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Australia: Country Risk Insights

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In a nutshell

- Australia's macroeconomic strength is anchored by its status as one of the most advanced countries in the world with per capita gross domestic product (GDP) based on purchasing power parity (PPP) of USD46,433 in 2014, ranking 16th globally. Its economy has been resilient, enjoying uninterrupted economic growth for 23 consecutive years since 1992 at an average of 3.4% per annum (p.a.). This is attributed to successful economic reforms which began with liberalisation and deregulation in the early 1980s. Booming mining investment-related activities since the year 2000 arising from growing demand in emerging economies, particularly China, have also contributed to Australia's economic strength. In addition, aggregate demand was supported by a resilient services sector, which accounted for 57.4% of GDP in 2014. Australia also registered the lowest growth volatility among its Organisation for Economic Co-operation and Development (OECD) peers, with a standard deviation of only 0.8% in the 15 years through 2014 (OECD: 1.8%).

- Australia's monetary policy has been credible in that the management of the benchmark Official Cash Rate (OCR) target has been successful in anchoring inflation expectations and had a swift impact on the overall aggregate demand. During the Global Financial Crisis (GFC), for instance, the Reserve Bank of Australia (RBA) reduced its benchmark OCR target by a cumulative 425 basis points (bps) to 3.0% in the eight months through to April 2009. Due to the effective pass-through effect of the official rate to market interest rates, aggregate demand rebounded swiftly and the inflation rate fell within the target range.

- On the fiscal front, despite running a deficit since the GFC, Australia has managed to maintain its public debt at a reasonably low level. In the five years since 2009-10, its net debt position averaged at just 8.4% of GDP, a stark contrast with other advanced countries whose average stood at 41.1% of GDP during the same period. More importantly, a big portion of the debt was denominated in Australian dollars (AUD), which to a large extent reduced foreign currency risks, despite the recent increase in the overall government liability position.

- Australia's economic strength has also been supported by its strong institutional framework and proactive policy making, as reflected in its ranking on the World Bank's Worldwide Governance Indicators (WGI). It scored well even when compared with its OECD and advanced countries peers, consistently scoring above the 90th percentile in all but one of the indicators since the survey started in 1996. Similarly, Transparency International (TI) ranked Australia at 11th place out of 175 countries in its Corruption Perception Index 2015. Australia is also highly ranked in both the World Economic Forum's (WEF) Global Competitiveness Index (GCI) and the World Bank's Ease of Doing Business Index, at 22nd and 10th place respectively, in 2014-2015.

- Notwithstanding all the positive attributes, Australia's external position does somewhat poorly by advanced countries' standards, with persistent current account (CA) deficits in all but two of the last 55 years, despite benefiting from the positive terms-of-trade over the past decade. Since the 1960s, the CA balance averaged at -3.2% of GDP, with the highest shortfall registered in 2007 at -6.7% of GDP. The persistent CA deficits have also saddled Australia with net foreign liabilities, as evidenced by its large negative net international position (IIP) which averaged at 55.9% of GDP in the ten years through to 2014. This reliance on external financing reflects structural weaknesses in the economy. Moderating the risks, however, is the narrowing trend in the CA deficit which will likely continue over the medium term thanks to rising resources export volume as past mining-related investments begin yielding results, notwithstanding the recent decline in key commodity prices. Additionally, the fully flexible exchange rate regime can act as an important buffer, given that most of Australia's assets are denominated in foreign currencies while its external liabilities are denominated in AUD.

Table 1: Selected economic indicators

	2009	2010	2011	2012	2013	2014
Real GDP Growth	1.6	2.3	2.6	3.7	2.1	2.7
Inflation Rate - CPI (%)	1.8	2.9	3.3	1.8	2.4	2.5
Unemployment Rate (%)	5.6	5.2	5.1	5.2	5.7	6.1
Commonwealth Fiscal Balance - FY end-June (% GDP)	-2.3	-4.1	-3.8	-3.1	-1.4	-2.2
Commonwealth Government Net Debt (% GDP)	-1.7	3.2	6.0	10.0	10.1	12.8
Current Account (% GDP)	-4.7	-3.5	-2.9	-4.3	-3.3	-2.8
International Reserves (USD bn)	41.7	42.3	46.8	49.1	53.2	53.9
Gross External Debt ex-Financial Derivatives (% GDP)	91.6	84.6	87.9	90.9	99.5	104.9
Net IIP Liability (% GDP)	59.9	54.7	55.7	55.9	54.0	54.2

