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A long-time CEDA contributor, Dr Caton has built a reputation as one of Australia's liveliest and most engaging writers and presenters on economic matters. He reports that he is kept youthful by his two young children.

The ASX set to close over 4000 points
LOUIE DOUVIS/Fairfaxphotos

CHRIS CATON

economic overview

The world economy in 2005

The world economic recovery continued in 2005, although at a slower pace than in 2004. This is only to be expected – recoveries usually begin rapidly and then moderate. World gross domestic product (GDP) growth, on a purchasing power parity basis, is expected to have come in close to 4 per cent in 2005, down from 4.8 per cent in 2004. Importantly, 2005 growth is still above the long-term average.

As in 2004, most of the heavy lifting was done by the United States and by China. US GDP grew by about 3.6 per cent in 2005, down from 4.2 per cent in the previous year, while China came close to replicating the 9.5 per cent growth it recorded in 2004. China is not only the fastest growing economy in the world – everybody knows that – it also continues to surprise on the upside.

Japan also did surprisingly well. Early in the year, it was generally expected that it would show less than 1 per cent growth; it is now estimated to have grown by close to 2.5 per cent.

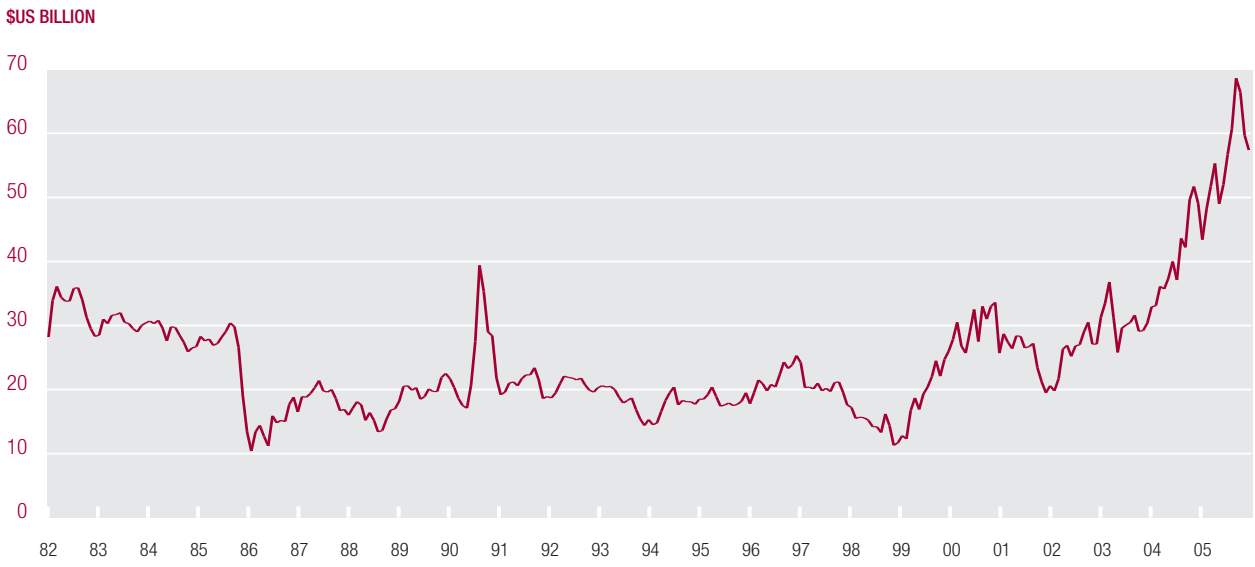
A year ago, this chapter identified three major international issues: oil prices, interest rate rises in the United States and the continued surge in growth in China. These are still with us.

The oil gusher has peaked

This heading is recycled from last year. What this means is that we were wrong 12 months ago. At that time, the oil price (West Texas Intermediate) had retreated from an October 2004 reading of US$55 to US$43, and we suggested the October reading had been a peak. It didn't take long to be proven wrong: the oil price hit US$60 in June 2005 and eventually reached US$70 in the immediate aftermath of Hurricane Katrina (see Figure 1). That looks like the peak; last year's forecast wasn't wrong, it was just early.

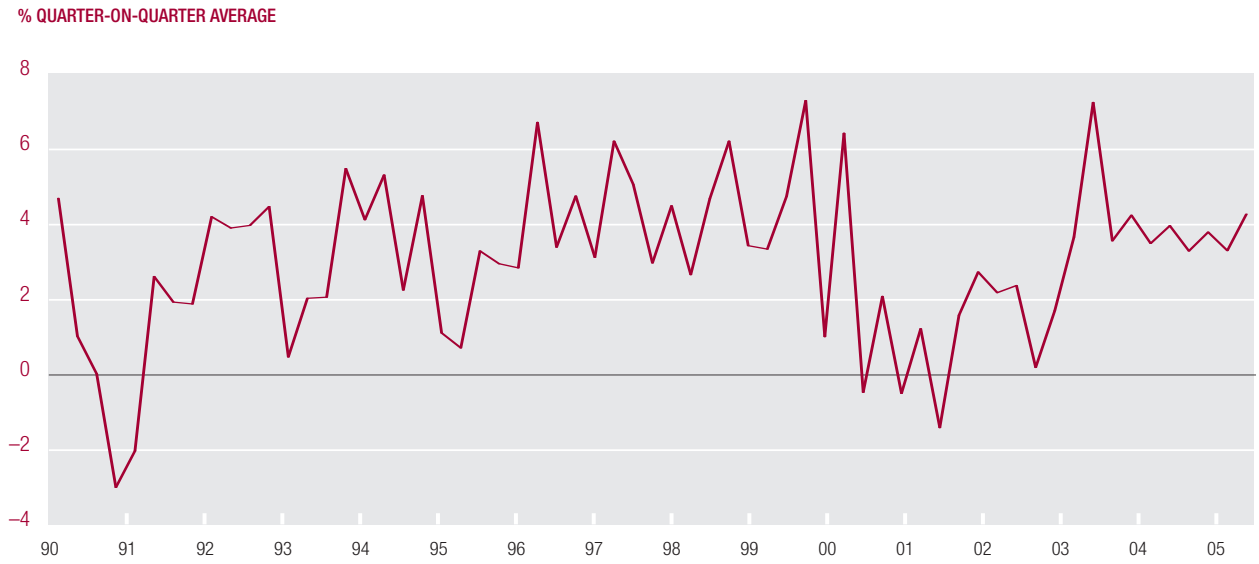
One reason to think this is that the oil price has now been high enough for long enough that economic agents are adjusting. Gasoline consumption in the United States, for example, is now lower than it was a year ago, and sales of SUVs (sport utility vehicles) have weakened significantly. China's electricity industry has now improved its capacity, so there is less reliance on diesel fuel for generation. The International Energy Agency has revised downwards its forecast of worldwide growth in demand for oil in 2006 in each of the past four months.

