

PART 2

BACKGROUND

Following is an assessment of economic developments that informs the longer-term policy agenda outlined in Part 1 of this submission. In short, while growth remains robust, there are a number of threats and risks to future growth. By sustaining robust, low inflationary growth, Australia can grow through these imbalances – but to do so requires decisive policy action.

RECENT ECONOMIC DEVELOPMENTS

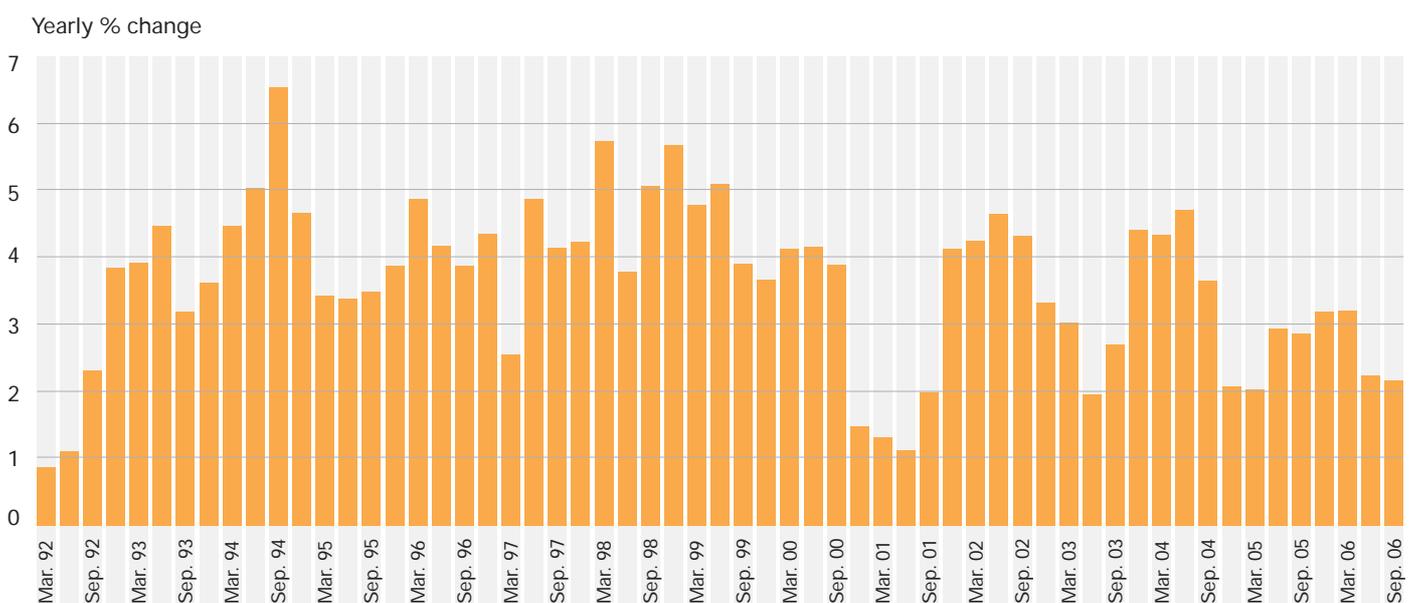
The Australian economy is now into its sixteenth year of uninterrupted expansion, the longest in its history (Figure 5).

The benefits of 15 years of continuous growth are plain to see. Unemployment is at its lowest levels in three decades. Employment and workforce participation rates are at record highs (Figure 6). More Australians are actively engaged in the real economy than ever before, and they are reaping the benefits in terms of incomes, wealth and living standards. A vibrant business sector has underpinned Australia's economic performance

as evidenced by strong corporate profitability and record highs in the Australian sharemarket.

