Economic Research

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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 key strength lies in its foundation as a wealthy and resilient economy. Its per capita income of USD47,769 on a purchasing power parity (PPP) basis ranked 18th globally and was higher than other major economies such as the United Kingdom (USD41,477) and Germany (USD47,254). In spite of the collapse of mining investment and global commodity prices, the economy continued to grow at a respectable pace of 2.4% in 2016, the same as in the preceding year. This marked the 25th consecutive year of uninterrupted economic growth, thanks to credible and pragmatic macroeconomic policies, which effectively support the economic adjustment to a more broad-based growth.

- Australia continued to embark on a credible monetary policy framework, alongside a fully flexible exchange rate regime that supports its sound economic fundamentals. Its swift impact on the overall aggregate demand reflects the prowess of its conventional monetary policy compared to unconventional policies implemented by some global central banks. Inflation expectation is well anchored, with the headline index having grown at an average rate of 2.4% over the past 10 years, well within the targeted rate of 2.0% to 3.0%. Combined with timely fiscal support, the reduction in the Official Cash Rate (OCR) to a record low has effectively mitigated the sharp decline in investment momentum by boosting consumption and exports growth.

- As an advanced economy, Australia's institutional setting remains remarkably strong and matured, underpinned by strong governance and effective yet flexible policy-making processes. The country's solid governance metrics are reflected in its ranking in the World Bank's 2016 Worldwide Governance Indicators (WGI). It scored above the 90th percentile rank in all but one of the major indicators, favourably stronger than other advanced countries and its Organisation for Economic Co-operation and Development (OECD) peers. Further complementing its institutional strength is the openness of the economy to operate a business. The World Bank's Doing Business 2017 report placed Australia's Ease of Doing Business ranking within the top 10% quantile, at 15th place out of 190 countries surveyed. Likewise, the country performed somewhat favourably in the World Economic Forum's (WEF) Global Competitiveness Index (GCI), securing the 22nd spot among 138 economies in 2016-2017.

- Moderating Australia's positive factors is the country's structural dependency on external financing, making it vulnerable to sudden shifts in capital flows. Decades of current account (CA) deficits have caused the economy to be saddled with high net foreign liabilities, as the relatively large domestic savings are inadequate to fully fund the massive influx of investments. Over the past 10 years, its negative net international investment position (IIP) averaged at 56.6% of gross domestic product (GDP), about 5.5 percentage points higher than its average in the 1990s. Going forward, MARC views that its CA deficits will stabilise around the current level (2016: 2.6% of GDP), as the rising export volume of its resources and improving foreign demand will help offset the gyrations in global commodity prices.

- While the easing in monetary policy has helped the economic transition more effectively, a prolonged period of low interest rate environment has induced demand for housing, causing the already high household debt to escalate further. After a short pause in 2016, home prices have since resumed their double-digit growth. While we rule out the possibility of a sharp property market downturn over the near term, the risk of escalating home prices in certain cities is worth monitoring. This is in view of the large banking system exposure (60% of banking system assets) to this sector, which is traditionally linked to systemic risk. Meanwhile, at 188.8% of disposable income in 2016 (136.2% of GDP), Australia's household debt is among the largest in the world. Of total, about 70% were for home financing, of which 25% of total housing debt were meant for investment purposes. As such, faster-than-expected increases in interest rates, combined with stagnant wage growth, could amplify the risk of large negative income shock. This could have a material effect on private consumption, should economic conditions worsen. We are of the view that the Australian Prudential Regulation Authority (APRA) would stand ready to tighten its measures further, in view of the reacceleration of higher-risk residential loans growth (e.g. investor housing and interest-only loans).

