Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/007/2016

Country Risk Monitor: Australia

Economic Research Led By:

Nor Zahidi Alias
Chief Economist
+603 2082 2277
zahidi@marc.com.my

In a nutshell

- Australia's macroeconomic strength is underpinned by its position as a wealthy economy whose performance has been remarkably resilient. Thanks to the economic liberalisation and deregulation in the 1980s, the country's labour productivity and per capita income have rapidly increased, contributing to the resilience of the economy. Its per capita income on a Purchasing Power Parity (PPP) basis stood at USD46,562 in 2014, ranking 18th globally. Notably, the economy weathered both the Asian Financial Crisis (AFC) in 1997/98 and Global Financial Crisis (GFC) in 2008/09 successfully and enjoyed economic growth for 24 consecutive years through to 2015. In spite of the recent rout in the global commodity market, Australia continued to demonstrate its resiliency against external shocks, growing by a still impressive 2.5% in 2015 (2014: 2.7%). This can be attributed to its effective macroeconomic policies in shifting to other growth drivers as mining investment wanes.

- The effectiveness of Australia's monetary policy framework in anchoring inflationary expectations and its impact on the overall aggregate demand reflects the credibility and flexibility of the Reserve Bank of Australia (RBA). The inflation rate is well within the targeted level of 2% to 3%, averaging at 2.6% in the 20 years through to 2015. Meanwhile, the country's free floating exchange rate regime complements its monetary policy flexibility as it provides an important buffer during a period of heightened global economic uncertainties. The recent rout in global commodity prices, combined with subsequent cuts in the Official Cash Rate (OCR) target have effectively weakened the currency considerably and has enabled non-mining sectors to regain some traction in driving economic growth.

- MARC views positively the government's ability to maintain its public debt at a reasonably low level, despite being saddled with persistent fiscal deficits since the GFC. While it has been on a rising trend, the Commonwealth government's net debt position averaged at just 9.5% of gross domestic product (GDP) in the six-year period post-GFC vis-à-vis advanced countries' average of 38.6% of GDP. It is worth noting that the increase in net debt position in the period post-GFC was mainly to finance the fiscal deficits since then. Accordingly, Australia's relatively low debt level leaves some space for the government to introduce countercyclical policy measures should the downside risks materialise. Most importantly, much of the debt is denominated in the local currency, which somewhat helps to reduce foreign currency risks.

- Like many other advanced economies, Australia's institutional framework is matured and remains remarkably solid, supported by a high degree of policy flexibility and effective policy-making. This is reflected in its ranking in the World Bank's Worldwide Governance Indicator (WGI), in which the country has consistently scored above the 90th percentile rank in all but one of the sub-indices since the survey started in 1996. Likewise, the World Bank's Doing Business 2016 report ranked Australia the 13th most favourable place to do business, while the World Economic Forum's (WEF) Global Competitiveness Index (GCI) saw Australia's position improved to 21st in 2015-16 (2014-15: 22nd). While Australia's ranking in the Transparency International Corruption Perception Index has deteriorated from 7th in 2012 to 13th in 2015 (2014: 11th), its position as the third-least corrupt nation in the Asia Pacific region continued to be affirmed.

- Australia's relatively weak external balance sheet moderates its overall economic strength. The current account (CA) of the balance of payments balance has been in the red in all but two over the past 56 years, pointing to a longstanding structural weakness of the economy. This has caused the economy to be saddled with high net foreign liabilities, especially during the mining investment boom period, as the country's relatively high domestic savings were inadequate to fully fund big inflows of mining investment projects. Accordingly, its net International Investment Position (IIP) liability position swelled to an average of 56.4% of GDP over the past decade from 47.7% of GDP in the early 1990s. Notwithstanding this, going forward, we are of the view that the CA deficits will narrow slightly over the near term, as the economy rebalances away from mining investment-driven growth to a more broad-based growth. This would somewhat stabilise the overall net liability position over the medium term. Additionally, a free floating exchange rate regime acts as an important buffer as the majority of Australia's assets are denominated in foreign currencies, while its external liabilities are denominated in the local currency.

