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8 economic overview

Chris Caton sees the threat of US recession hanging over Australia's economy, and the new government facing a fiscal policy challenge.

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Executive summary

2007 was a year of surprises. The Australian economy grew more rapidly than expected, headline inflation was lower than expected, and interest rates were raised twice – in an election year. While monetary policy was being tightened, fiscal policy was being loosened; an odd result to say the least. The Coalition tried in vain to convince the electorate that it was demonstrably superior to Labor at the task of economic management. The current account deficit increased again, despite further improvement in Australia's terms of trade. The exchange rate hit levels not seen for 23 years, with some speculating about parity with the US dollar.

The world economy continued to grow well, although financial market turbulence, following on from the sub-prime crisis in the United States (US) had many expecting real economic flow-on effects from the subsequent extraordinary jamming up of credit markets.

Looking ahead, the consensus view sees a sixth successive year of above-trend world growth, which will be an extraordinary result. There is, however, one major threat: the possibility that the soft landing in the US morphs into something much harder, with the dreaded "R" word being used by many. Were this to occur, and the risk is high, then we are likely to discover that the rest of the world economy has not "decoupled" from the US, and Australia will not be immune. If the consensus forecast turns out to be correct, however, Australia should enjoy another year of solid growth. In this case, we may pay a price: unless growth falls back to trend of its own accord, inflation is likely to pick up, and the Reserve Bank of Australia (RBA) will raise rates again.

The Australian economy in 2007

2007 was certainly an interesting year. First, the Australian economy did remarkably well, growing by almost 4 per cent, the strongest rate since 2002. Employment grew by 2.7 per cent in the year to October, and the unemployment rate fell to a 33-year low of 4.2 per cent. Also, bear in mind that growth was held back by the drought; indeed, the

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This article was written before the financial market instability of January 2008. The forecasts contained in the article remain current.

non-farm economy grew by almost 4.5 per cent. It is said that success has many fathers, and many are prepared to take responsibility for this growth performance. The extraordinary boost to Australia's income arising from the commodity-price boom has certainly been a major cause. The rise in Australia's terms of trade (the ratio of export prices to import prices) is estimated to have added about 6 per cent to real incomes in just the past four years; there isn't another developed country in the world on which the gods have smiled to this extent.

In 2007, business fixed investment was once again the strongest component of demand, increasing by more than 12 per cent. As has been the case in recent years, much of this growth came from the mining industry, as commodity producers endeavoured to increase capacity. Consumer spending increased by close to 4 per cent. Government spending slowed to 2.6 per cent, while residential construction grew by close to 3.5 per cent. Trade continued to be a drag on growth, with imports growing by more than 10 per cent, and exports by just 4 per cent. Despite the increase in our terms of trade, the current account deficit blew out from $55 billion in 2006 to close to $62 billion in 2007. The blow-out came mainly from the net income deficit, which increased mainly because of the profits made by foreign-owned resource companies. Note that these profits are included in the current account deficit (CAD) even if they don't leave the country.

Those whom the gods wish to destroy, they first make economic forecasters

It has to be said that the strength of the economy in 2007 was a major surprise. When I wrote last year's *Economic Overview*, my forecast – which was below the consensus view at the time – was for 2.8 per cent GDP growth, and for the unemployment rate to drift upwards and average 5.1 per cent for the year. Expected consumer price index (CPI) inflation was put at 2.7 per cent (it will be closer to 2.3 per cent), and yet I expected no further interest-rate rises, mainly because of the only moderate expected pace of growth. I also fearlessly predicted that the Australian dollar would average 75 US cents. And there was not one word in the 2007 Economic Overview about the Shanghai share market, or about sub-prime mortgages. I prefer to believe that this doesn't mean that I'm a bad forecaster; rather it means that in any one year there will be unexpected events. Add in the increased volatility in share markets, and in the Australian dollar, and you would have to say that 2007 packed more than its share of surprises.

As good as it has been, growth cannot continue at its 2007 pace. The economy is running out of room; it is bumping up against the ceiling in many industries, and tales of labour shortages abound, particularly in the West. Inflationary pressures have increased, and the RBA felt it necessary to raise interest rates twice last year after three increases in 2006, with the expectation that there may be more to come.

Monetary policy – a first time for everything

The RBA has never before raised rates in an election year, and now it has increased rates during an election campaign. This move was not without controversy. The RBA's job is to keep headline CPI between 2 and 3 per cent, and when it raised rates in November the CPI had risen by just 1.9 per cent, below the lower end of the target range, as the Coalition was diligent in reminding us. So why on earth did the RBA raise rates?

What the RBA did is the right thing. First, the oft-repeated claim that rates never go up in an election year is mainly because, more by good luck than good management, election years have usually coincided with periods in which rates have actually been falling.

