

# Economic Watch

## Australia

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Economic Analysis

Asia

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## Room for policy maneuver limits risks

*Australia has been in the spotlight in recent weeks, not only for a tumultuous bout of intra-party politics last month, but for investor concerns about the outlook following a weaker-than-expected Q4 2011 GDP outturn and disappointing job growth. Also weighing on sentiment are concerns about the health of the global economy and slowdown in China, Australia's largest export market. As such, it is timely now to assess developments and the outlook for Australia's economy. Based on a recent visit to Australia, we remain optimistic about the outlook especially given the room for policy maneuver to address risks.*

### Summary:

- After weathering the 2008-09 Global Financial Crisis (GFC) better than its advanced economy peers, Australia's economy continues to perform well, delivering positive GDP growth and stable inflation. While growth slowed in 2011, partly due to the impact of floods in Queensland which disrupted food supplies and coal mining operations, the economy is projected to rebound in 2012-13 in line with potential growth of 3-4%.
- With a public debt-to-GDP ratio of around 27%, Australia enjoys AAA status by the major rating agencies. The credibility of the Reserve Bank of Australia's inflation targeting regime is also an asset, anchoring inflation in the 2-3% official target range.
- Besides sound economic management, Australia's strong performance is due to a measure of good luck owing to a rich natural resource endowment and close ties to Asia. High commodity prices and growth in Asia have resulted in an unprecedented resource boom, enabling Australia to become one of the world's largest exporters of coal and iron ore. China is Australia's largest export market, accounting for 25% of the total, up from around 5% a decade ago; Japan, Korea, and India are also significant markets which, together with China, now account for about 60% of total exports.
- Lurking below the surface, however, are a number of challenges and risks. Chief among them are symptoms of a "Dutch Disease" brought on by the resource boom, in which mining and currency appreciation crowd out manufacturing and other traditional activities.
- The authorities' policies are based on the premise that the resource boom is permanent rather than cyclical. Consequently, rather than supporting ailing industries and impeding adjustment, policies are aimed at saving the benefits of the boom and facilitating the movement of production towards mining and associated activities.
- The authorities' approach is not without risks, as it entails a growing reliance on the resource sector and continued demand from China. In particular, a collapse in commodity prices and/or a hard landing in China (which we regard as unlikely; see [China Outlook](#)) could result in strong downward pressures on Australia's growth trajectory. In such an event, currency flexibility and room for policy stimulus would provide important buffers.
- Other sources of risk relate to banks' reliance on wholesale funding, and high housing prices and consumer debt levels. These appear manageable for the time being. While the banking sector continues to rely on wholesale funding, vulnerability ratios have improved since the 2008-09 GFC. Moreover, strong banking supervision and a willingness to adopt proactive policies should help to contain risks. At the same time, housing prices are supported by fundamentals, and household savings are on the rise.