Table 1: Selected economic indicators

	2010	2011	2012	2013	2014	2015
Real GDP Growth	2.4	2.6	3.6	2.0	2.7	2.5
Inflation Rate - CPI (%)	2.9	3.3	1.8	2.4	2.5	1.5
Unemployment Rate (%)	5.2	5.1	5.2	5.7	6.1	6.1
Commonwealth Fiscal Balance - FY end-June (% GDP)	-4.1	-3.8	-3.1	-1.4	-2.3	-2.6
Commonwealth Government Net Debt (% GDP)	3.2	6.0	10.0	10.1	12.8	15.0
Current Account (% GDP)	-3.5	-2.9	-4.2	-3.4	-3.0	-4.8
International Reserves (USD bn)	42.3	46.8	49.1	53.2	53.9	49.3
Gross External Debt ex-Financial Derivatives (% GDP)	84.5	88.0	91.5	101.0	106.8	117.9
Net IIP Liability (% GDP)	54.6	55.0	55.2	54.7	55.3	59.0

Source: ABS, RBA, CEIC, MARC Economic Research

Key Strengths

An advanced country with remarkably resilient economic performance

Australia's macroeconomic strength is underpinned by its position as a wealthy economy whose performance has been remarkably resilient. Thanks to the economic liberalisation and deregulation in the 1980s, the country's labour productivity and per capita income have rapidly increased, contributing to the resilience of the economy. Its per capita income on a PPP basis stood at USD46,562 in 2014, ranking 18th globally, higher than other major economies such as the United Kingdom (UK) and Germany. Notably, the economy weathered both the AFC in 1997/98 and GFC in 2008/09 successfully and enjoyed economic growth for 24 consecutive years through to 2015. It is one of the fastest-growing economies, yet the least volatile among advanced countries. In the 10 years through to 2015, Australia's economic growth averaged 2.7%, twice as fast as its advanced countries and Organisation for Economic Co-operation and Development (OECD) peers' growth of 1.3% and 1.4% respectively. Meanwhile, its growth volatility stood at just 0.8% over the past decade, vis-à-vis both the OECD's and advanced countries' standard deviation of 1.9%.

The Australian economy has benefitted from the massive influx of investments, particularly in the resources sector since the early millennium, which coincided with the significant rise in terms-of-trade. This was a result of booming demand from emerging economies, particularly China, for Australia's abundant mineral resources. Accordingly, mining-related activities have increasingly grown in importance in recent times, although the services sector remains a major contributor to the economy. In 2015, the services sector comprised 57.7% of GDP (2014: 57.1%), while the mining sector accounted for 8.6% of total output (2014: 8.5%), an increase by nearly 2.0 percentage points since early 2000. Nevertheless, it is worth noting that the emergence of investment in mining-related activities over the past 15 years was at the cost of declining competitiveness of non-mining sectors. The manufacturing sector's share, for instance, declined to a record low of 6.0% of GDP in 2015, from a peak of 13.3% of GDP in mid-1970s.

The mining investment boom, however, appears to have subsided while terms-of-trade have declined continuously from its peak in 2011, weighing on nominal income growth. These coincided with the sharp decline in global commodity prices since late 2014. Nevertheless, Australia's economy continued to demonstrate its resiliency against external shocks, in spite of its position as a major global commodity player. In 2015, the economy grew by a still impressive 2.5%, marginally lower than the 2.7% expansion registered in the preceding year. Rising resources export volumes as a result of past mining investments have helped partially offset broadly lower export values. Accordingly, net exports remained a positive contributor to the headline GDP growth, adding 1.0 percentage point in 2015 (2014: 1.7 percentage points). Domestically, demand was underpinned by proactive macroeconomic policies, particularly from the monetary side. Household consumption growth remained resilient at 2.8% in 2015, unchanged from the preceding year's pace, while public consumption growth rebounded strongly to 2.9% from 0.6% in

