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AUSTRALIA

2003 IN REVIEW

Real GDP grew by 3% in 2003, compared with 3.6% in 2002. This mild downturn was due, in the main, to a sharp deterioration in the balance between export and import volumes. Contributing to this deterioration were drought-related shortfalls in agricultural exports, generally weak growth in world demand for Australian products and strong real appreciation of the Australian currency. Through the year, unemployment averaged 5.9% of the labour force and core inflation remained low.

Policy debate in 2003 focused on a variety of issues, including strategies for supporting drought-affected rural Australia, the appropriateness of monetary policy settings, and the challenges of a rising exchange rate. There will be a federal election in 2004 (most likely towards the end of the year), likely to re-focus debate on taxation and spending on defence, health and education.

Real private consumption grew by 4.3% in 2003 (4.2% in 2002). Underlying the strength in consumer demand has been strong growth in household wealth fuelled in the main by substantial rises in housing prices. Solid growth in employment has been another positive factor.

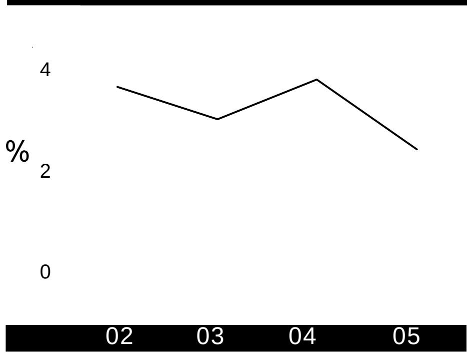
Dwelling investment increased by around 6% in 2003 after rising by over 20% in 2002. The surge in 2002 was partly driven by low mortgage rates, supplemented by the once-off effects of a top-up to the First Home Owners Grant scheme. In 2003, without the effects of the top-up and with mortgage interest rates on the rise, growth in dwelling investment has fallen, but the level of investment remains historically high. Real business investment increased significantly in 2003 (up 10.3%), with the major positive factors being low real interest rates, high rates of profitability, and tightening capacity constraints in some sectors.

Public final demand is dominated by government consumer spending—wages of public servants and current spending on goods and services. Government consumption is growing faster than the economy as a whole, boosted by a large-spending program on defence, border protection and airport security.

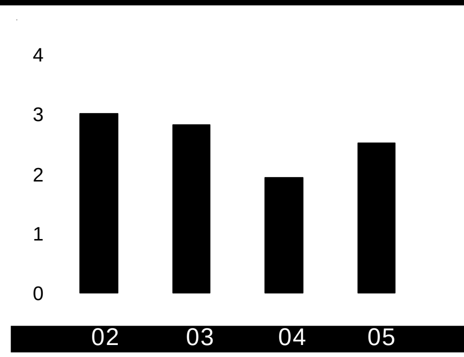
Export volumes fell by 2.1% in 2003, while imports were up 11.6%. The fall in exports reflects weak work demand, little or no growth in international tourism, the impacts of drought on agricultural exports, and strong real appreciation of the Australian dollar. The increase in imports in 2003 mostly reflects strong growth in import-intensive elements of domestic demand and real exchange rate appreciation.

The deterioration in the balance between export and import volumes moved the trade account balance further into deficit. In 2002, Australia had a trade deficit worth around 1.3% of GDP. In 2003, that had widened to a deficit worth about 3% of GDP. Reflecting the deterioration in the

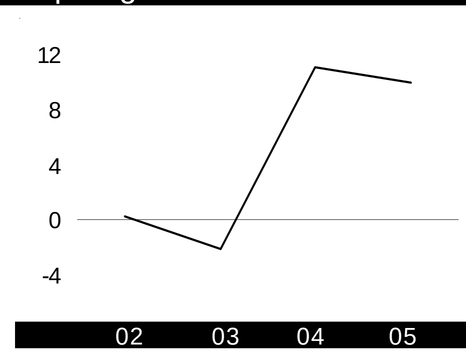
GDP growth



CPI inflation



Export growth



trade account balance, the deficit on current account rose from 4.3% of GDP in 2002 to 6% in 2003.