Table 1: Selected economic indicators

	2011	2012	2013	2014	2015	2016
Real GDP growth	2.6	3.7	2.1	2.8	2.4	2.4
Inflation rate - CPI (%)	3.3	1.8	2.4	2.5	1.5	1.3
Unemployment rate (%)	5.1	5.2	5.7	6.1	6.1	5.7
Commonwealth fiscal balance - FY end-June (% GDP)	-3.8	-3.1	-1.4	-2.2	-2.6	-2.3
Commonwealth government net debt (% GDP)	6.0	10.0	10.1	12.8	15.0	18.1
Current account (% GDP)	-2.9	-4.1	-3.2	-2.9	-4.8	-2.6
International reserves (USD bn)	46.8	49.1	53.2	53.9	49.3	55.1
Gross external debt ex-financial derivatives (% GDP)	88.0	91.3	100.6	106.3	117.7	113.9
Net IIP liability (% GDP)	55.0	55.1	54.4	54.8	58.9	60.7

Source: ABS, RBA, CEIC, MARC Economic Research

Key Strengths

Remarkably resilient advanced economy

Australia's key strength lies in its foundation as a wealthy and resilient economy. This can be attributed to the significant economic liberalisation and deregulation that took place since the 1980s which contributed to the rapid increase in labour productivity and per capita income. In 2015, its per capita income of USD47,769 on a PPP basis ranked 18th globally and was higher than other major economies such as the UK (USD41,477) and Germany (USD47,254).

The economy enjoyed uninterrupted economic growth in the past 25 years through to 2016. This was in spite of uncertainties that prevailed at the domestic and external fronts, which include, among others, the unwinding of mining investments since 2012 and the collapse of global commodity prices since late 2014. The remarkably resilient economy is also evidenced by its ability to weather both the Asian Financial Crisis (AFC) in 1997/1998 and the Global Financial Crisis (GFC) in 2008/2009. The economy grew at an average rate of 2.7% over the past decade, nearly double the pace of other advanced countries of 1.5%. In addition, its growth volatility of 0.8% over the past 10 years was broadly lower than advanced countries' standard deviation of 2.4%.

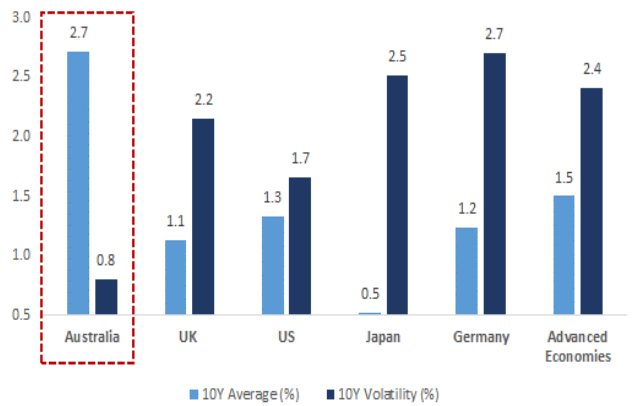
Traditionally, the economy has been reaping the benefit from a massive influx of mining investments post-2000, thanks to its abundant mineral resources and booming demand from China. While the services sector continued to act as the major contributor to the economy, the mining sector has increasingly grown in importance. The services sector's share stood at 58.6% of GDP in 2016, while the mining sector took a record 6.9% of total output. Nonetheless, it is important to note that the emergence of investment in mining-related sectors since 2000 has led to a "crowding out" effect on the non-mining sector. The manufacturing sector, for instance, comprised a mere 5.8% of total output, half of its peak of 13% in 1970s-1980s.

Credible and pragmatic policies effectively support economic adjustment and cushion the impact of the reversal in mining investment activities and lower global commodity prices. Real GDP growth stood at a respectable pace of 2.4% in 2016, the same as in the preceding year, albeit moderating from a cyclical high of 3.7% in 2012. Evidently, rising resources exports volume as a result of past mining investments has helped offset lower commodity prices, causing net trade to add 1.5 percentage points to headline growth. Domestic demand, meanwhile, is getting a boost from timely and effective fiscal and monetary policy measures. As a result, resilient public and private consumption growth managed to offset the continuous drag from the decline in mining investment. Total consumption added 2.2 percentage points to headline growth in 2016 (2015: 2.2 percentage points), while investments took off 0.7 percentage points from real GDP growth.

While we foresee further repercussions from Australia's efforts to rebalance its economy in the near to medium term, we envisage the economy to stay remarkably resilient, backed by pre-emptive and credible macroeconomic policies as evidenced in the past. A continuing increase in exports volume as a result of past mining investments will help offset the gyrations in key commodity prices, and to a certain extent, help stabilise its CA situation. In addition, the recent improvement in global trade and the stability of China's economy will generate positive spill over effects to the economy over the near term.