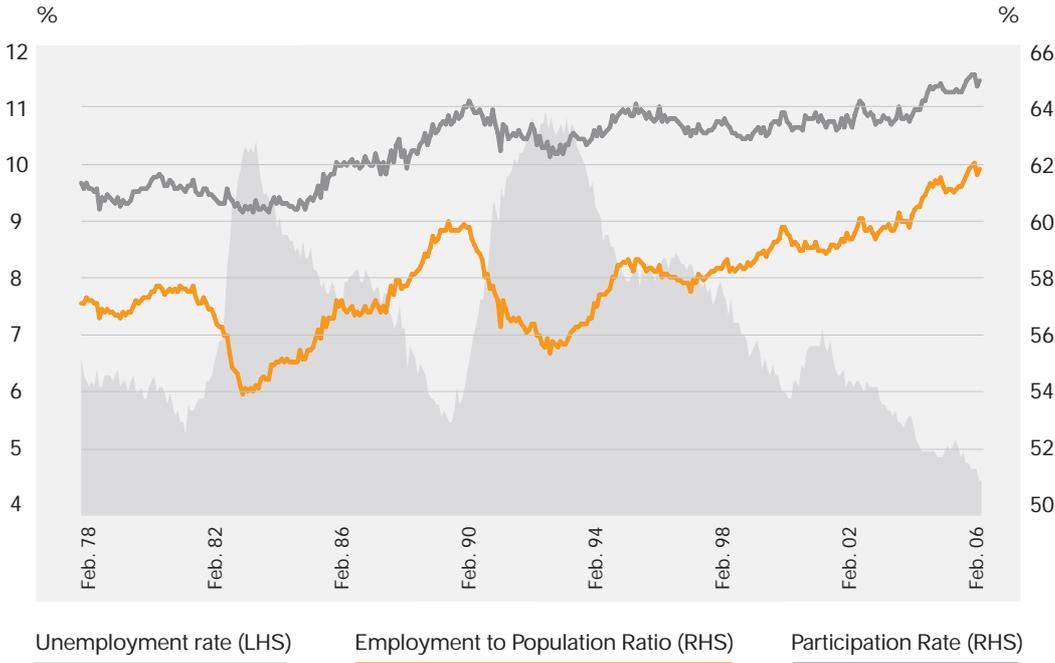
Over the last decade and a half, the economy has remained strong in the face of significant 'shocks' and has progressed through a number of cycles or 'phases' during which different sectors of the economy have underpinned growth. Recently the economy has continued to grow despite the cessation of the housing boom in some regions, with strong business investment replacing housing construction and household consumption as the leading component of GDP growth (Figure 7).

FIGURE 5 The long boom: annual GDP growth



Source: ABS 5206.0, *Australian National Accounts: National Income, Expenditure and Product*, Table 2, September 2006.

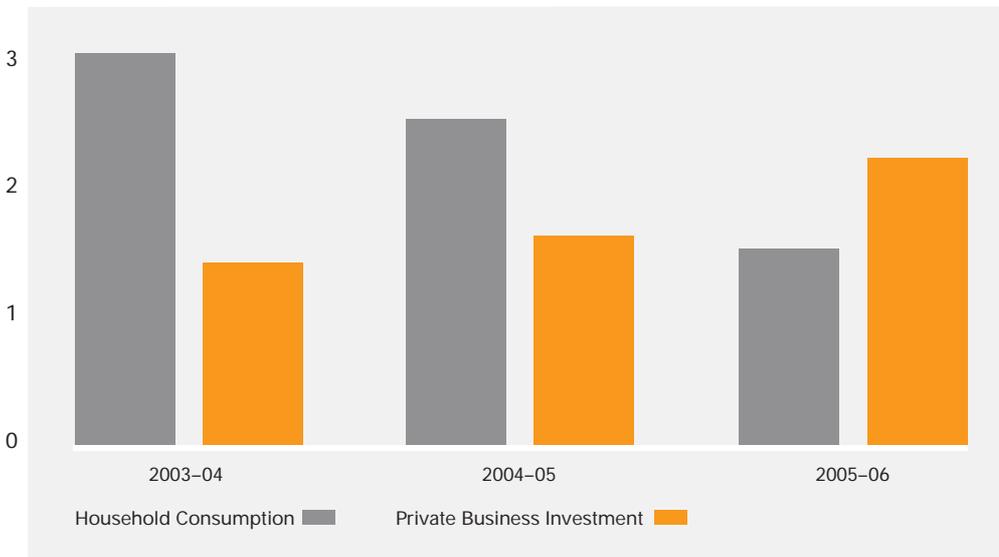
FIGURE 6 The benefits of the long boom



Source: ABS 6202.0.55.001, *Labour Force, Australia, Spreadsheets, Table 2, 2006.*

FIGURE 7 The smooth transition: household consumption and business investment in recent years

Contribution to GDP growth (percentage points)



Note: This chart is based on annual data and therefore does not include the latest National Accounts results. Based on the quarterly data in those accounts, business investment detracted from growth, suggesting that we are coming to the end of the business investment cycle. The broader point about the role that business investment has played in supporting growth in recent years, however, remains valid.