Figure 1: Oil prices (West Texas) in US$ billion SOURCE: DATASTREAM



It is quite remarkable that forecasts for ongoing world growth, at the current level of close to US$60 per barrel, are very close to what they were when the price was US$30.

Figure 2: US real GDP SOURCE: DATASTREAM



In the past year there has been much talk of reaching "peak production" in the oil industry within a matter of years. Peak production occurs when, despite the fact that there is still a lot of oil down there, it can no longer be extracted in greater volumes each year, because of technological reasons or because the most fecund fields are drying up. If peak production were looming, then oil prices would have to rise still further, but this is not convincing. It can, however, be said that oil will remain relatively expensive, but this probably implies that it settles down between US$50 and US$60 per barrel in 2006 (see Figure 1).

As said last year, the rise in the price of oil was unlikely to derail the world recovery. It is quite remarkable that forecasts for ongoing world growth, at the current level of close to US$60 per barrel, are very close to what they were when the price was US$30. The rise in the price possibly has limited growth, but if it has it has clearly been offset by other forces.

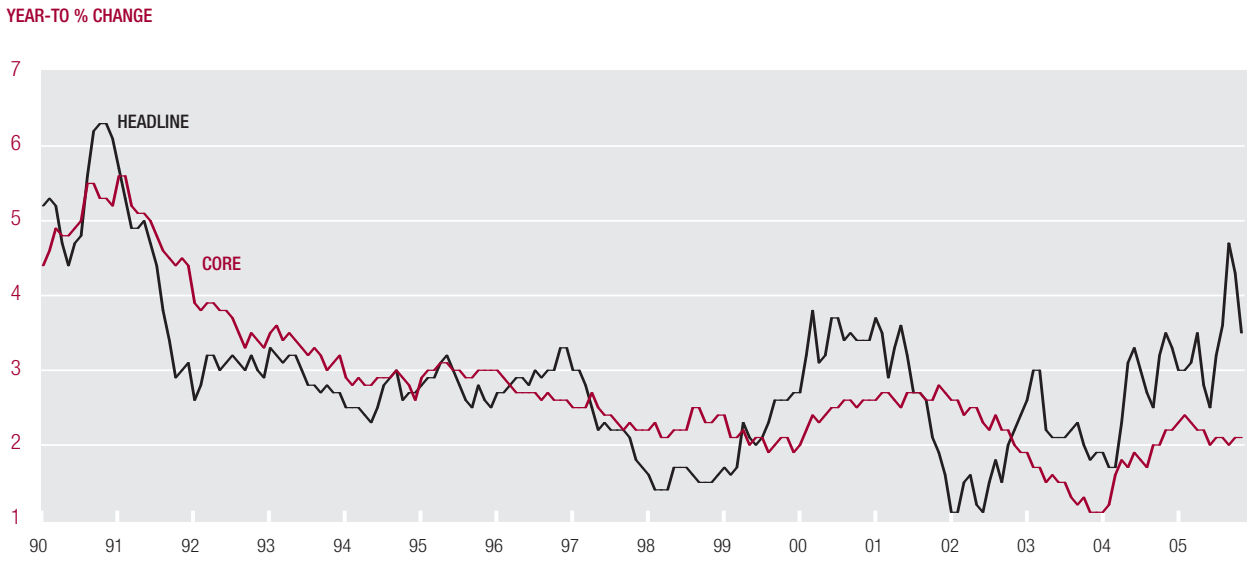
The Fed continues to tighten

How hard must it be to be a member of the Federal Open Market Committee (FOMC), the body that decides monetary policy in the United States? All you have to do is show up at the meeting, raise rates by 25 basis points, make a few minor changes to the accompanying statement and go home. That's what the Fed did all year. At the time of writing, the Fed funds rate was 4.25 per cent, up from 1 per cent in mid-2004 when this process started.

The Fed isn't raising rates because it has to – say, because of problems in the economy – it is raising them because it can, and because the economy is doing quite well. Remarkably, the US economy has grown by between 3.3 and 4.3 per cent (annual rate) in each of the past seven quarters (to Q3 2005). In the history of quarterly data (the post-war period), there has never been such a prolonged period of smooth growth. Such an economy no longer needs "accommodating" monetary policy, so tightening has taken place at a "measured" pace. It is possible that the US economy was knocked temporarily from this smooth path in the last quarter of 2005, but if it was it is almost certainly because of the one-time effects of the ugly sisters, hurricanes Katrina and Rita (see Figure 2).

The Fed is concerned about future inflation, and the main reason for its concern is the virulence of energy inflation. In the year to December, the consumer price index (CPI) rose by 3.4 per cent, with energy prices up by 17.1 per cent. The core CPI, which strips out energy and food prices, was still a remarkably benign 2.2 per cent, but the fear is that energy inflation has

Figure 3: US consumer prices SOURCE: DATASTREAM



been going on for so long that it must shortly percolate through into other prices, in which case the Fed needs to slow the overall economy. The market view is that the Fed funds rate will continue to rise, to 4.75 per cent by mid-year (see Figure 3).