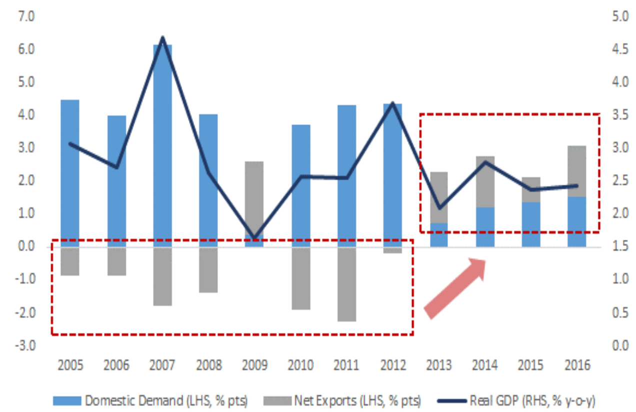
However, the downside risks to the economy remain its rising house prices and high household debt which could be negatively impacted if interest rates rise markedly. Meanwhile, the inward trade policies of other advanced economies, particularly the United States (US) if they materialise, could also derail global trade recovery over the foreseeable future.

Chart 1: Australia's average real GDP growth and volatility versus advanced economies



Source: CEIC, IMF, MARC Economic Research

Chart 2: Real GDP growth and contribution to growth



Source: CEIC, MARC Economic Research

Credible and flexible monetary policy framework

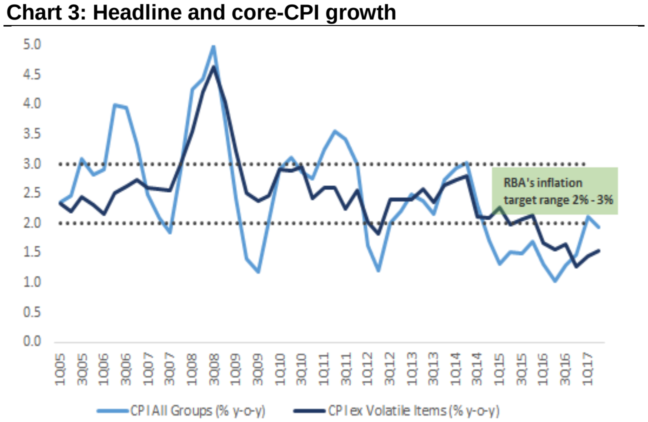
Australia continued to embark on a credible monetary policy framework, alongside a fully flexible exchange rate regime that supports its sound economic fundamentals. Its swift impact on the overall aggregate demand reflects the prowess of its conventional monetary policy compared to unconventional policies implemented by some global central banks. As a result, inflation expectation is well anchored, with the headline index having grown at an average rate of 2.4% over the past 10 years, well within the targeted range of 2.0% to 3.0%. The positive track record of the Reserve Bank of Australia (RBA) in managing inflation is also evidenced by its low volatility, with a standard deviation of 0.9% over the past decade, vis-à-vis advanced countries' 1.4%.

The continued easing in the monetary policy proved to be effective in shifting the economy away from investments in mining-related activities. This coincided with the sharp fall in major commodity prices and declining inflation expectations since late 2014. Combined with timely fiscal support, consumption growth remained broadly resilient, mitigating the sharp decline in investment momentum. Meanwhile, the relatively weak exchange rate helped boost exports' competitiveness. To recap, the RBA lowered the benchmark OCR target by a combined 100 basis points to a fresh low of 1.5% in the 19 months through August 2016, and has kept the rate steady since then. Accordingly, the headline inflation rate, which has been below the central bank's target since late 2014, is slowly gaining momentum since 3Q2016. It clocked a 2.0% rate in the first six months of 2017, the strongest since 3Q2014, due in part to a slight recovery in global commodity prices. The core measure, however, remained fairly subdued at 1.5% in 1H2017, reflecting a continuous slack in the labour market, which was partly due to weak wage growth and high underemployment.