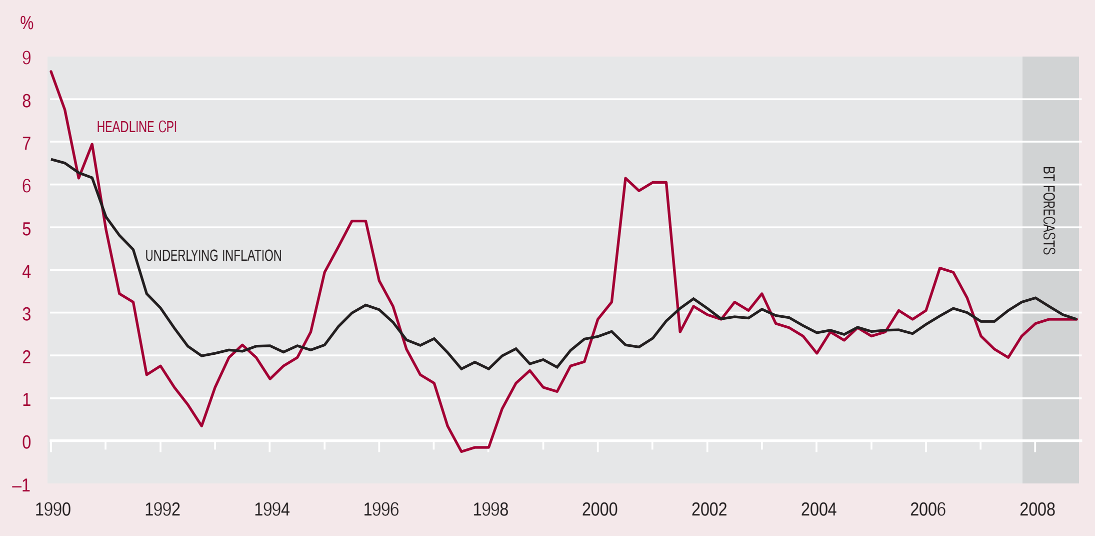
This was true in 1993, 1996, 1998 and 2001. The only time it hasn't been true in modern history was in 2004, when one could make the case that the RBA hiked early (in 2003) so that it wouldn't have to in 2004.

Second, the RBA's focus is on future inflation, rather than the current rate, and when it looks at growth in the non-farm economy, and at the 33-year low in the unemployment rate, it is justified in drawing the conclusion that inflation pressures are building up. Indeed, we already have something of an inflation problem. The RBA calculates a measure of "underlying" inflation – the technical details need not concern us here, but it aims to strip the headline rate of "one-offs" – which it believes gives a better indication of where inflation is going. That measure currently stands at 3 per cent and, almost inevitably, will be above 3 per cent for at least the next two quarters (see Figure 1).

While the fact that the headline measure is currently below the bottom of the target range did give the RBA a presentational problem, the low reading for year to September was a complete fluke, owing a lot to a change in childcare subsidy arrangements and to (drum roll please) bananas, which rose rapidly in price in the June quarter 2006, but have since fallen hugely. Now as soon as one starts taking stuff out of the headline measure, some others smell fish, so let's not take anything out. Let's instead change the period over which we measure inflation to get around the banana issue. If we begin before banana prices rose, in the March quarter 2006, and measure headline CPI inflation over the following 18 months, to the September quarter 2007, we get 2.9 per cent inflation (annual rate). If, on the other hand, we start after banana prices fell, in the March quarter 2007, we get 3.8 per cent. No more needs to be said; inflation is already uncomfortably high.

Figure 1

Australian inflation: Annual percentage change in the CPI and the underlying price level



Source: Australian Bureau of Statistics (ABS)

The RBA's statement accompanying the rate rise was hawkish, with a strong suggestion that there may be at least one more rate rise to come. It had to say this. The RBA had just raised rates two and a half weeks prior to an election; it couldn't leave anyone with the impression that the hike was anything other than absolutely necessary, and the easiest way to do this was to signal that there will probably be more to come. Unless inflation pressures recede quickly in Australia, rates may rise further, but it is by no means inevitable. As I shall argue below, there is a strong chance that the US economy will slow further in the near future, which may well have knock-on effects on the Australian economy.

Changing the guard: what difference does it make?

There has been a good deal of concern about the market and economic effects of the election result. Suffice it to say that elections have no systematic (or even discernible) effect on markets. As to the economy, I don't know a single private-sector economist who had two forecasts for the future economy depending on which side won, and there are good reasons for this. In particular, the argument as to which party will oversee higher interest rates is at best inconclusive and at worst silly. The Coalition points to a 17 per cent variable mortgage rate under Labor in 1989, while Labor can point to a 22 per cent short-term bill rate, and a 13 per cent variable mortgage rate, under the Coalition in 1982. Both parties apparently live in a glasshouse.

The world has changed hugely in the past 18 to 25 years. First, inflation is lower (it hit 12 per cent in 1982 and 8 per cent in 1989), so interest rates are now so much lower, and we are not going back to high inflation. Second, the extremes in interest rates in 1989 occurred in the immediate aftermath of the deregulation of the banking sector, when banks lent like there was no tomorrow (think Bond, Skase and so on), and businesses and consumers kept on borrowing until rates were close to the stratosphere. Finally, of course, the setting of rates is now out of the hands of the politicians, so any tendency to go for broke now and worry about the consequences later simply won't happen. If we really want to keep rates low, perhaps we should just have elected the RBA!

There will, of course, be some economic effects of the change in government. The phasing out of workplace agreements (AWAs) runs the risk of leading to higher wage inflation, given the current tightness of labour markets. But bear in mind that the phase-out will be slow, that less than 10 per cent of workers are covered by an AWA, and that there will be something that looks very much like an AWA for many workers making more than $100,000. So the magnitude of this effect should be small.