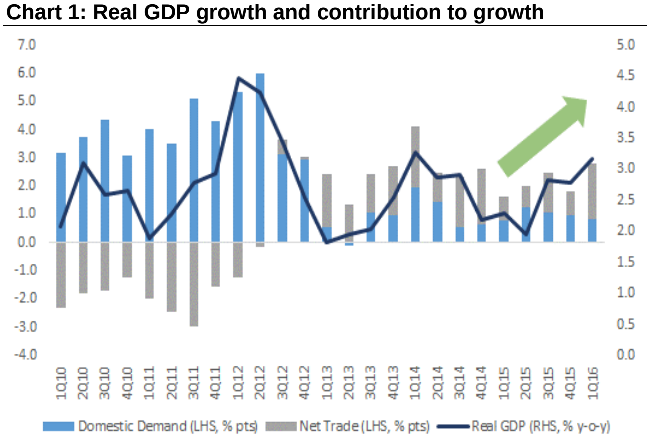
2014. This has helped mitigate the continuous decline in investment since 2013, which plunged by 4.0% in 2015, the most since the last time the economy contracted in 1991.

On the supply side, real GDP growth was driven mainly by the pick-up in the services sector, rising 3.6% in 2015 from its cyclical low of 2.2% in the preceding year. It was fuelled by the strong growth in wholesale and retail trade as well as the financial and insurance services sub-sector, which collectively accounted for 30% of total services. The mining sector, meanwhile, recorded slower growth against the backdrop of depressed global commodity prices, increasing by 4.1%, down from the blistering 10.3% pace in 2014. The manufacturing sector, on the other hand, extended its contraction for a fourth straight year, dropping 1.8% in 2015 (2014: -1.4%).

Going forward, MARC is of the view that the economy will remain resilient over the medium term in the face of heightened global uncertainties, supported by pre-emptive and credible macroeconomic policies as demonstrated in the past. The economy is currently shifting from mining investment activities towards mining production and export, which could help offset the gyrations in key commodity prices through rising exports volume. In fact, 1Q2016 economic growth has unexpectedly accelerated to 3.2% from a year earlier, the strongest pace since 3Q2012, driven by the recovery in demand for its commodities. The services sector, meanwhile rebounded, reflecting the effectiveness of the country's macroeconomic policies in shifting to other growth drivers. These will help the economy maintain its growth trend and productivity over the longer term, which to a certain extent, will help stabilise its CA deficit. The currently weak currency would also continue to help bolster competitiveness and productivity in non-mining sectors.

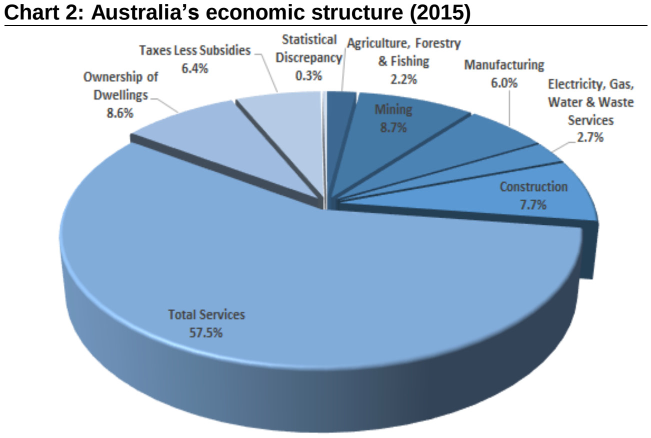
Of concern is the momentum in global trade which is expected to remain sluggish over the foreseeable future. While we think the impact from Brexit on Australian trade and economic growth will be rather limited, the financial ramifications following the departure of the UK from the European Union (EU) could reverberate across the globe if the overall sentiment among global investors remains anaemic. Nevertheless, the expectation that major central banks will maintain an accommodative monetary stance and the US Federal Reserve (Fed) will become less enthusiastic in raising rates would continue to support global growth going forward. Meanwhile, the recent stabilisation of China's economy, the biggest consumer of Australia's exports (32.4% of total exports in 2015), will be positive for Australia