Source: ABS, RBA, CEIC, MARC Economic Research

Key Strengths

Advanced country with a history of resilient economic growth

Australia's macroeconomic strength is anchored by its status as one of the most advanced countries in the world, with per capita GDP based on PPP of USD46,433 in 2014 and ranking 16th globally, higher than the UK and Germany. It is the 12th largest economy in the world based on nominal value, representing about 2.0% of total global output.

Economic reforms which started with liberalisation and deregulation in the early 1980s have resulted in a remarkable increase in labour productivity and large savings to the government, which contributed to the resilience of the economy. This has enabled Australia to enjoy uninterrupted economic growth for 23 consecutive years since 1992, averaging at 3.4% annually. The Australian economy also weathered the GFC effectively, expanding by 1.6% in 2009. It has the lowest growth volatility among its OECD peers, with a standard deviation of only 0.8% in the 15 years through to 2014 compared with the total OECD standard deviation of 1.8%.

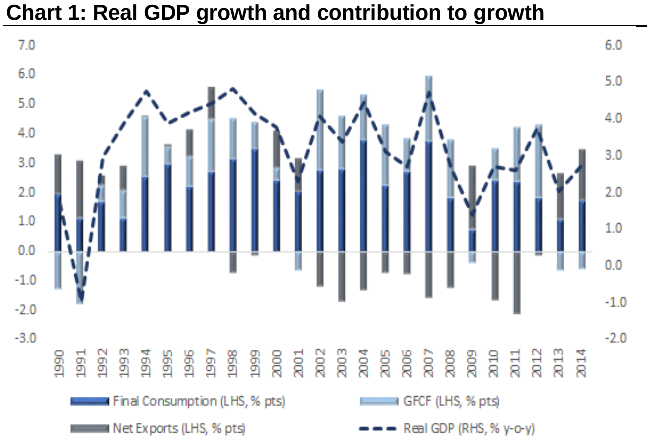
While the services sector remains a major contributor to the economy, accounting for an average 56.0% of the economy since the early 1990s, mining-related activities have increasingly grown in importance over the past decade. In 2014, the services sector accounted for 57.4% of the GDP, while the manufacturing sector accounted only 6.3% of the economy, the lowest since recording began in 1975. The share of mining sector, on the other hand, jumped to a record high of 8.6% of GDP.

Much of the economic growth experienced since the beginning of the new millennium is attributed to investments in mining-related activities, which contributed to gains in terms-of-trade. The mining investment boom since the year 2000 was a result of growing demand from emerging economies, particularly China, a major export market for Australia since 2009. However, it appears that these investments have peaked, coinciding with the continuous decline in terms-of-trade since 2012. The proportion of mining investment dropped slightly to 6.8% of GDP in the fiscal year 2013-14 from a peak of 7.5% of GDP in the year before, slashing 0.5 percentage points from the 2.9% headline growth as compared to an average of 1.8 percentage points contribution in the preceding two-year period. It is worth noting that the increase in investment in mining-related activities over the past decade was at the expense of declining productivity in other sectors. For example, the share of the manufacturing sector towards GDP halved to just 6.3% in 2014 from around 13% during the liberalisation era in the early 1980s. Nevertheless, Australia's total productivity growth remains high when compared with its OECD peers, particularly in the past three years with growth in GDP per person employed averaging at 1.9% vis-à-vis a 0.6% increase for the OECD countries.

