mining sector GDP, on our estimates, is expected to fall to well below its 35-year average for the first time since 2004 in 2013/14.

This would be the first soft landing from a mining boom in Australia's history. This is our central case, for a number of reasons.

First, unlike previous occasions, we have not seen widespread exuberance across the economy associated with the mining boom. Indeed, inflation has been falling until recently and wages growth across the economy has weakened to its slowest pace in over a decade. Rather than overheat the economy, the expansion of the mining sector saw other sectors of the economy crowded out to make way for the boom. Australia has also been insulated from the full force of the mining investment run-up by the large imported share of mining capital investment (over 50% on RBA estimates). Of course, this import share of capital investment will also insulate the local economy as mining investment begins to fall.

Second, we see the investment that has been made as largely an appropriate allocation of capital, given our outlook for medium-term resources demand. In the iron ore sector, this has been reflected in still buoyant iron ore prices, despite already strong growth in iron ore export volumes. For LNG, which accounts for over two-thirds of all the resources sector investment in Australia, revenues streams are largely locked in, with Australia's LNG prices set in long term supply contracts. For both iron ore and LNG we also remain optimistic about long term demand, given our views on Asian infrastructure investment and energy demand.

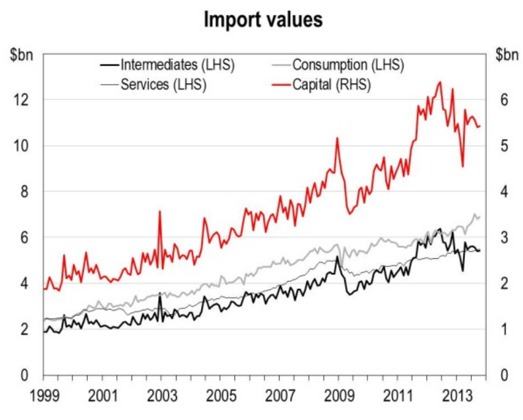
For coal, the story is a bit different. There does appear to have been some over-investment in the coal sector, particularly thermal coal, where demand has been falling due increased global supply of gas, which is a cleaner substitute. Much of the wind back in investment plans in the past couple of years has been in the coal sector.

## Investment fall cushioned by high import share

During the ramp up in mining investment there was significant angst about the very high import share of the capital investment that was occurring. The large import share meant that some jobs associated with the investment boom were going offshore, rather than being created locally. The LNG projects were particularly import-intensive, with large modular sections being built offshore and only 'bolted together' in Australia.

From its trough in mid-2009 to its peak in mid-2012, the value of capital imports rose by +80% in AUD terms (Chart 8). While there are no measures of mining capital imports, historical analysis by the RBA has shown that mining investment tends to be around half imported. Assuming that half of all capital imports have been for mining would suggest that instead of mining investment boosting the economy by around +2 percentage points a year in 2011 and 2012, it probably boosted the domestic economy by closer to 1 percentage point each year.

8. A fall in imports to help offset the investment decline



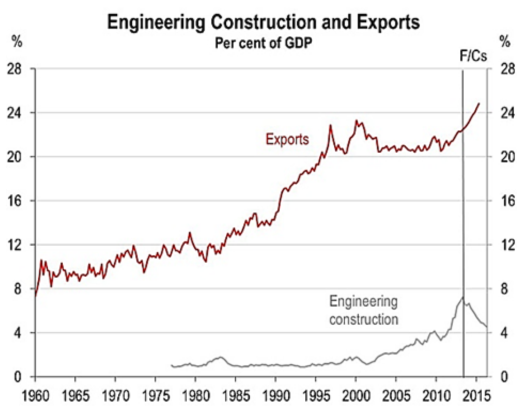

Source: ABS

Of course, as mining investment falls the high import share will provide a cushion for growth. The estimated 2% of GDP fall in mining investment that is expected over the next two years may turn out to have only half that direct effect on the domestic economy.

## Export rise to offset investment fall

The fall in mining investment that is expected in 2014 and 2015 is likely to be more than offset by a rise in exports, with strong export growth expected in coming years (Chart 9). Government forecasts suggest iron ore export volumes are expected to rise by +17% in 2013/14, following a rise of +12% in 2012/13. Coal volumes are expected to rise by around +5% in 2013/14, following growth of around +12% in the previous year. LNG exports are expected to ramp up from 2015 onwards, when new capacity is expected to start to come on-line. Australia is then set to see a boom in LNG exports that stretches out over the rest of the decade.

**9. Exports are set to ramp up to a new record share of GDP**

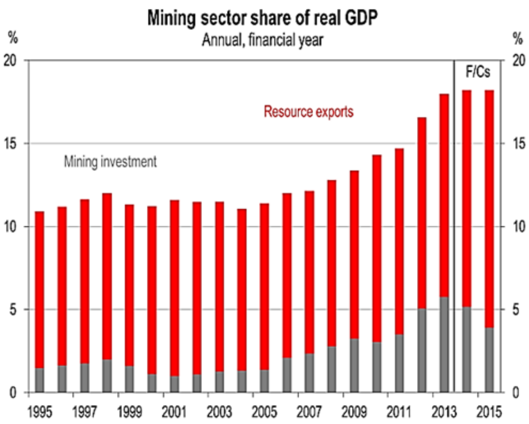



Source: ABS; HSBC estimates

We are forecasting that the export share of GDP will rise to a new record high by the end of 2014 and continue to pick up from there, supported by very strong growth in LNG exports. (For more on LNG see: Bloxham, P. and Richardson, A. (2013) '[Downunder Digest: Australia's growing role in Asian gas markets](#)', 26 September.)

Summing up the expected fall in resources sector investment with the expected ramp up in exports shows that the mining sector is forecast to broadly level out as share of the real economy over the next couple of years (Chart 10).

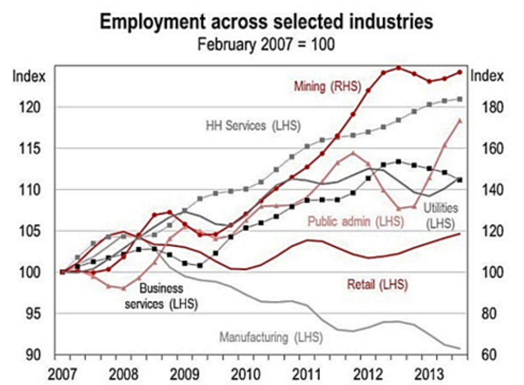
**10. Mining sector should level out as a share of real GDP**




Source: RBA; HSBC estimates

The slowdown in mining investment has already become apparent in new hiring. Mining employment peaked in late 2012 and levelled out over the past year or so (Chart 11). Indeed, employment in the mining sector is likely to fall in coming years as the production phase of the mining expansion is expected to be less labour intensive than the investment phase.

**11. Employment in the mining sector has levelled out**




Source: ABS

## Nominal impact matters

So far, we have focused on the real economy – that is, volumes of capital investment and exports – but, of course, prices also matter, as does the level of the AUD, given that the prices of Australia's commodity exports are set in USD.