## Economic developments and outlook

- Australia has experienced robust growth in recent years despite external shocks, thanks to sound economic management and its geographical vicinity to Asia. Over the past few decades, the policy approach has evolved from one based on a high degree of regulation that included a fixed exchange and wage controls in the early 1980s, to a system today based on liberalized markets, strong central bank independence, and a floating exchange rate. At the same time, strong economic links to Asia have propelled growth through demand for commodity exports, and have served as a crucial buffer against the slowdown in advanced economies.
- As evidence of these strengths, the economy defied predictions of a sharp downturn during the 2008-09 Global Financial Crisis (GFC). Despite having a current account deficit and relying on external borrowing and bank wholesale funding, the Australian economy registered positive growth throughout the GFC, in contrast to deep contractions in nearly all developed economies. A proactive policy stance, including fiscal stimulus and extension of a guarantee on bank liabilities, and strong commodity demand from China were the keys.
- Current circumstances, however, present a more mixed picture. On the one hand, broad macro indicators are fairly robust (Table 1 and Figure 1): GDP growth is expected to pick up in line with potential, inflation is well within the 2-3% official target range, and the economy is operating at close to full employment.
- On the other hand, recent developments make the outlook appear more challenging. An overvalued exchange rate and record high terms-of-trade due to strong commodity prices have undermined non-mining parts of the economy. In the coming year or two, the Australian Treasury estimates that the mining sector will grow by 12% per year, while non-mining sectors are projected to grow by just 2% (see the Australia Treasury's "Mid-Year Economic and Fiscal Outlook 2011-12").
- Overall GDP growth was only 2.0% in 2011 and job creation was weak. Fourth quarter GDP growth slowed and disappointed to the downside (0.4% q/q, s.a. vs. consensus: 0.8%). More recently, the unemployment rate ticked up to 5.2% in February after weaker-than-expected job growth proved a strong outturn in January to be temporary.
- The retail, tourism, and traditional manufacturing sectors are being hit especially hard. Private consumption has led to modest retail sales growth (just 2-3% in 2011, compared to an average of 6.4% in the pre-GFC period of 2002-2007) as consumers turn more cautious and continue to reduce their debt levels.
- Consumer and business sentiment remain weak, after bottoming out in August 2011. Pessimism persists due to the soft performance of non-mining sectors, as discussed above. A silver lining of the weak consumer sentiment and spending is an increase in household savings, with the savings rate having increased to around 10% of GDP from close to zero prior to the GFC. This increase is welcome as it is helping to contain the growth of household debt (around 150% of disposable income), as well as the current account deficit.
- Some of the economic weakness in 2011, however, is due to the lingering effects of floods in Queensland early last year that shut down major coal mines and disrupted food supplies and transportation links. With mining activities in Queensland coming back on stream and reconstruction spending adding to demand, we expect growth to pick up to about 3% in 2012 (Table 1).
- Based on the authorities' view that the commodity boom is permanent - fed by strong demand from China, India, and other emerging markets - the policy approach is to allow the adjustment to take place.

- As such, the Reserve Bank of Australia (RBA) continues to adhere to the inflation targeting regime that has been in place since 1993, in which it aims to keep inflation to within 2-3% on average over the economic cycle. This allows the RBA to set overall monetary conditions in line with the cyclical needs of the economy.

Table 1

**Australia economic outlook**

	2007	2008	2009	2010	2011	2012F
Real GDP growth (YoY%)	4.9	2.3	1.5	2.4	2.0	3.2
Private consumption (YoY%)	5.5	2.0	1.0	2.9	3.4	3.3
Investment (YoY%)	12.9	6.3	-4.2	6.0	8.4	6.1
Inflation (YoY%, avg)	2.3	4.4	1.8	2.8	3.4	2.6
Foreign exchange rate (USD/AUD, eop)	0.88	0.69	0.90	1.02	1.02	1.02
Policy rate (% eop)	6.74	4.25	3.75	4.75	4.25	3.75
Fiscal balance (% of GDP)	1.9	1.1	-3.4	-4.3	-3.3	-0.9
Current account (% of GDP)	-6.4	-4.5	-4.2	-2.5	-2.2	-2.8

Source: BBVA Research

- Core inflation has been contained within the official 2-3% target range over the past year, while headline inflation has been more volatile. In early 2011 headline inflation rose due to a surge in food prices after the Queensland floods, peaking at 3.6% y/y in the second quarter, and easing to 3.1% y/y in the fourth quarter (Australia publishes inflation outturns only quarterly).
- After cutting interest aggressively during the GFC (from 7.25% to 3.00%), in October 2009 the RBA became the world's first major central bank to begin raising interest rates. Given renewed risks to the external outlook and domestic weakness, the RBA reversed course and cut rates twice, in back-to-back moves in November and December 2011, to 4.25% at present. It defied market expectations of another rate cut in February, saying that the global outlook had stabilized, on positive steps in Europe, a moderate expansion in the US, and continued growth in China. It maintained this stance in March.
- Consistent with its inflation targeting regime, the RBA allows the Australian dollar to float freely. The currency has fluctuated in a wide range since the GFC, bottoming out at 0.65 USD/AUD in October 2008 to around 1.05 at present due to the rising terms of trade, as well as a large onshore interest differential. This currency flexibility plays an important role as a buffer for the economy against external shocks and commodity price volatility. As noted above, however, the high exchange rate has undermined competitiveness in non-mining parts of the economy, and we expect the currency to weaken somewhat, to around 1.02 by end-year.
- With both headline and underlying inflation expected to remain within the 2-3% target range in 2012, and growth on track to return to trend, the RBA has signalled that it views current interest rate levels as appropriate. However, in its March 6 policy statement, it left open the door to further rate cuts, "should demand conditions weaken materially." We expect the RBA to lower rates one more time, most likely in the second quarter, to 4.00%.
- The government aims to return fiscal policy to surplus in 2012/13 (fiscal year ending June 30), after running deficits since the GFC. The rationale for returning the budget to surplus is to save the resource windfall from the commodity boom.
- Public debt is still very low, at just 27.5% of GDP in 2011, despite an increase since the GFC (the public debt ratio was 11.7% in 2007). The low debt level provides ample room for stimulus measures if needed to counter an economic downturn.