On the other hand, there is reason to believe that fiscal policy may be more responsible under Labor. This may seem like an extraordinary thing to say, so let me justify it. Both parties behaved like drunken sailors in the run-up to the election, signing chits for tens of billions in tax cuts and spending promises. Labor did promise somewhat less, it is true, but that's not where its advantage comes from. Labor has indicated that it will look hard for areas of spending that can be cut to offset (partially) its largesse elsewhere. It's always going to be easier for a new government to find areas of (the previous government's) spending to cut!

There are likely to be economic differences as a result of the two sides' different degree of enthusiasm for climate-change policies. Labor has now ratified the Kyoto Protocol. Figuring out the effects of policies designed to slow down climate change is a very new sport, so there is a good deal of uncertainty about magnitudes. But it seems clear that

> … there isn't another developed country in the world on which the gods have smiled to this extent.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any such policies will tend to reduce growth and increase inflation in the short term, being the price we have to pay to improve the environment, and hence the economy, in the long term.

At a sectoral level, climate change policies will clearly be positive for companies involved with renewable energy, and negative for the rest of the energy sector, since the cost of energy will surely rise.

Economic performance by state

The 2007 story was not much different from previous years. The resource-rich states led the way. In the year to the September quarter, growth rates of gross final demand ranged from 1.3 per cent in South Australia to 12 per cent in Western Australia. In the year to October, trend employment growth ranged from 1.2 per cent in South Australia to 4.2 per cent in Western Australia. Somewhat oddly, these were the only two states where the trend unemployment rate didn't improve over the same interval. Trend (smoothed) unemployment ranges from 3.5 per cent in Western Australia to 5.3 per cent in Tasmania (see Table 1).

Early in the year, there was still talk of a "technical" recession in New South Wales. This was never likely. The difference in economic performance between states largely reflects differences in industrial mix, with a large mining sector being a big plus and a large manufacturing sector a big minus. (This shouldn't be news to anyone!)

The story should be broadly similar in 2008, unless commodity prices fall significantly, which will make times tough in Western Australia and Queensland in particular.

Fiscal policy: what is the correct stance?

Both major political parties are committed to balancing the federal budget "on average over the course of the business cycle". A little thought

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suggests that when the economy is strong, the correct fiscal policy response is to run a surplus, and to allow this surplus to increase, as a share of GDP, as the economy strengthens further. Similarly, when the economy is weak, the Budget should be allowed to fall into deficit. This is known as counter-cyclical fiscal policy.

TABLE 1
Labour market performance by state
Trend Measure (%)

	EMPLOYMENT GROWTH	UNEMPLOYMENT RATE	
	Year to October 2007	October 2006	October 2007
New South Wales	1.7	5.0	4.6
Victoria	2.7	4.8	4.3
Queensland	3.1	4.2	3.8
Western Australia	4.2	3.4	3.5
South Australia	1.2	5.0	5.0
Tasmania	2.3	6.1	5.3
Australia	2.5	4.6	4.3

Source: ABS

One way to permit this to occur is to do nothing, and simply allow the Budget's "automatic stabilisers" to work. The automatic stabilisers ensure that tax revenues grow faster than spending when the economy strengthens (in part because many spending programs are relatively static, and in part because spending on welfare and unemployment benefits should fall as the economy strengthens), and conversely when the economy weakens. In fact, many would argue that doing nothing is the least one should do, and that discretionary policy moves should add to the variation of the surplus/deficit over the course of the business cycle.

Instead of this, we have fallen into a standard operating procedure that means that fiscal policy is, in fact, pro-cyclical. The rule appears to be that appropriate policy is to run a surplus of about 1 per cent of GDP, almost without regard to the current state of the business cycle. Accordingly, we have had individual tax cuts in each of the past five Budgets, even as unemployment came down. And thus, during the election campaign, we were told that it was correct to consider/promise further tax cuts because the economy had grown so strongly. Strong growth meant that the cuts could be afforded.

This makes some political sense. There is no constituency, for example, for ever-larger surpluses. One can only imagine how the Treasurer would have been greeted on Budget night had he announced no new fiscal measures, along with a projected surplus of more than $20 billion! But to go from there to the oft-repeated statement that so long as the surplus remains constant as a share of GDP fiscal policy is not expansionary, turns expedient politics into very bad economics. To repeat, as the economy grows above its trend pace (which generally means that the unemployment rate is falling), the surplus should be allowed to increase as a share of GDP.

Does this then mean that the annual individual income-tax cuts were just plain wrong? No, although they were overly generous. First, much of the tax cuts were financed by the extraordinary growth in company profit taxes, which itself reflected the commodity price boom. That boom was not caused by the strengthening Australian economy, so the ensuing revenues could be treated as a windfall. (A word of warning: fiscal policy is going to have to be remarkably adroit if and when commodity prices fall, and revenues are thus weakened significantly). Second, the tax cuts were designed to affect work incentives, and hence to increase the future supply of labour and the level of GDP. They will do this to some extent, although the experience of the US in the early 1980s, when President Reagan cut taxes significantly in the name of supply-side economics, suggest that such cuts always increase demand more than they do supply.

As mentioned, when the economy is growing above trend, neutral fiscal policy requires the surplus to grow as a share of GDP. But by how much? This is not so easy to answer. Indeed, it may be that keeping the surplus constant as a share when the economy grows is some way down the list of deadly sins. But it is certainly odd that, as has been the case in recent years, we are loosening fiscal policy at the same time that we are tightening monetary policy. Odd, yes, but still not manifestly wrong. Former Treasury Secretary John Stone, for example, has argued that it's the right thing to have been doing because, in his view, fiscal policy is too tight and monetary policy too loose. And the RBA itself has suggested that the progressive loosening of fiscal policy in recent years may have made little difference to the path followed by interest rates. That said, it surely has added to the pressure of demand, and hence must have added to the risk of more rate rises.