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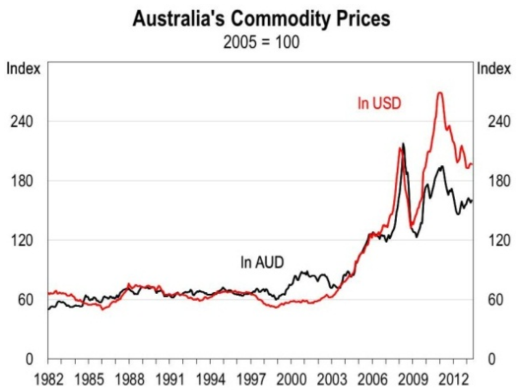
Over 2013, the price of the basket of commodities that Australia exports fell by -4%, with a rise in iron ore prices not quite enough to offset the fall in coal and base metal prices that occurred (Chart 12). But in AUD terms, the average price of Australia's commodity basket rose by +12%, reflecting a sharp fall in the exchange rate.

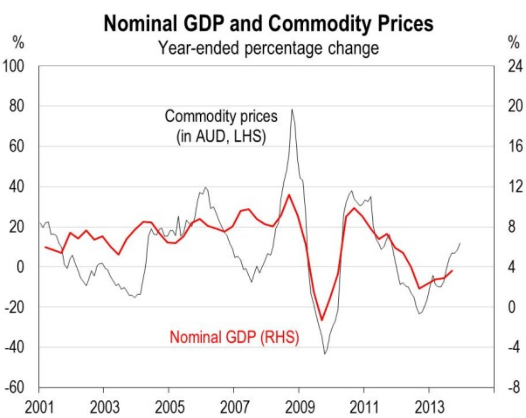
12. Commodity prices are cycling around high levels




Source: RBA

Of course, the AUD price of commodities is what is most relevant for local income growth – in the form of profits earned and wages and taxes paid. Australia's nominal GDP growth has been positively correlated with AUD denominated commodity price swings, particularly in recent years (Chart 13). The rise in AUD-denominated commodity prices over the past year is likely to have supported a modest upswing in nominal GDP growth recently.

13. Steady commodity prices and falling AUD are lifting GDP




Source: ABS; RBA

As the exports phase of the mining expansion ramps up further, this should support a pick-up in mining company profits and tax revenues. Resource producers typically face an average tax rate of around 40%, once Australian company tax, state royalties, the petroleum resources rent tax and mineral resources rent tax are taken into account. Somewhat offsetting this tax burden will be the company's ability to offset their tax liability against capital expenditures.

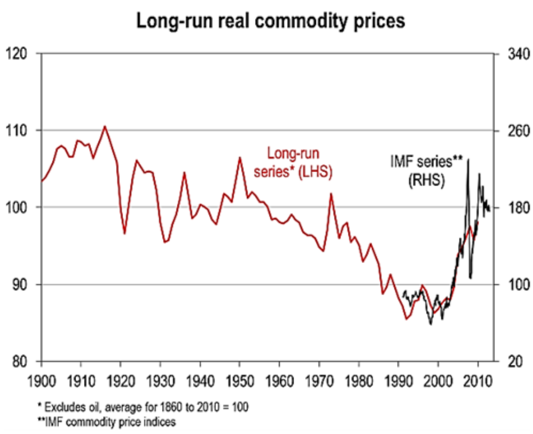
It is also worth keeping in mind that the resources sector is around four-fifths foreign-owned so that much of the profit is likely to flow offshore, which will dampen the expected ramp up in profitability. However, the offshore exposure also means that the risk of a fall in profits is shared with overseas investors, rather than being all held locally.

## Commodity prices still high

The level of commodity prices is important for the profitability of the resources sector and the viability of much of the investment that has occurred in the resources sector in recent years. In broad terms, our view remains fairly optimistic. We do not expect commodity prices to rise back to the peak levels they reached in 2011, but we expect them to remain well above the low levels of the 1980s and 1990s. That is, we expect commodity prices to remain 'structurally high'.

Two elements support our commodity prices view. Empirically, we observe that commodity prices are not, in fact, exceptionally high right now, rather, they were exceptionally low in the 1980s and 1990s. Data for the past 150 years shows that real commodity prices are actually currently around their long run average levels (Chart 14).

**14. Commodity prices are around their long run averages**



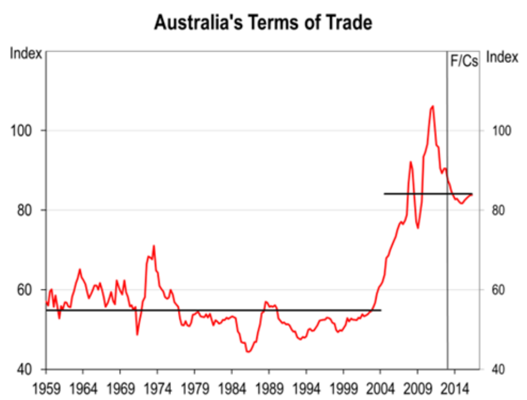

* Excludes oil, average for 1860 to 2010 = 100
**IMF commodity price indices

Source: UN; IMF based on Thomson Reuters Datatream data

The second element reflects our view that commodity prices will continue to be supported by the shift in the weight of global growth towards Asia and these economy's strong needs for hard commodities to build infrastructure, and energy commodities for electricity. As there is significant urbanisation and industrialisation yet to come, we expect the emerging economies to continue to require substantial amounts of commodities in order to grow. This view was most recently set out here: Bloxham, P. and Richardson, A. (2013) '*Global commodity prices: More super, less cycle*', 5 September.

While we expect commodity prices to ease modestly in 2014, we have in mind that they will remain well above their historical average levels, and that this will hold up Australia's terms of trade at well above its historical average levels (Chart 15).

**15. Commodity prices expected to remain 'structurally high'**




Source: ABS; HSBC estimates

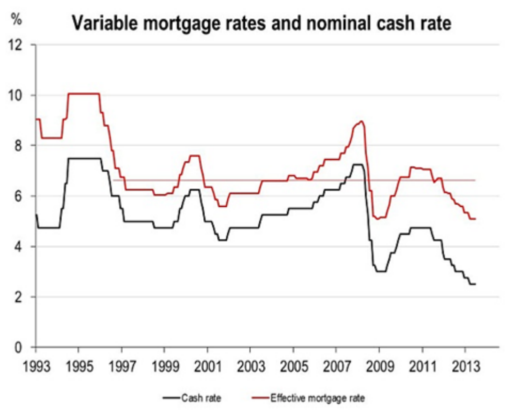
# More rebalancing needed

- The bulk of the economy is outside of the mining sector and low rates and a lower AUD should support growth in these sectors
- Housing prices and construction are expected to pick up further in 2014, also supporting a rise in household spending
- Fiscal policy is set to support growth this financial year, after having been a significant drag in the 2012/13 financial year

## Rebalancing slowly: so far

With growth in the mining sector slowing down, other sectors need to pick up. We have been describing this as '*Australia's Great Rebalancing Act*' (7 December 2012). To facilitate this rebalancing, the RBA has cut its cash rate from 4.75% in October 2011 to 2.50% by August 2013, the lowest level in its history (Chart 16).