Chart 1: Real GDP growth and contribution to growth



Source: CEIC, MARC Economic Research

Chart 2: Australia's economic structure (2015)



Source: CEIC, MARC Economic Research

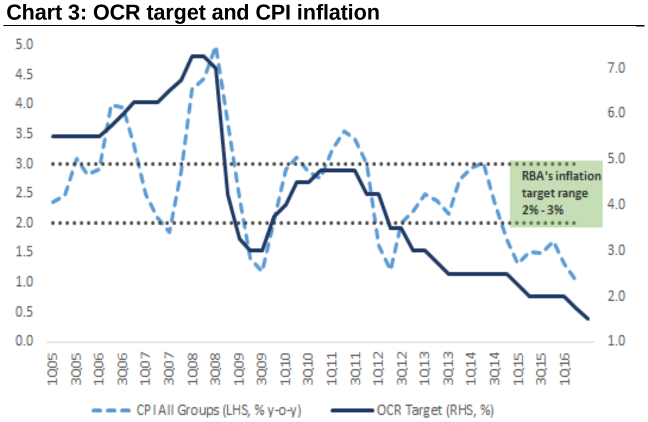
Credible and flexible monetary policy framework

The effectiveness of Australia's monetary policy framework in anchoring inflationary expectations and its impact on the overall aggregate demand reflects the credibility and flexibility of the RBA. Since the introduction of inflation targeting policy in 1993, the inflation rate is well within the targeted level of 2% to 3%, averaging at 2.6% in the 20 years through to 2015. The transition between the policy rate, the OCR target, and the real economy was rather quick particularly during the global economic crises. For instance, during the height of the GFC, the RBA cut its benchmark OCR target by a cumulative 425 basis points (bps) to 3.0% in the eight months through April 2009. Consequently, both the short-term rates and government bond yields strongly followed suit, with rates being not much higher than the benchmark rate. Similarly, the average bank lending rate for standard variable housing loans declined by 3.9 percentage points to 5.8% in April 2009 from 9.6% in August 2008. The inflation rate, meanwhile, effectively slowed to an average of 2.4% in the post-GFC period, after peaking at 4.4% in 2008. More importantly, the volatility of the inflation rate is well-contained with a standard deviation of only 0.7%, as opposed to OECD countries' 2.0%.

In response to subdued inflationary pressure and weaker commodity prices since late 2014, the RBA lowered its benchmark OCR target by a combined 100 bps in four separate moves to a fresh low of 1.5% in early August 2016. In particular, headline inflation rate has been below the official target range since 4Q2014, averaging at just 1.4% in the seven quarters through 2Q2016. The AUD, while has weakened by as much as 37.7% from its peak of USD1.102 in late July 2011 to USD0.6864 in mid-January 2016 – a level that the RBA appears comfortable with – the latest move by the central bank indicates that it remains wary about the recent strength of the AUD which has appreciated by about 11% to USD0.7596 in July 2016 from its mid-January trough.

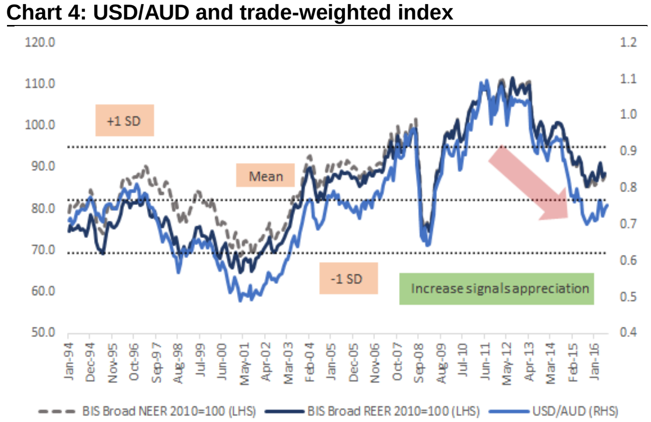
The country's free floating exchange rate regime, which has been in place since the early 1980s, complements its monetary policy flexibility. It provides an important buffer during a period of heightened global economic uncertainties, in view of its huge liability position. The economy has also benefitted from the strong AUD, as a result of the mining investment boom which helped contain imported inflationary pressures. Meanwhile, the recent rout in global commodity prices, combined with the easing in monetary policy, have weakened the currency considerably, enabling non-mining sectors to regain some traction in driving economic growth as mining investment wanes.