Source: ABS 5204.0, *Australian System of National Accounts, 2005-06, Table 3, 2006.*

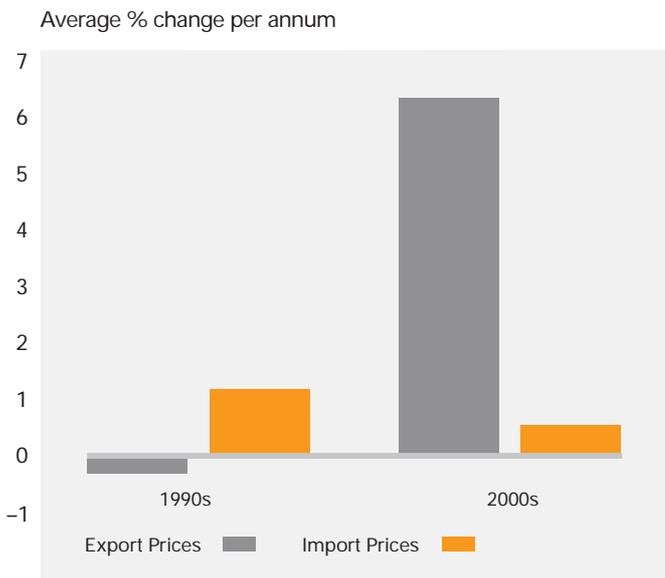
This enviable track record stands in stark contrast to past experience. It reflects sound economic management and the benefits of wide-ranging microeconomic reforms instituted by successive governments since the early 1980s. These have resulted in a more flexible economy able to withstand and adjust to adverse shocks to confidence and activity. The development of clear and transparent monetary and fiscal policy frameworks has supported more appropriate macroeconomic policy settings, which in turn have underpinned sustained growth in Australia.

Australia's continuing economic expansion has also benefited from good luck in recent times. The surge in world commodity prices over the last two to three years, and continued price competition in manufactures as production has taken off in developing countries (such as China) has seen Australia's export prices increase while import prices have remained relatively steady.

The result has been a significant improvement in Australia's terms of trade, in other words our national purchasing power (Figures 8a and 8b).

FIGURE 8a

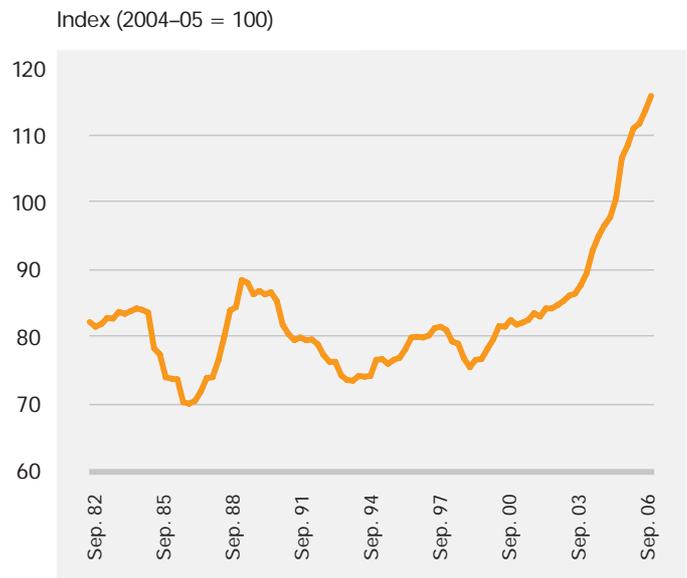
Growth in Australia's export and import prices



Source: ABS 5302.0, *Balance of Payments and International Investment Position, Australia*, Table 6, September 2006.

FIGURE 8b

Australia's terms of trade



Source: ABS 5302.0, *Balance of Payments and International Investment Position, Australia*, Table 6, September 2006.

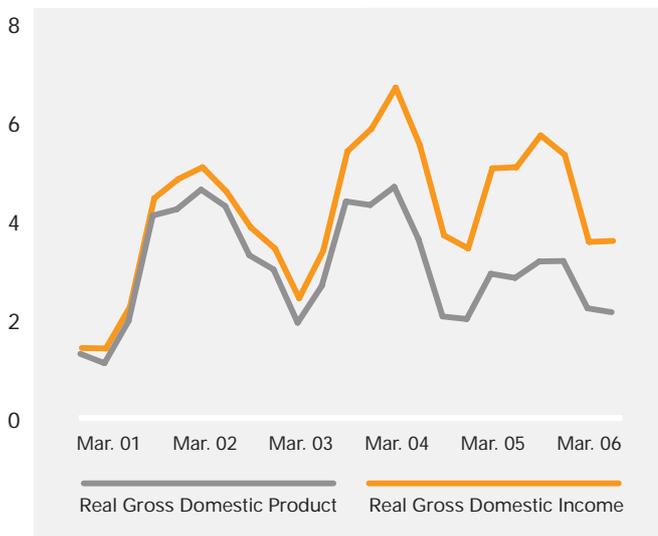
The terms of trade improvement has resulted in a substantial income boost to the Australian economy (Figure 9), which in turn has provided broader economic benefits. Higher incomes, profits and wealth in the economy stemming from the terms of trade surge have aided consumption. The rise in the terms of trade has also contributed to tax windfalls for the federal government, in particular corporate tax revenues.