- The current account deficit narrowed to 2.2% of GDP in 2011, due in part to the increase in household savings. The modest size and composition of the deficit make it less worrisome: much of it can be explained by a sharp rise in investment in the mining sector and/or net outflows in the income account as merchandise trade is more evenly balanced (and was in surplus in 2011).

## Risks to the outlook

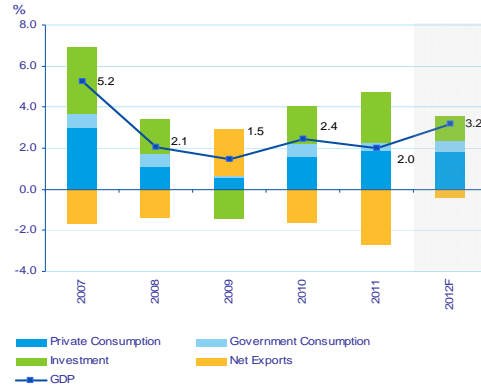
- The main risks to the outlook relate to: (i) the economy's growing dependence on the resource sector and demand from China; (ii) banks' reliance on wholesale funding; and (iii) high housing prices and household indebtedness. While Australia continues to enjoy AAA sovereign credit ratings by the major agencies, a persistent current account deficit and high levels of external borrowing leave it vulnerable to external financing shocks. Smaller banks in particular may be vulnerable to external shocks that could result in high unemployment and a sharp fall in housing prices.
- There is no doubt that the economy remains vulnerable to a steep fall in commodity prices and/or a hard landing in China. However, the risk of such an event in the near term appears low in our view given the continued outlook for strong commodity demand from emerging markets and the likelihood that China will avert a hard landing. More generally, the economy's dependence on the resource sector presents risks, but these are offset by: (i) the floating exchange rate, which acts as a buffer against external shocks; (ii) the scope for fiscal and monetary policy stimulus; and (iii) sound banking supervision.
- Banks' reliance on wholesale funding, and external borrowing in particular, remains a key risk, often referred to as the "Achilles heel" of the Australian economy. The root of this reliance is the persistent current account deficit, which has averaged around 4.5% of GDP in recent years (although it is significantly lower at present, at around 2% of GDP). Deposits account for only about half of total liabilities, and the loan-to-deposit ratio is around 120%. Pressures from the European sovereign debt and financial crisis exacerbate these risks.
- There are, however, two positive factors. First, key ratios have been trending in the right direction since the GFC due in part to tougher banking supervision and an acceleration of Basel III implementation: the mix of funding has improved thanks to an increase in deposits, and loan-to-deposit ratios have fallen (Figure 2). Moreover, reliance on European banks has fallen as a share of external funding from over 50% in 2008, to just over 20% at present. Second, comfort can be taken in how well the banks weathered the financing shock of the GFC. This can be attributed to the authorities' proactive policy stance, which included the extension of a guarantee on bank liabilities during October 2008- March 2010 (which was not subsequently used by any financial institution). A deposit guarantee remains in place (up to AUD 250,000 per deposit), and we believe there would be a willingness to re-instate the broader guarantee in the event of an external shock.
- Finally, the risk of a downward correction in housing prices and high household indebtedness need to be watched. Housing prices tripled in the decade from the late 1990s, and the ratio of household debt-to-disposable income remains high, at round 150%. Since 2009, however, housing prices have been moderating, and the household debt ratio has leveled off. Moreover, barring a sharp rise in unemployment to the 8-9% range (from around 5% at present), housing prices should remain supported by underlying demand and population growth, as well as limited supply. Delinquency rates are also expected to remain low given modest loan-to-value ratios (around 63%) and a strong mortgage repayment culture. The wide use of mortgage insurance should also help to protect banks in the event of a downturn.

