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International Economy Comments

IEC SPECIAL COMMENT #1,17 MAY 2011

Charting Australia's economic outlook: Budget 2011-12

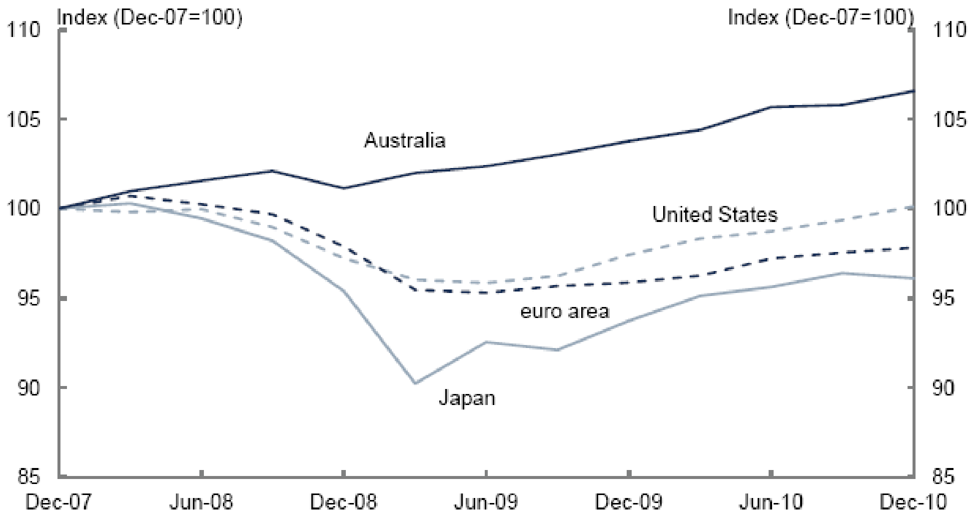
The budget papers provide a neat graphical snapshot of the official view of the international forces shaping Australia's economic outlook.

An interesting aspect of what was by-and-large a fairly uninteresting budget was the insight into the official view of the forces shaping Australia's economic future provided by the budget papers. The charts in the budget documents provide a neat, graphical snapshot of an Australian economy that is:

- currently outperforming most other developed economies;
- being remade by the forces of the Great Convergence in general, and of a China-led resources boom in particular;[1]
- forecast to be shaped by those same forces for many years to come.

Australian economic outperformance relative to the rest of the developed world is visible across a range of indicators, including growth, employment, and fiscal health. For example, while many developed economies are struggling to return to pre-GFC levels of output, the Australian economy suffered relatively little fallout:

Chart 1: Level of real GDP in selected advanced economies



Source: ABS cat. no. 5206.0, national statistical agencies, Thomas Reuters and Treasury.

Source: Budget papers 2011-12, Statement 1

Australia's relative labour market performance also stands out, with lower unemployment and higher job creation:

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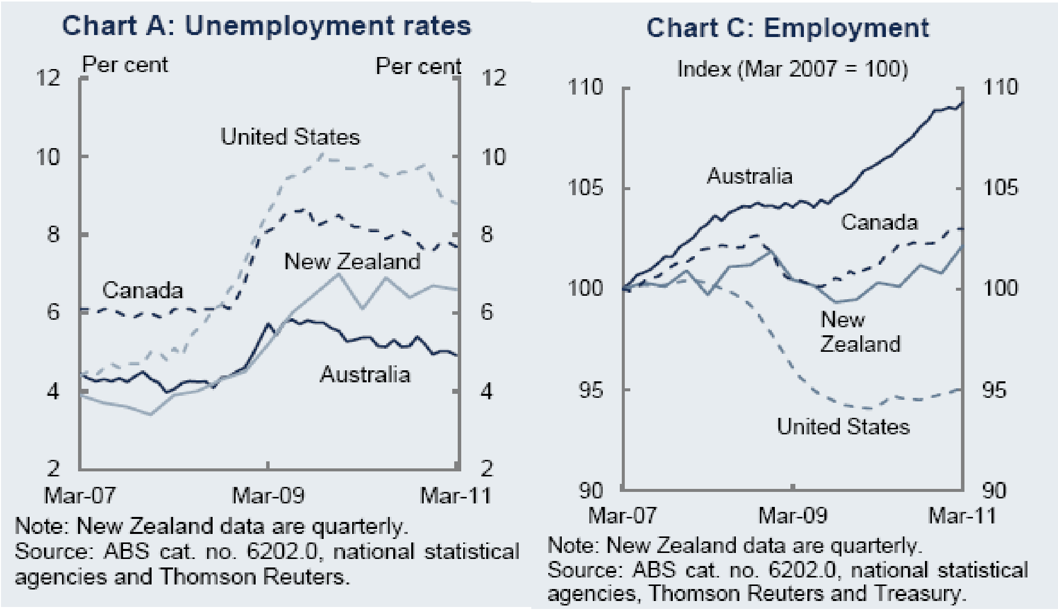
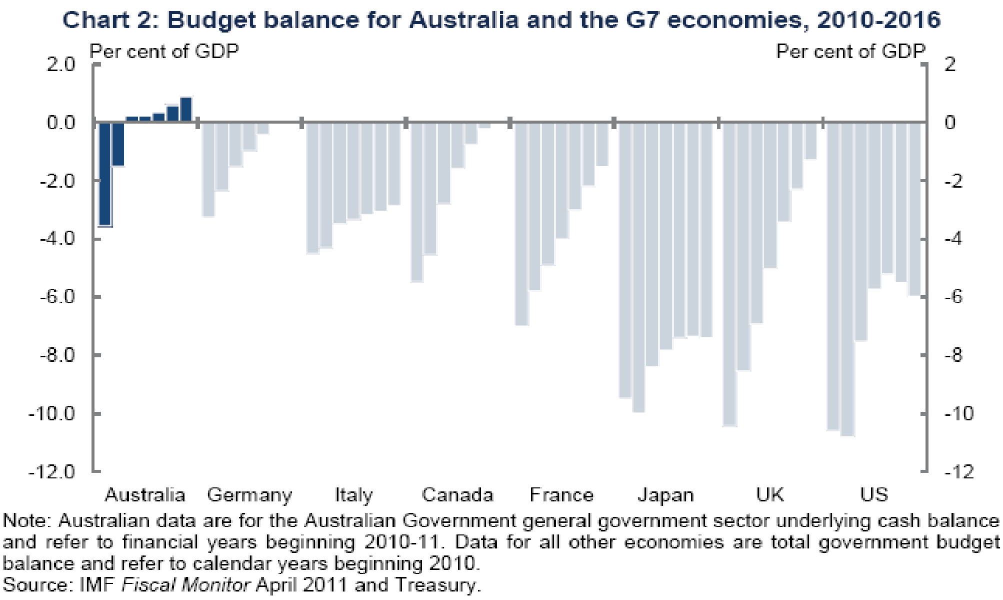


Source: Budget papers 2011-12, Statement 2

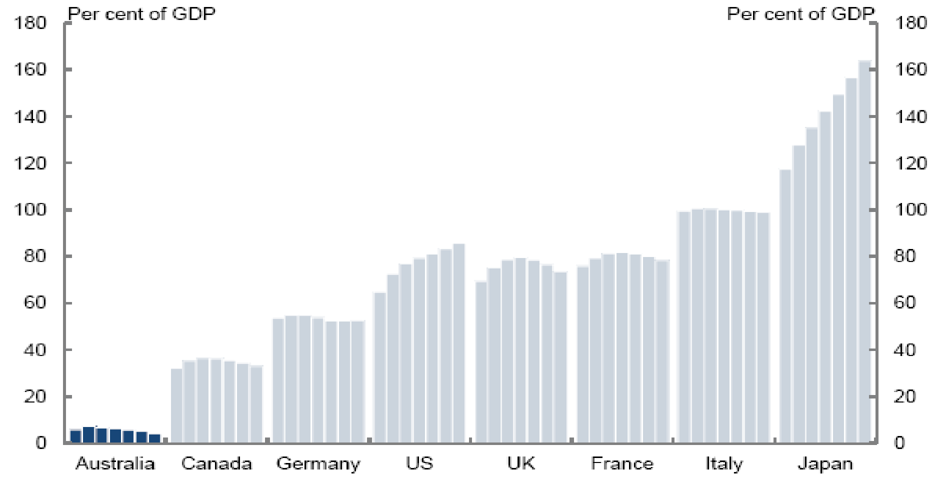
Similarly, Australia's fiscal position is in much better shape than that of most other developed economies:



Source: Budget papers 2011-12, Statement 1

The same is true for the public sector balance sheet more generally, with Australia's net government debt forecast to peak at a mere 7.2% of GDP in 2011-12:

Chart 3: Net debt for Australia and the G7 economies, 2010-2016

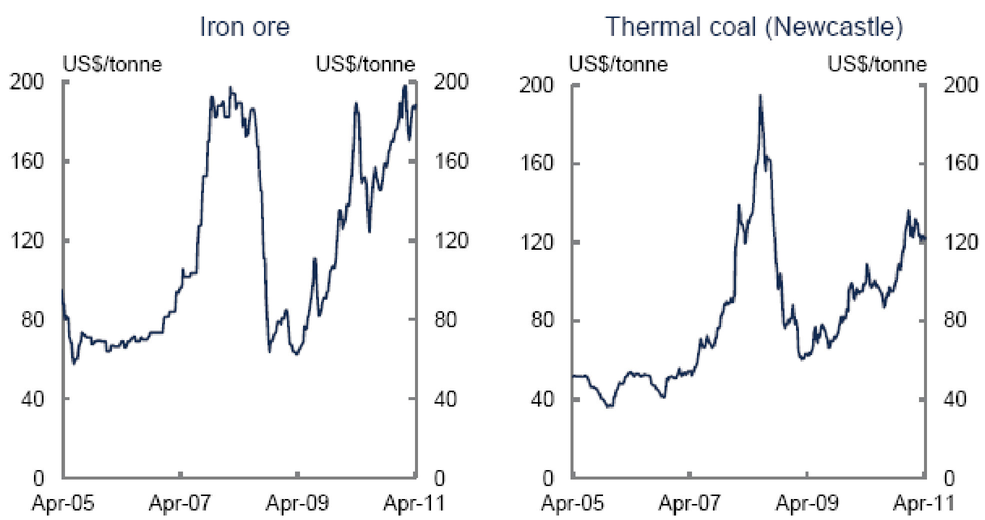


Note: Australian data are for the Australian Government general government sector and refer to financial years beginning 2010-11. Data for all other economies are total government and refer to calendar years beginning 2010.
Source: IMF *Fiscal Monitor* April 2011 and Treasury.

Source: Budget papers 2011-12, Statement 1

Of course, a very important part of the explanation for this relative outperformance is the way in which the Australian economy has benefitted from the mining boom. The current version of that boom is the post-crisis continuation of the previous boom (Treasury calls it mining boom mark I) that was temporarily derailed by the GFC. This second boom (mining boom mark II) has delivered a rapid bounce back in the prices of key Australian commodity exports, in particular for iron ore and thermal coal:

Chart 11: Bulk commodity prices



Source: Bloomberg and Global Coal.

