

Chapter 6 External Economic Environment

Key Points

- The significance of the mining and tourism industries makes the Territory economy particularly reliant on exports and susceptible to developments in key export markets.
- Demand for Territory-produced goods and services comes from the rest of the world and from other Australian states and territories.
- The global economy grew strongly in 2004, led by the United States and China.
- Global growth has been supported by expansionary monetary and fiscal policy settings in many of the world's major economies.
- Despite subdued export growth, the Australian economy has maintained a solid pace in recent years due to strong domestic demand.
- Nationally and globally, growth is expected to moderate in 2005, potentially leading to lower demand for Territory exports, including tourism-related services exports.

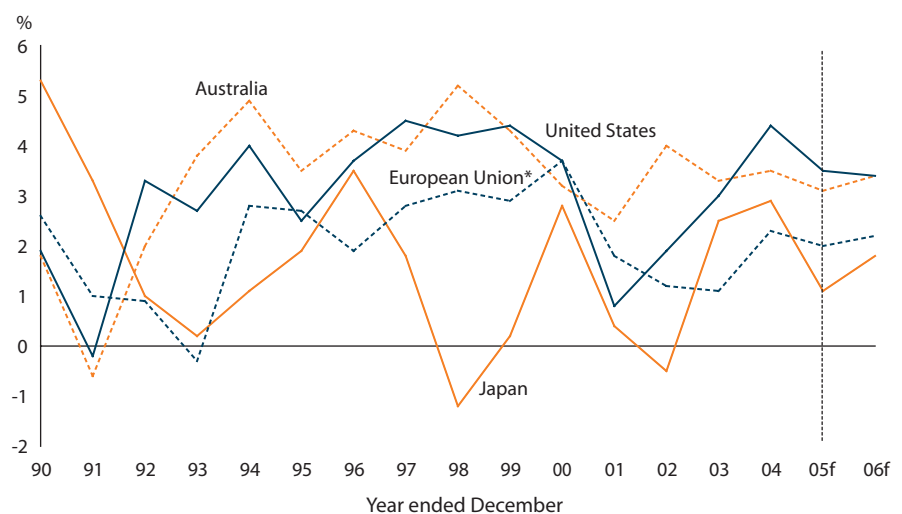
Overseas and Australian markets

Overseas export demand constitutes almost 20 per cent of Territory final demand, while demand from other Australian states and territories is estimated at more than 12 per cent. External demand is therefore particularly significant for the Territory economy and it is useful to examine likely changes in external demand, both in aggregate and in the markets of major individual trading partners.

As discussed in the International Trade chapter, much of the Territory's exports consist of crude oil, mineral ores, live cattle and tourism-related services exports. The major destination markets for mineral ores are the United States (US), China and Japan. Live cattle are exported mainly to the Philippines and Indonesia. Oil is primarily exported to Singapore, China, the US and South Korea for refining. International visitors come primarily from Western Europe, North America and Japan.

Indirect trade links between the Territory and the US are critical for the Territory's export demand. Many of the Territory's primary products are used in manufacturing production in Asia, for subsequent export to the US and other nations. It is through these demand linkages that economic conditions in the major growth centres of the world can affect the Territory economy.

Chart 6.1: Real GDP Growth – Japan, European Union, US, Australia (year on year percentage change)

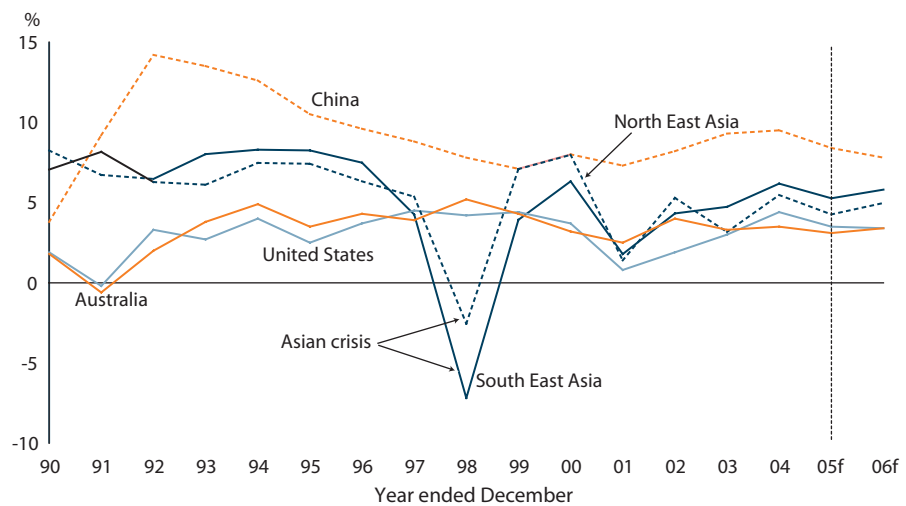


* Prior to May 2004, the European Union comprised Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. From 1 May 2004, the European Union includes 10 new member states, primarily from Eastern Europe.