**16. Interest rates are at very low levels relative to history**




Source: RBA

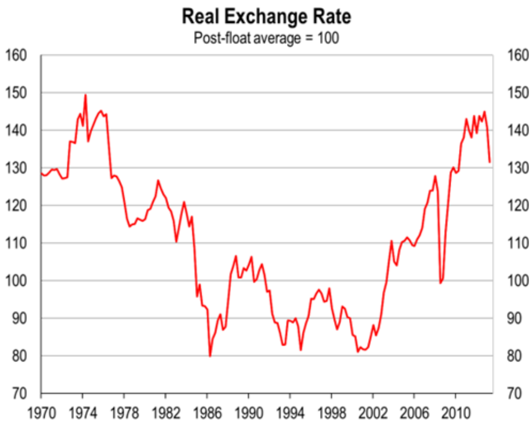
This has seen effective mortgage rates fall to the same very low levels they had reached in early 2009, after the failure of Lehman's bank (Chart x). Business borrowing rates have also fallen to low rates, on average, although collateral requirements have increased for some small business loans in the post-global financial crisis period.

But despite low interest rates, the rebalancing of Australia's growth has been slow. While the established housing market has been booming, and this is showing signs of feeding through to an upswing in housing construction, there were only limited signs of rebalancing beyond housing for most of 2013.

There are a number of possible factors that have constrained Australia's rebalancing act.

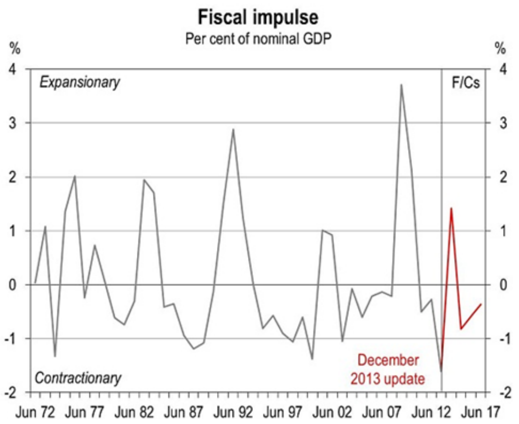
First, has been the high level of the AUD. In the past, low interest rates and a fall in commodity prices have seen corresponding falls in the exchange rate. But, on this occasion, the AUD has been slow to respond. Despite commodity prices having peaked in 2011, the AUD stayed very high through 2012 and into 2013. This partly reflected the major global central bank's zero interest rate and quantitative easing policies, which saw more capital flow to Australia in a search for yield. However, as 2013 progressed, the AUD did start to move more into line with fundamentals (Chart 17), falling by -11% on a nominal trade weighted basis over the year as a whole (it was down -14% against the USD).

17. The AUD has been very high until recently




Source: RBA

18. Fiscal policy to be less of a drag this financial year




Source: Australian Treasury; HSBC estimates

Second, weak productivity growth combined with the high exchange rate has weighed on Australia's competitiveness, which has discouraged new business investment and is weighing on the local manufacturing industry, in particular.

Third, the lead up to the Federal election in September 2013 weighed on business and consumer sentiment, as political uncertainty appeared to make businesses weary about making large hiring and investment decisions.

A fourth factor has been tight fiscal policy, which has been a drag on the economy. For 2012/13, our estimates suggest that tight fiscal policy was the biggest drag on growth since the early 1970s (Chart 18). Public demand fell last year for the first time in the 54 year history of the quarterly GDP numbers, as the previous government sought to meet political promises, initially, to return to budget surplus and subsequently to keep spending growth below a certain threshold. This fiscal austerity was, however, unfortunately timed as it occurred in a year when global growth was slowing and commodity prices were falling.

## Policy is now more supportive

In 2014, policy settings are far more supportive of Australia's great rebalancing act.

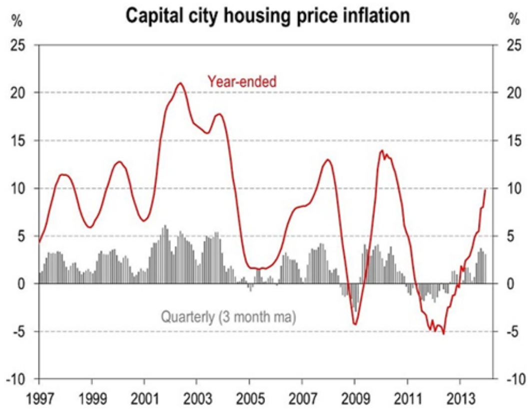
The RBA has kept its cash rate at its historic low of 2.50% and their public campaign to talk down the AUD got some traction in the latter months of 2013, with the AUD closing out the year at US89 cents, down from US104 cents at the end of 2012.

The new government has, for the moment, also backed away from previously made plans for a near term fiscal austerity drive, with the budget deficit set to expand to 3.0% of GDP in 2013/14, from 1.2% of GDP in 2012/13. Simple fiscal impulse estimates imply support for growth to the tune of +1.8% of GDP.

## Housing price boom underway

Australia is already experiencing a housing price boom as a result of low interest rates. Nationwide housing prices have risen by +12% since their trough in May 2012 and by +9.8% over the past year (Chart 19). Housing prices are rising most strongly in Sydney, Perth and Melbourne, although they are increasing in all of the state capitals.

19. Australia's housing price boom set to continue




Source: RP Data-Rismark

So far, the rise in house prices has been in line with what might be expected given the level of mortgage rates. In this respect, the pick-up in prices looks like a normal housing price cycle.

We remain of the view that Australia does not have a housing bubble and, at this stage, we do not think that the acceleration in housing prices is worrisome.

There are a number of reasons why we see Australia's housing prices as sustainable. Fundamentally, the level of housing prices in Australia reflects strong demand and weak supply of new housing. Unlike other countries that have suffered large housing price collapses in recent years and associated financial crises, Australia does not have an over-supply of housing. Cross-country comparisons also show that while Australia's housing prices are high, they are not unusually high, with the housing price to income ratio at a similar level to that in a collection of similar developed economies (for more details, see Bloxham, P. and Richardson A. (2013) '*Downunder digest: Australia's housing boom: No bubble yet*', 8 October).

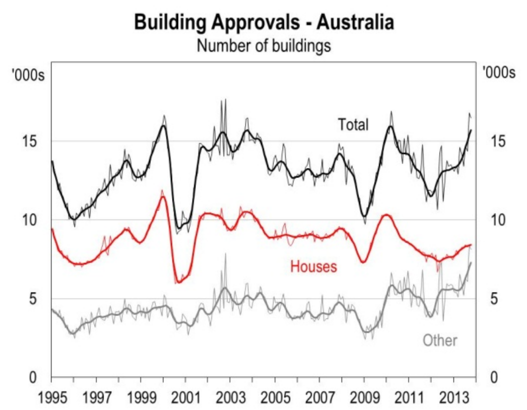
In terms of household finances, we also see Australia's household debt levels as sustainable, despite being fairly high. This reflects a number of factors including that: most of the debt is held by high income households that can afford to continue to service it; Australia's mortgages are all full-recourse loans; and, most households are well ahead on their mortgage repayments, with the latest data showing that the average mortgage is pre-paid by 21 months (for more details, see Bloxham, P. and Richardson A. (2013) '*Downunder digest: Australia's household debt: Why we are not worried*', 21 November).