## Financial sector outlook

- Notwithstanding the risks described above, the outlook for Australia's financial sector remains sound in our view. Profitability is strong due to wide interest margins, and business models are oriented toward core lending activities with relatively low reliance on complex financing instruments and securities. Capital ratios are strong, and a solid regulatory framework should help limit risks. That said, credit growth remains subdued at just 3.5% y/y as the economy continues to deleverage.
- The banking sector is heavily concentrated, with the top four banks accounting for 75% of total assets. In this regard, a policy initiative announced in December 2010 is to enhance competition by reducing transaction costs for consumers in switching their activities across banks. As a result, it is now easier, for example, to refinance mortgages, switch accounts, and compare fees and interest rates across banks (see the Australian Treasury's 2010, "Competitive and Sustainable Banking").
- Banks are continuing to diversify their funding sources, which is a positive development in view of the vulnerability posed by reliance on wholesale financing. In this regard, competition for deposits is increasing, although it is resulting in an increase in banks' funding costs. Another factor in helping banks to diversify their funding source is the October 2011 allowance of covered bond financing (after the first issuance of covered bonds by ANZ in November, major banks have by now issued a total of AUD 22 billion).
- The focus of banking supervision and regulation is now on implementing Basel III requirements on an accelerated timetable. With deposit-taking institutions already in a position to meet the new capital criteria, the supervisory authority (APRA) has proposed to implement the new criteria from January 1, 2013 (ahead of the Basel III timetable, which allows a two-year phase-in period). The focus now is on implementing liquidity ratios with a view to improving the mix of funding and the net stable funding ratio. The authorities are also currently evaluating international too-big-to-fail proposals, living wills, and SIFI initiatives.
- Another focus is on improving regulation of superannuation funds, which are privately managed and in which employers are required to contribute 9% of employees' salaries and wages. The funds have grown in size, to around AUD 1.6 trillion, or more than 100% of GDP.
- We anticipate that the IMF will undertake another Financial Sector Assessment Program (FSAP) during 2012, as a follow-up to the one undertaken in 2006.

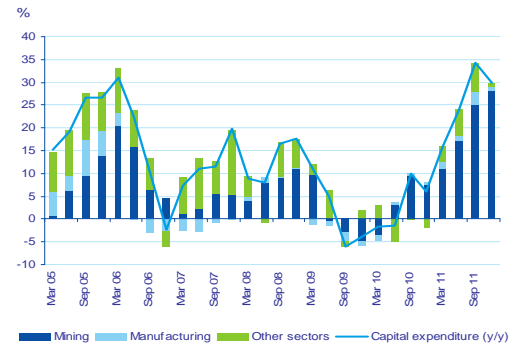
Figure 1: Recent economic developments

**Growth has held up reasonably well**



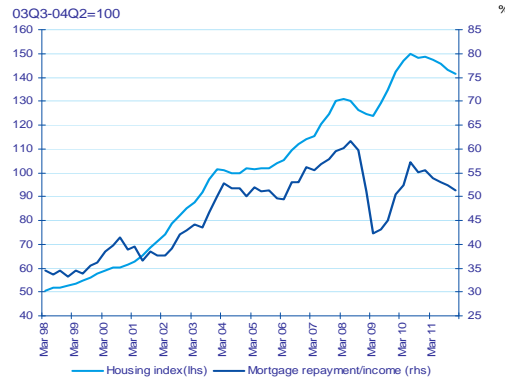
Source: Haver Analytics and BBVA Research

**Investment is rising, especially in mining**



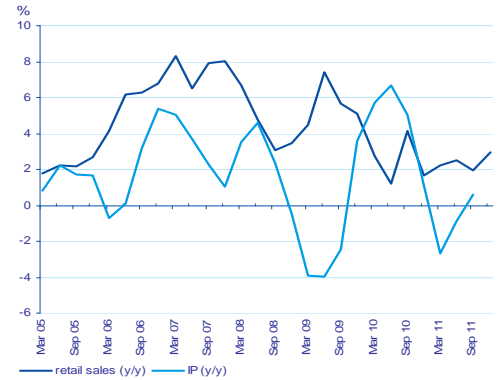
Source: Haver Analytics and BBVA Research