The latter have provided scope for recent tax cuts and further sustained consumption growth.

FIGURE 9

The terms of trade income boost: annual income and output growth

Yearly % change



Source: ABS 5206.0, *Australian National Accounts: National Income, Expenditure and Product*, Table 1, September 2006.

The terms of trade increase has helped boost consumption at the same time as the wealth effects of rising house prices have faded in the economy (Figure 10).

However, the benefits that rising commodity prices have provided to the economy, to an extent, have also served to mask underlying structural weaknesses. Rising commodity prices have boosted the value of exports in recent years, even though export volumes have been weak (Figure 11).

FIGURE 10

Lucky timing: terms of trade replaces house prices

Yearly % change



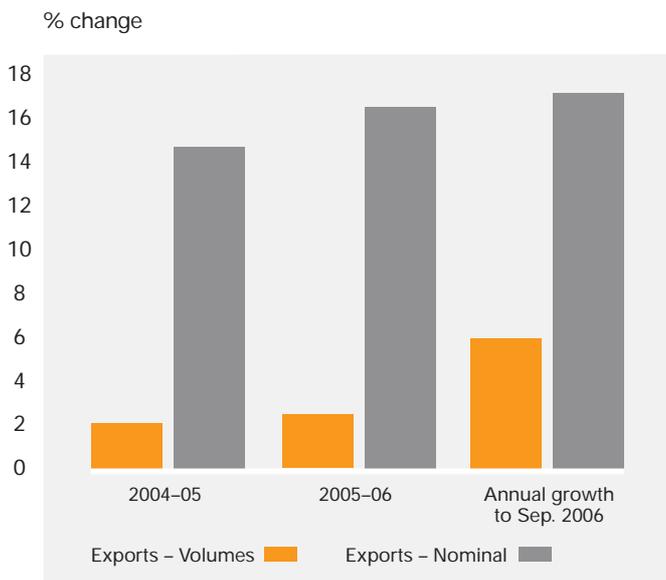
Source: ABS 6416.0, *House Price Indexes: Eight Capital Cities*, September 2006; ABS 5302.0, *Balance of Payments and International Investment Position, Australia*, Table 6, September 2006.

As the business investment cycle reaches its peak, new investment cannot be relied on as a strong source of growth in the future. The maturation of the business investment cycle in Australia, together with the moderation of household consumption growth in line with higher interest rates and flat house prices, mean that the contribution to growth from exports becomes critical. While export volume growth has begun to increase in the last year, it is still too early to be confident that a strong export recovery is inevitable.

In addition to this 'vulnerability', there are a number of other potential risks to Australia's ability to sustain strong growth. These include the impact of the severe drought affecting many parts of Australia, high household debt servicing requirements (which increase the susceptibility of households to interest rate increases or declining asset prices and hence a deterioration in household balance sheets), and the current account deficit.

FIGURE 11

Export volumes languish



Source: ABS 5206.0, *Australian National Accounts: National Income, Expenditure and Product*, Tables 2 and 3, September 2006.

The benefits that rising commodity prices have provided to the economy have masked underlying structural weaknesses

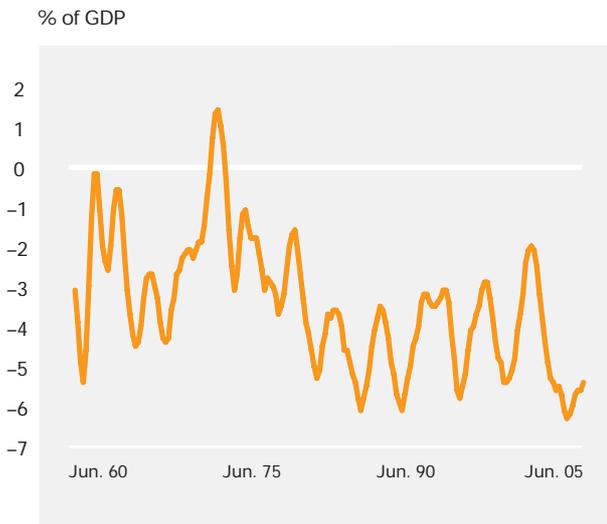
Australia is currently running historically high current account deficits (Figure 12). Many commentators have noted that such large deficits are not a matter for concern as they have been largely driven by increasing investment rather than a fall in national savings. However, the composition of investment in Australia in recent years, in particular the strong residential dwelling investment throughout the early part of the decade, does raise questions about the ease with which the economy will be able to service the accumulation of liabilities associated with successive current account deficits.