> "The economy is running out of room…"

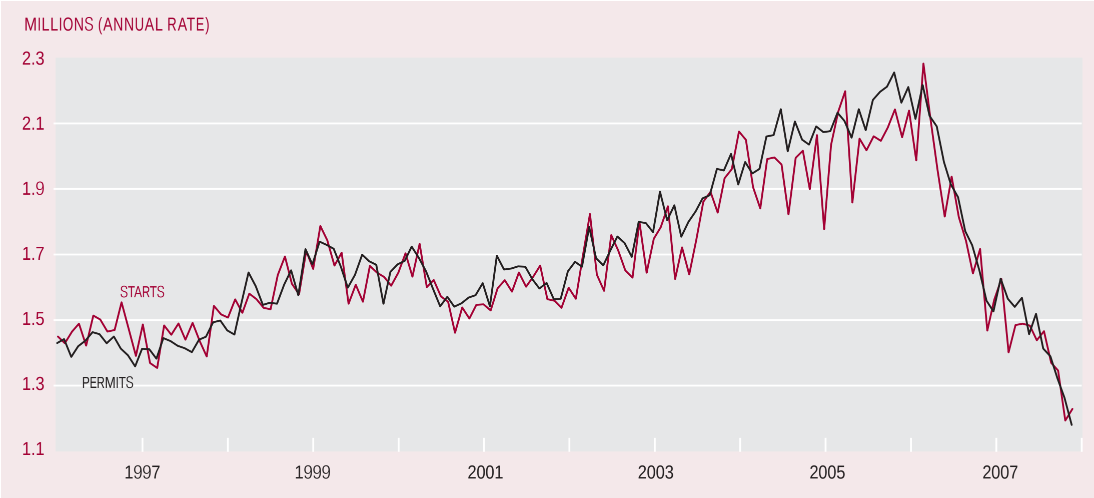
The world economy in 2007

The world economy had a good year in 2007. Indeed it was the fifth successive year of above-trend growth, a performance unmatched for several decades. On a purchasing-power parity basis, the world economy grew by more than 5 per cent.

China again led the way, growing by more than 11 per cent, its fifth successive year of double-digit growth. Other developing economies also did well, with India growing by more than 8 per cent.

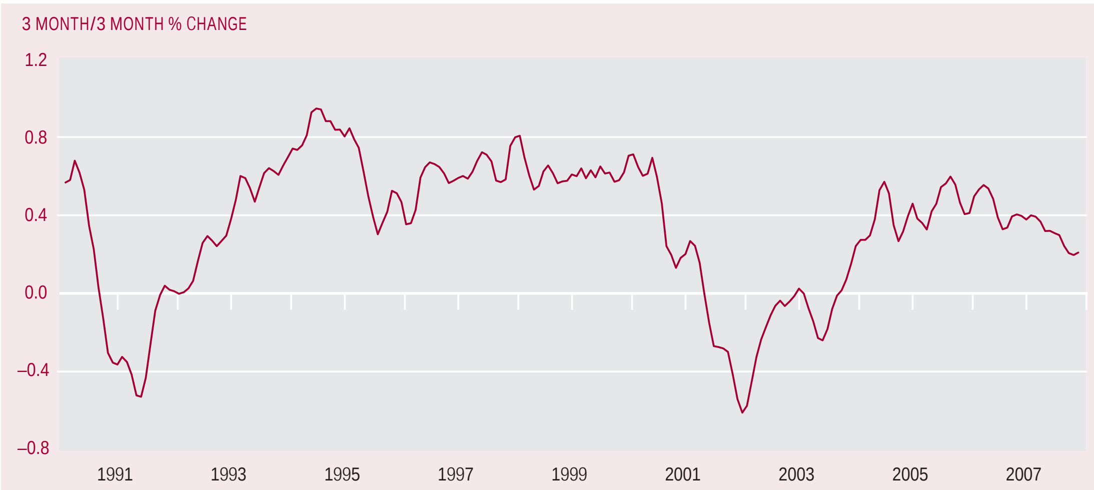
In the developed world, growth expectations have been cut back since the financial market turmoil began in mid-July. Japan yet again flattered to deceive, with expectations of 2.5 per cent growth early in the year being cut back to an estimated 2 per cent. The Eurozone, which picked up speed from 1.6 per cent growth in 2005 to 2.9 per cent in 2006, turned in a relatively respectable 2.6 per cent (estimated) in 2007. The US economy slowed from 2.9 per cent growth in 2006 to about 2.2 per cent in 2007. Last year, I wrote about the possibility of a hard landing in the US. That remains a risk; indeed, it is far and away the biggest economic risk.

Figure 2
US housing:
US permits and starts, annual rate, in millions



Source: Datastream

Figure 3
US employment doesn't look like a recession (yet?):
Total US non-farm employment, quarterly figures, three-month percentage change



Source: Datastream

As mentioned, growth in the US has clearly slowed, from more than 4 per cent to 2–2.5 per cent in less than two years. But 2–2.5 per cent growth is not a disaster; it represents a soft landing.

