

News Release

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Report: post-election economic clouds looming

Interest rates to rise, constraining growth and the housing market

Despite the uncertain outcome of the weekend's Federal Election, whichever party forms government will continue to face a familiar set of policy issues over the medium-term, says leading industry analyst and economic forecaster, BIS Shrapnel. These issues will ultimately manifest into the re-emergence of serious inflationary pressures and high interest rates before the next election in late 2013.

BIS Shrapnel's *Long Term Forecasts, 2010 – 2025* report predicts economic growth will accelerate and average 3.8 per cent per annum over the next three years. The report also forecasts solid employment growth to push the unemployment rate down to below four per cent by early-to-mid 2013.

However, the company warns tightening labour markets and accelerating household spending will lead to higher consumer price inflation (CPI), forcing cash rates up towards 6.5 per cent and housing rates towards nine per cent.

"While the no-policy election might drag on into next week, it is important to get back to the day-to-day running of the economy. Mining profits, the budget deficit, immigration and a 'sustainable' level of population were the key areas of debate, but the real policy issues for the economy were either given only cursory consideration or put in the too hard basket," says report author and BIS Shrapnel senior economist, Richard Robinson. "We still have a number of critical policy issues which need to be addressed, including a serious housing shortage, ongoing infrastructure deficiencies and bottlenecks and, of course, a skills shortage.

"These capacity constraints will remain a problem for the economy while the mining investment boom continues," says Robinson. "This boom, when it really ramps in one to two years, will leave little room for governments and businesses to address these chronic shortages, and the miners themselves will struggle to get through their projects."

BIS Shrapnel says the pick up in population growth in the three years to 2008/09 played a key role in extending the economy's long run of growth and dampening wage pressures. However, it also created additional demands on housing and infrastructure which were already stretched.

Weaker population growth will take the pressure off future growth in demand for housing. However the current undersupply of housing is not likely to be adequately addressed through the current cycle given that mortgage rates are already around neutral levels. The combination of significant pent-up demand, strong rents and yields, rising incomes and an easing in funding for property developers, is expected to sustain a recovery in activity over the next two to three years.

However, Robinson warns that the housing upswing won't last.

"Minimal slack in labour markets, a recovery in consumer spending and, subsequently, business investment, will quickly see the re-emergence of capacity constraints from 2011/12," he says. "Labour shortages and a synchronisation of construction cycles will lead to a build up of inflationary pressures over 2011/12 and 2012/13. The RBA will be forced to respond by raising interest rates to a maximum of 6.5 per cent, which will take mortgage rates back over nine per cent and send housing activity into a controlled downturn over 2013/14."

BIS Shrapnel says the housing shortage is a major problem because it inflates mortgage debt, which increases household sensitivity to rising interest rates and unemployment and widens the current account deficit. The shortage of housing is also a major influence on the CPI through its impact on the rental market.

Australia's large current account deficit means it has to source significant offshore funds to finance its national debt. During the GFC the cost of funds soared and businesses experienced significant difficulties accessing finance. Funding constraints have subsequently eased and large businesses have been able to tap into international financial markets.

However, finance for small businesses is scarce and the cost remains elevated. Changes to the risk weighting of assets by banks for capital requirements as a result of Basel II, and the heightened risk aversion in the wake of the GFC, has disadvantaged small businesses and favoured bank lending to households for the purchase of residential property. Reduced competition from non-bank lenders has exacerbated the problem.

But Robinson says there is some good news.

"The current account deficit is set to improve dramatically over 2010/11 and 2011/12," he says. "Firstly as a result of a surge in the terms of trade and higher productive minerals capacity and, subsequently, strengthening world demand for exports. Unfortunately, the strength of commodity demand and the associated strength of minerals investment has, and will continue to have, an adverse effect on non-mining tradeables and import-competing sectors through the impact of high commodity prices on the Australian dollar."

BIS Shrapnel warns that while ever mining investment continues to run at, or above, the current high levels there is little room for other investment cycles, particularly given labour shortages. The economy is starting from a position of minimal spare capacity in labour and product markets. Dwelling activity is the first private sector investment cycle to gain momentum post-downturn, taking up the slack from public sector activity which was a key driver of growth through 2008/09 and 2009/10, but is set to weaken over the next two to three years.

Although the next round of mining projects is now largely locked in, with oil and gas activity leading the way, it will take time for activity to gain momentum. Meanwhile, financial conditions are not yet strong enough to justify a further round of commercial and industrial building, which is still two to three years away from gaining momentum.

"This means there is now a limited opportunity for the public sector to fast track much needed infrastructure spending at a time when there is little risk of crowding out private sector activity," says Robinson. "However, the election has been partly fought around which party can most swiftly bring the budget back to surplus, which will see investment weaken."

"Longer term, while the public sector may not actively crowd out private sector investment through the current cycle, it will indirectly constrain growth because of the insufficiency of existing infrastructure to support the projected growth in private sector demand, which will lead to the re-emergence of inflationary pressures," says Robinson. "The lack of infrastructure, skills and education spending over the past 15 years will constrain the much-needed pick-up in long term productivity, and ultimately constrain the economy."

These and other issues will be discussed at the forthcoming 93rd series of BIS Shrapnel's Business Forecasting Conferences held around Australia in September. 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 December 2011. 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 46-year history, BIS Shrapnel has built up a strong level of expertise and unique methodologies for forecasting.

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