We expect the housing price boom to continue in 2014, supported by low interest rates. After having risen by +9.8% over 2013, we expect housing prices to increase at low double digit rates over 2014.

## Residential building boom

Rising housing prices, low interest rates, a pick-up in immigration rates and weak housing supply in recent years, are all expected to support an upswing in housing construction in 2014. Timely indicators of new activity suggest an upswing is already underway, with new building approvals rising by +22% over the past year (Chart 20).

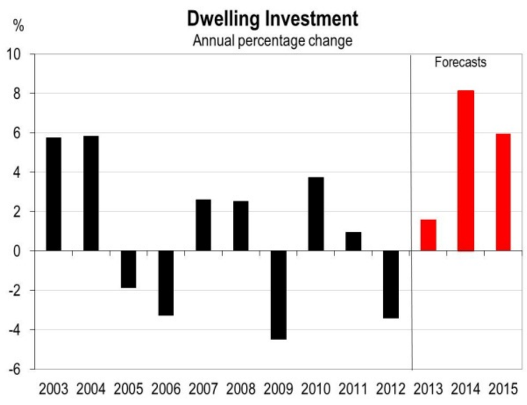
20. Leading indicators of housing construction are strong




Source: ABS

The flow through to housing construction has, however, been weak so far, with the Q3 2013 GDP numbers showing residential investment only rising by +1.7% y-o-y. This may partly reflect that the upswing in new approvals has been largely for medium-density dwellings (including apartments), which generally take longer to complete than detached houses. While the flow through has been slow, we expect it to pick-up pace in 2014, with dwelling investment forecast to grow at its strongest rate in 12 years (Chart 21).

21. Construction expected to pick up strongly in 2014

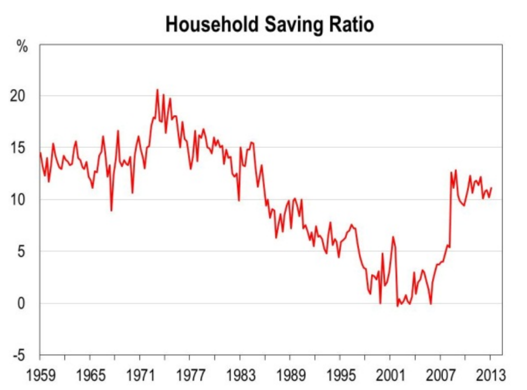



Source: ABS; HSBC estimates

## Consumption needs to rise

Despite low interest rates and rising asset prices, Australian consumers remained cautious in 2013. The household saving rate was broadly steady through the year at fairly high levels when compared with history (Chart 22).

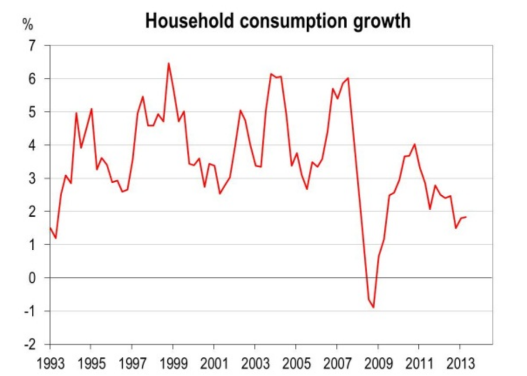
22. Consumers are cautious, but also well placed to spend




Source: ABS

The increased cautiousness of households in recent years may reflect a response to the global financial crisis, which saw many Australian households sustain large capital losses, particularly in their pension funds. Surveys also suggest that it could reflect general uncertainty about the economic outlook, particularly employment prospects. Growth in household spending has been weak over the past year (Chart 23).

23. Household consumption has been weak, but should rise




Source: ABS; HSBC estimates

While the saving rate out of income has remained fairly high over the past year there are, however, some signs that household risk-appetite has been rising. Growth in bank deposits has been slowing down and there has been a portfolio shift in household assets towards equities and residential investment property. This is one of the transmission mechanisms of monetary policy – low interest rates are discouraging households from holding deposits and driving them to shift their saving to other assets with rising prices.

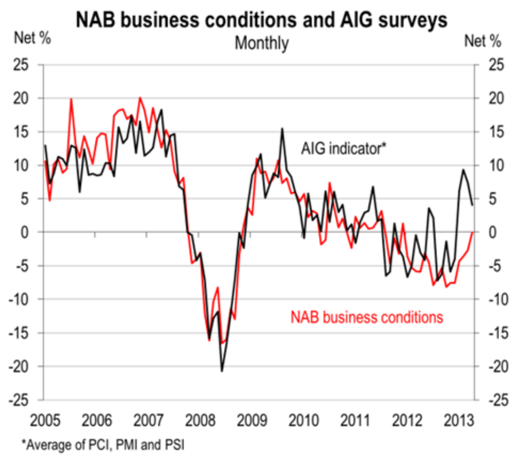
With interest rates remaining low and household risk appetite gradually increasing, we expect to see a rise in household consumption soon. We also expect household consumption to get some support from the housing boom, with rising house prices expected to support consumer sentiment and a pick-up in new house building expected to support demand for durable goods as households seek to fill their new houses with goods.

The high saving rate means that there is room for households to consider spending a bit more. A lower AUD is also expected to support more local spending as it may discourage international travel by local residents, which has been at record levels recently.

## Business conditions improving

Business conditions fell to their lowest levels since the global financial crisis in the middle of 2013 (Chart 24). This appeared to reflect the dampening influence of the high AUD, worries about the Chinese economy and local political uncertainty in the run-up to the September 2013 election. Following the election, there has been an improvement in business conditions.

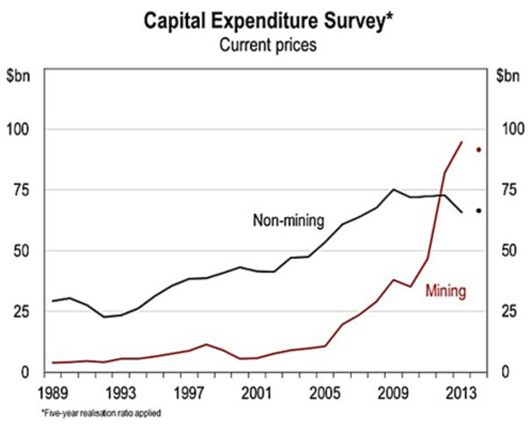
**24. Business conditions have lifted since the election**




Source: Bloomberg; Thomson Reuters Datastream

As yet, forward-looking investment surveys suggest few signs that investment outside of the mining sector is expected to rise in the 2013/14 financial year (Chart 25). Beyond this horizon we expect to see some improvement, supported by improving confidence, a pick-up in household spending and improved competitiveness associated with lower AUD.