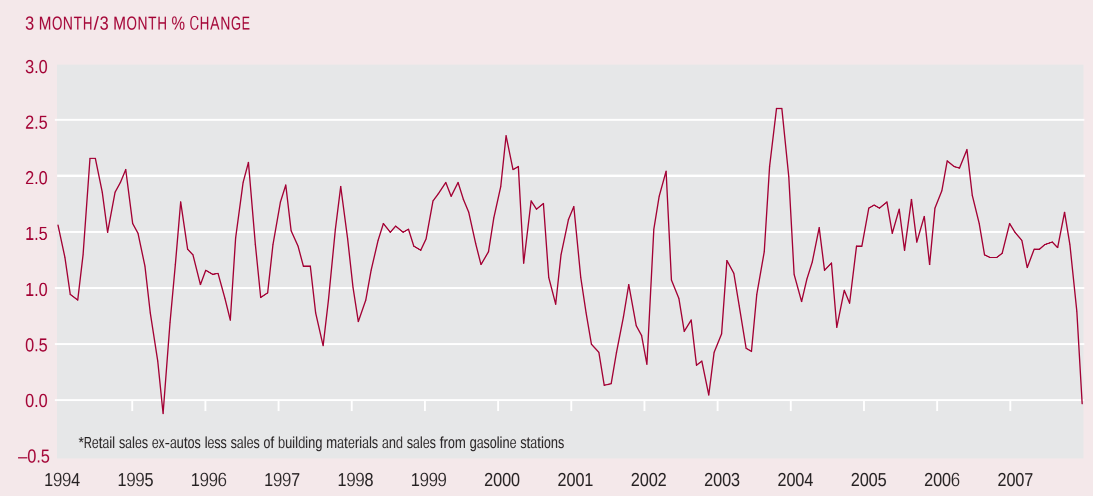
The question is: will US growth slow still further, to the point where output actually falls? The answer will depend on what happens next to the housing sector, which has caused most of the weakness to date. Housing starts have fallen some 46 per cent from their January 2006 peak, and they haven't hit bottom yet. The collapse in housing contributed to the sub-prime mortgage problem, since it caused house prices to stop rising and start falling, and thus pushed many sub-prime borrowers into a position where they held negative equity in their homes. Likewise, the sub-prime problem has a significant feedback effect on housing starts since it, together with the consequent tightening of credit conditions for all borrowers, clearly affects the future demand for housing (see Figure 2).

The decline in housing starts has led to a massive 16 per cent fall in residential construction spending in the past year. So far, the rest of the economy has remained relatively impervious, although there is some sign of weakness recently in retail sales, and the labour market is clearly softening. So-called "non-volatile" retail sales have fallen in the past three months; this hasn't happened since 1995. Private-sector employment has risen by just 0.25 per cent in the past three months (see Figure 3).

Let me give you some rather chilling facts:

- You have to go back to 1966 to find the last time that housing starts fell by 46 per cent or more and there wasn't a recession.
- You have to go back to 1967 to find the last time that private-sector employment slowed to its current pace and there wasn't a recession.

Figure 4
US retail sales:
Less automobile, building materials and gasoline station sales, quarterly figures, three-month percentage change



Source: Datastream

- In the past year, employment has grown more slowly than in the 12 months leading up to any of the previous ten US recessions in the post-war period.
- A three-month moving average of the unemployment rate has risen by 0.26 percentage points from its trough early in 2007; there are no instances in the post-war period in which this average has risen by 0.3 percentage points and a recession hasn't ensued.
- The consensus view of economists has never forecast a recession before it has begun.
- In March 2001, 95 per cent of US economists surveyed said that the US would avoid recession that year. According to the official scorekeepers, the National Bureau of Economic Research, the 2001 recession began that month.

Does this mean that a US recession is inevitable? No it doesn't. First, while employment growth has clearly weakened, at any one time there will be a range of indicators about the health of the overall economy, and the employment report has been towards the weak end of this range. Second, the US Federal Reserve is on the job. It has cut rates three times already, and has made it clear that it is prepared to cut again. This must help, although history suggests that rate cuts can only ameliorate a recession rather than prevent it. But clearly, what the above considerations do mean is that one can't be complacent about the immediate future of the US economy.

The key will be what happens to consumer spending, which in the US is close to 70 per cent of GDP. So far it has held up well, although consumer confidence has fallen significantly in recent months. If consumers begin to worry about their job prospects, their loss of wealth because the price of their house has fallen, and the rising price of gasoline, then the economy could be in serious trouble. And there is just a hint that this may be beginning to happen. In the past three months, so-called "core" retail sales (which exclude cars, gasoline and building materials) have fallen, for the first time in 12 years (to be fair, the fall 12 years ago did not cause a recession) (see Figure 4).

Share markets usually see recessions coming (they are smarter than economic forecasters), and thus they weaken early. The current period of share-market weakness is primarily due to continued concern about the knock-on effects of the sub-prime episode, but it may eventually be seen as presaging economic weakness. Incidentally, on 26 November, the S&P 500 index closed down 10.1 per cent from its October peak. This is the first 10 per cent "correction" in the long bull market since March 2003, and this is a record length of time to go without such a correction.

Of course, a weak US economy doesn't mean what it used to do. There is an emerging view that the rest of the world can "decouple", and continue to grow at a healthy rate despite US weakness. This is true to some extent, but weakness in the US still matters, and the overall world growth story is likely to be less supportive going forward. Note that there has recently been speculation about weakness in Japan, still the world's second-largest economy, and European growth prospects have stopped improving.