The country's free-floating exchange rate regime complements its monetary flexibility by providing an important buffer during the period of heightened global economic uncertainties. While the traditionally strong Australian dollar (AUD), as a result of the previous mining investment boom, has helped contain imported inflationary pressures, the weakening of the currency amid weaker commodity prices and continued monetary easing has enabled non-mining sectors to regain some traction in driving economic growth. Year-to-date, the AUD has recovered somewhat, appreciating 6.3% in June 2017 from end-2016, though remaining 30% below its peak of USD1.095 reached in July 2011.

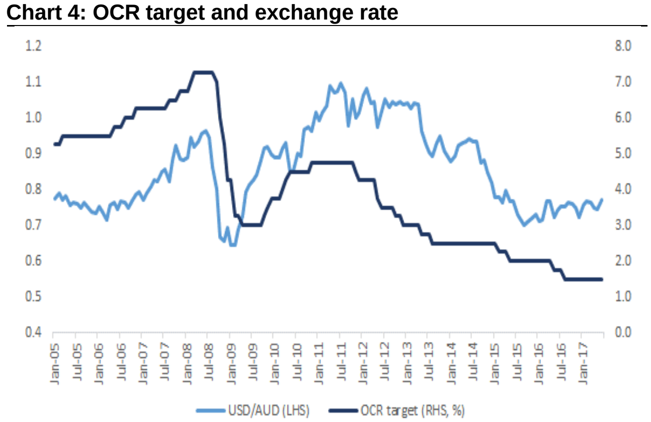
Going forward, MARC is of the view that the monetary policy stance would remain highly accommodative for a considerable period to facilitate the ongoing economic adjustment to ensure a more broad-based growth. While we foresee the RBA still has plenty of room to react should the economy weakens considerably, further reduction in the policy rate appears limited at this juncture due to heightening housing market risks and high household indebtedness. In this regard, we are of the view that its fully flexible exchange rate regime would continue to act as an important shock absorber that helps the transition from the downturn in mining investments towards a more balanced economy. Meanwhile, further monetary policy normalisation by the US Federal Reserve would benefit the economy via a weaker AUD, which will be supportive of the export-oriented sector over the medium term. On the other hand, the recent strength of the AUD amid positive interest rate differentials and the relatively attractive Australian assets will continue to be the central bank's major concern going forward.

Chart 3: Headline and core-CPI growth



Source: CEIC, MARC Economic Research

Chart 4: OCR target and exchange rate



Source: RBA, CEIC, MARC Economic Research

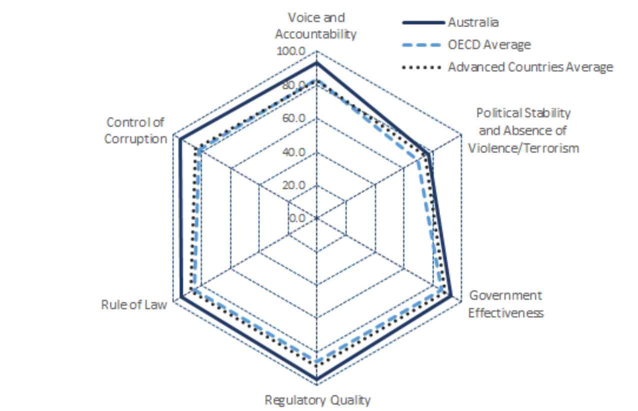
Strong and matured institutional setting

As an advanced economy, Australia's institutional setting remains remarkably strong and matured, underpinned by strong governance and effective yet flexible policy-making processes. The country's solid governance metrics are reflected by its ranking in the World Bank's 2016 WGI which has remained favourably stronger than other advanced countries and its OECD peers. Australia consistently scored above the 90th percentile rank in all but one of the major indicators since the survey started in 1997. While its score for *political stability and absence of violence/terrorism* has been below the 90th percentile rank since 2002, it continued to outperform the OECD and advanced countries' average. Similarly, Australia is also well known for its transparency and for being relatively corruption-free, securing 13th place out of 176 countries in 2016, while affirming its position as the third-least corrupt nation in the Asia Pacific region.