Source: Budget papers 2011-12, Statement 2

And as virtually every presentation on the Australian economy notes these days, these higher prices for resources have in turn contributed to a dramatic increase in the terms of trade – the ratio of export to import prices – pushing them up to historical highs:

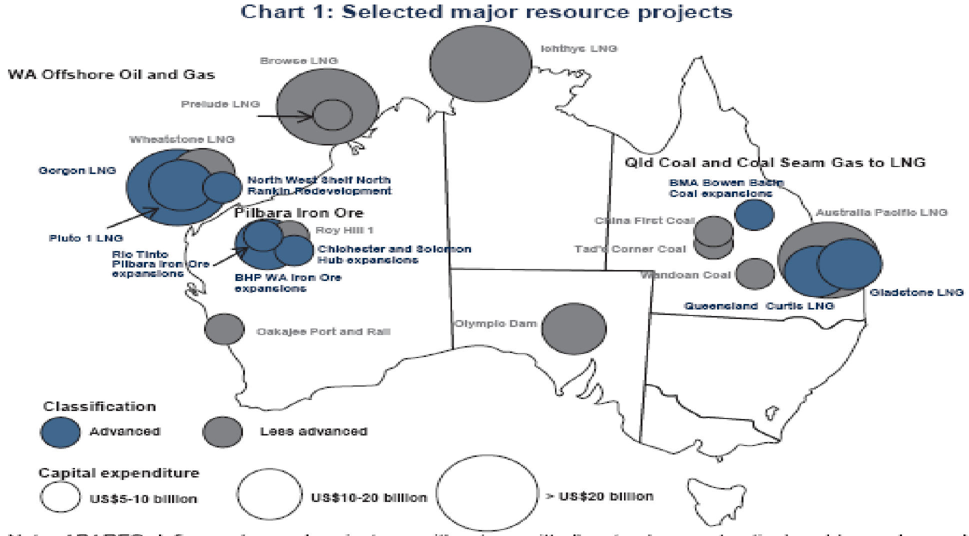
Chart 10: Terms of trade

Source: ABS cat. no. 5206.0 and Treasury.
Source: Budget papers 2011-12, Statement 2

Although the forecasts in the budget papers do assume that future increases in the global supply of coal and iron ore will see the terms of trade decline from their current peak, they also forecast that this decline will be gradual, on the grounds that 'strong resources-intensive investment in China and India will continue for many years to come'. As a result, the forces of the mining boom – and the Great Convergence – are expected to continue to drive the Australian economy.

Meeting this demand for resources also means that the mining sector will continue to power a major investment boom: the ABS reckons that mining investment could reach a record A$76 billion in 2011-12, and investment is forecast to remain at high levels over future years, with ABARES estimating that the current pipeline of resource investment is more than A$380 million: the 'Australian economy is in the early stage of the biggest investment boom on record':

Chart 1: Selected major resource projects



Note: ABARES defines advanced projects as either 'committed' or 'under construction' and less advanced projects as those undergoing a feasibility (in some cases, pre-feasibility) study, or that have not yet been subject to a final investment decision since the completion of a feasibility study.
Source: Indicative estimates based on ABARES, company reports and other publicly available information.

Source: Budget papers 2011-12, Statement 2

The record terms of trade, strong relative growth performance and higher policy rates have together helped the Australian dollar climb to post-float highs. At the time of the budget, in real, trade-weighted terms, the dollar was about 40 per cent above its post-float average:

Chart 2: Real trade-weighted exchange rate

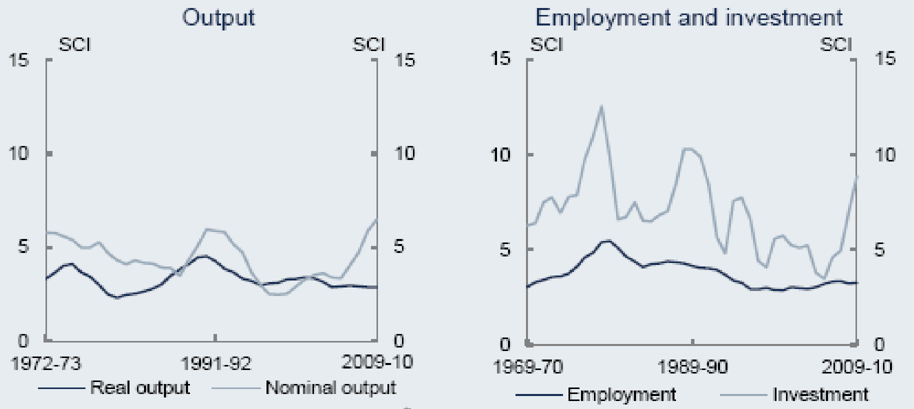
(Post-float average = 100)

Source: RBA.