The latest data show that the economy has shifted to a lower growth mode, particularly in 2Q2015 with growth expanding by only 1.9%, down from the 2.5% pace in the preceding quarter (1H2015: 2.2%, 2014: 2.7%). While fading investment and relatively weak exports demand have put a brake on growth, an acceleration in domestic consumption has lent a helping hand to the economy. Government consumption growth accelerated to 2.9% in 1H2015 (2014: 2.0%), while the expansion in private consumption picked up slightly to 2.6% (2014: 2.5%), adding a combined 1.9 percentage points to headline growth (2014: 1.7 percentage points). In contrast, total investment declined at a faster pace, contracting at a rate of 3.5% in 1H2015, the most since the peak of the GFC, compared with the 2.1% drop in 2014. In particular, private investment subtracted the most from GDP growth, even higher than during the GFC, shaving 0.7 percentage points (2014: -0.6 percentage points) from the 2.2% growth registered in 1H2015. Externally, contribution from net exports came in lower at only 1.0 percentage point in 1H2015 (2014: 1.7 percentage points) amid weakening demand abroad as well as sharp falls in key commodity prices.

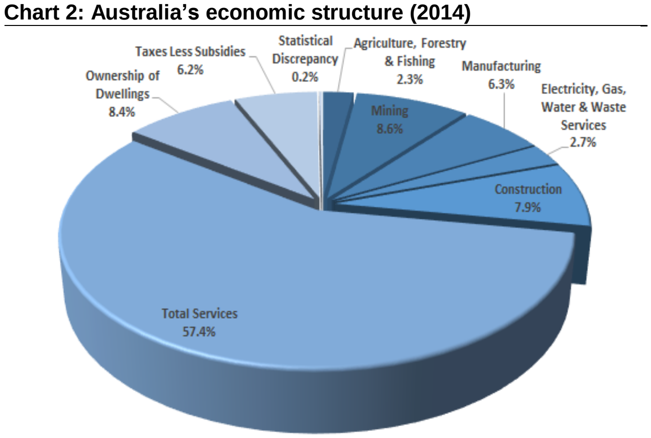
Going forward, MARC foresees the economy to undergo a structural shift from investment in mining-related activities towards the mining production and export phase as the former may have reached its maturity as evidenced by the continuing decline in terms-of-trade. There is a need for more broad-based growth to maintain trend growth and productivity over the longer term. The currently weak currency will, to some extent, help to revive competitiveness and productivity in the non-mining sectors, although the economy may grow below its capacity for some time. On the external front, the Australian economy should benefit in terms of rising resources export volume, despite weaker commodity prices, and this will help to lower its CA deficit over the medium term. The wildcard, however, are the prospects of China's economy, which absorbs the majority of Australia's exports (33.6% of total exports in 2014), specifically non-rural commodities such as coal and iron ore. In addition, persistent uneven recoveries in other advanced economies, especially Japan and the euro zone, will likely undermine Australia's growth prospects in the near term.

Chart 1: Real GDP growth and contribution to growth



Source: CEIC, MARC Economic Research

Chart 2: Australia's economic structure (2014)



Source: CEIC, MARC Economic Research

Credible monetary policy

Australia's monetary policy has been credible in that the RBA, via the benchmark OCR target, has been able to anchor inflationary expectations as well as to swiftly affect aggregate demand, particularly during economic crises. Like in the case of many other conventional central banks, the objectives of the monetary policy which were set by the Reserve Bank Act 1959 are to maintain (1) the stability of the AUD; (2) full employment; and (3) economic prosperity and welfare. As such, in achieving the goal of medium-term price stability – and thus currency stability – the target of keeping inflation rate between 2% to 3% over the cycle seems appropriate.

During the height of the GFC, the RBA reduced its benchmark OCR target by a cumulative 425 bps to 3.0% in the eight months through to April 2009. Consequently, due to close ties with market interest rates, both short-term rates and government bond yields strongly followed suit, with rates being not much higher than the benchmark rate. From a high of 8.0% in February 2008, the short-term 90-day Bank Acceptance Bills rate declined by a cumulative 491 bps to a low of 3.1% within 14 months. As the pass-through effects were strong, the impact on the overall aggregate demand was rather quick. As such, the average bank lending rate for standard variable housing loans shrank by 3.9 percentage points to 5.8% in April 2009 from 9.6% in August 2008.