Such a continued rise in US rates should put no pressure on Australian interest rates, but the narrowing of the gap between the two may have some implications for the value of the Australian dollar, of which more will be said later.

US imbalances and their possible effects

Much of the discussion of the United States economy focuses on its perceived problems or imbalances. Americans have a housing bubble, which must burst one day. They don't save enough. The federal deficit is too big (it's actually about US$100 billion lower than it was a year ago). And most importantly, its current account deficit (CAD) is out of control. For 2005, the US CAD came close to US$800 billion, up from US$666 billion in 2004. A figure this large means that the United States is "absorbing" close to 70 per cent of the gross current account surpluses of those countries that are in surplus.

To the extent that the US CAD is a problem, it is a global problem. It is a feature of the "globalised" world that some countries will naturally consume more than they produce (run current account deficits), while others will naturally produce more than they consume (run current account surpluses). The former category includes the United States and Australia, while the latter category includes China, other developing countries in Asia, and Japan and Germany among others. Countries in the first category are quite happy to consume more than they produce, but the countries in the second category are also happy. Running surpluses drives a lot of their growth and, in the case of China, facilitates a rise in living standards.

There is an emerging view – Fed Chairman-designate Dr Ben Bernanke was an early proponent – that the desire of Asian countries to run surpluses is actually the progenitor of this global "imbalance". This is equivalent to saying that there is an *ex ante* excess of world saving over world investment. The "proof" of this is that global interest rates are remarkably low, suggesting an excess of saving. If it were the United States merely inhaling too much global capital then, it is argued, interest rates would be chronically high rather than surprisingly low.

To the extent that the description above is correct, the surprisingly large trade deficits and surpluses around the world are the product of "consenting adult" behaviour. As a result, they can exist for a

long time yet. There doesn't ever have to be a day of financial reckoning. Over time, the US current account deficit should come slowly down. Part of this will happen because of adjustments made within the US economy, but part will also happen because of adjustments elsewhere – China and the rest of Asia will eventually take more internal responsibility for their own economic growth. The consumption share of GDP in China is 42 per cent. In the United States it is 71 per cent. Over time, the Chinese share must rise.

China does it again

For the second year in a row, China grew by more than 9 per cent. It withstood external pressure to revalue its currency for the first half of the year, but then moved the yuan by 2.1 per cent on 21 July. At the same time, it shifted the "peg" for the currency from the US dollar to a basket of currencies. It was generally assumed that the currency would be allowed to revalue further, little by little, but four months after the change it has hardly moved any further (by a grand total of 0.4 per cent) against the US dollar. Since the latter has strengthened over this period, the yuan has probably moved up against the "basket" of currencies to which it is pegged.

Mainly because of the small size of the revaluation, there was no dramatic reassessment of China or Asian growth prospects, or of the likely demand for Australian resources. Accordingly, the entire episode passed without any financial-market volatility. At first glance this is remarkable, given, for example, the sharp reaction in Asian share markets to the Chinese premier's speech in April 2004, when he announced measures thought likely to slow growth dramatically. The lack of financial-market volatility merely emphasises the puny size of the revaluation.

For the moment, the Chinese currency is off the front pages and away from the attention of the Washington solons. This may not last. For now, however, the main China story is the continued robustness of growth. Chinese GDP is expected to grow by more than 8 per cent again this year. If history is any guide, this number will be revised up as the year goes on.

If that were all we knew, it would be a great message for Australian resources. But we also know that commodity prices cycle, mainly because, if prices are high enough for long enough, then capacity expansion takes place and supply responds. For the commodities that Australia sells, history suggests that the average length of time between the trough in commodity prices and the subsequent peak is less than three years. Prices have been rising for more than five years already, and it is difficult to find a forecaster who doesn't think there are another couple of years in the upswing yet. This will make it a very long upswing. Message: at some time in the not too distant future, commodity prices may surprise on the downside.

The sun also rises

The other Asian giant, Japan, also surprised on the upside last year. Early in 2005 expected growth in Japan was less than 1 per cent. It grew by close to 2.5 per cent, and should add at least a further 2 per cent this year. Importantly, the surprisingly strong result was driven by the private sector. Japan is likely to show another year of solid growth, perhaps of the order of 2 per cent, in 2006. This may well have the effect of pushing some price measures, including the core CPI, back in to positive territory. That is, 2006 may be the year in which Japan rids itself of the scourge of deflation.

Japan, of course, benefited significantly from its proximately to, and trading relationships with, China. The United States economy is also an important driver.

Australia has weaned itself from dependence on Japan, although it is still our single biggest export market, so a better performance there is good news.

Europe to do better?

It could hardly do worse. The year was a disappointment in Euroland, with growth once again below average. Next year should be better, as the depressing effects of this year's jump in oil prices dissipate, and as still-favourable financial conditions support domestic demand. Indeed, there appears already to be some improvement in the recent economic data.

The European Central Bank, always a bunch of party poopers, is threatening to raise interest rates, mainly because of concern about the future of inflation.

Meanwhile, across the Tasman

The New Zealand economy has continued to do quite well. Growth in 2005 probably exceeded 2.5 per cent, and its unemployment rate, 3.4 per cent at the time of writing, is at a multi-decade low. Inflation is above the Reserve Bank of New Zealand's comfort zone, so the latter body has been raising interest rates aggressively. The New Zealand cash rate now stands at a world-leading (for developed countries) 7.25 per cent, with the likelihood that it may go higher yet. As a result of the significant interest rate differential, the Kiwi dollar has been remarkably strong, both against the US dollar and the Australian dollar.

The world outlook

In summary, United States growth may slow somewhat this year, but should remain above 3 per cent. China and Japan should come close to replicating their 2005 growth, and Europe should do a little better – it could hardly do worse. As a result, world growth should again be close to 4 per cent on a purchasing-power-parity basis.

It is, as is usually the case, easier to identify downside rather than upside risks to the world outlook. Consumer retrenchment or a dramatic bursting of the United States housing bubble could worsen the outlook there. For whatever reason, Chinese growth could slow dramatically.