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

Going forward, MARC is of the view that the monetary policy stance will remain highly accommodative for a considerable period, in view of the continued uncertainties at the global front and persistently subdued inflationary pressures. Evidently, the RBA still has plenty of room to manoeuvre as compared to its peers if economic expectations weaken considerably. While the domestic economy has somewhat recovered, the uneven recovery in other advanced economies and uncertainties with regards to Brexit as well as

China's tepid growth will continue to undermine Australia's growth potential going forward. In this regard, Australia's fully flexible exchange rate regime has managed to help the transition from mining investment activities towards a more balanced economic growth effectively. On the other hand, further monetary policy normalisation by the US Fed, although at a slower-than-expected pace, will benefit the Australian economy via a weaker currency, which will support the export sector over the medium term.

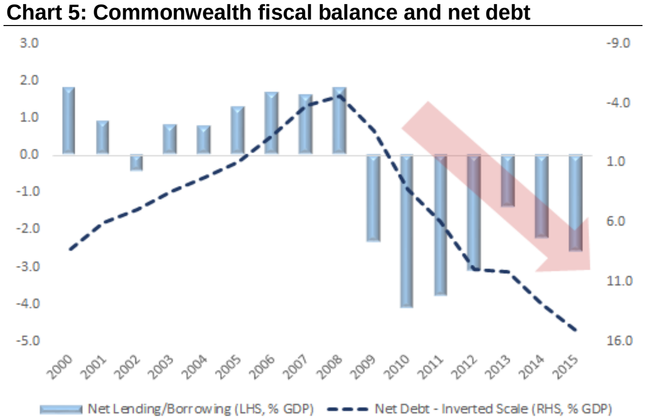
Reasonably low public debt

MARC views positively the ability of the Australian government to maintain its public debt at a reasonably low level relative to its advanced countries and OECD peers, despite being saddled with persistent fiscal deficits since the GFC. Accordingly, its relatively low debt level leaves some space for the government to introduce countercyclical policy measures should the downside risks materialise. While it has been on a rising trend, the Commonwealth government's net debt position averaged at just 9.5% of GDP in the five-year period post-GFC. This compares with other advanced countries' average of 38.6% of GDP during the same period, with both the US and UK being close to 100% of GDP. As at end-2014-15, the Commonwealth government's net debt position stood at 15.0% of GDP, an increase of 2.2 percentage points from the preceding year.

It is worth noting that the increase in net debt position in the period post-GFC was mainly to finance the fiscal deficits since then. In fact, the Commonwealth government was in a net asset position in the four years through to 2008-09, before the GFC forced the government to pump-prime the economy. As a result, the Commonwealth government's fiscal balance turned to deficit since 2009 after enjoying six consecutive years of fiscal surpluses (which average at 1.3% of GDP). Currently, weak export prices and subdued nominal growth have complicated the task of turning the fiscal balance into surplus, thus causing the debt level to trend higher. Meanwhile, the general government's net worth position at the consolidated level (including the Commonwealth, state and local governments as well as multi-jurisdictional) remained exceptionally strong, albeit moderating, with total assets far exceeding its total liabilities at an average of 57.7% of GDP in the six-year period post-GFC.

