Australia’s economy slowed more than expected during the 2002-03 financial year. Real GDP growth averaged 2.7% for the year as whole, a little less than the 3% envisaged in the Government’s May budget, and down from 3.8% in 2001-02. In the June quarter itself, real GDP was only 2.0% higher than a year earlier.

This apparently sharp loss of economic momentum was the net result of a markedly divergent pattern of growth across different sectors of the Australian economy. Domestic spending grew by almost 6% in 2002-03, reflecting buoyant household spending combined with a more than 18% increase in business investment. However, nearly half of this increased domestic spending was absorbed by imports rather than by domestic production. And exports fell for a second consecutive year (the first time this has happened since the early 1950s), reflecting the impact of the drought on rural exports (which fell by nearly 13%) and of continued softness in the economies of many of our major trading partners on other exports. This combination of surging imports and falling exports subtracted more than 3 percentage points from overall economic growth in 2002-03. It was also responsible for the dramatic widening in Australia’s current account deficit to more than $42 billion, or 5.6% of GDP.

Economic growth will pick up in the current financial year, on our forecasts to about 3½%. And growth will be better balanced, with exports picking up, whilst domestic spending and imports slow somewhat from the heady pace of the past financial year.

The expected recovery in exports is predicated on the breaking of the drought and an upturn in the world economy.

The past few months have brought increasing evidence that the period of weak global growth which followed the collapse of the late 1990s stock market bubble is now coming to an end. The ‘headwinds’ which have dampened growth since early 2001 – falling share prices, corporate scandals, fear of terrorism, the long build-up to the war in Iraq, higher oil prices and the SARS epidemic – have all receded or reversed sufficiently to allow the substantial stimulus which governments and central banks have been implementing through this period finally to begin to work.

Provided those ‘headwinds’ do not spring up again – a risk which of course cannot be entirely dismissed – the world economy is likely to grow by 4% next year. That would be the strongest performance since 2000.

The emerging upturn in the world economy is not wholly dependent on the US – which is just as well since sluggish demand for labour (the flip-side of strong productivity growth) and the absence of the traditional pent-up demand from households for consumer durables and housing (since these have not declined over the past two years) mean that household spending is likely to play a smaller role than usual in driving the US business cycle. However Japan’s economy is at long last showing signs of more sustainable growth, following an extended period of restructuring by larger companies (although much remains to be done in other areas of Japan’s economy. China has rebounded strongly after taking a temporary ‘hit’ from SARS; and some other Asian economies less affected by the SARS outbreak, notably Thailand and Malaysia, are also experiencing strong growth. Finally, while Europe’s economic performance has been extremely disappointing so far this year, there are signs that it, too, will experience a modest upturn in 2004.
Stronger world growth will boost corporate profits, a prospect now already being anticipated by share markets. It also means that the decline in global interest rates is over, and that central banks in the world’s major economies will eventually start moving official interest rates back towards more ‘normal’ levels. This won’t happen as quickly as global bond markets have begun to ‘price in’ over the past few months. Inflation is likely to remain very low, and unemployment uncomfortably high, in most of the major economies for some time still to come. But by around this time next year, it is likely that at least some central banks, including the US Federal Reserve, will have embarked upon a gradual tightening of monetary policy.

While stronger world growth and a near-record grain crop should produce a rebound in the volume of Australian exports in 2003-04, growth in domestic spending should slow somewhat from the torrid pace of 2002-03.

This latter expectation partly reflects an anticipated slowing in the growth rate of business investment. A number of major non-residential construction and engineering projects will be completed during the current financial year; and some mining projects originally contemplated when the A$ was somewhat lower have since been deferred. Equipment investment will also grow much more slowly this year than in 2002-03, partly as a result of substantially lower aircraft purchases. However, since imports typically account for well over half of all capital goods spending (and more than two-thirds of it in 2002-03), this deceleration in equipment investment will be mirrored by a slowing in import growth, re-inforcing the contribution stronger exports will make to narrowing the current account deficit.

2003-04 should also see some easing in the housing boom. Expenditure on the construction of new dwellings will decline moderately, with an upturn in work on detached housings moderating the impact of a sharper fall in medium-density construction.