This, of course, leaves Asia, and China in particular. China is still growing at double-digit rates, and a lot of this comes from domestic sources. In addition, it is frequently argued that China is now less dependent on the US than it used to be because Europe is now a more important destination for China's exports. This argument is wrong – what is important is that exports to the US are a larger share of China's GDP than they used to be. A slowdown in the US will certainly affect China's and Asia's growth – the question is by how much.

"A slowdown in the US will certainly affect China's and Asia's growth – the question is by how much."

That said, the consensus forecast for world economic growth sees China again growing by more than 10 per cent, Japan turning in its usual moribund less than 2 per cent, and Europe growing by about 2 per cent.

The 2008 outlook for Australia

Let us assume for the moment that the consensus forecast for the world economy is correct: that the US avoids recession, and that world economic growth continues at an above-trend pace (for the sixth year in a row!). What then is the outlook for Australia?

The consensus view foresees somewhat slower growth next year, but still sees GDP advancing by about 3.7 per cent. Once again, my forecast would be somewhat lower, around 3.3 per cent. Business capital spending, in particular, is thought likely to slow, to just 6 per cent growth, while consumer spending slows to 3.3 per cent growth. This is close to an optimal result; faster growth would increase concern about the build-up of inflationary pressures, and thus add to the upward pressure on interest rates.

The consensus view is that the unemployment rate will to drift up slightly, to an average of 4.6 per cent, while inflation is expected to be close to 3 per cent. This latter forecast is worrying – if it becomes reality, the spectre of interest-rate rises will be with us throughout the year. Adding to the pressure on inflation will be the strength of oil prices, and the possible end to the "export of deflation" by China. Going the other way will be the effects of the strong Australian dollar. That said, Australian inflation is now less sensitive both to energy prices and to the price of imports than it used to be. The current account deficit is expected to remain around $60 billion.

My view is that the risks to both growth and inflation next year are on the downside, mainly because I am not as optimistic as the consensus about the US economy.

Financial markets

It has certainly been an eventful and volatile year for financial markets. There have been three significant share-market corrections. November 2007 was the worst month for the US market in more than five years. In addition, exchange-rate markets have been extremely volatile, with the biggest story being a chronic weakening of the US dollar. Gold and oil prices have also hit record levels.

The first two share-market corrections occurred because markets were overvalued. Overvalued markets do not have to fall, but while they are overvalued they are vulnerable to shocks, and these shocks can take surprising forms. At the beginning of the year, very few would have predicted that the two catalysts for share-market corrections would have been a fall in the Shanghai share market (which doesn't even matter all that much for the Chinese economy) and US sub-prime mortgages. The third correction appears due to continuing concern about the sub-prime issue, and the possible knock-on effects on the US economy, and hence on corporate earnings. History, of course, teaches that one should buy the dips, but it's very difficult to apply that lesson optimally in real time as markets weaken.

The Australian market, as it always does, followed overseas markets down. Between mid-July and mid-August, the ASX 200 fell by about 13 per cent, and then recovered so quickly that it hit a record high in October. While the Australian market will continue to react to overseas market developments, it also dances to its own tune these days, with commodity prices being an important consideration (see below). Incidentally, something remarkable occurred in the US share market on 26 November. On that day, the S&P 500 index closed 10.1 per cent below its October peak. This was the first "correction" since the market turned in early 2003, and this is a record length of time for the US market to go without such a correction.

A word of caution about the Australian market: we usually trade on a lower price/earnings (P/E) ratio than the rest of the world, mainly because of the relatively large size of both the financial and resource sectors. Right now, the Australian P/E ratio is higher than that for the world on average. This suggests that the Australian market is starting to look relatively expensive.

It is worthwhile pointing out that part of the strength of share markets in recent years has come from the fact that profits have increased as a share of GDP. In both the US and Australia, that share has hit a record high in the past two years, but in both cases it has fallen recently. When profits stabilise as a share of GDP, the impetus to share markets will be less, and this is even more true if the profit share falls significantly. Message: share-market gains will slow in 2008.

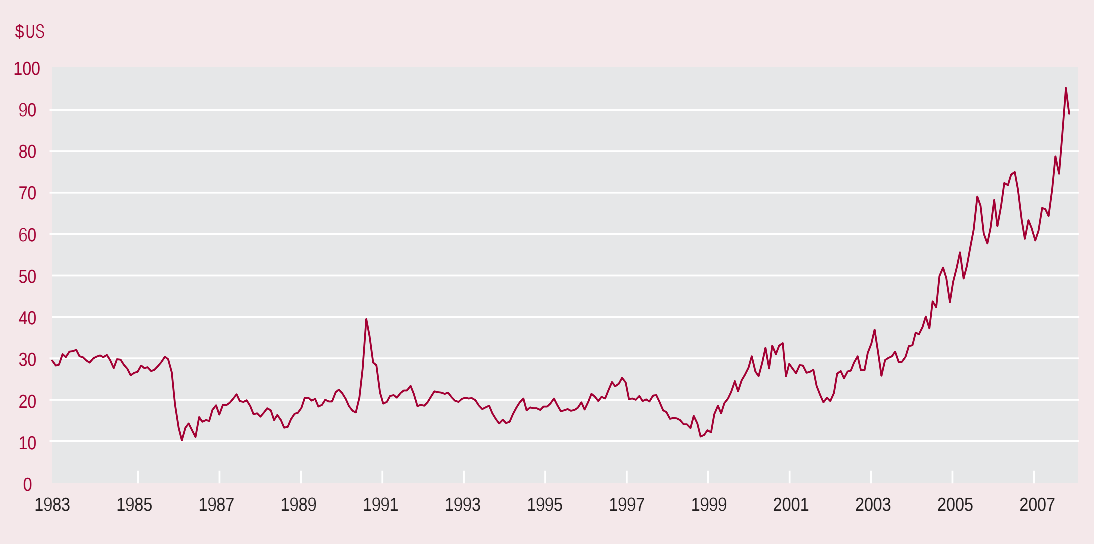
Meanwhile, credit markets remain extremely perturbed. Short-term market rates are very high relative to official rates, reflecting the continued unwillingness of lenders. Among other things, this means that monetary conditions are tighter than suggested just by looking at official short-term rates. At least one Australian mortgage lender has announced a hike in its variable mortgage rate as a result of the higher cost of funds in the wholesale market. This, of course, should reduce the further official tightening required to slow growth.