e: estimate; f: forecast

Source: Consensus Economics, IMF

Chart 6.2: Real GDP Growth – China Asia, US, Australia (year on year percentage change)



Weighted averages have been used to calculate South East Asia (Indonesia, Malaysia, the Philippines, Singapore and Thailand) and North East Asia (Hong Kong, South Korea and Taiwan).
 e: estimate; f: forecast
 Source: Consensus Economics, IMF

Global Economy

The global economy expanded rapidly in late 2003 and early 2004, driven by the solid economic recovery of the US and continued strength in the Chinese economy. The second half of 2004 saw a moderate deceleration of growth, affected by sharp increases in crude oil prices and slowing US growth.

The slowdown is likely to continue in 2005, influenced by further moderation of economic growth in the US and recent policy moves in China to moderate strong growth over the past decade. Further, crude oil prices jumped in early 2005 and pose significant downside risk to the global economic outlook. Consensus Economics forecasts world economic growth to moderate from 3.9 per cent in 2004 to 3.0 per cent in 2005, and to 3.1 per cent in 2006.

Australian Economy

The Australian economy, also a major destination for Territory goods and services, looks set to experience continued growth in 2005, although at a slower pace than 2004. Cooling domestic demand is expected to be offset somewhat by improving net exports, although the strong Australian dollar will have a negative impact and capacity constraints, notably in the transport sector, will inhibit short to medium term growth prospects. Further out, growth is forecast to strengthen again in 2006 as international demand for Australian commodities boosts net exports while domestic demand conditions remain buoyant.

United States

Easing Growth

Following strong growth of 4.4 per cent in 2004, Consensus Economics expects US output growth to moderate to 3.5 per cent in 2005 and 3.4 per cent in 2006. The 4.4 per cent growth rate for 2004 was the highest in five years and acted as a major driver of global growth over the year.

After sluggish growth in 2001 and 2002, the US economy began to recover in 2003, supported by low interest rates and tax cuts. Growth continued to strengthen in early 2004, across both consumption and business investment. The recovery is now starting to flow through to the labour market, with the unemployment rate falling to 5.4 per cent in February 2005. Combined with rising household wealth, continuing low interest rates and rising consumer confidence, the outlook for consumer spending remains buoyant. Conditions in the business sector also remain favourable, with sharp increases in business investment and profits over 2004 and solid business sentiment.

Table 6.1: Australian and Overseas
Real GDP Growth Forecasts
(percentage change, calendar year)

	1999	2000	2001	2002	2003	2004	2005f	2006f
United States	4.4	3.7	0.8	1.9	3.0	4.4	3.5	3.4
Japan	0.2	2.8	0.4	-0.5	2.5	2.9	1.1	1.8
China	7.1	8.0	7.3	8.2	9.3	9.5	8.4	7.8
European Union*	2.9	3.7	1.8	1.2	1.1	2.3	2.0	2.2
Australia	4.3	3.2	2.5	4.0	3.3	3.5	3.1	3.4
Hong Kong	3.4	10.2	0.5	1.9	3.2	7.8	4.7	4.5
Indonesia	0.8	4.9	3.8	4.3	4.5	4.9	5.2	5.5
Malaysia	6.1	8.9	0.3	4.1	5.3	7.1	5.3	5.5
New Zealand	4.0	3.8	2.6	4.7	3.4	4.8	2.5	2.8
Philippines	3.4	4.4	3.4	5.5	4.9	6.1	4.6	4.5
Singapore	6.9	9.7	-1.9	2.2	1.1	8.1	4.2	4.8
South Korea	9.5	8.5	3.8	7.0	3.1	4.7	3.9	4.7
Taiwan	5.4	5.9	-2.2	3.9	3.3	5.9	4.2	4.3
Thailand	4.4	4.8	2.2	5.3	6.9	6.1	5.3	5.4

* Prior to May 2004, the European Union comprised Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. From 1 May 2004, the European Union includes 10 new member states, primarily from Eastern Europe.

e: estimate; f: forecast

Source: Consensus Economics, IMF

However, while the outlook for the US economy remains upbeat, GDP growth is expected to moderate to 3.5 per cent in 2005. The Federal Reserve has been moving interest rates higher since mid 2004 in an effort to avoid inflationary pressures associated with expansionary fiscal policy and the impact of low interest rates on demand. The federal funds rate increased to 2.75 per cent in March 2005, the seventh consecutive increase, up from 1.0 per cent less than a year ago. Further rate rises through 2005 are likely.