**Housing prices have begun to fall**



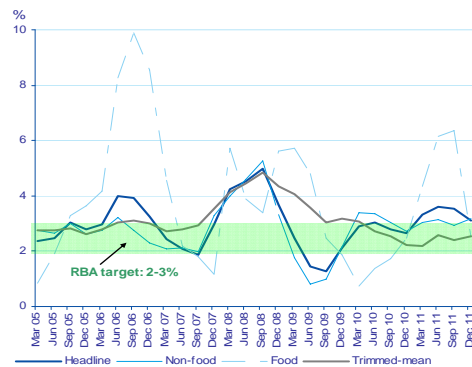
Source: Haver Analytics and BBVA Research

**Retail sales and industrial production are weak**



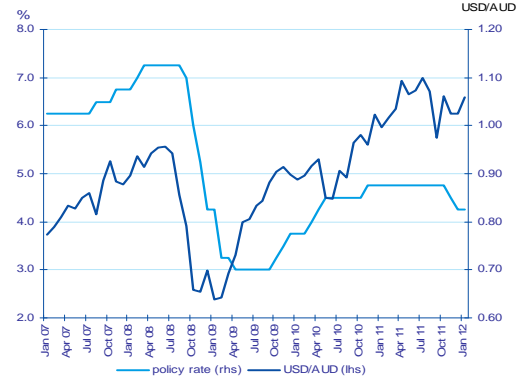
Source: Haver Analytics and BBVA Research

**Inflation remains within the target range**



Source: Haver Analytics and BBVA Research

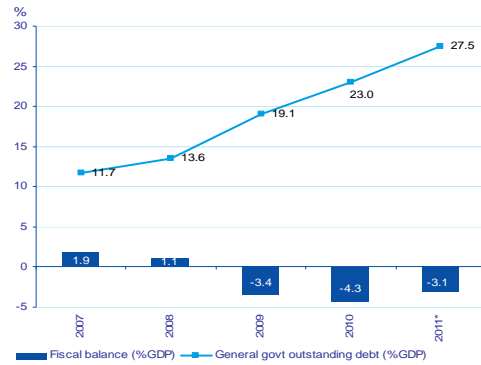
**Policy rates are about neutral, while the currency is very strong**



Source: Haver Analytics and BBVA Research

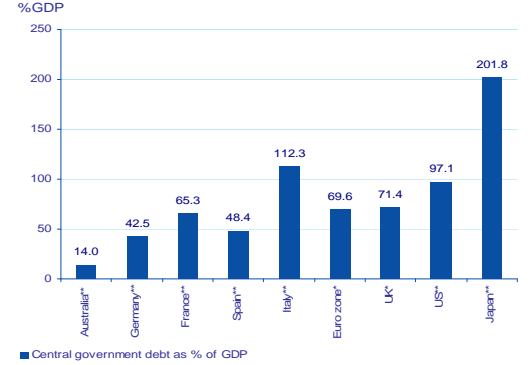
Figure 1 cont'd: Recent economic developments

**Public finances are on a strong footing...**



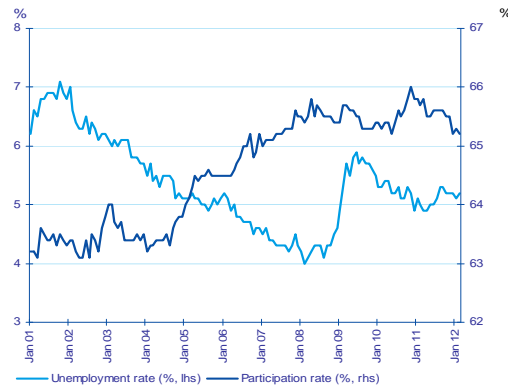
\* as of Q3 2011  
Source: Haver Analytics and BBVA Research

**...compared to other heavily indebted peers**



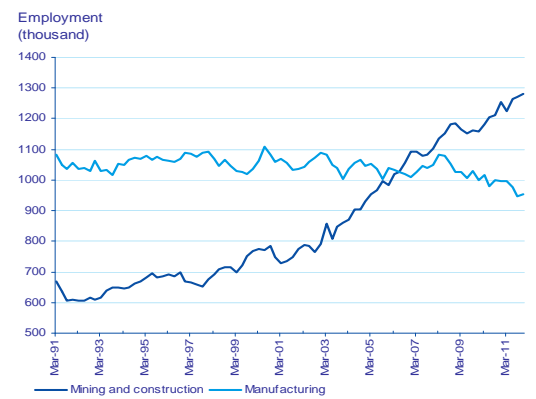
\*2010 data; \*\* 2011 data  
Source: Haver Analytics and BBVA Research