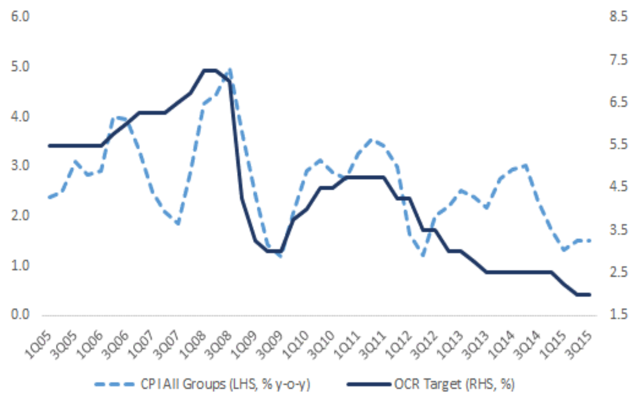
The effectiveness of the monetary policy also can been seen in its impact on the overall inflation rate, which effectively slowed to an average of 2.6% in the five-year period post-GFC, after peaking at 4.4% in 2008. In addition, the volatility of the inflation rate also appears lower when compared with other OECD countries, averaging at 0.8% in the 14 years through to 2014 vis-à-vis 1.8% for the total OECD. In 2014, the inflation rate remained well within the central bank target range, averaging at 2.5%, a tad higher than the 2.4% pace registered in the preceding year. In the year to date, however, the inflation rate appears subdued, as consumer prices rose by only 1.4% in the first nine months of 2015, dragged down by the continuous decline in transportation costs amid the fall in energy prices since 4Q2014.

MARC attributes the relatively strong AUD over the past decade to massive capital inflows into the mining sector as well as increases in terms-of-trade which benefited the economy during that period. The strong AUD was also partly due to the positive interest rate differential which led to foreign investors favouring Australian assets over those of other advanced countries, especially after the GFC. While the stronger currency has helped to contain imported inflationary pressures since 2000, it has also contributed to the declining competitiveness of the non-mining sectors.

After keeping the benchmark OCR target at a low of 2.5% for 18 consecutive months, the RBA unexpectedly joined the global monetary easing wave in February 2015, lowering the policy rate by 25 bps to 2.25%. The decision came against a backdrop of a stubbornly strong AUD despite sharp falls in major commodity prices, which threatened government efforts to achieve balanced economic growth. Three months later, the RBA reduced its OCR target again by another quarter point to a new low of 2.0% in an effort to reflate an economy impacted by waning mining investments and to reduce the strength of the AUD. As a result, the local currency depreciated in the following months to a level the RBA appeared comfortable with. In the year to date, the AUD has weakened to a level unseen since March 2009, depreciating by 14.5% against the greenback to USD0.701 in September 2015, about 36% below its historical peak of USD1.095 in July 2011.

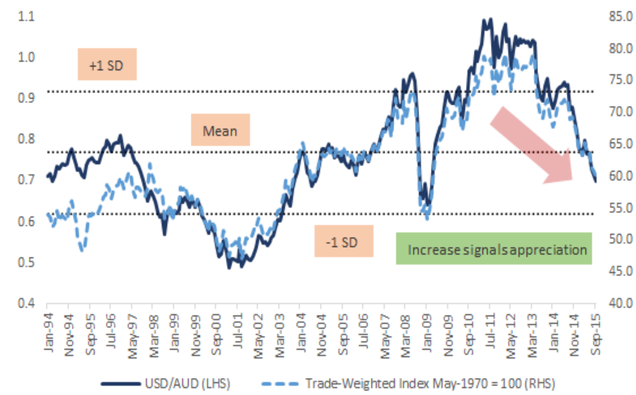
Looking ahead, we expect the RBA's monetary policy stance to remain accommodative for a considerable time as overall growth prospects remain uncertain due to the anticipated end of the decade-long mining investment boom as well as the recent rout in global commodity markets. In addition, the potential spillover from slower-than-expected global growth, mainly from East Asia, will continue to undermine Australia's growth potential going forward. We view positively the recent downward momentum of the AUD as it adjusted to the significant drop in commodity prices. This will act to cushion the impact on the overall economy by making other goods more competitive, thus helping the transition towards more balanced economic growth. Moreover, accommodative monetary policy normalisation in other advanced economies, such as the US and the UK, are expected to benefit the Australian economy from the viewpoint of a weaker AUD, which will support the export sector over the medium term.