More importantly, the rapid gains in residential property prices over the past few years should level off, particularly in Melbourne and Sydney. The spectacular rise in capital city property prices since the late 1990s is largely due to the enormous increase in the debt servicing capacity of Australian households arising from the structural decline in interest rates over the past decade and the faster growth in average real incomes, combined with rapid growth in the number of households which has almost exactly matched the increase in the stock of housing. But with the structural decline in interest rates now having run its course, and the enhanced debt servicing capacity of Australian households almost completely taken up, further significant increases in house prices over and above the rate of growth in average incomes is almost certainly not sustainable.

Arguably the greatest medium-term risk now confronting the Australian economy is the possibility that investors could prolong the boom in property prices, setting the stage for a subsequently more destabilizing correction. Rapidly rising property prices have boosted personal wealth significantly over the past few years, allowing consumer spending to rise faster than disposable income (and contributing to the emergence of negative personal saving rate during 2003-04). If property prices level out over the next year or so, then growth in consumer spending can be expected to ease back gradually to a pace more in line with income growth. If property prices were to fall outright, from a higher level than today, the impact on consumer spending and the economy more broadly could be much more pronounced.

Borrowing for investment housing has been rising rapidly. 45% of all lending for housing over the past 12 months has been to investors and commercial borrowers, rather than to owner-occupiers.
The growing presence of investors potentially represents a new source of volatility in Australian property markets, in that they will be sensitive to rising vacancy rates and changing expectations for price movements in a way that owner-occupiers traditionally are not. Hence it would be a source of comfort if the rate of growth in borrowing for property investment were to ease back somewhat over the course of this financial year.

Over the past financial year the Reserve Bank has had to strike a balance between the risks associated with weakness in the global economy (and, for a time, with the rapid appreciation of the Australian dollar), and those associated with the rapid growth in household borrowing. The result of this 'balancing act' was that interest rates have been left unchanged since June last year. Cutting rates would not have boosted demand from foreign economies; nor would it have made it rain; and these days it might not have stemmed the rise in the A$: but it may well have prompted even more rapid growth in household borrowing.

Now that prospects for the world economy are looking somewhat brighter, the Reserve Bank will be giving greater weight to the risks associated with continued rapid growth in household borrowing. The Reserve Bank will emphatically not be trying to stop the housing price boom in its tracks; rather, their aim is likely to be to lessen the impetus that monetary policy provides to the boom by reducing the extent to which interest rates are below 'neutral' (a level they have previously designated as implied by a cash rate of 5½-6%). In that context, it's likely that there will be one or two ¼ percentage point increases in the official cash rate during the first half of next year, followed by a period of steady rates in the second half (during which a Federal election is likely to be held).

The fortunes of the Australian dollar will continue, as they have done since the late 1990s, to mirror those of the US dollar. The steady decline in the US dollar from its peak in February last year has more recently been partially reversed as global investors moved to position themselves for a recovery in the US economy and stock market.

However as economic recovery becomes more synchronized around the world during 2004, the US will encounter greater difficulty attracting sufficient capital both to finance its widening current account deficit and push the US dollar still higher. Rather, next year is likely to see a resumption of the US dollar’s decline, initially against ‘freely floating’ currencies such as the euro and the Australian dollar; and, at a later stage, against at least some of the Asian currencies if and when Asian central banks reach the limits of their preparedness to buy US dollars in order to prevent their currencies from rising. With Australia’s current account deficit likely to be declining sharply (to about 3½% of GDP) next year, and the US dollar to be falling, the Australian dollar is likely to make another run at the US70¢ level.

Australia’s economy has withstood the difficult global economic conditions of the past three years remarkably well, largely as a result of good economic management but not without an element of luck. Turning a temporarily blind eye to the emergence of some imbalances (such as the current account deficit and a negative personal saving rate) has been a small price to pay for this outcome. But as the world economy begins to brighten, it will be in the longer term interests of Australia’s economy for a more balanced pattern of growth to be restored. This seems the most plausible scenario for 2003-04.

- Saul Eslake
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