Commodities

Commodity prices continue to be strong. In recent months, rural commodity prices have led the way, with wheat prices up by 36 per cent in the three months to October. The picture for base metals has been more volatile. They fell in the market turmoil in August, but then recovered to some extent,

Figure 5

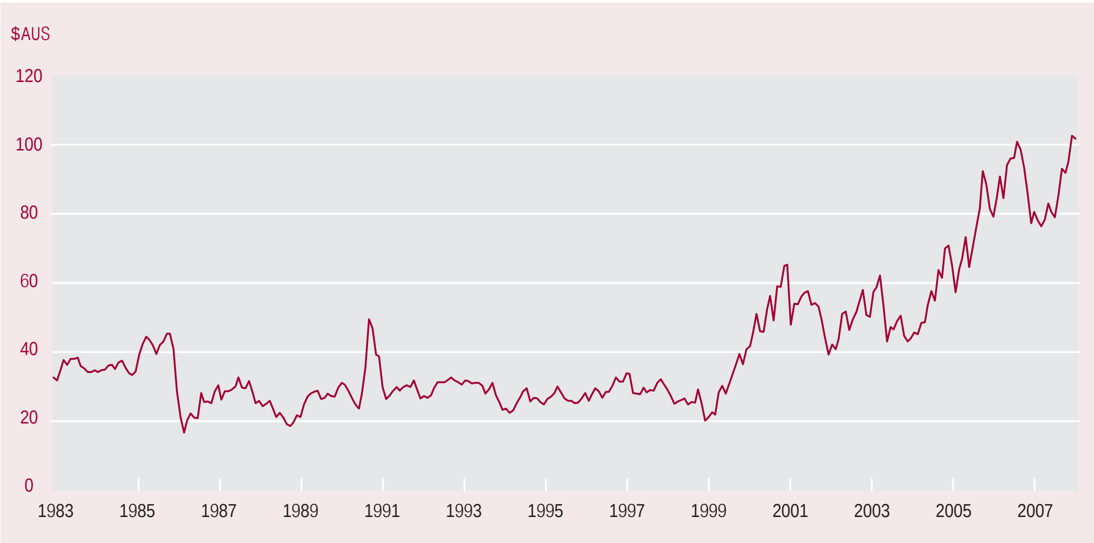
West Texas crude price in $US per barrel



Source: Datastream

Figure 6

West Texas crude price in $A per barrel



Source: Datastream

> The Australian market, as it always does, followed overseas markets down.

although they remain generally well below their peaks of early May. Forecasts show base metal prices remaining close to their current levels for some years. Meanwhile, iron ore and coal contract prices are expected to rise further over the next year, with ore contract prices expected to rise by 30 per cent in April 2008.

This would suggest that there is still some potential upside to the resource sector. In particular, the recent takeover activity in the sector suggests that the players themselves remain optimistic.

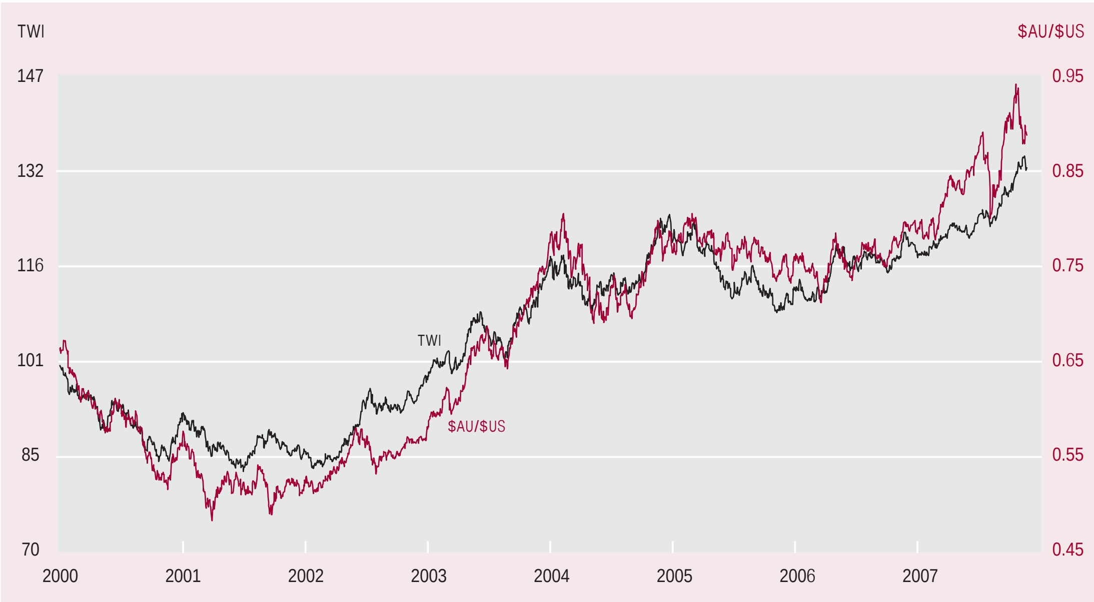
I mentioned earlier that Australia had benefited hugely from the increase in its terms of trade. Among other things, this has been a major source of finance, via surprisingly strong company tax receipts, of the now-annual income-tax cuts. We may just have seen the thin end of the wedge; the terms of trade fell by 0.8 per cent in the September quarter, the first fall in about six years!