Chart 3: OCR target and CPI inflation



Source: CEIC, MARC Economic Research

Chart 4: USD/AUD and trade-weighted index



Source: RBA, CEIC, MARC Economic Research

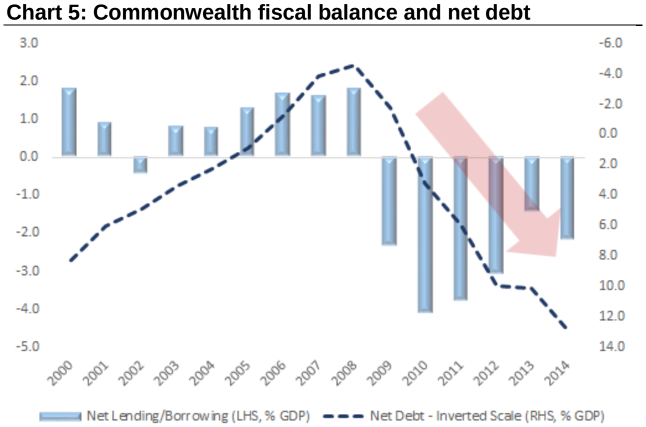
Reasonably low public debt

Despite running a fiscal deficit since the GFC, Australia has managed to maintain its public debt at a reasonably low level when compared with other advanced countries. The Commonwealth government's net debt position, while on a rising trend, averaged 8.4% of GDP in the five years since 2009-10. As a comparison, the average net debt position of other advanced countries stood at 41.1% of GDP during the same period, with both the US and UK at close to 80.0% of GDP. As of 2013-14, the Commonwealth government's net debt position stood at 12.8% of GDP, an increase of 2.7 percentage points from the preceding year.

It is important to note that the increase in net debt position in the post-GFC period was mainly to finance the fiscal deficit. In fact, in the four years prior to 2010, the Commonwealth government's net debt position was negative, coinciding with a period of fiscal surpluses which averaged at 0.7% of GDP. Meanwhile, the general government net worth position at the consolidated level (including the Commonwealth, state and local government, as well as multijurisdictional) remained strong, albeit declining, with total assets far exceeding its total liabilities which averaged at 58.9% of GDP in the five years through to 2013-14.

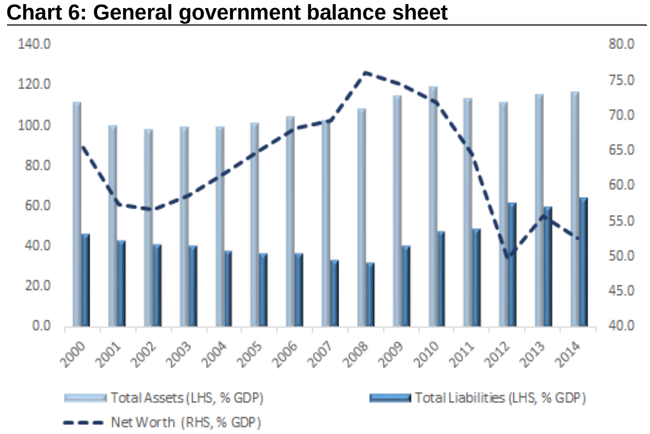
While we expect government net debt to rise further in the foreseeable future, we are not overly concerned given its relatively low level as a percentage of GDP compared to other advanced countries. More importantly, much of the debt was denominated in domestic currency (all new Commonwealth Government Securities issuances are denominated in AUD), which somewhat helps to reduce foreign currency risks, although the high portion of foreign ownership bears watching.