**25. Non-mining investment projections remain subdued**

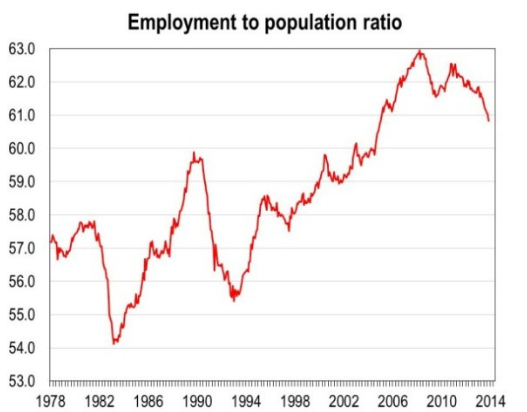



Source: ABS

## Labour market still loose

Below trend growth and weak business confidence have seen employment growth remain well below trend. Combined with a pick-up in population growth over the past year this has seen the employment-to-population ratio fall to its lowest level since the mid-2000s (Chart 26). The fall partly reflects demographics – as the population ages more people enter older age groups where participation in the labour market tends to be lower. But it also reflects weak domestic demand, which has discouraged job search by some people.

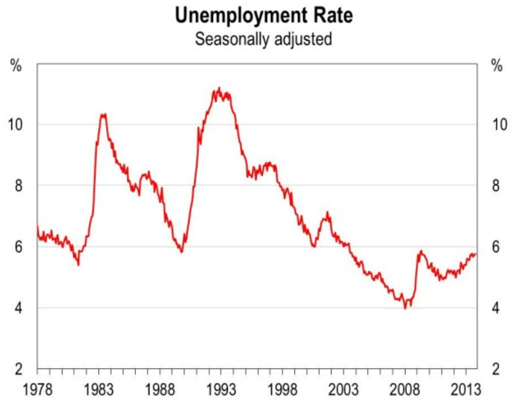
**26. Population is rising, but jobs growth has remained weak**




Source: ABS

Despite the fall in the employment-to-population ratio, the unemployment rate has drifted up only slowly over the past 18 months or so (Chart 27), as weak employment growth has been largely matched by declining participation in the labour market.

27. The unemployment rate has drifted upwards

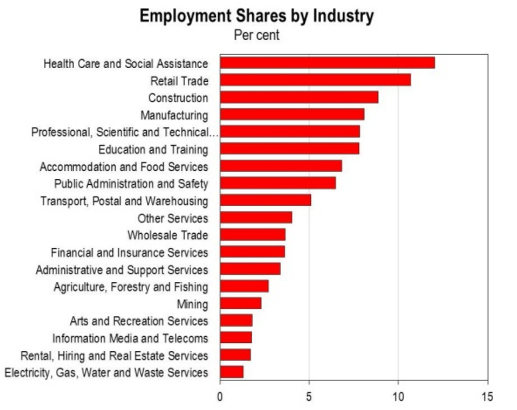



Source: ABS

We expect employment growth to pick up in 2014, supported by our forecast growth in the housing market, residential construction, household consumption and the services sectors.

These sectors account for a far larger share of the Australian economy than the mining sector (Chart 28). On a value-added basis, the mining industry only accounts for around 9% of GDP and even adding in all of the downstream services associated with a mining investment boom (engineering, construction and professional services) the resources sector is still only estimated to be around 20% of the economy. For employment, the mining sector is even smaller at around 3% of employment. The sectors of the economy which we expect to pick-up this year are sectors that account for the bulk of employment.

28. Mining accounts for only a small share of employment




Source: ABS

# What's next? Asian opportunities

- With the mining sector set to contribute less to growth in the future, other sectors need to contribute more
- Growing ties to Asia present the greatest opportunity for Australia, and could eventually be the source of a 'third boom'
- The expanding middle classes in Asia are set to demand more education, tourism and financial services as well as agricultural products, which are areas Australia needs to focus on

## What's next?

With Australia's previous two booms behind it, a key question is: what's next? Does Australia now underperform? Is this the end of 'Australian exceptionalism'? Are Australia's 'salad days' behind it and are we now stuck in the 'dog days' as a prominent local academic economist, Ross Garnaut, has been suggesting?

There is certainly a case to be made that growing Australia's economy is likely to be tougher in the next couple of years than it has been in recent years. There is a need for reform and policy missteps pose a risk to growth (see Chapter 5 for more on this).

But Australia also has a number of other growth opportunities, outside of mining, that are largely due to its already strong ties to Asia and the rapid expansion of the Asian middle classes. The convergence of emerging Asia's living standards towards those of the advanced economies has only just begun and is expected to play out over multiple decades. Australia's mining boom is just the beginning of this story, with other sectors set to benefit from Asia's on-going growth.

## Asian opportunities

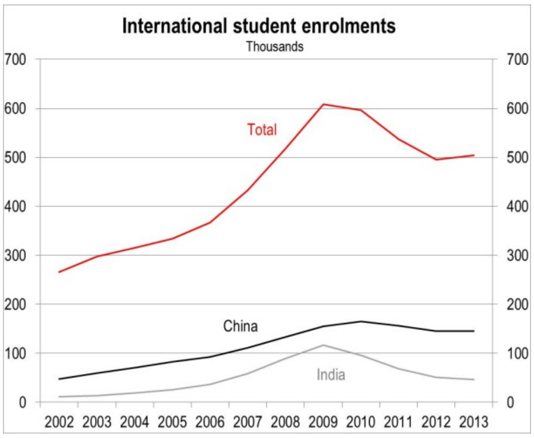
HSBC estimates suggest that almost 3 billion people will join the middle classes by 2050. The largest regional contributor to the new middle classes is expected to be Asia, led by growth in China, India, Indonesia, the Philippines and Malaysia (see Ward, K. and Neumann, F. (2012) '*Consumer in 2050: The rise of the EM middle class*', 15 October). This rise is set to support demand for a range of goods and services as preferences change and spending power grows.

We see strong medium-term opportunities for Australia in areas such as education services, tourism, business and financial services and agriculture.

## Education services

Education is already an important source of export earnings for Australia, being its fourth largest export earner. Around four-fifths of the students that come to Australia are from the Asian region, with China, India and South Korea the three largest export markets. However, student numbers had declined between 2009 and 2012, reflecting a range of factors, including: the high Australian dollar; decisions by previous governments to cut back on student visa issuance; and, reduced enrolments due to racially motivated attacks in 2010. The trends have improved a little more recently, with international student numbers rising in 2013 (Chart 29).

**29. International student numbers are rising again**



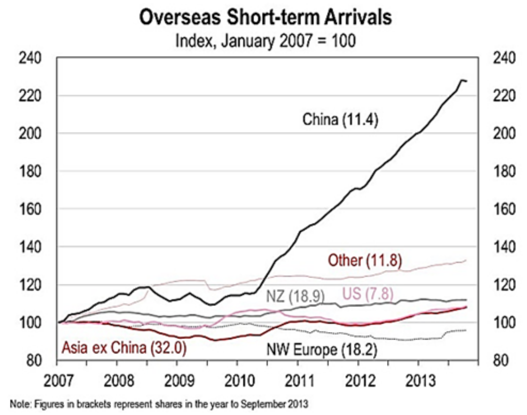

Source: Australian Education International

## Tourism already lifting

Tourist arrivals from Asia have already ramped up in recent years, with particularly strong growth from China (Chart 30). This is despite the high level of AUD and largely reflects rapid growth in middle class incomes in China and the broadening range of activities that a growing group of Asians can afford to partake in.