Source: Budget papers 2011-12, Statement 2

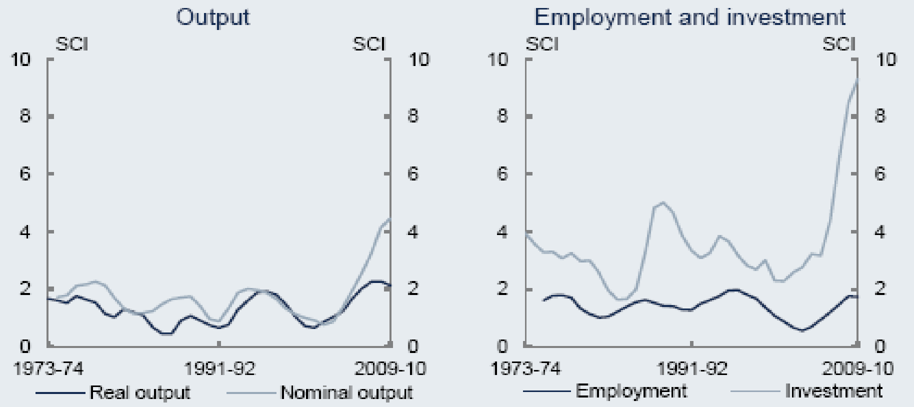
The positive shock to the terms of trade, the mining investment boom and real exchange rate appreciation are all restructuring the Australian economy. The budget papers report various measures of structural change that confirm this shift: thus measures of industrial structural change based on nominal output and investment shares show change occurring at an historically rapid pace and a rate of change in Australian economic geography that has been even faster:

Chart 6: Structural change between industries



Note: SCI = $1/2\sum 100|x_{i,t}-x_{i,t-5}|$ where $x_{i,t}$ is the i^{th} industry group's average share of output, employment or investment in 5-years to time t for 9 industry groupings. The SCI shows the rate at which the economy's composition changes. SCIs take values between 0 and 100. For example, where the share of one industry group increases by one percentage point over a five year period, with a corresponding decrease in other groups, the SCI would have a value of 1. A large number represents a sharp change in industry composition. Real output in 2008-09 dollars. See also RBA (2010b) and Productivity Commission (1998).
Source: ABS 5204.0, 5206.0 and 6291.0, RBA, Butlin (1985), Withers et al. (1985) and Treasury.

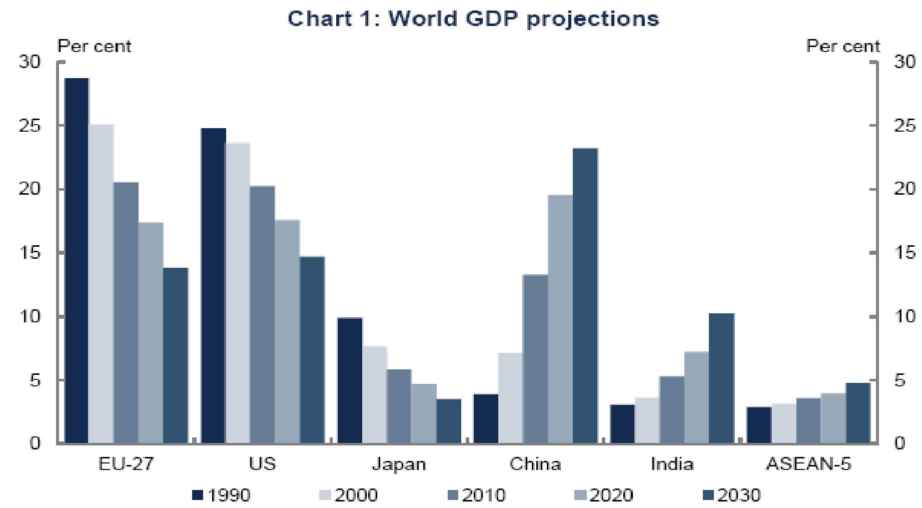
Chart 12: Structural change between states and territories