Chart 5: Commonwealth fiscal balance and net debt



Source: ABS, CEIC, MARC Economic Research

Chart 6: General government balance sheet



Source: CEIC, MARC Economic Research

Strong institutional framework

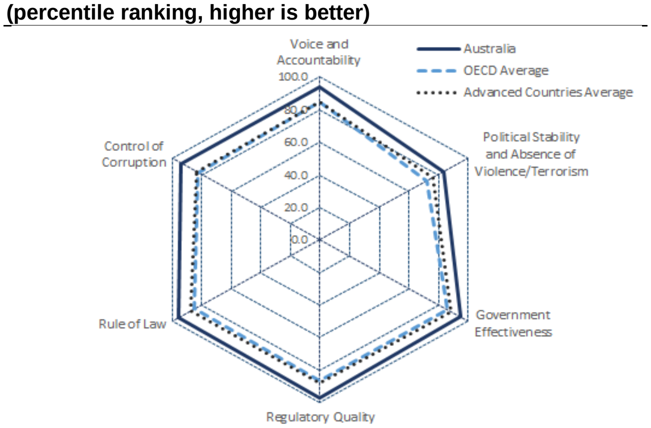
Australia is well-known for its strong institutional framework and proactive policy making, as reflected by its ranking in the World Bank's 2014 WGI. It scored favourably among advanced countries, and much better than its OECD peers. Australia has consistently scored above the 90th percentile rank in all but one of the six indicators since the survey started in 1996, namely in voice and accountability, government effectiveness, regulatory quality, rule of law, and control of corruption. Its score for political stability and absence of violence has persistently been below the 90th percentile mark since 2000, although it remained relatively strong and above the OECD and advanced countries average. In 2013, the rank improved to 83.4th from its record low of 74.5th in the prior two-year period.

Similarly, TI placed Australia as one of the cleanest countries in the world, ranking it at 11th out of 175 countries in its Corruption Perception Index 2014 with a score of 80 out of 100. However, both the score and rank have somewhat deteriorated, partly due to a few high profile corruption cases such as the Securency scandal as well as an increasing number of inquiries raised by the New South Wales Independent Commission Against Corruption. Notwithstanding this, Australia has maintained its status as the third least corrupt nation in the Asia Pacific region.

Based on the WEF's GCI, Australia is ranked favourably among the advanced countries, although its overall performance deteriorated slightly, particularly during the post-GFC period. After peaking at 15th place in 2009-2010, both its ranking and score fell gradually to 22nd place in 2014-2015. The decline can largely be attributed to weakening macroeconomic conditions and increase in budget deficit as well as public debt, although the overall level remained lower than the OECD average. Nevertheless, Australia ranks fairly consistently across the 12 pillars of the GCI, with rankings no lower than 30th place in all but one category. The World Bank Doing Business 2015 report maintained Australia's ranking at 10th place in terms of ease of doing business for the second consecutive year. The country performs well in terms of starting a business (7th place), getting credit (4th place), and enforcing contracts (12th place), though it does somewhat poorly in protecting minority investors (71st place).

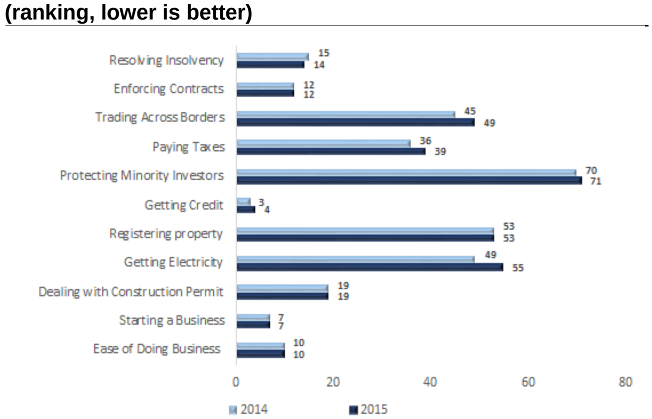
While we foresee a continued mild deterioration of certain international rankings, particularly in the GCI, we believe the overall business environment will not change significantly over the medium to longer term, thanks to an exceptionally strong institutional framework. MARC feels that the Australian government will be able to maintain its status as one of the least corrupt nations in the world, although it has slipped from the top ten list.