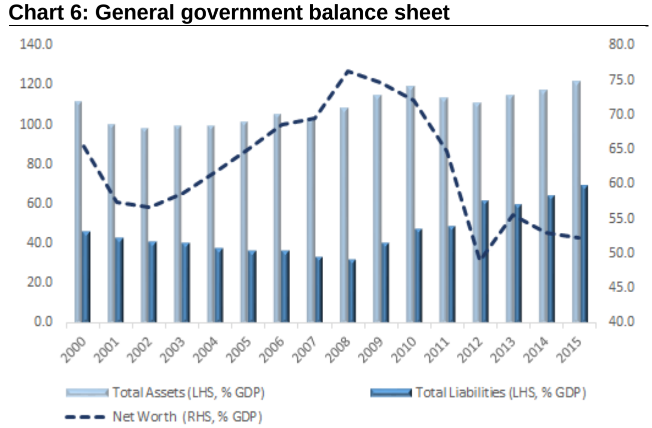
Going forward, while we foresee that the government's debt burden will continue to rise in the near future, we are not overly concerned as it will still remain relatively low as compared to its peers. Moreover, Australia's debt affordability will likely remain high, supported by a low domestic interest rates environment, with interest payments averaging at just 5.6% of total revenue in the six-year period through 2014-15. Most importantly, much of the debt was denominated in the local currency, with all new Commonwealth Government Securities (CGS) issuances denominated in AUD, which somewhat helps reduce foreign currency risks. Notwithstanding this, 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

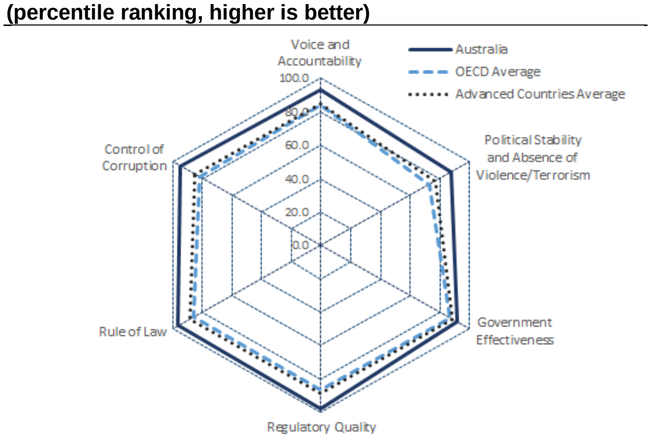
Matured and solid institutional framework

Like many other advanced economies, Australia's institutional framework is matured and remains remarkably solid, supported by a high degree of policy flexibility and effective policy-making. This is reflected in its ranking in the World Bank's 2015 WGI update, where it scores favourably among OECD countries and indeed, is better than its advanced countries peers. Since the survey started in 1996, Australia has consistently scored above the 90th percentile rank in all sub-indices save for *political stability and absence of violence/terrorism*. While its score for *political stability and absence of violence/terrorism* has been below the 90th percentile rank since 2002, it has remained relatively strong and outperformed the OECD and advanced countries' average. Notably, the country's rank improved for a third consecutive year to 87.4th in 2014 (2013: 83.4th) from its record low of 74.5th in the preceding three-year period. Similarly, Australia remains as one of the cleanest countries in the world as confirmed by its ranking in the Transparency International Corruption Perception Index 2015. While its ranking has deteriorated from 7th in 2012 to 13th in 2015 (2014: 11th), its position as the third-least corrupt nation in the Asia Pacific region continued to be affirmed.

Meanwhile, the World Bank's Doing Business 2016 report ranked Australia as the 13th most favourable place to do business out of 189 countries, with the country performing well in terms of *dealing with construction permits* (4th place), *enforcing contracts* (4th place), and *getting credit* (5th place), but doing somewhat poorly in *trading across borders* (89th). Likewise, the WEF GCI continued to place Australia positively among all advanced countries, with the country's overall position improving slightly to 21st in 2015-16 from 22nd in the year before, ending its four-year slide in the ranking. It is important to note that the country's overall ranking has been on a declining trend after peaking at 15th in 2009-10, due largely to weakening macroeconomic conditions and a deteriorating public balance sheet. Nevertheless, its performance remains strong across all spectrums of the GCI, with rankings no lower than the 30th place in all but one of the 12 pillars.