Further complementing its institutional strength is the openness of the economy to operate a business. The World Bank's Doing Business 2017 report placed Australia's Ease of Doing Business ranking within the top 10% quantile, at 15th place out of 190 countries surveyed. Similarly, the country performed somewhat favourably in the WEF's GCI, securing 22nd place among 138 economies in 2016-2017. Notably, Australia ranked in the top 10 of three GCI pillars and registered higher than the 28th place in the remainder. It is important to note that while the pillar of *macroeconomic environment* has taken a toll on its overall competitiveness ranking over the past few years, it remained remarkably strong in 2016-2017. In fact, the ranking improved by five points during the year despite the prolonged commodity bust, thanks to pre-emptive and credible policy actions.

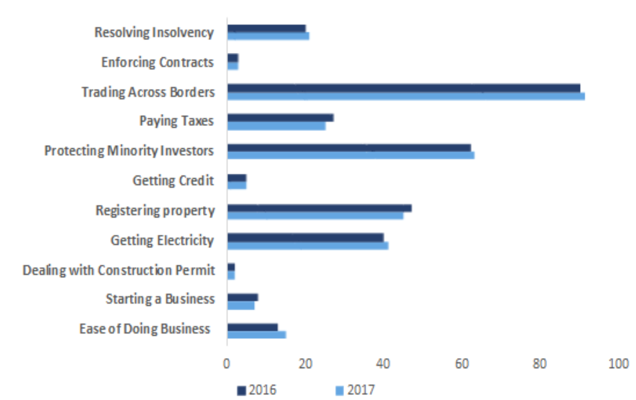
MARC believes Australia's institutional setting would remain sturdy over the foreseeable future. The slight recovery in commodity prices in recent months provides an impetus for the country to improve its position going forward, primarily in the competitiveness metrics which have weakened slightly compared to a decade earlier. While the overall governance metrics are expected to remain remarkably solid compared to its peers, there are areas for improvement. In particular, the weakening of the *political stability and absence of violence/terrorism* score in recent years masked a relatively unstable political environment following the frequent change in government leadership over the past few years. Notwithstanding this, we believe that policy continuity, especially with regards to macroeconomic stability, will remain policymakers' upmost priority going forward.

Chart 5: World Bank Worldwide Governance Indicators 2016 (percentile ranking, higher is better)



Source: World Bank, MARC Economic Research

Chart 6: World Bank Ease of Doing Business 2017 and 2016 (ranking, lower is better)



Source: World Bank, MARC Economic Research

Major Challenges

Structural dependency on external financing

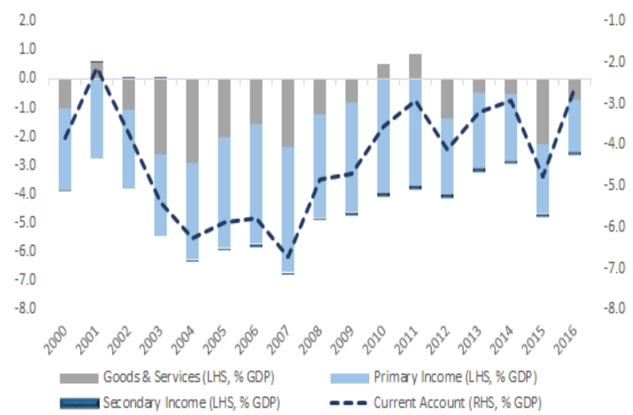
Moderating Australia's positive factors is the country's structural dependency on external financing, making it vulnerable to sudden shifts in capital flows. The CA of the balance of payment has been in deficit in all but two years over the past five decades. As a result, the economy continues to be saddled with high net foreign liabilities, reflecting a long-standing structural weakness of the economy. On the flipside, the country's prolonged CA deficits can be attributed to high capital investments, particularly during the mining investment boom, rather than the shortfall in domestic savings. Indeed, Australia's savings are as large as other advanced economies, averaging 23.4% of GDP over the past 10 years (advanced economies: 23.8% of GDP), while its total investment of 27.5% of GDP was broadly larger than its peers (advanced economies: 22.1% of GDP).