Chart 7: World Bank Worldwide Governance Indicators 2014 (percentile ranking, higher is better)



Source: World Bank, MARC Economic Research

Chart 8: World Bank Ease of Doing Business 2015 and 2014 (ranking, lower is better)



Source: World Bank, MARC Economic Research

Major Challenge

Relatively weak external position

Australia's external position does somewhat poorly by advanced countries' standards. The CA balance has been in deficit in all but two of the last 55 years, despite benefiting from positive terms-of-trade over the past decade. Since the 1960s, it has averaged -3.2% of GDP, with the highest shortfall registered in 2007 when it reached -6.7% of GDP. Australia's persistent CA deficit, which indicates reliance on external financing, reflects structural weaknesses in the economy. Not surprisingly, Australia is a net debtor nation as evidenced by a large negative net IIP. It is important to note that its persistent CA deficits are not really due to a savings shortage but due to high capital investments, especially in mining-related activities since the early 2000s. In fact, Australia's savings rate is nearly as high as other advanced countries, averaging at 22.7% of GDP in the 15 years since 2000 versus advanced countries' average of 23.4%. Investment as a percentage of GDP, on the other hand, was higher than its peers, averaging 27.1% in the 2000-2014 period, vis-à-vis an average of 23.4% for all advanced countries.

In spite of relatively weak export prices, recent data show that the CA deficit has started to stabilise after hitting its peak in 2007, standing at a 13-year low of 2.8% of GDP in 2014 (2013: -3.3% of GDP). This was in line with a moderation in new investments in mining-related activities, which has helped to slow the pace of imported capital goods. Combined with higher resource export volume, the shortfall in goods and services balance narrowed to AUD9.9 billion in 2014 from AUD10.5 billion in 2013. The deficit in net income balance has also sharply declined to the lowest level in nine years to AUD35.1 billion (2013: -AUD41.4 billion) due to the fact that as most mining investments are foreign-owned, relatively weak commodity prices mean reduced income accruing abroad.

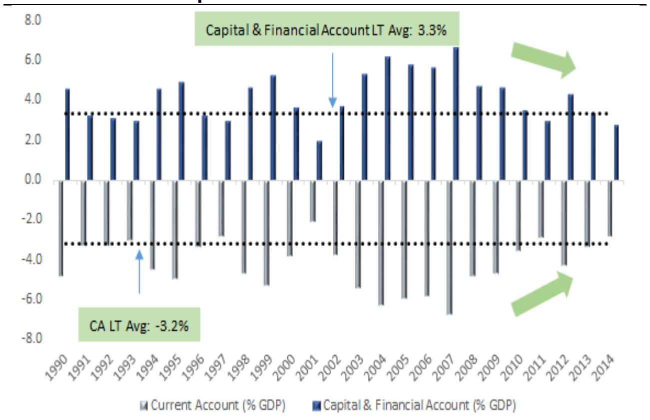
Due to persistent deficits in its CA, Australia is saddled with net foreign liabilities. As a percentage of GDP, its net IIP liability position is reasonably high by advanced countries standards, averaging 55.9% of GDP in the ten years through to 2014, higher than the 52.3% of GDP registered in the preceding decade. At the same time, its gross external debt had been rising quite rapidly. This was especially so during the mining investment boom period as its relatively large domestic savings were inadequate to fully fund big inflows of mining investment projects. From a low of 49.1% of GDP in 1994, Australia's gross external debt has more than doubled to 104.9% of GDP in 2014, although its overall position remains relatively low when compared with other advanced countries. On a net basis, Australia's total net external debt in the five years through 2014 stood at an average of 51.8% of GDP, slightly higher than the 50.1% of GDP registered in the five-year period prior to the GFC.

Going forward, MARC opines that the CA deficits will remain more or less at the current level over the medium term as the economy starts to experience more broad-based growth following the end of the mining investment boom period. The trade deficit is expected to narrow further on account of the pickup in resources export volume as past mining-related investments begin yielding results, coupled with a slowdown in capital imports attributed to the slower stream of new investment activity. This would somewhat stabilise the overall net liability position. However, it is expected to be offset by the widening income deficit as mining investors repatriate some of their incomes should the global commodity market start to recover, or due to interest rates normalisation in other advanced countries. Domestic savings, meanwhile, are anticipated to remain large as the private sector continues to deleverage following the decline in terms-of-trade as well as rising uncertainties in the global economy. Rising household wealth following higher housing prices in recent years could also contribute to higher private savings over the short term.