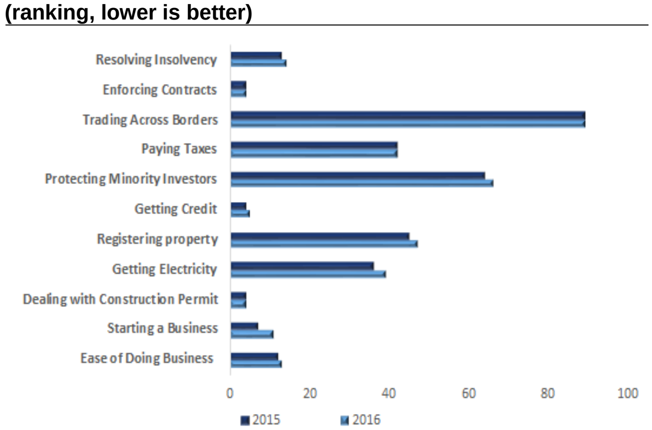
Looking ahead, we are of the view that Australia's strong institutional setting will continue to be preserved, despite the heightened uncertainties at the global front. While the recent rout in commodity prices will take a toll on certain international rankings, particularly in the GCI, we believe the country's overall business environment will remain conducive over the medium to longer term, thanks to its pre-emptive and effective policy-making. On corruption, MARC is of the view that the government will be able to maintain its status as one of the cleanest countries in the world, although it has slipped from the top ten list since 2013.

Chart 7: World Bank Worldwide Governance Indicators 2015 (percentile ranking, higher is better)



Source: World Bank, MARC Economic Research

Chart 8: World Bank Ease of Doing Business 2016 and 2015 (ranking, lower is better)



Source: World Bank, MARC Economic Research

Major Challenge

Relatively weak external balance sheet

Australia's relatively weak external balance sheet moderates its overall economic strength. The CA balance has been in the red in all but two over the past 56 years, pointing to a longstanding structural weakness of the economy. This has caused the economy to be saddled with net foreign liabilities as evidenced by its large negative net IIP. Nevertheless, it is worth noting that the country's persistent CA deficits are certainly not due to lack of savings, but rather due to high capital investments, particularly in the resources sector since the early 2000s. In fact, Australia's savings rate is as high as other advanced countries, averaging at 23.3% of GDP in the 10 years through to 2015, vis-à-vis advanced countries' average of 22.7%. Total investments, meanwhile, stood at an average of 27.7% of GDP over the past decade, broadly higher than the average of 22.5% for all advanced countries.

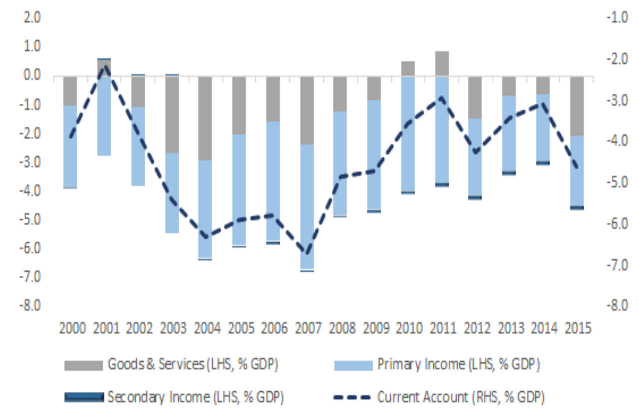
The CA deficit has somewhat widened in 2015, ending the moderation trend seen since hitting its cyclical peak in 2007. In value terms, the CA deficit reached a record of AUD78.3 billion in 2015 and equivalent to 4.8% of GDP, an increased by 1.8 percentage points from the preceding year. This can be attributed to the widening shortfall in the goods and services balance to AUD36.1 billion (2014: AUD9.8 billion), amid the sharp decline in key commodity prices. Likewise, the deficit in the income balance widened by 8.3% to AUD42.2 billion from AUD39.0 billion in 2014, on the back of higher income repatriation by foreign investors, particularly in the mining sector.