We see this growth as likely to continue. HSBC estimates that 60 million people left China for an overseas trip in 2012 and that this is expected to have risen to 130 million by 2015. If Australia attracts and even share of these visitors, there will be more visitors from China than from any other place, except New Zealand, by 2015.

**30. Chinese tourist arrivals have ramped up in recent years**




Source: ABS

## Business and financial services

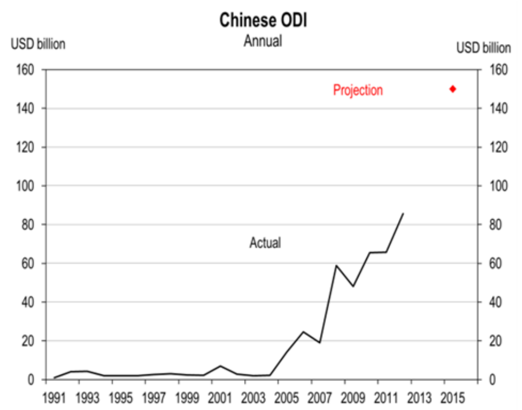
Australia's international trade and population flows are dominated by links to Asia, but financial linkages are still fairly limited. The majority of both Australia's investment abroad and foreign investment in Australia still comes from and heads to Western markets. The UK, US and European markets account for 64% of Australia's total offshore investment, while 58% of foreign investment in Australia comes from those Western markets.

While financial linkages to Asia are still fairly limited, they are growing quickly and offer significant opportunities. Australia is well placed to benefit from the opening up of the Asian financial system, given its already strong trade and population linkages and its deep, liquid and open financial markets. Further liberalisation of the Chinese financial system would give Australian businesses greater opportunities in attracting offshore investment for expansion and local investors more options when looking to diversify offshore.

Overseas direct investment is a priority within the Chinese government's current five year plan, with the Ministry of Commerce projecting a 17%

annual increase in ODI between 2011 and 2015 (Chart 31). Australia is currently the largest single recipient of Chinese overseas direct investment (see Bloxham, P. and Richardson A. (2013) '*Downunder digest: Australia's financial ties to China set to grow*', 12 December).

31. China's plans see overseas direct investment doubling



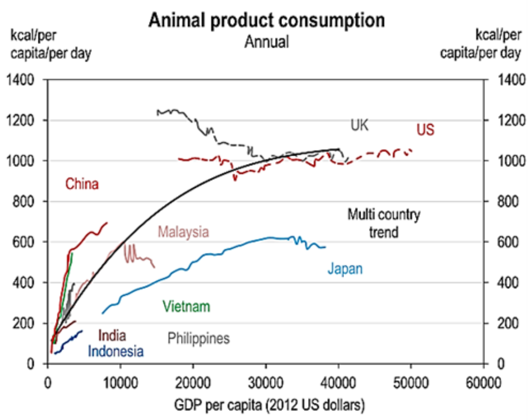

Source: CEIC; Ministry of Commerce projection

## Agriculture: a dining boom, anyone?

Australia's small population and large land mass make it a large global exporter of agricultural products. Australia is the world's largest exporter of wool, third largest exporter of beef, cotton, sugar and the fourth largest exporter of wheat. While agricultural exports only account for 12% of total exports, there are likely to be opportunities for this sector to expand as Asia's middle class incomes rise, diets change and food demand increases.

Historical patterns suggest that the largest opportunities are likely to exist in the production of animal products, such as meat and dairy (Chart 32). New Zealand has been a key beneficiary of rising demand for these products, as we have noted elsewhere (see Bloxham, P. and Richardson A. (2014) '*New Zealand in 2014: Firing on all cylinders*', 10 January).

32. Asian demand for animal products likely to rise further




Source: FAO; Conference Board; HSBC

To support these opportunities policymakers need to focus on reform to increase Australia's productivity and competitiveness. The recent fall in the AUD will go some way to supporting these industries. In the next chapter, we discuss some of the reform challenges Australia faces.

# Policy implications and challenges

- Lifting productivity and competitiveness is becoming more pressing, with policymakers needing to focus on reform
- The government faces the challenge of putting Australia back on a sustainable fiscal path, without unnecessarily tightening fiscal settings at the wrong time
- The RBA is likely to focus on jawboning to keep the AUD in the US80-90 cent range, as low rates are already doing their job

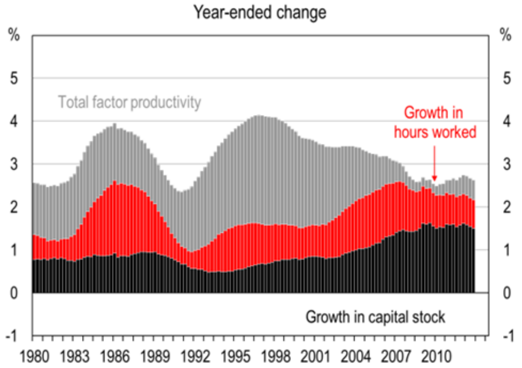
## Productivity and competitiveness challenges

Productivity growth has been weak in Australia for a number of years. Total factor productivity has slowed from an annual rate of +2.2% from 1991 to 2003 to +0.5% since then. The slowdown in productivity growth reflects a range of factors, some of which are temporary, although many of which are likely to be structural.

Combining the slowdown in productivity growth with the fall in labour market participation in recent years, suggests that the economy's potential growth rate is likely to be lower than it has been in the past (Chart 33). Our estimates show that Australia's potential growth rate may now sit around 2.8% a year, down from rates that were closer to 3.5% in the first half of last decade (see Bloxham, P. and Richardson A. (2014) '*Downunder digest: Australia's lowered potential*', 22 January).

**33. Trend growth is lower, presenting a challenge**

**Factor Contribution to Potential GDP Growth**
Year-ended change




Source: ABS; HSBC estimates

Productivity has been weakest in the mining and utilities sectors. For mining, this is likely to be at least partly temporary, reflecting that there has been significant investment in the sector, which has involved labour and capital, but there has been little measured output, as yet, because the ramp up in exports still has quite some time to run.

For utilities, weak productivity growth partly reflects increased reliability of service standards in recent years, which has increased the 'quality' of electricity and water provision, but not the quantity. For electricity, this has involved building significant capacity to meet peak demand levels, even though much of this capacity is underutilised at other times. For water, investment in desalination plants has also weakened measured productivity as this is an expensive way to acquire water.

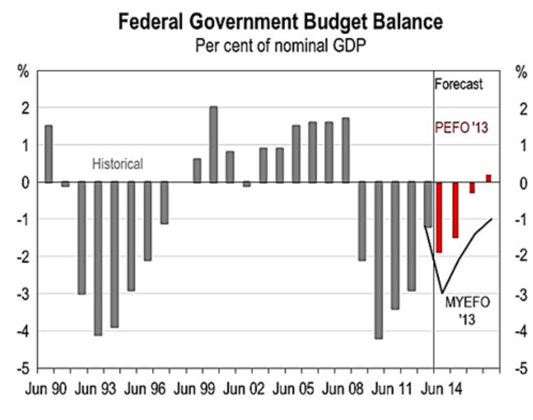
But productivity growth has slowed across all sectors of the economy, suggesting that there are also macroeconomic factors at work. As the Australian Productivity Commission has repeatedly emphasised, reform is needed in regulatory arrangements, including tax, labour market and competition policies.  Policymakers also need to focus on skills and infrastructure.