Bird flu

There is always something for forward-looking financial markets to worry about, and one of the growing concerns is the possibility of a worldwide outbreak of bird flu.

There is growing belief that bird flu could evolve to the stage where it is capable of being transmitted from human to human and that, even if this doesn't happen, some day soon the world will be faced with the threat of a pandemic. There are reckoned to have been three pandemics in the twentieth century: Spanish flu in 1918–19, Asian flu in 1957–58 and (relatively mild) Hong Kong flu in 1968–69. The first of these was the worst, with a death toll of more than 40 million at a time when world population was less than a quarter of what it is now. There are no authoritative studies of the economic and financial effects of these episodes, and it could be argued, in any case, that economies and markets are so different now that these episodes don't provide any information.

There is one recent example that may throw some light on possible outcomes; namely, the outbreak of SARS in Asia in early 2003. Both consumer and capital spending were reduced significantly in the countries most affected; namely, China, Hong Kong, Singapore and Taiwan. The overall economic cost in East Asia of SARS was estimated to be $18 billion, or 0.6 per cent of GDP. Financial market effects were clearly negative; elsewhere in the world, share markets turned in mid-March, but they continued to fall in Asia. Since April 2003, however, Asian markets have risen faster than other markets, so the market effects of SARS were clearly temporary.

The World Bank has recently attempted to estimate the possible effects of a bird flu pandemic. Its report assumes that such an event could cause between 100,000 and 200,000 human deaths in the United States alone. There would be significant economic losses, caused mainly by "panic and disruption" as people tried to avoid infection by staying away from work places and shops. An outbreak of this magnitude, it is estimated, would reduce world GDP by about US$800 billion (2 per cent). The effects of this on financial markets would obviously be significantly negative.

Investors should not panic. What we have here is a very small probability of a very significant event.

Australia – the long up-cycle continues

Australia began 2005 at a fairly low ebb, at least if the GDP statistics are to be believed. Over the course of 2004, economic growth had slowed significantly. The drought was one reason. Residential construction was falling. Consumer spending growth had clearly slowed. And, finally, there was little growth in the volume of our non-rural exports (remember the stories about Dalrymple Bay and Newcastle).

There is always something for forward-looking financial markets to worry about, and one of the growing concerns is the possibility of a worldwide outbreak of bird flu.

Over the course of 2005 growth actually picked up slightly. The drought was less of a negative, and business capital spending provided some impetus. Much of this capital spending was in mining, clear evidence that commodity prices are having some effect. In the year to the September quarter, GDP grew by 2.6 per cent. Growth for the entire year should come in close to 2.5 per cent. Last year, we forecast 2.9 per cent growth. The result is down from the 3.5 per cent recorded in 2004 (see Figure 4).

As mentioned, commodity prices played a role in this growth. The best manifestation of the commodity price effect comes in Australia's terms of trade – the ratio of export prices to import prices. In the two years to the September quarter, Australia's terms of trade rose by a world-leading 12.4 per cent, which added 4–5 percentage points to real national income growth over that interval. As a result, the profit share of factor income has been pushed to a record high (see Figures 5a and 5b on page 12).

The rise in the terms of trade also accounts for at least some of the strength of employment growth. In the year to November, employment grew by 2.3 per cent nationwide, with the unemployment rate at 5.1 per cent (see Figure 6 on page 13). In commodity-rich Western Australia, employment growth was 4.4 per cent, almost double the national figure, while the unemployment rate fell to 4 per cent. It is rumoured that job advertisements there frequently stipulate "applicant must have a pulse".

CPI inflation hit 3 per cent in the year to the September quarter, with petrol prices playing a large role. The underlying measures favoured by the Reserve Bank of Australia (RBA), however, remained closer to 2.5 per cent. The RBA's mandate requires it to keep inflation between 2–3 per cent, "on average over the course of the cycle". The mandate refers explicitly to headline inflation. Operationally, this means that the Bank must consider raising rates if its forecast for headline inflation sees it pass through and staying above 3 per cent. In its November *Statement on Monetary Policy*, the Bank suggested that CPI inflation would be at or close to 3 per cent for some time yet. It also said that, if its forecasts for inflation and growth are close to correct, then current policy settings are appropriate (rates will remain flat), but if demand and inflation pressures are greater than expected, then policy adjustment will be required. Message: short-term interest rates may rise at some stage in 2006, but any move is unlikely to be large. Things change, of course. Unexpected weakening of the economy in 2006 could mean lower rates before the end of the year, but this is far less likely (see Figure 7 on page 13).

