

News release

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This isn't just a short-term shock to the economy

BIS Shrapnel expects a fall in business investment will continue to constrain growth for some years

Last week, the Reserve Bank of Australia appeared before the House of Representatives Standing Committee on Economics saying that the outlook for the economy is 'near-term weakness' but Australia is 'well placed to benefit from a renewed expansion'.

Leading industry analyst and economic forecaster BIS Shrapnel agrees that Australia does not have the same issues as other developed nations as a result of the global financial crisis – Australia is experiencing a credit squeeze not a financial crisis – but the shortage of both debt and equity funding will be disastrous for business investment.

BIS Shrapnel's chief economist, Dr Frank Gelber, says we need to look beyond the current situation to understand how the Australian economy will fare over the next five years.

BIS Shrapnel's *Long Term Forecasts, February 2009 Update* argues the financial crisis in many developed countries means they will experience sharp recession followed by prolonged weakness. Australia, on the other hand, will experience a relatively moderate downturn, which will be followed by lingering weakness as falls in business investment constrain growth.

"Currently, investment remains firm as we finish the last round of projects across the board," explains Dr Gelber. "However the next round of projects has been slashed and business investment will fall sharply over the next two years."

The company says this sentiment won't be apparent in this week's Capital Expenditure figures to be released by the Australian Bureau of Statistics as investment expectations always miss the turn of the cycle.

Dr Gelber says the current downturn contains little of this. Initiated by last year's rise in interest rates, but now driven by the collapse in confidence, both consumers and businesses have gone into precautionary saving mode.

"Households aren't spending for fear of unemployment and businesses are cutting costs," he says. "And the shock to demand is starting to hit profits and employment.

"Fear of unemployment is self-fulfilling," Dr Gelber continues. "We will probably see the unemployment rate approaching seven per cent some time next year. Sure, the global financial crisis has driven a collapse in equity markets and the credit squeeze, but in terms of the real economy, we're shooting ourselves in the foot."

BIS Shrapnel believes the downturn in Australia won't be nearly as bad as other overseas developed economies.

"The financial crisis is overseas, where a collapse in asset values has required banks to write off substantial bad debts causing a loss of bank equity," says Dr Gelber. "Many developed western economies such as the US, the UK, Germany and Japan are experiencing sharp recessions with the prospect of protracted weakness as they refinance their banking systems and work their way through the millstone of bad debt."

BIS Shrapnel notes Australia would normally see a quick rebound as lower interest rates pump income into the mortgage belt, confidence recovers, undersupplied housing markets rebound and households start to spend again, particularly with the government cash injections.

"But this time, weak exports, the fall in commodity prices and the shock to demand have hit the financial viability of projects," says Dr Gelber. "Meanwhile, the continuing credit squeeze and constraints on equity funding mean there is little finance available for new projects. And that has slaughtered business investment."

The company notes property development has already been hit. Minerals investment will also fall sharply – BIS Shrapnel's current forecast is for a fall of 50 per cent, with the possibility it could be worse.

"Investment, and particularly construction, is the primary growth driver for the economy," explains Dr Gelber. "Fortunately, there are factors offsetting the weakness of business investment. The 'Ruddbank' can help to put the finger in the dyke to contain the leakage of overseas bank funding. But that is just a stopgap – the real need is for equity finance."

Government infrastructure spending has a much greater role to play in filling the gap left by the fall in business investment. BIS Shrapnel says the question is how long it will take to get these projects off the ground and how determined the government will be in the face of an escalating deficit.

"Meanwhile, we've seen the bottom of the residential cycle," says Dr Gelber. "The next stage is an upswing, probably next year, building momentum into what will become a boom."

BIS Shrapnel believes the short-term weakening of the economy has been self-inflicted. Australia's short-term prospects will depend on how strong the downturn caused by precautionary saving and the credit squeeze will be. However, BIS Shrapnel warns the end of the credit squeeze won't solve all our problems. Instead, we need to look beyond the current weakness to understand the factors that will shape the economy over the next five years.

BIS Shrapnel says there are four factors to be considered when analysing the medium-term strength of the Australian economy:

- The impact of a lower Australian dollar on domestically produced goods and services, the strength of domestically produced tradeables and the corresponding weakness of import-related businesses – the retail sector will do it tough while the dollar stays low;
- The influence of stimulatory interest rates on the undersupplied housing market and the timing of the housing recovery;
- The impact of falling business investment in general, and the collapse of minerals investment in particular, over the next three years; and
- How much government infrastructure spending will offset weakening business investment.

"The result is that Australia will experience a moderate downturn followed by protracted weakness as reduced investment constrains growth," says Dr Gelber. "Whether or not there is a technical 'recession' is not the point to get hung up on, but this is a substantial downturn.

"Businesses need to survive the current shock but they also need to look beyond it and understand where they fit into the changing structure of the economy, particularly the shift away from imports and back to domestic production which will be underwritten by the lower Australian dollar."

BIS Shrapnel concludes that the strength of the economy over the next five years will depend on the extent to which strong housing and government spending on infrastructure will offset falling business investment.

These and other issues will be discussed at the forthcoming 90th series of BIS Shrapnel's Business Forecasting Conferences held around Australia in March. The series of half-day briefings on the Australian economy, building and property markets will provide a clear overview of the economic and industry outlook to June 2010. Media are invited to attend these sessions. For more information and registration visit: http://www.bis.com.au/conferences/australian_conferences.html

About BIS Shrapnel

BIS Shrapnel is Australia's leading provider of industry research, analysis and forecasting services. BIS Shrapnel helps clients better understand the markets in which they operate, through reliable and detailed market data, analysis of developments and drivers and thoroughly researched forecasts.

BIS Shrapnel compiles accurate, clearly explained and detailed information on industry sectors, markets and industries in which their clients operate. BIS Shrapnel provides market size and segmentation data, market shares, consumer attitudes and supplier reputation information, and regularly conducts both business-to-business and consumer research.

Over the company's 45-year history, BIS Shrapnel has built up a strong level of expertise and unique methodologies for forecasting.

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