Reform is needed so that Australian businesses can reduce their cost bases and become more competitive. This is becoming a more pressing need as the fields Australia will need to compete, to take advantage of the trading opportunities Asia presents, are very competitive industries. While Australia has a natural comparative advantage in producing commodities, given its endowment and history, competing in other areas requires more policy focus.

## Fiscal challenges

Australia also faces fiscal challenges. Despite Australia's recent economic successes, governments have not managed to maintain fiscal surpluses. Indeed, the Australian government has had deficits since the global financial crisis began in 2008 and current government projections suggest deficits will continue over the coming four years (Chart 34).

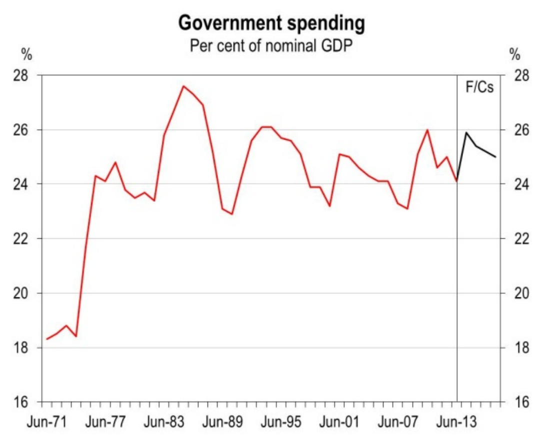
34. Budget deficits despite the mining boom




Source: Australian Treasury

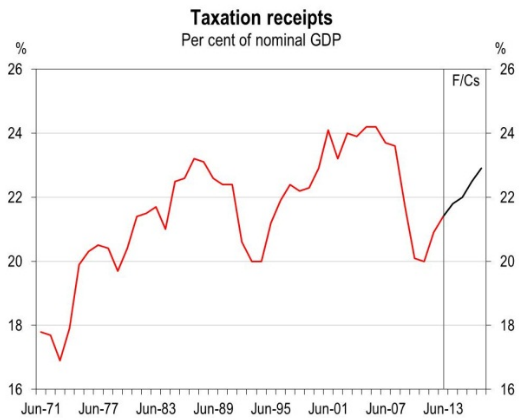
Part of the reason for the sustained budget deficits of recent years has been the fiscal stimulus that occurred in response to the global financial crisis, with some of the increase in government spending being locked in for a number of years (Chart 35). However, this is not the main explanation for Australia's weakened fiscal position. While government spending has risen, it is not high by international standards or when compared with public spending in Australia over the past 35 years. The main driver of the fiscal deficits has been a large fall in tax revenues (Chart 36).

35. Public spending remained fairly constant in recent years




Source: Australian Treasury

36. Taxation receipts have fallen and need to rise




Source: Australian Treasury

Tax receipts have fallen sharply since the global financial crisis for a range of reasons.

First, income tax cuts that were delivered in the early stages of the mining boom (2003-2007) reduced the ability of the income tax system to deliver government revenue as they changed the structure of the tax system.

Second, large capital losses sustained across a range of asset classes during the global financial crisis meant that capital gains tax revenues have been weak. This has been exacerbated by rules that allow capital losses to be offset against future capital gains tax liabilities for a period of five years after the loss is crystallised.

Third, revenue from the goods & services tax has been weak due to slower growth in household consumption and a range of exclusions in the coverage of the tax, including the exclusion of goods purchased from offshore using on-line providers.

### What needs to be done?

Quite simply, the government needs to either cut spending or find more tax revenue. Perhaps a bit of both will be needed. It seems likely, however, that the solution will require at least some increase in taxes.

A government-appointed 'Commission of Audit' is expected to present the Treasurer with recommendations, in early 2014, on how to put the budget on a firmer medium-term footing. These are, however, not expected to be published, with the Treasurer expected to be guided by the recommendations in formulating the May budget.

Amongst other measures, the budget is expected to include the government's plans to remove the carbon and mining taxes. Both of these adjustments are likely to make it even more difficult to improve the budget bottom line, as they would subtract from government revenues, but the removal of both these taxes was a part of the Coalition party's election campaign agenda.

Other major tax changes are not expected to be announced as the government has indicated that it plans to take any proposed tax changes to the next election (likely in 2016). A tax review is due to be published sometime this year.

The May budget is therefore likely to be focused on spending cuts, rather than tax changes. This is a risk to the growth outlook. Care should be taken in the timing of any government spending cutbacks, given that growth is already tracking at a below average pace.

## RBA's role

The Reserve Bank is already playing a central role in the rebalancing of Australia's growth.

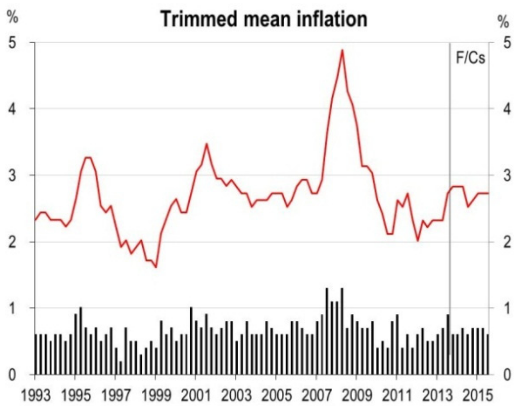
The RBA has its cash rate at a record low of 2.50% and effective mortgage rates are at their lowest levels in 50 years. Low interest rates have already supported a strong pick-up in the established housing market, with house prices rising by +10% over 2013. There are signs that the pick-up is spreading to a rise in housing construction, particularly of apartments.

For businesses, interest rates are also at very low levels. As the RBA Governor, Glenn Stevens, noted just before Christmas, for businesses, the cost of borrowing is not the factor that is holding back growth.

The RBA has also focused on trying to loosen financial conditions further by talking down the Australian dollar. In the latter months of 2013, officials repeated the message that the currency was 'uncomfortably high'. The RBA Governor also gave a press interview, articulating that he would be more comfortable with the currency closer to US85 cents. The central bank has largely had their wish granted. A combination of their own jawboning and the beginning of the reduction in the US Federal Reserve's quantitative easing program, the so-called 'tapering', has seen the Australian dollar trade around a three-year low of US88 cents recently. The currency is now 15% lower than a year ago, loosening financial conditions substantially.

With the AUD having fallen significantly already, we also see underlying inflation as likely to remain in the upper half of the RBA's target range (Chart 37).