Australia's huge net foreign liabilities reflect its high financing needs, especially during the mining investment boom period, as its relatively high domestic savings were inadequate to fully fund big inflows of mining investment projects. Accordingly, its net IIP liability position swelled to an average of 56.4% of GDP over the past decade, as compared to the 47.7% of GDP recorded in the early 1990s. While it has declined from a peak of 59.8% of GDP in 2009, the net negative IIP resumed its upward trend in 2015, increasing by 3.7 percentage points from the preceding year to 59.0% of GDP. Similarly, Australia's gross external debt doubled from 59.1% of GDP in 1999 to reach a record high of 117.9% of GDP in 2015, although its overall position remains relatively low when compared with other advanced countries. On a net basis, Australia's total external debt also stood at a historical high of 62.5% of GDP in 2015 (2014: 59.0% of GDP), as compared to its cyclical low of 46.8% of GDP in 2010, although the growth in general has slowed for three consecutive years to just 8.0% during the same period (2014: 8.3%, 2013: 13.9%).

Going forward, we are of the view that the CA deficits will narrow slightly over the near term as the economy rebalances away from mining investment-driven growth to a more broad-based growth. The trade deficit is expected to narrow from the current level, taking its cue from the recovery in global commodity prices and the pick-up in resources export volumes, together with a slowdown in capital imports following a slower stream of new investment activity. This would be positive for Australia as it will somewhat stabilise the overall net liability position over the medium term. However, the widening income deficits may continue over the foreseeable future as foreign investors repatriate some of their mining incomes should the global commodity market start to recover. Domestic savings, meanwhile, are projected to remain significant over the near to medium term, underpinned by rising household wealth following the recent pick-up in the housing market. Additionally, the private sector which continues to deleverage following the decline in terms-of-trade as well as rising uncertainties in the global economy could also contribute to higher private savings over the short term.

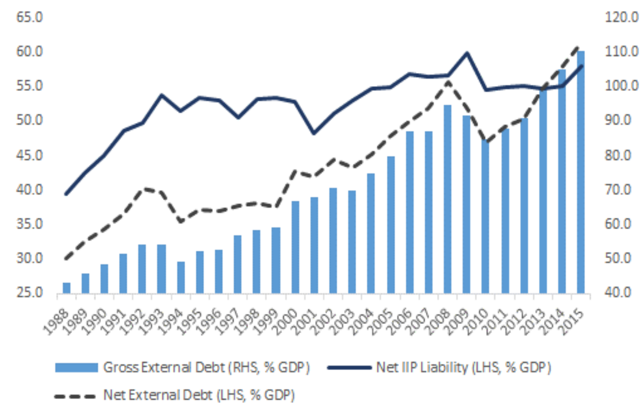
Technically, Australia's external susceptibility is relatively high given its heavy dependency on foreign funding and its position as a global commodity player. While its official reserves assets have continued to strengthen in recent years, amounting to AUD67.4 billion in 2015 (2014: AUD65.7 billion), its short-term external debt coverage remained relatively low, standing at only 14.3%, down from 16.7% in the preceding year. Nevertheless, we take comfort from the recent trend of rising external assets which will likely continue over the medium term and stabilise its overall liability position. This will enable the country to build sufficient buffers against further deteriorations in the global economy. In addition, most of Australia's foreign assets are denominated in foreign currencies, while its external debt is denominated in local currency. In this regard, a free floating exchange rate regime acts as an important buffer as a stronger AUD will increase its overall asset position, while a depreciation in the exchange rate will somewhat lower the overall liability profile. Meanwhile, the decline in short-term external debt over the past decade augurs well for greater debt management, particularly for the private sector. On the whole, with global interest rates to remain low and the RBA to maintain a highly accommodative monetary stance in the near term, Australia's external imbalances are expected to narrow gradually and help facilitate the economy's shift to non-resource based growth.

Chart 9: CA and its composition



Source: CEIC, MARC Economic Research

Chart 10: Net IIP liability and external debt



Source: CEIC, MARC Economic Research

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my