Figure 4: Australian GDP SOURCE: DATASTREAM

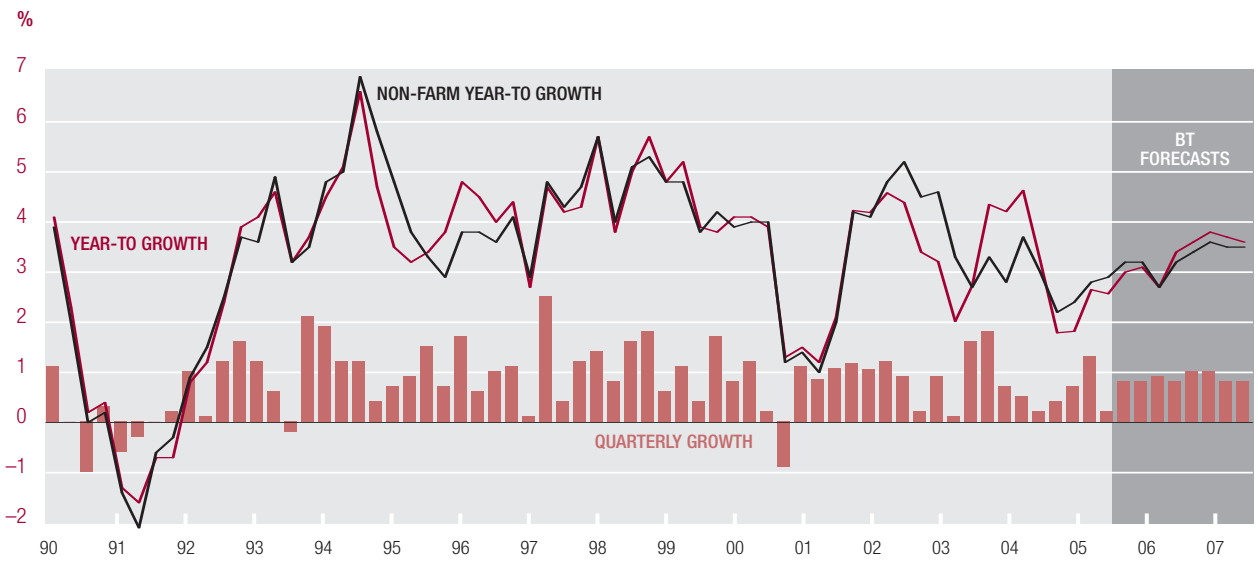


Figure 5a: Terms of trade SOURCE: DATASTREAM

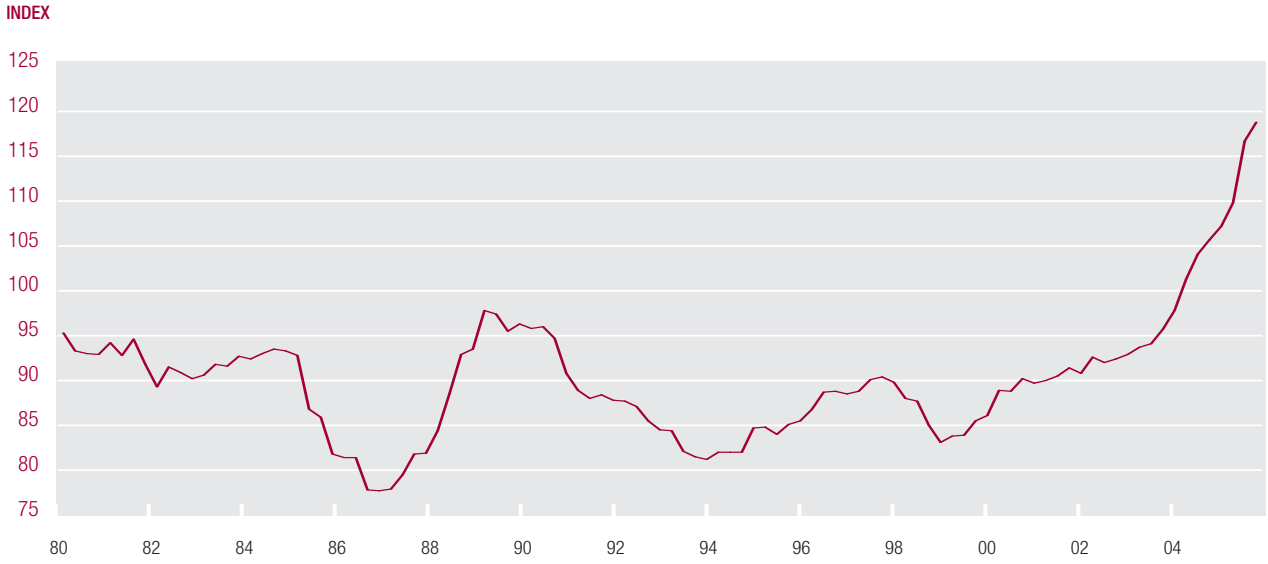
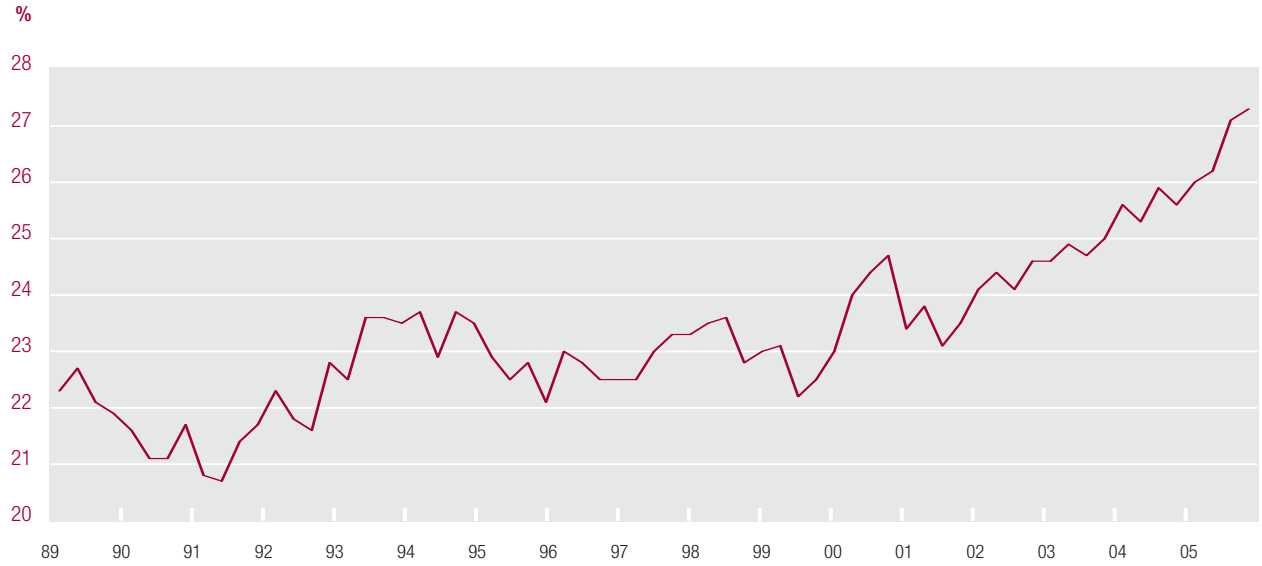


Figure 5b: Profits share of total factor income SOURCE: DATASTREAM



More about the inflation outlook

As mentioned, inflation hit 3 per cent in the September quarter. Going forward, it is likely that petrol prices will, if anything, tend to subtract from inflation, but wage growth is clearly picking up. The wage price index rose by 4.1 per cent in the year to the September quarter, more than it has on any previous occasion in its seven-year history, while average weekly ordinary time earnings (AWOTE – a less reliable measure) rose by more than 6 per cent. Given the improvement in labour markets, it should not be a surprise that wage inflation is picking up. The largest gains are in the strongest states – Western Australia and Queensland – and in the stronger industries – mining, and transport and storage.