The net income deficit component of the current account – which represents the excess of dividends and interest paid to foreign owners of Australian debt, shares and businesses, over similar payments to Australian residents owning foreign assets – is currently at historically high levels, and has deteriorated dramatically in recent years as world and domestic interest rates have risen (Figure 13).

These developments underscore the growing importance of improving and sustaining the competitiveness of Australia's products and services, and increasing the export intensity of output in order to stabilise Australia's current account position and maintain strong economic growth.

FIGURE 12

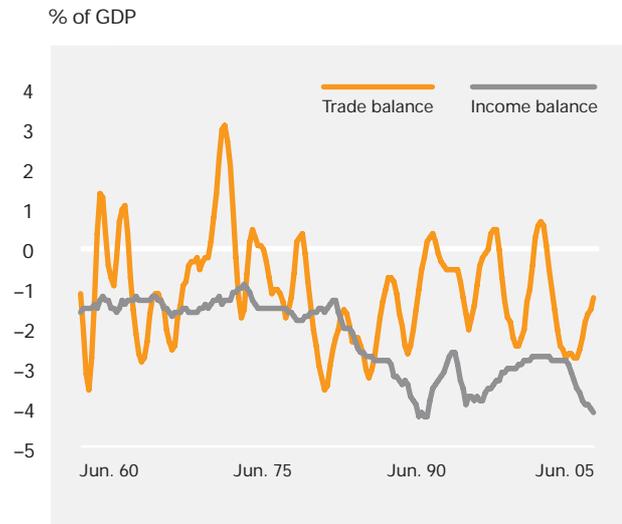
Australia's current account balance



Source: ABS 5302.0, *Balance of Payments and International Investment Position*, Australia, Table 35, September 2006.

FIGURE 13

Components of the current account deficit: trade and income balances



Source: ABS 5302.0, *Balance of Payments and International Investment Position*, Australia, Table 35, September 2006.



NOTES

- 1 For example, the Asian financial crisis, the tech-wreck, global economic downturn, SARS and global terrorism.
- 2 See for example 'Managing Prosperity', address by Dr Ken Henry, Secretary to the Treasury, to the 2006 Economic and Social Outlook Conference, Melbourne, 2 November 2006; and Paul Kelly, 'Conserving Energy at the Core of Politics', *The Australian*, 4 November 2006, p. 1.
- 3 Business Council of Australia, *Locking in or Losing Prosperity: Australia's Choice*, Melbourne, August 2005.
- 4 Based on information presented by Dr Ken Henry to a meeting of the Business Council of Australia in November 2006.
- 5 But also including Malaysia, Turkey, Belgium and Greece. See Business Council of Australia, *Corporate Taxation: An International Comparison*, Melbourne, December 2006.
- 6 See for example Robert Carling, *State Taxation and Fiscal Federalism: A Blueprint for Further Reform*, CIS Policy Monograph 73, The Centre for Independent Studies, Sydney, 2006.
- 7 Access Economics, 'The Costs of Federalism', in *Reshaping Australia's Federation: A New Contract for Federal-State Relations*, Business Council of Australia, Melbourne, October 2006.
- 8 See Bryn Battersby, *Does Distance matter? The Effect of Geographic Isolation on Productivity Levels*, Treasury Working Paper 2006—03, Canberra, April 2006.
- 9 See for example *Reshaping Australia's Federation: A New Contract for Federal-State Relations*.
- 10 For example, completing an apprenticeship.
- 11 This is based on the latest available data from September 2005. See ABS Catalogue No. 6220.0, *Persons Not in the Labour Force*, Canberra, September 2005.
- 12 There has been extensive discussion of this including in regard to the welfare of children in households where there is no parent in paid employment. See for example Peter Saunders, *Australia's Welfare Habit and How to Kick It*, Duffy & Snellgrove/The Centre for Independent Studies, Sydney, 2004.
- 13 ABS Catalogue No. 1370.0, *Measures of Australia's Progress*, Canberra, 2006, p. 53.

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