**Unemployment is close to historical norms**



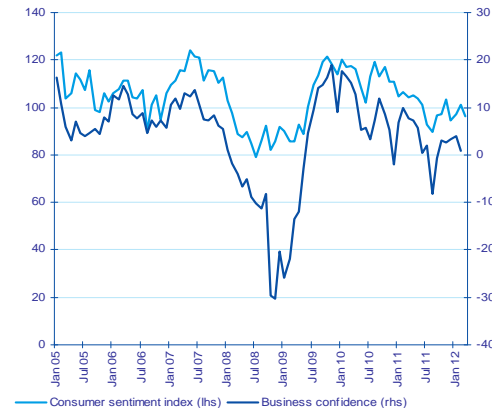
Source: Haver Analytics and BBVA Research

**Manufacturing employment is weakening**



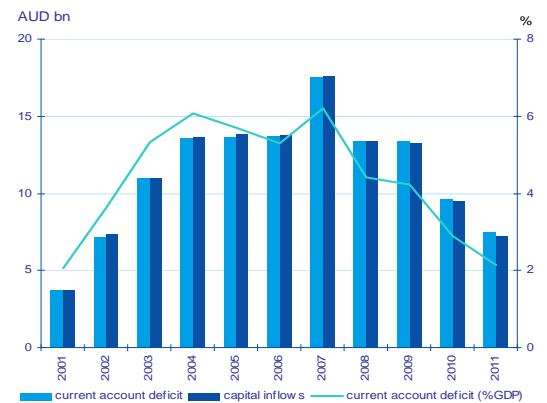
Source: Haver Analytics and BBVA Research

**Consumer and business confidence is subdued**



Source: Haver Analytics, Westpac-Melbourne Institute, National Australia Bank and BBVA Research

**The current account deficit has narrowed**



Source: Haver Analytics and BBVA Research

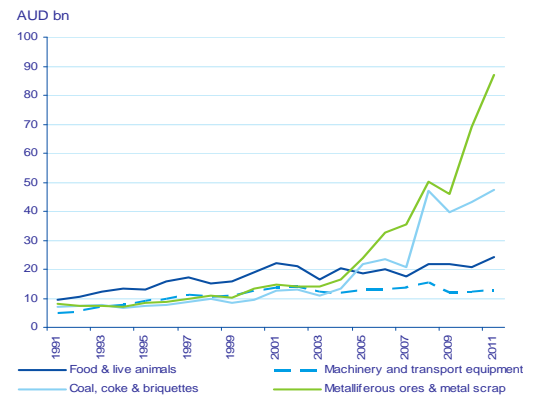
Figure 1 (cont'd): Recent economic developments

**China is Australia's largest single export market**



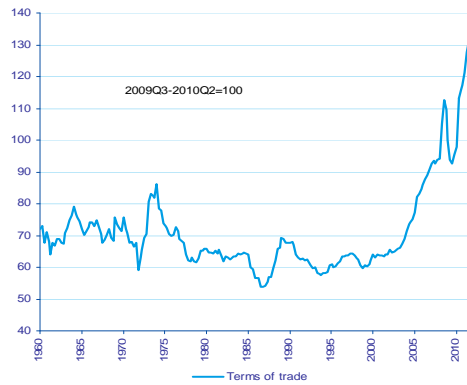
Source: Haver Analytics and BBVA Research

**Iron ore and coal are the main commodity exports**



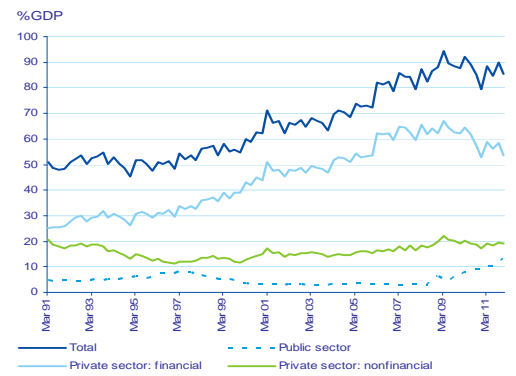
Source: Haver Analytics and BBVA Research