Figure 6: Australian labour market SOURCE: DATASTREAM

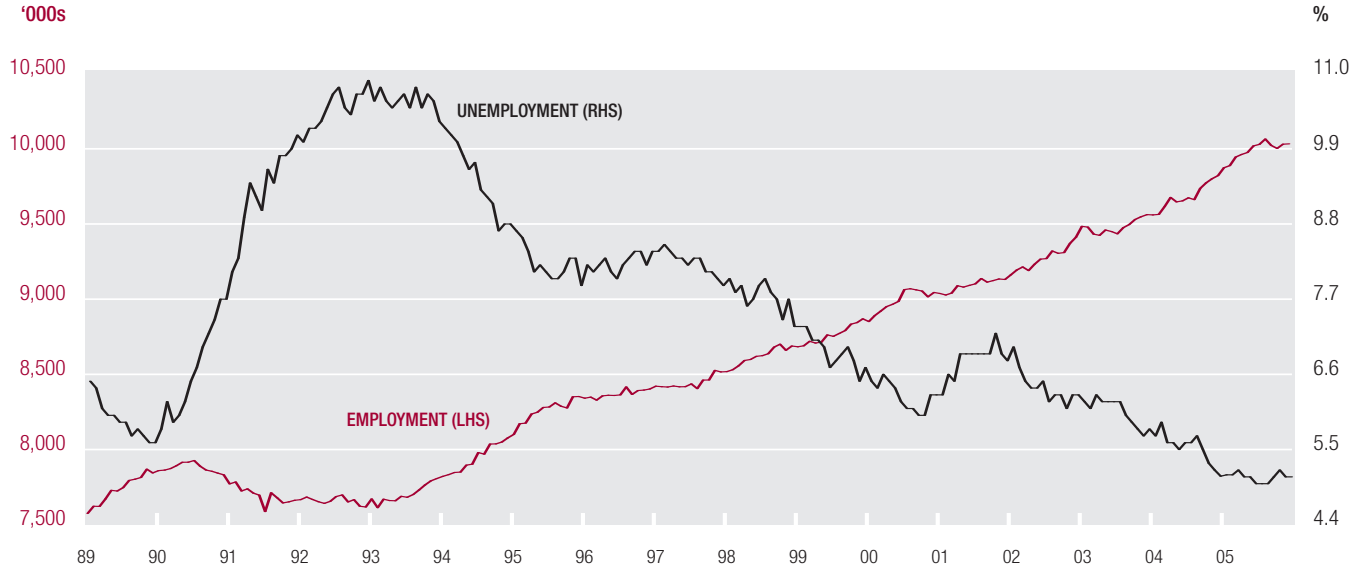
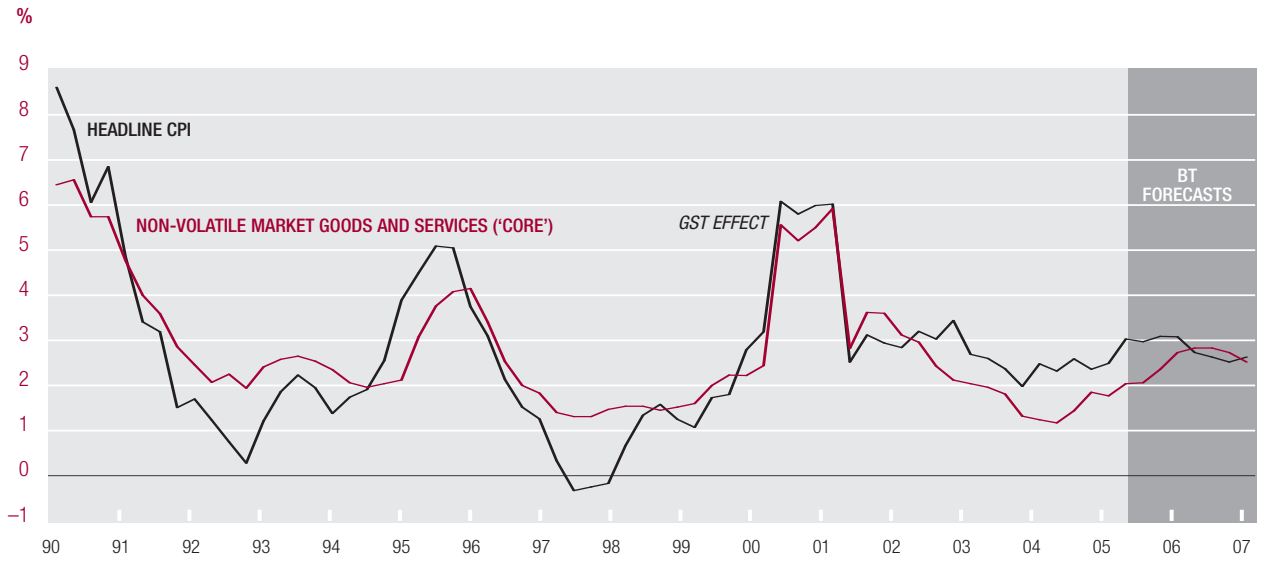


Figure 7: Australian inflation SOURCE: DATASTREAM



We're bigger than we thought we were

It doesn't happen very often but the Australian Bureau of Statistics has found more economic output (GDP) in our history. From as early as 1960, the Bureau has revised up the level of GDP, by an amount that comes eventually to $27 billion (considerably more than 3 per cent) in 2000. About half of this gain comes in the 1990s, which means that this long recovery (Australia last had a recession in 1991) now appears even stronger. Much of the increased output is in consumer spending and in construction, while this is balanced on the income side by stronger small business income, and wages and salaries. While it is not a simple matter, discovering that the economy is bigger than we thought, and usually growing faster than we

thought, may be one reason why the federal government keeps taking in more revenue than it estimates it will.

