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News release

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Australia Setting up for Strong Growth Period but with Higher Interest Rates **Long Term Forecast Predicts Build-up to Boom Later this Decade**

The Australian economy is on the threshold of a major cyclical upswing. Growth will pick up speed over the next two years and build into a boom later this decade, driven by rolling investment cycles, says leading economic forecaster and industry analyst, BIS Shrapnel.

BIS Shrapnel's *Long Term Forecasts, February 2010 Update* reports the economy currently has enough spare capacity and slack in the labour markets to cater for the initial phase of the upswing without exciting either demand or cost-side pressures. However, the forecaster warns problems will occur in three-to-four years' time when all the major construction cycles synchronise and inflationary pressures re-emerge, leading to higher interest rates.

BIS Shrapnel was one of the few forecasters who, in the first six months of last year, consistently predicted that Australia would not suffer a recession.

"We are now well and truly into recovery from what turned out to be a modest downturn – and not a recession as other forecasters predicted at this time last year," says BIS Shrapnel report author and senior economist, Richard Robinson. "But it's now time to look forward not backward. We're into a rebuild phase, rather than a rebound.

"Two years is a long time in investment markets. I know the Global Financial Crisis (GFC) is still front of mind, but it won't take long before we forget," he adds. "Remember the 'disastrous' sharemarket crash of October 1987, which was quickly followed by the property boom of 1989, which preceded the recession 'we had to have'. The build up this time will be slower, but it's the current caution in risk averse debt and equity markets that is setting us up for the stock and capacity shortages that will underwrite the next boom later this decade."

Initially, housing upswing to become the key driver of growth

“Investment, and particularly the construction side of it, is the primary driver of growth in the economy. The next phase of investment will underwrite growth in the economy, but the timing and logic of each construction cycle is different, with varying knock-on effects to different sectors and across the states,” says Robinson.

Currently public sector investment is now the strongest of the investment sectors, offsetting further declines in business investment over 2010, but activity will peak this year. The schools program has probably already peaked, health-related construction is still increasing, while the social housing program is behind schedule. The infrastructure works under the ‘Nation Building’ program will ramp up this year, but this will only partially replace a number of large state-funded projects finishing soon. After 2010, BIS forecasts public investment will decline as the Federal and State governments attempt to rein in their deficits, but the real cuts to government expenditure won’t occur until after the Federal election due later this year.

“From 2010, housing construction will take over from waning public spending as the key driver of growth. Initially spurred on by a combination of first home owner/builder grants and low interest rates, this upswing will gather momentum into a boom by 2012. Despite lingering affordability problems, healthy consumer confidence, high rents, a chronic undersupply and rising immigration will continue to boost first home owner, investor and upgrader demand. But the question is how long will the housing boom continue in the face of rising interest rates?” asks Robinson.

Business investment booming by 2012/13, but we still need more public infrastructure

Next year, BIS Shrapnel expects the next round of mining projects to get underway, with the rebound in commodity prices and a rosier outlook for the global economy providing the impetus. Plant and equipment investment should also pick up later this year, as businesses, increasingly confident about the outlook and able to access finance, take advantage of the high Australian dollar to buy ‘cheap’ imported equipment.

Then, sector-by-sector, private non-residential building and infrastructure construction will increase as equity and debt finance recover alongside leasing markets. Indeed, notes the report, there may be some upside to both business equipment and construction capital expenditure in 2010/11, particularly if finance becomes available and a number of projects – which were in an advanced state of pre-construction prior to the GFC – are fast tracked. By 2012/13 BIS Shrapnel expects overall business investment and housing investment to be booming, partially offset by further steep declines in public investment.

“We have an issue with the expected declines in public investment,” says Robinson. “Although public investment probably needs to ease back to make room for private sector spending, we still need to build a lot more infrastructure. The cutbacks to infrastructure and education spending over the decade to the mid-2000s caused severe bottlenecks, capacity constraints and lowered productivity growth. We fear that the really worthwhile public infrastructure – that is, the capital works that underwrites long run productivity and the economy’s growth potential – will be again cut now, ultimately realizing the same problems that occurred pre-GFC. With this likely to happen, then the government’s two per cent (2%) productivity target just looks like a vain hope.”

Consumer spending slower to ramp up, and no tax cuts means only moderate growth

In the near term, consumer spending will be constrained by slow growth in household disposable income, due to less full-time work, weaker growth in wages, dismal profits and dividends, a lack of tax cuts this year and higher interest rates pushing up mortgage repayments. Consumer confidence is high, but households still remain cautious about increasing personal debt.

But as the recovery builds, employees will increasingly switch back to full time work, wages growth will accelerate and households will again start to use credit to fuel spending. Nevertheless, BIS says Australia won’t see retail spending growth return to the pre-GFC levels. Tax cuts will be off the agenda until the budget returns to surplus, and this will tend to moderate household spending for a few years, according to the forecaster.

But higher dollar damaging tradeables sectors and overall GDP

“But it’s not all good news,” warns Robinson. “The high Australian dollar is damaging the competitiveness and viability of domestically produced tradeables industries, particularly manufacturing, tourism and other tradeable services. This not only acts as a constraint on those exports, but more significantly sucks in more imports. With import volumes forecast to outpace stronger export volumes in the medium term, there will be a negative external contribution to GDP. This will act to keep GDP below four per cent (4%) in 2011/12 and 2012/13, despite booming domestic demand.”

On the other hand, the mining sector and many of the non-tradeable sectors such as retailing, wholesale trade, transport, health and financial and professional services, are already starting to strengthen and have good prospects over the medium term.

Inflation not a problem now, but will be later, and that means further rate rises

The strengthening in total investment, exports and the overall economy is expected to lead to a marked strengthening in employment and consumer spending from 2011/12. With the economy in full-swing BIS expects capacity constraints and skilled labour shortages to emerge, eventually fuelling inflationary pressure.

The 2008/09 downturn led to a sharp drop in capacity utilization, excess production capacity and considerable slack in labour markets as employees switched from full-time to part-time. In the initial stages of the upswing, much of the increases in the output of goods and services will come from higher utilization of spare production capacity and currently underutilized labour. “This will be the golden age – rising capacity utilization will realize a cyclical increase in productivity, lower unit costs, lower inflation and higher profits and real wages,” says Robinson.

“However, because the Australian economy entered the downturn with little excess capacity and then only experienced a shallow downturn, it will take less time for capacity constraints and inflationary pressures to re-emerge,” the author says. “We will then see the Reserve Bank hike rates from neutral to contractionary, meaning a cash rate over six per cent (6%) and the housing variable toward nine per cent (9%) before the next episode is over.”

Current and medium-term issues affecting the economic outlook will be discussed at the forthcoming 92nd series of BIS Shrapnel’s business forecasting conferences which will be 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 the end of 2011. Media are invited to attend these sessions. For more information and registration please visit: http://bis.com.au/conferences/australian_conferences.html

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