In 2016, the shortfall in its CA narrowed to AUD44.5 billion or 2.6% of GDP (2015: AUD77.9 billion or -4.8% of GDP), as a pickup in resources exports volume helped offset persistently low commodity prices during the year. Alongside a decline in imports of capital goods, the deficit in the goods and services balance shrank by a hefty 67.3% from a year earlier, contributing 74.6% of the decline in the CA deficit. Likewise, the surplus in the capital and financial account – a reflection of high foreign investments – declined by 33.6% to AUD48.6 billion in 2016, amid large withdrawals in portfolio investments and financial derivatives. For the first time since the onset of the GFC in 2007, portfolio investment experienced a net outflow, amounting to AUD31.9 billion, the largest in its history. Meanwhile, net outflows of financial derivatives more than doubled to AUD11.3 billion in 2016 (2015: AUD4.9 billion). Mitigating these are the continued increase in net direct investments (2016: AUD57.7 billion, 2015: AUD50.8 billion) and net inflows of other investments of AUD45.4 billion (2015: AUD-37.3 billion).

Australia's sizeable net IIP liability position demonstrates the country's high financing need, as its relatively large domestic savings are inadequate to fully fund the massive influx of investments, particularly in the mining-related sector post-2000. Over the past 10 years, its net IIP liability position averaged at 56.6% of GDP, about 5.5 percentage points higher than its average in the 1990s. In spite of the recent decline in CA deficit, Australia's net IIP liability position unexpectedly increased, reaching a record high of 60.7% of GDP in 2016. As a large portion of external liabilities were denominated in the domestic currency, foreign equity assets losses alongside the recent currency appreciation have somewhat increased its net liability position. In particular, its equity net asset position fell to a mere AUD327 million in 2016 from a whopping AUD60.1 billion in the preceding year. In addition, due to its safe-haven status, Australian assets remain attractive and that has, to a certain extent, caused its net liability position to trend higher.

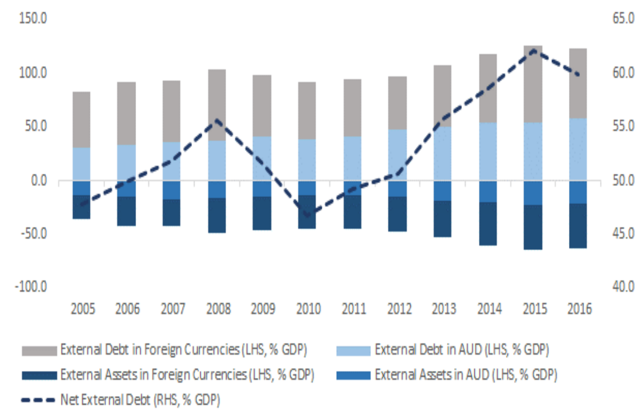
Looking forward, MARC opines that Australia's CA deficits would stabilise around the current level, taking cue from further stability in key commodity prices and improving foreign demand, particularly from China. Indeed, rising resources exports volume and declining capital imports over the past year have kept the CA balance in check, offsetting the increasingly volatile global commodity prices.

Chart 7: CA and its composition



Source: CEIC, MARC Economic Research

Chart 8: External balance sheet composition by currency



Source: CEIC, MARC Economic Research

High home price inflation and household indebtedness

While the easing in monetary policy has helped the economic transition more effectively, a prolonged period of low interest rate environment has somewhat induced demand for housing, causing the already high household debt to escalate further. Notably, some of the slack from the downturn in mining investment has been picked up by rising dwelling constructions. This softened the impact of the mining bust.