Air continues to come out of the housing bubble

We have looked at housing in each of the past two reviews. It is perhaps best to step back to late 2003, when house prices were still roaring, and housing credit growth was close to 22 per cent annually. This was clearly unsustainable, and was a matter of great concern for the RBA. It could have hardly expected a better outcome than that which has occurred. The housing sector has apparently achieved an almost perfect soft landing. Housing credit growth has slowed to 13 per cent, and house prices nationwide on average have been flat for a year. Investor interest has fallen, but there has been little or no panic selling. There is still some potential vulnerability should employment prospects deteriorate, or should interest rates rise significantly. And the flatness in house prices is not yet over. A simple ratio of Australian house prices to the size of the total economy suggests that they may still be overvalued by some 10–15 per cent. This overvaluation could be removed by two more years of flat prices (see Figure 8).

Mortgage equity withdrawal

The extraordinary rise in house prices in recent years, and financial innovation, has enabled homeowners to withdraw equity from their homes, and this has almost certainly added to the strength of consumer spending in recent years. It is estimated, at one stage in 2003, equity withdrawal was adding close to 6 per cent to household disposable income.

The RBA released an interesting paper last year, which cast some light on this phenomenon. It turns out that most equity withdrawal occurs not by households running up their mortgages. Rather it is associated with a transaction – when an existing house is sold, the buyer has a larger mortgage than the seller. The paper also found that most equity withdrawal was not used for current spending, but for debt repayment and for other investment. Nevertheless, as the house price picture has changed, equity withdrawal as a share of income has fallen, thus being one of the reasons for slowing consumer spending. In real terms, consumer spending grew by 6.4 per cent in the year to March 2004. It had slowed to 2.7 per cent in the year to the September quarter 2005.

The current account deficit

Despite the favourable movement in Australia's terms of trade discussed above, Australia's CAD remains very high, both in dollar terms and as a share of GDP. Between 2003/04 and 2004/05, it increased from $47 billion to $57.5 billion, or from 5.6 per cent of GDP to 6.5 per cent. Only a little of this increase is in the trade deficit, which grew by $1.8 billion. Far and away, it is the net income deficit that is the driver of movements in the CAD these days. Between 2003/04 and 2004/05 the net income deficit rose from $23.7 billion to $32.3 billion. We are, in one sense, a victim of our own success. A large part of the Australian resource sector is, in fact, foreign-owned, which means that much of the gain in commodity prices accrues to overseas interest. Interestingly, this phenomenon affects the CAD even if the companies involved keep the money in Australia by way of retained earnings.

In the last half of the 1980s, a large current account deficit was taken as a sign of clear economic problems for the country, and the exchange rate was punished heavily on more than one occasion. These days, the CAD has to date been treated with benign neglect by financial markets, presumably because, when they look at the rest of the economy, they see a stellar growth performance, low inflation and a healthy federal budget position.

The CAD is already showing tentative signs of improvement. It was down to 5.8 per cent of GDP in the third quarter of 2005, from close to 7 per cent earlier in the year. Given the solid outlook for world growth, this improvement should continue, although the CAD will remain high for several years yet.

Back to the exchange rate

The Australian dollar was remarkably stable in 2005, spending almost the entire year in between 74 and 78 US cents. We don't so much forecast the exchange rate as make assumptions, and the easiest assumption to make is that the currency remains near its current level in 2006. We have made the point before that the fluctuations of the Australian dollar over the past six years have had remarkably

Despite the favourable movement in Australia's terms of trade discussed above, Australia's current account deficit remains very high, both in dollar terms and as a share of GDP.

Figure 8: Ratio of Australian house prices to GDP SOURCE: UBS, BT FINANCIAL GROUP