**The terms of trade is at a record high**



Source: Haver Analytics and BBVA Research

**External debt is beginning to decline**

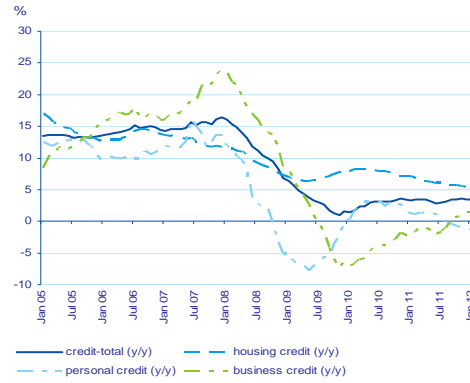


Source: Haver Analytics and BBVA Research



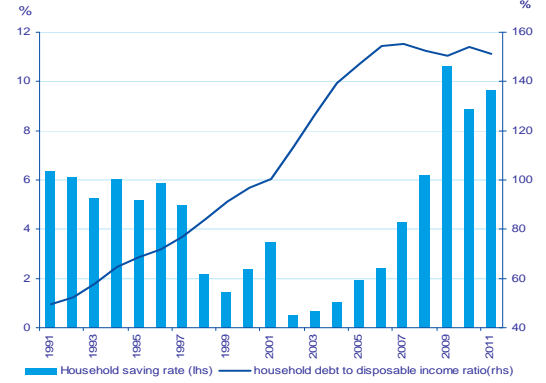
Figure 2: Money and banking

**Credit growth remains subdued**



Source: Haver Analytics and BBVA Research

**Higher household saving rates are helping to contain household debt**



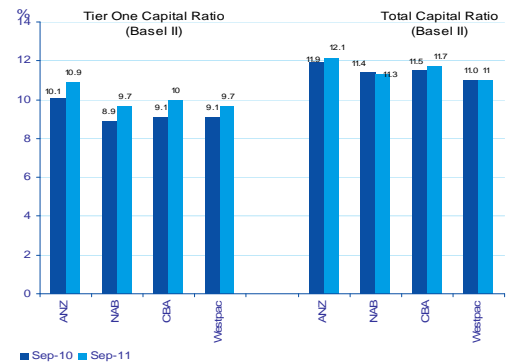
Source: Haver Analytics and BBVA Research

**Banks' loans to deposits ratios are declining**



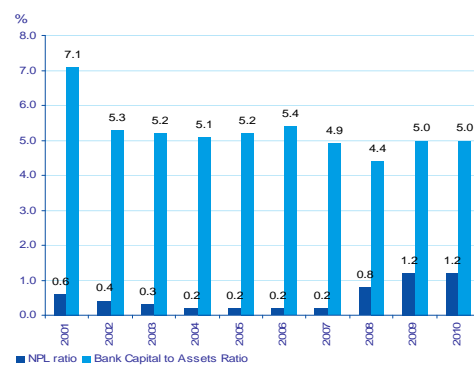
Source: Haver Analytics and BBVA Research

**Bank capital adequacy is strong**



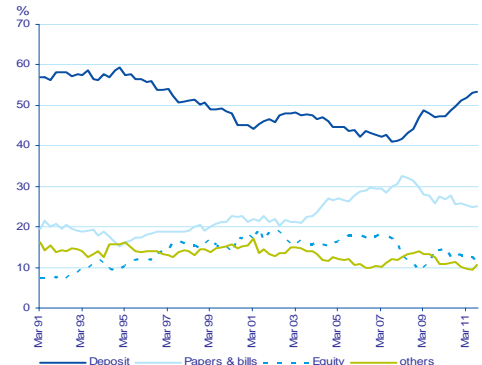
Source: Jang an Sheridan (2012), "Bank Capital Adequacy in Australia", IMF Working Paper WP/12/25

**Asset quality remains high**



Source: World Bank and BBVA Research

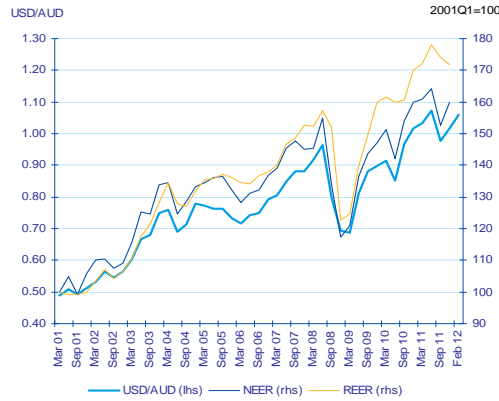
**Banks still rely on wholesale funding**