Note: SCI = $1/2\sum 100|x_{i,t}-x_{i,t-5}|$ where $x_{i,t}$ is the i^{th} state or territory's average share of output, employment or investment in the 5 years to time t. The SCI shows the rate at which the economy's composition changes. SCIs take values between 0 and 100. For example, where the share of one state increases by one percentage point over a five year period, with a corresponding decrease in others, the SCI would have a value of 1. A large number represents a sharp change in composition. Real output in 2008-09 dollars. See Box 1, RBA (2010b) and Productivity Commission (1998).
Source: ABS 6204.0.55.001, 5220.0, Donovan (1981), Harris and Harris (1992) and Treasury.

Source: Budget papers 2011-12, Statement 4

Given the central role played by the mining boom in all this, it is no surprise that the economic re-emergence of Asia – or the Great Convergence – is central to the official outlook for the Australian economy. In other words, official forecasts are basically part of what I've described elsewhere as 'our consensus future'.[2] So, for example, by 2020, China and India together are forecast to account for more than a quarter of world GDP, equivalent to the combined share of the US, Japan and the ASEAN-5. By 2030, their share is projected to have risen further, to account for a third of world GDP:



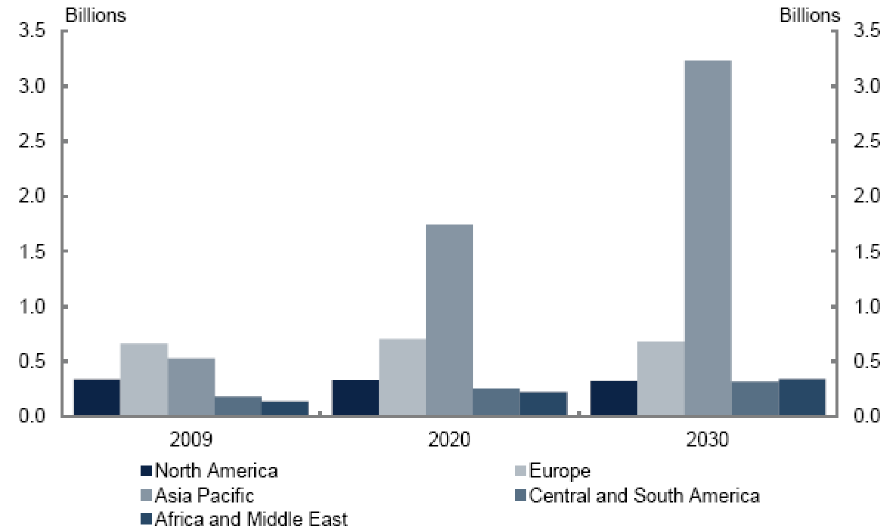
Note: Purchasing power parity adjusted GDP. ASEAN-5 comprises Indonesia, Malaysia, The Philippines, Thailand and Vietnam.
Source: The Conference Board Total Economy Database, Maddison (2007), IMF World Economic Outlook Database, World Bank, OECD, United Nations Population Database and Treasury.

Source: Budget papers 2011-12, Statement 4

To date, the main consequence of this shift in global economic weight has been felt via the rapid industrialisation and urbanisation of Asia, and the consequent boost to global demand for Australian commodities. This convergence process is expected to continue, further supporting the mining boom. In addition, however, the budget papers also highlight another significant consequence of the Great Convergence – the development of a new, global middle class that will be located overwhelmingly in Asia.[3] The implication is that this shift will create new consumers and new markets for Australia.