Two important commodities worldwide are, of course, oil and gold. Oil prices continue to defy gravity. A year ago, West Texas Intermediate sold for $US60 per barrel; lately the price has threatened to hit the $100 barrier (see Figures 5 and 6). And still it seems to have little or no effect on world growth prospects, or even on core inflation. The latest spike appears to owe a lot to a pickup in Middle East tensions, and to speculation; it is important to point out that demand for oil has not been growing rapidly .

As I wrote at some length last year, I have never been a believer in the so-called “peak oil” theory,

Figure 7

The Australian dollar and the US Trade Weighted Index (TWI)



Source: Datastream

which states that we are at or near the point where it's difficult to increase the rate of extraction of oil from the ground. Were this the case, with the developing world still increasing its demand for oil, the only way the market could clear would be by persistent increases in the price of oil. My belief is that the price is already high enough that it will lead to greater exploration, improved technologies to extract from existing fields, and greater use of admittedly very inefficient forms of oil, such as tar sands and shale oil. Accordingly, my forecast would be that the price will be lower a year from now, perhaps around $US80 per barrel. That said, oil will never be cheap again.

The price of gold has soared to a record high. At the time of writing, the price is $US825 per ounce, up from $630 a year ago. It's not the only factor, but the biggest single cause of the gold price rise (and of the price rises in many other commodities) has been the persistent weakening of the US dollar. On a trade-weighted basis, the US dollar has fallen by more than 11 per cent in the past year, mainly

TABLE 2
The Australian economic outlook

YEAR AVERAGE GROWTH (%)	2006	2007 (ESTIMATE)	2008 (FORECAST)	2009 (FORECAST)
GDP	2.8	3.9	3.3	3.2
Non-farm GDP	3.0	4.4	3.3	3.2
Farm product	–5.6	–19.0	6.0	2.0
Private consumption	2.8	3.9	3.3	3.2
Residential construction	–2.6	3.5	6.0	4.0
Business investment	8.9	12.0	6.0	6.0
Private final demand	3.4	5.5	4.0	3.5
Public final demand	4.0	3.0	4.0	3.0
Stocks (contribution to GDP)	–0.7	0.7	–0.2	0.0
GNE	3.1	5.5	3.5	3.3
Exports	3.3	4.6	7.5	6.0
Imports	7.3	11.0	8.0	6.0
Unemployment rate	4.8	4.4	4.5	4.7
CPI inflation	3.5	2.3	2.8	2.7
Current account deficit ($ billion)	55.1	62.0	60.0	60.0
Exchange rate ($A/$US)	0.75	0.86	0.85	0.85

Source: ABS; BT Financial Group

because of the economic weakness, and hence expected lower interest rates, there.

One other consequence of the weaker US dollar is a stronger Australian dollar. Figure 7 shows something quite remarkable. The darker line is the Australian dollar as a fraction of the US dollar (look to the right scale). The other line is a trade-weighted index (TWI) of the US dollar, measured against the currencies of the developed world, with weights determined by the amount of trade done by the US with each country (look to the left-hand scale). That line is inverted, so that it goes down when the US dollar strengthens, and up when it weakens.

Figure 7 demonstrates that for most of the past seven years, the US dollar has been the principal driver of the Australian dollar. Since March of this year, the story has been somewhat different, with the Australian dollar first rising sharply, apparently because of strong commodity prices and because of the "carry trade", whereby money is borrowed in low-yielding currencies, such as the yen, and invested in high-yielders, such as the Australian dollar or New Zealand dollar. Then, in the flight from risk beginning in mid-July, the Australian dollar fell again, to a low of 78 cents. Order, it appeared, had been restored, but the carry trade took flight once more when equity markets began to recover in mid-August, and the currency was pushed to a 23-year high of 94 cents, albeit for a nanosecond. There was even some loose talk of parity. In recent weeks, the Australian dollar has been in retreat again, and now sits close to 87 cents. The chart suggests that this is now close to "fair value", although fair value will rise should the US dollar continue to fall.

This suggests that after "living in the 1970s" for about three years, the Australian dollar should henceforth trade in the 1980s. On the surface, this makes it hard for (non-commodity) exporters, but recall that most of the strength in the past year has come from the weak US dollar, so cross-rates, against sterling and the euro, for example, are not particularly high.

The views expressed in this article are those of the author, and should not be otherwise attributed.

> "… after 'living in the 1970s' for about three years, the Australian dollar should henceforth trade in the 1980s."