Source: World Bank and BBVA Research

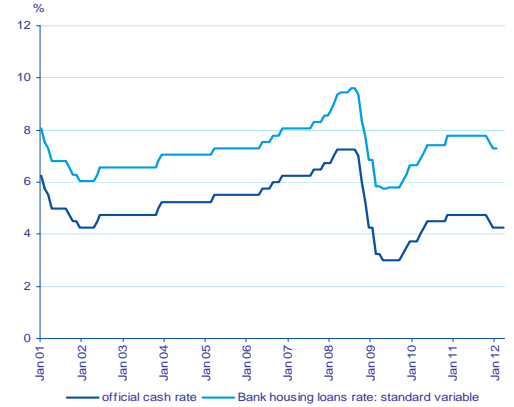
Figure 3: Financial markets

**The Australian dollar has appreciated sharply**



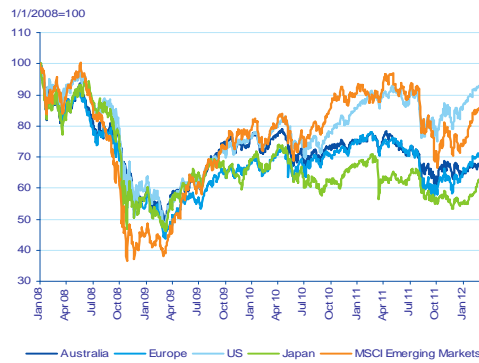
Source: Haver Analytics and BBVA Research

**Housing loan interest rates are still low**



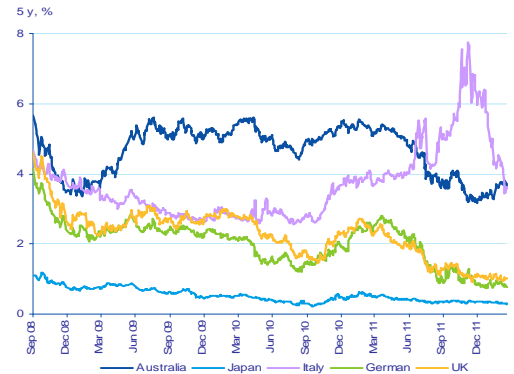
Source: Haver Analytics and BBVA Research

**The Australian stock market has underperformed**



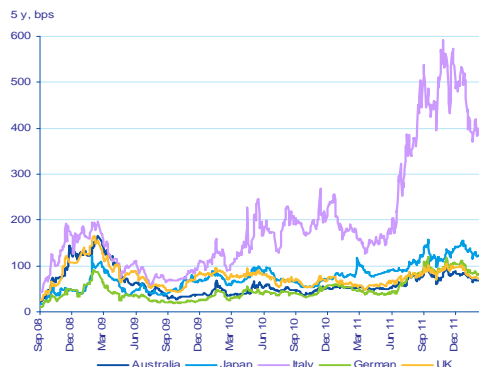
Source: Bloomberg and BBVA Research

**Australia's AAA Bonds offer attractive yields...**



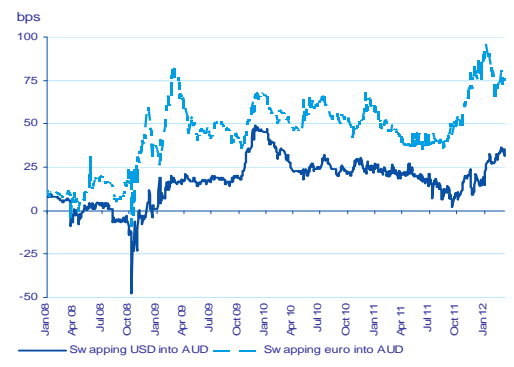
Source: Bloomberg and BBVA Research

**...and are less risky based on CDS spreads**



Source: Bloomberg and BBVA Research

**A rise in cross-currency basis swap spreads\* is a sign of rising funding costs for banks**



\*cost to hedge cash flows on foreign currency bond issuance  
Source: Bloomberg and BBVA Research

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