Employment increased by 2.3% in 2003, following a rise of 2% in 2002. This precipitated a fall in the average unemployment rate from 6.3% in 2002 to 5.9% in 2003. Headline CPI-inflation was steady at 3% in 2003. Much of the inflation has come from increased prices in domestically focused sectors—housing, health services and fresh food. On the other hand, the rising nominal value of the Australian dollar has seen prices of imported consumption goods fall.

The Reserve Bank is slowly raising interest rates back to neutral levels. The official cash rate, which was held at 4.75% between the middle of 2002 and the third quarter of 2003, has now been increased to 5.25%, with a further increase of 0.25 percentage points likely before the middle of 2004.

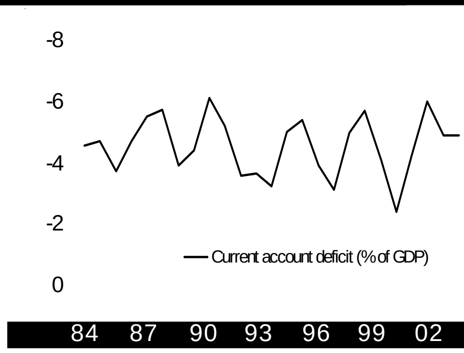
Australia experienced one of the severest and most widespread droughts on record throughout most of 2003. Current estimates indicate that the drought reduced agricultural output on average by almost 30% in the 2002–03 (July–June) financial year. This was enough to remove almost 1 percentage point from Australia's GDP growth rate. The drought is now over in most areas. However, some shortfall in agricultural production is still likely in the first half of 2004 before a full recovery takes place in the second half of the year.

Historically, the value of the Australian dollar has been determined by economic fundamentals: interest rate differential, the strength of the world economy and the position on the commodity price cycle. However, between the start of 1999 and the middle of 2002, the traditional rules seemed not to apply: the Australian dollar fell when the global economy grew strongly and then remained low when the global economy weakened even though commodity prices were relatively strong. The major factor influencing the Australian dollar during this period appeared to be the strength of the US dollar. Regardless of the fundamentals, the Australian dollar was out of favour.

Since the middle of 2002, the gap between commodity prices and the Australian dollar has closed and investors are taking notice of the fact that Australian interest rates are well above most international rates. As a consequence, the Australian dollar increased significantly in value. Against the Trade Weighted Index, the Australian dollar rose in value by almost 30% between the middle of 2002 and the end of 2003, while against the US dollar the increase was almost 40%. In real terms, the increase was of a similar magnitude, implying a significant deterioration in competitiveness for Australia's traded goods industries. This has slowed the improvement in the current account deficit which would otherwise come from a recovery in rural exports and a general pick up in world demand. On the positive side, though, a stronger currency reduced inflationary pressures, which eased the pressure on the Reserve Bank to further raise interest rates in 2004.

Six % again!

Australia's current account deficit reached 6% of GDP in 2003. However, as the chart shows, this is not an unusual event, with our forecasts pointing to a mild reversal in 2004.



OUTLOOK FOR 2004 AND 2005

The key assumptions underlying our forecasts for 2004 are

- little change in real interest rates
- steady cyclical decline in housing investment through the year resulting in a year-on-year decline of 4.9%, coupled with an increase of 4.8% in real private business investment
- growth in real public final demand of 2.3% (the spending surge in 2003 appears to be over, with the Federal Government preparing for tax cuts in the lead up to a second-half election)
- improvement in Australia's terms of trade of around 2%, compared with 3.7% in 2003
- a strong pick-up in Australian exports, with a robust rural rebound coupled with increased mining exports
- little change in the current high level of oil prices until mid year
- little change in the value of the currency from current levels (TWI = 60 and US/AUS = 0.75).

Overall, GDP growth will pick up to 3.8% in 2003, supported by a strong improvement in the balance between export and import volumes. Partly offsetting this factor are

- a fall in growth in dwelling investment (–4.9%, compared with 5.9%) and
- a fall in growth in business investment (4.8%, compared with 10.3%).

The forecast improvement in net trade volume is expected partly to arrest the rate of deterioration in the current account balance. In 2004, the current account deficit is valued at 4.9% of GDP. The forecast for CPI-inflation in 2004 is 1.9%. For 2005, real GDP growth is expected to be lower than in 2003 (2.4% compared with 3.8%), but with no improvement in the current account deficit as a share of GDP.