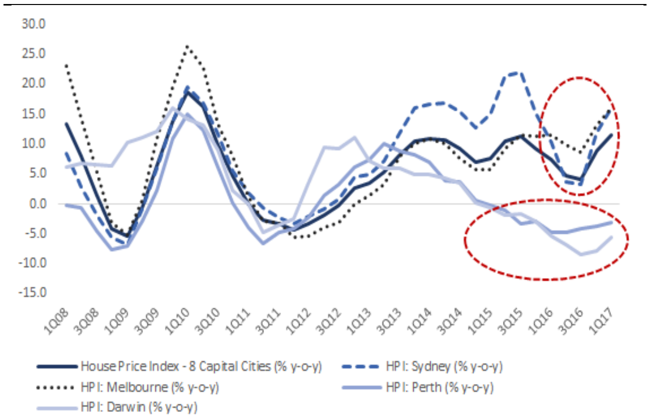
Although house prices grew at a more moderated pace of 6.2% in 2016 (2015: 9.7%), they rebounded to 11.5% in 1Q2017. A notable divergence can be seen across major cities, with Sydney and Melbourne resuming their double-digit price increases since 4Q2016 after six months of price moderations, while mining cities such as Perth and Darwin suffered nine consecutive quarters of price contractions. While we rule out the possibility of a severe property market downturn over the near term, the risk associated with escalating home prices in certain cities is worth monitoring. This is in view of the large banking sector exposure (60% of banking system assets) to this sector, which is traditionally linked to systemic risk.

Notably, about 70% of the increase in total bank credit over the past three years can be explained by the rise in housing loans compared to less than 50% in the three-year period prior to 2009. In tandem with the trend in the housing market, the momentum in loan expansion has shown tentative signs of a pick up after tighter prudential measures led to a temporary slowdown in 2016. As of June 2017, total bank credit increased by 5.8% (end-2016: 5.7%, end-2015: 6.8%), of which 75.3% of the gain can be attributed to the rise in housing loans. Of concern is the resurgence of the riskier investor housing loans, following a contraction through most of 2016.

Australia has one of the highest household debt in the world, at 188.8% of disposable income and 136.2% of GDP in 2016 (2015: 183.0% of disposable income and 132.7% of GDP). Of total, more than 70% were for house financing, of which about a quarter of total housing debt were meant for investment purposes. While household net worth remained at a comfortable level, standing at 521.3% of GDP in 2016, stagnant wage growth and excessive increase in household lending could lead to rising debt burden. In addition, sharper-than-expected increases in interest rates, if they materialise, could also lead to a higher debt service burden, and will have a material impact on private consumption and the economy as a whole.

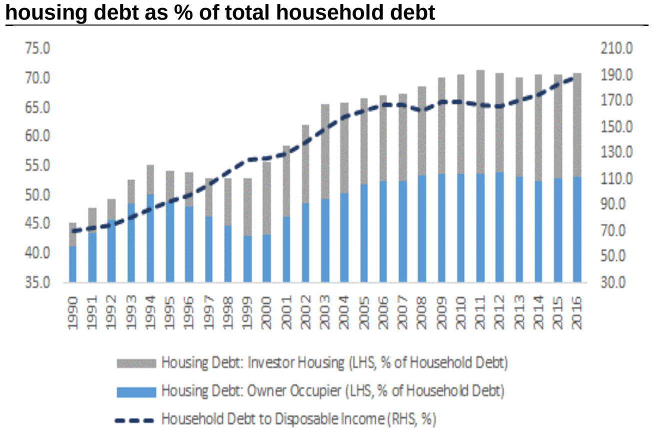
On a positive note, APRA had imposed stricter prudential and regulatory measures since late 2014, which include, among other things, lower loan-to-value ratios, 10% annual growth limit for investor housing loans, higher banks' capital requirement for mortgage exposures, and most recently, a ceiling of new interest-only residential loans to not more than 30% of total residential loans. While some of these measures had effectively stabilised house prices and residential loans growth over the past year, we are of the view that the regulator should stand ready to tighten further, in view of the reacceleration of higher-risk residential loans growth (e.g. investor housing and interest-only loans).

Chart 9: Home price growth by selected cities



Source: CEIC, MARC Economic Research

Chart 10: Household debt to disposable income ratio and housing debt as % of total household debt



Source: CEIC, MARC Economic Research

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MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
19-07, Level 19, Q Sentral, 2A Jalan Stesen Sentral 2, KL Sentral, 50470 KUALA LUMPUR
Tel.: +603 2717 2900 Fax: +603 2717 2910 E-mail: marc@marc.com.my
Homepage: www.marc.com.my