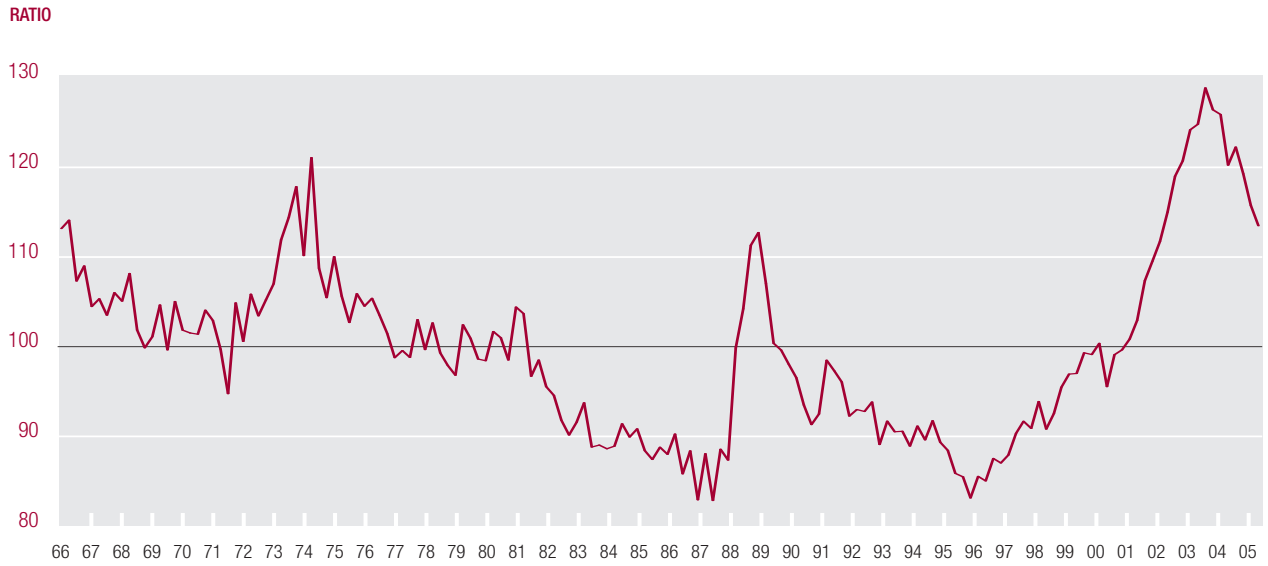
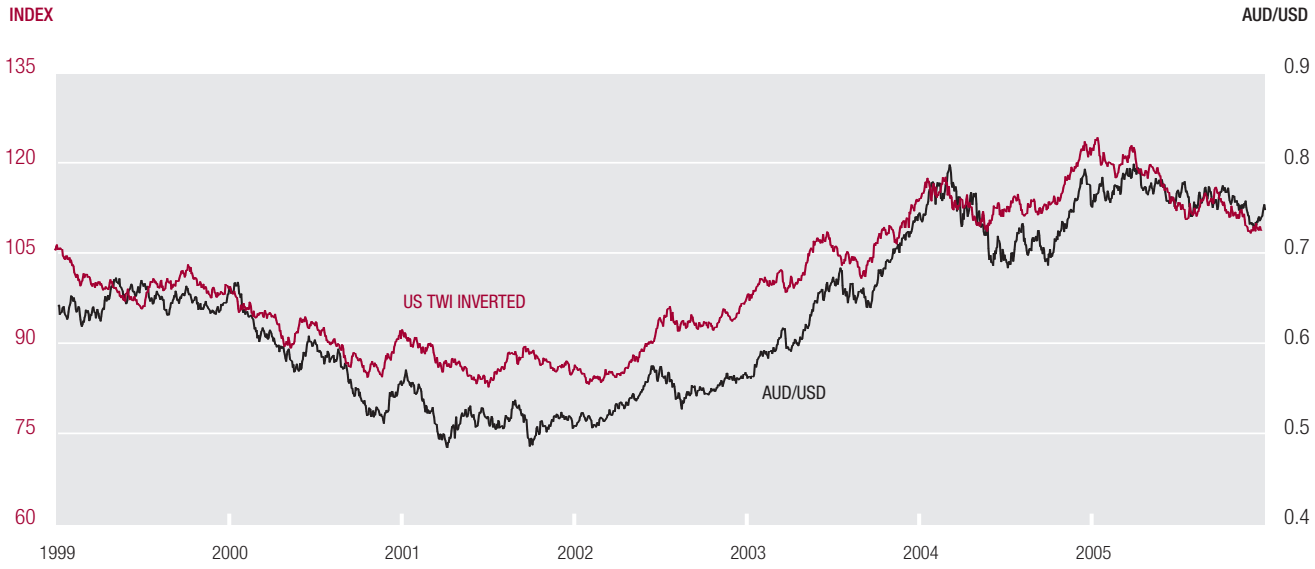


Figure 9: The Australian dollar and the US trade weighted index (TWI) SOURCE: DATASTREAM



little to do with the Australian economy, or with anything else Australian. When the Australian dollar fell, it did so mainly because the US dollar was rising, and when it rose it was usually because the US dollar was falling. Figure 9 on page 15 illustrates this point.

The 2006 outlook in summary

This should be a year of moderate GDP growth. The slowdown in 2004, which continued to early 2005, was caused mainly by the drought, by declining residential construction and by a slackening in the pace of consumption growth. None of these is likely to continue to subtract from growth. Over the year to the September quarter, net exports subtracted 1.3 percentage points from the expenditure measure of GDP growth. This is to say that the excess of imports growth over exports growth was equal to 1.3 per cent of GDP. It is very unlikely that trade will be as much of a drag in the future. Accordingly, it is reasonable to expect GDP growth in 2006 to come in close to 3.5 per cent, up from 2.5 per cent in 2005.

This sort of growth should lead to further increases in employment, though probably at a less rapid rate than over the course of 2005, but enough to keep the unemployment rate close to its current level of 5.2 per cent.

Inflation may hover close to 3 per cent, which will keep the Reserve Bank on its toes. There is certainly far more chance of an increase in interest rates in 2006 than of a cut.

Chris Caton is the Chief Economist for BT Financial Group. The views expressed here are his own, and should not be otherwise attributed.

TABLE 1: AUSTRALIAN ECONOMIC OUTLOOK

YEAR AVERAGE % GROWTH	2002	2003	2004	2005 (f)	2006 (f)	2007 (f)
GDP	4.1	3.1	3.5	2.5	3.2	3.7
Non–Farm GDP	4.7	3.5	2.9	2.8	3.1	3.6
Farm product	–7.7	–8.5	18.4	–6.9	6.5	7.7
Private consumption	3.9	3.8	5.7	3.1	2.9	3.8
Residential construction	25.1	5.9	3.1	–2.5	1.1	5.9
Business investment	14.5	16.0	10.4	13.5	7.5	3.8
Private final demand	7.1	5.5	6.1	4.0	3.6	4.0
Public final demand	3.5	2.9	5.3	2.4	1.5	3.4
Stocks	–0.1	0.9	–0.3	0.2	0.1	–0.2
GNE	6.2	5.7	5.7	3.8	3.3	3.2
Exports	0.0	–2.2	4.0	2.0	6.8	12.8
Imports	10.7	10.5	15.1	8.0	6.1	10.9
Unemployment rate (%)	6.4	6.1	5.5	5.1	5.3	5.5
CPI inflation (%)	3.0	2.8	2.3	2.7	2.7	2.5
Current account deficit ($bn)	31.4	45.3	54.5	52.6	46.5	42.6
Exchange rate (USD/AUD)	0.55	0.66	0.74	0.75	0.75	0.75