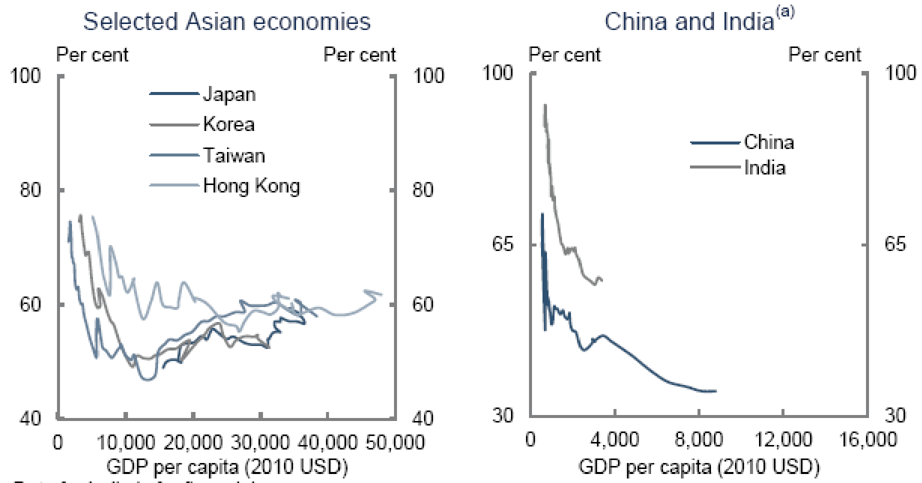
Past experience with economic development in Asia suggests that the ratio of consumption to GDP can decline as incomes grow at lower levels of GDP per capita, before rising again as economies get wealthier. In the case of China, for example, the budget papers note that although the share of consumption in Chinese GDP has now fallen to around 35 per cent of GDP, China is now approaching levels of GDP per capita at which consumption growth tends to pick up, suggesting the possibility of a sharp increase in consumption in the future:

Chart 16: Projection of the global middle class by region, persons



Source: Kharas and Gertz (2010).

Chart 17: Private consumption as a share of GDP



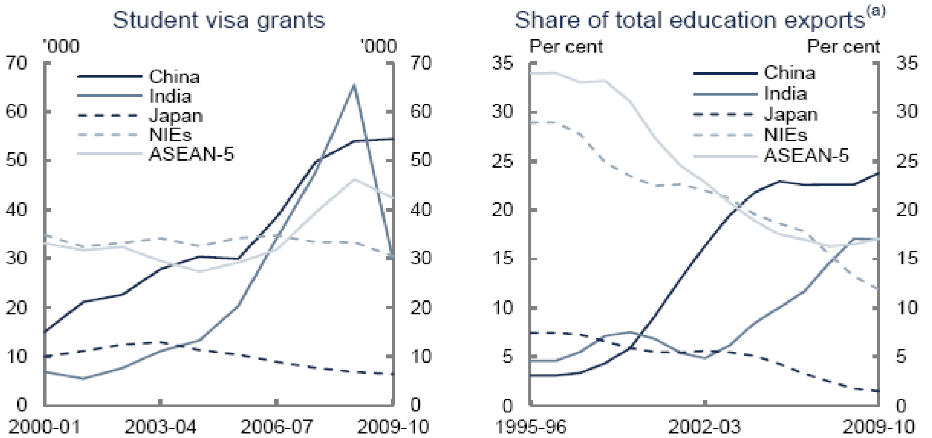
(a) Data for India is for financial years.
Note: Purchasing power parity adjusted GDP.
Source: National statistical agencies, World Bank, Conference Board Total Economy Database and Treasury.

Source: Budget papers 2011-12, Statement 4

This newly affluent global middle class means that there should be significant potential for Australia to secure economic benefits from the Great Convergence that go beyond the mining boom to reach other sectors of the economy, particularly services. For example, the number of international students coming from China, India and the ASEAN-5 to study in Australia has grown strongly in recent years.