Generally, Australia is somewhat susceptible to external shocks given its global commodity exposure and high reliance on foreign funding. Moreover, the amount of official reserves is relatively small when compared with its short-term liability as it represented only 17.0% of total short-term external debt as at end-2014. In absolute amounts, it stood at AUD65.7 billion as at end-2014, albeit higher than its cyclical low of AUD30.5 billion in 2008 (11.1% of total short-term external debt). However, given that the current trend of rising external assets which will likely continue over the medium term, MARC is of the view that

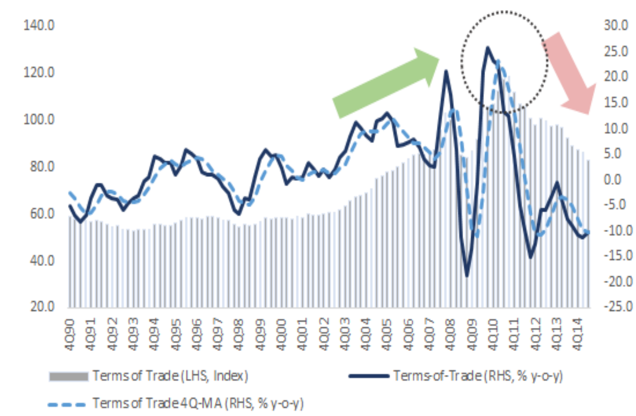
Australia's overall liability position should start to stabilise, enabling the country to build sufficient buffer against further deterioration in the global economy. It is important to note that most of Australia's foreign assets are denominated in foreign currencies, while its external debt is denominated in AUD. In this regard, a fully flexible exchange rate regime acts as an important buffer as a stronger domestic currency will increase its overall asset position, while a depreciation in the exchange rate will somewhat lower the overall liability obligations. Meanwhile, the declining portion of short-term external debt over the past decade is a positive sign, particularly for the private sector, as it would help lower the overall risk profile.

Chart 9: CA and capital and financial account



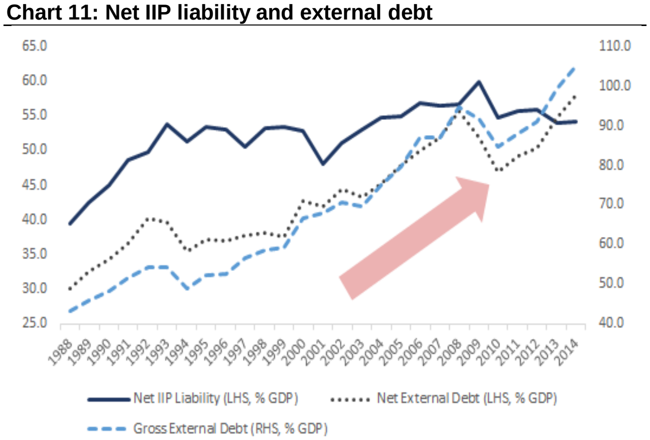
Source: CEIC, MARC Economic Research

Chart 10: Terms-of-trade



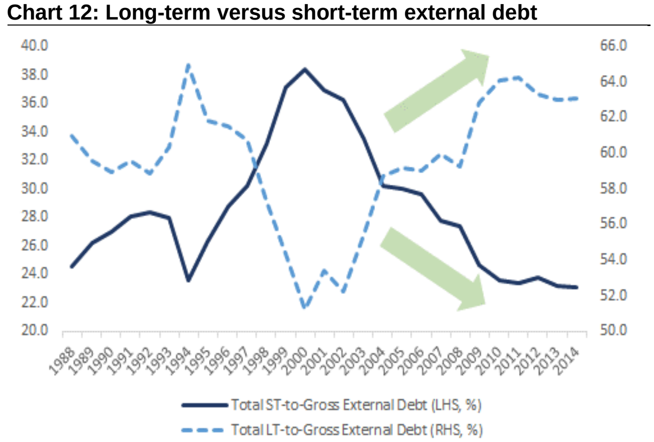
Source: CEIC, MARC Economic Research

Chart 11: Net IIP liability and external debt



Source: CEIC, MARC Economic Research

Chart 12: Long-term versus short-term external debt



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