37. Underlying inflation expected to rise through 2014

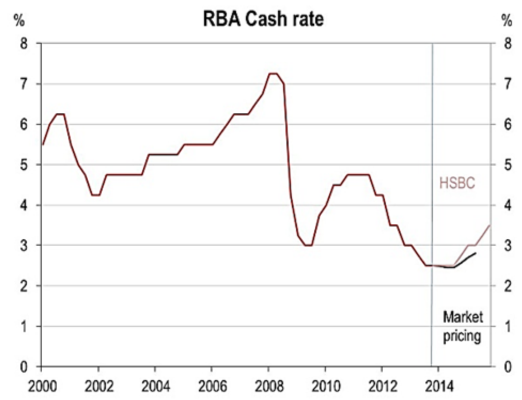



Source: ABS; HSBC estimates

Given the housing boom that is already in progress, potential concerns about over-inflating the housing market, and the recent lift in inflation we think the RBA will be reluctant to cut rates further this year. While growth could be supported further by rate cuts, the trade-off would be increased risk of financial instability sometime in the future.

We see the RBA as likely to remain focused on talking down the AUD to keep financial conditions loose, rather than cutting rates further. Indeed, given the expected lift in inflation, we think the RBA may need to start lifting interest rates before year-end (Chart 38).

38. We expect the next move is likely to be up, not down




Source: Bloomberg; RBA; HSBC estimates

## Risks

Local risks are more prominent in 2014 and 2015 as policymakers and businesses need to adjust to the end of the mining investment boom.

A key local risk is a fiscal policy misstep. Plans need to be made to improve Australia's fiscal position in the medium-term, but near-term aggressive fiscal austerity would be the wrong move.

Policymakers and businesses also need to be focused on improving Australia's productivity and competitiveness. These sorts of reforms can present a downside risk to near term growth as changes drive uncertainty. A lack of reform, however, is a downside risk to the medium-term outlook, as a lack of reform could weigh further on Australia's potential.

In terms of international risks, a slowdown in China remains the key international risk for Australia, if it were to see a significant slowdown in fixed asset investment or the steel sector. The risk of a hard landing remains, particularly given risks stemming from the shadow banking sector (see King, S. et al (2013) '*Top 10 risks for 2014: Multi-asset special*,' 10 December).

Commodity prices are also a key risk. A sharper than expected fall in commodity prices could weigh on Australia's income growth, although a matching fall in the AUD would offer the economy some protection.

Developments in the US this year will also be important for Australia, but mostly through the impact they have on the AUD. A weaker US economy could see the AUD appreciate from here, which would constrain the rebalancing of Australia's growth. Faster growth in the US and a stronger USD could put additional downward pressure on the AUD and lift local inflation.

Japan's outlook also matters for Australia. The significant quantitative easing programme that the Bank of Japan already has in place could see an increase in offshore capital flows from Japan into Australia, which could support local growth. Likewise, further strength in the Japanese economy could be an upside to Australian export growth, as Japan is our second largest trading partner.

HSBC

# Forecast table

HSBC's forecasts for Australia

| | Year-average | | | Year-ended | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | Q313 | Q413e | Q114e | Q214e | Q314e | Q414e | Q115e |
| %* | | | | | | | | | | |
| **AUSTRALIA** | | | | | | | | | | |
| **GDP** | 2.4 | 2.8 | 3.4 | 2.3 | 2.7 | 2.8 | 2.6 | 2.9 | 2.8 | 3.1 |
| Consumption | 1.8 | 2.6 | 2.8 | 1.8 | 2.1 | 2.4 | 2.4 | 2.8 | 2.9 | 2.9 |
| Public consumption | 1.2 | 2.4 | 1.8 | 1.7 | 3.0 | 2.4 | 2.9 | 2.2 | 2.2 | 2.0 |
| Investment | -1.8 | 0.4 | 2.4 | -1.9 | -2.8 | 0.2 | -0.1 | 0.6 | 1.0 | 1.8 |
| - Dwelling | 1.6 | 8.1 | 6.0 | 1.7 | 1.5 | 5.4 | 7.6 | 10.3 | 9.2 | 7.5 |
| - Business | -2.0 | -1.8 | 0.5 | -2.5 | -5.8 | -1.0 | -1.3 | -2.8 | -1.9 | -0.7 |
| - Public | -4.5 | 0.8 | 6.0 | -3.1 | 6.6 | -0.6 | -3.6 | 4.0 | 3.5 | 5.1 |
| Final domestic demand | 0.8 | 2.1 | 2.6 | 0.9 | 1.1 | 2.0 | 1.9 | 2.2 | 2.4 | 2.6 |
| Domestic demand | 0.3 | 2.2 | 2.6 | 0.1 | 0.9 | 2.2 | 1.8 | 2.6 | 2.4 | 2.6 |
| Exports | 6.6 | 6.2 | 9.0 | 6.1 | 5.8 | 5.2 | 5.2 | 7.0 | 7.3 | 8.2 |
| Imports | -2.6 | 3.8 | 6.1 | -3.7 | -2.6 | 2.3 | 0.9 | 5.9 | 5.9 | 6.5 |
| GDP (% quarter) | -- | -- | -- | 0.6 | 0.8 | 0.6 | 0.6 | 0.8 | 0.8 | 0.9 |
| **CPI**** | 2.4 | 2.7 | 2.8 | 2.2 | 2.7 | 3.0 | 3.0 | 2.5 | 2.4 | 2.5 |
| Trimmed mean | 2.4 | 2.8 | 2.7 | 2.3 | 2.7 | 2.8 | 2.8 | 2.8 | 2.5 | 2.6 |
| Unemployment rate | 5.7 | 5.8 | 5.6 | 5.7 | 5.8 | 5.9 | 5.8 | 5.7 | 5.7 | 5.6 |
| Labour price index | 2.9 | 2.9 | 3.6 | 2.7 | 2.6 | 2.6 | 2.7 | 3.0 | 3.2 | 3.4 |
| Current A/C (%GDP) | -3.1 | -3.3 | -3.0 | -3.3 | -3.4 | -3.1 | -3.4 | -3.5 | -3.3 | -3.3 |
| Terms of trade | -4.7 | -5.8 | -1.8 | -3.5 | -3.1 | -6.2 | -7.6 | -5.4 | -4.1 | -3.2 |
| Budget balance (%GDP) | -1.3 | -3.0 | -2.0 | -- | -- | -- | -- | -- | -- | -- |
| Capital city house prices | 6.1 | 9.8 | 7.3 | 7.6 | 8.1 | 9.5 | 9.4 | 10.1 | 10.1 | 9.3 |
| Private sector credit | 3.4 | 6.3 | 6.2 | 3.3 | 4.2 | 5.4 | 6.2 | 6.8 | 6.8 | 6.5 |
| USD/AUD (end period) | 0.90 | 0.86 | 0.86 | 0.92 | 0.90 | 0.89 | 0.88 | 0.87 | 0.86 | 0.86 |
| 90 day bank bill rate | 2.80 | 3.05 | 3.80 | 2.62 | 2.80 | 2.80 | 2.80 | 2.80 | 3.05 | 3.30 |
| **Cash rate (end period)** | 2.50 | 2.75 | 3.50 | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 | 2.75 | 3.00 |

*unless otherwise specified

Source: ABS; RBA; Bloomberg; HSBC estimates

# Notes

# Notes

# Notes

# Disclosure appendix

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