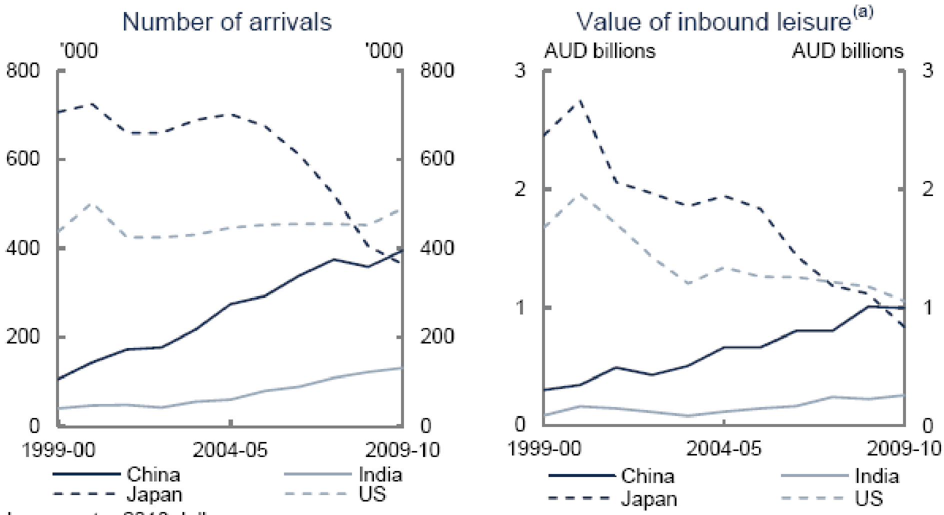
Similarly, visitors from China and India now make up a growing share of international tourist arrivals:

Chart 21: Australia's education exports



(a) 'Education related travel services' by country (which include fees and other spending from international students studying onshore) as a share of total education related services exports.
Note: NIEs include Hong Kong, Korea, Singapore and Taiwan. ASEAN-5 consists of Indonesia, Malaysia, The Philippines, Thailand and Vietnam.
Source: DIAC, ABS 5368.0.55.003 and Treasury.

Chart 22: International arrivals to Australia by country



(a) June quarter 2010 dollars.
Source: Tourism Research Australia (2010).
Source: Budget papers 2011-12, Statement 4

At the same time, however, the structural shifts occurring in the national economy, including real exchange-rate appreciation, mean that these sectors face adjustment challenges of their own.

In summary, then, the analysis laid out in the budget papers confirms two important things.

- First, the Great Convergence is *already* reshaping the Australian economy. Its impact has been felt on trade, prices, incomes, industrial structure and economic geography.

- Second, official forecasts for Australia's economic future assume that the forces of the Great Convergence will continue to exert a strong gravitational pull on our economic trajectory. In this regard, Canberra's views are very much in line with the forecasts of a wide range of private-sector players (investment banks, consultancy firms and so on) as well as with the views of the international financial institutions such as the IMF and World Bank. That is, Canberra is yet another believer in our consensus future.

So, the official view of the future is one that is both in line with the consensus, and consistent with the persistence of the Great Convergence. As such, it makes for a sensible and realistic baseline. Remember, however, that is only a statement about *relative* probabilities (that is, that this is a reasonable guess as to the most likely future scenario) and says little about *absolute* probabilities (that is, the likelihood we get this consensus future).

Unfortunately, past experience suggests that the (implicit) probability that we are currently assigning to this outcome is quite likely to turn out to be too high. This means that planning for Australia's economic future involves preparing not just for the powerful consequences of the Great Convergence, but also for what happens if our current consensus future turns out not to be the future that actually unfolds.

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[1] See IEC#4 on the Great Convergence.
[2] Mark Thirlwell, *Our consensus future: The lay of the land in 2025*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010.
[3] The data presented in budget statement are from Homi Kharas and Geoffrey Gertz, The new global middle class: A cross-over from west to east, in *China's emerging middle class: Beyond economic transformation*, ed. Cheng Li. Washington DC, Brookings Institution Press, 2010.