Fiscal stimulus will also be gradually wound back, with a projected budget deficit of 3.5 per cent of GDP in 2005, down from 3.6 per cent in 2004.

The major downside risk to the US economic outlook relates to the current account deficit, which increased by 24 per cent in the year to December 2004. Continued deterioration in the current account deficit could lead to a significant depreciation of the US dollar, which would have adverse consequences for countries dependent on US demand for their exports, as well as global financial markets generally. Further, devaluation of the US dollar could also have a negative impact on US economic performance by exerting upward pressure on domestic inflation and interest rates.

Japan

Uncertain Outlook

Following growth of 2.9 per cent in 2004, Consensus Economics predicts Japanese GDP growth of 1.1 per cent in 2005, strengthening to 1.8 per cent in 2006. Growth in 2004 was stimulated by strong export demand, robust business investment and relatively strong consumption growth.

Deflationary pressures, which have had a significant negative impact on economic growth in recent years, also eased in 2004, with zero CPI growth in the year to December. Consensus anticipates consumer prices growth to increase to 0.3 per cent in 2006.

While year on year economic growth was relatively strong in 2004, the Japanese economy has been slowing since mid-year, with production and retail sales falling in the December quarter. Falling household wealth and tax increases planned for 2005 have raised concerns about the strength of domestic demand looking forward.

Easing world economic growth and the appreciation of the yen against the US dollar may result in a weaker export performance in 2005. Over 23 per cent of Japanese exports went to the US in the first half of 2004. Continued growth in the US is therefore crucial for Japanese economic performance, and a sharp downturn in the US economy could pose a significant downside risk to Japan.

In the medium term, sustained economic growth remains dependent on economic restructuring. There has been significant progress in reforming the banking sector, with the major banks continuing to reduce their stock of non-performing loans (NPLs). Profitability in the banking sector remains low, however, and NPL ratios remain at relatively high levels in the country's smaller regional banks.

Japan's ageing population is also of considerable concern in the medium term. Japan is facing the pressures of a shrinking workforce and growing demand for government services much sooner than other economies, and this will continue to put considerable pressure on fiscal reforms.

China

Continuing Strong Growth

Chinese economic growth has been consistently strong over the past decade and was 9.5 per cent in 2004. Consensus Economics expects economic growth to moderate to 8.4 per cent and 7.8 per cent in 2005 and 2006 respectively.

Reflecting its increasing importance in the world economy, China directly accounted for a quarter of global economic growth over the past two years. China's rapid expansion has caused a huge increase in its demand for raw materials which has led to strong growth in commodity prices over the two years.

Economic growth has been associated with strong investment and export growth flowing through to solid consumption and other domestic demand. Fixed asset investment grew by almost 27 per cent in 2004, representing a massive 45 per cent of GDP. Due to fears that the economy has been overheating, the Chinese Government has introduced policies such as industry-specific credit restrictions and a tightening of monetary policy to slow growth and broaden the mix of activity.

The success of China in achieving a 'soft landing' is an important issue for the world economy given it is currently the major driver of global growth. Medium term growth prospects in China will depend on the success of structural reforms, notably in the banking and state-owned enterprise sectors.

India

Economic growth in India was 6.4 per cent in the 2004 fiscal year (which is April through to March), a significant decline from the 8.5 per cent growth of 2003, influenced by weak agricultural production and high oil prices. Strong industrial production has contributed to recent growth, underpinned by solid capital investment and consumer demand.

Consensus forecasts economic growth in India to increase to 6.8 per cent in the 2005 fiscal year. However, there are significant downside risks to this forecast including continuing high oil prices, another weak monsoon in 2005 impacting on agricultural production and the impact on high levels of government debt if interest rates rise more quickly than expected.

European Union

Western Europe recorded modest economic growth of 2.3 per cent in 2004. With relatively subdued domestic demand, exports were the main contributor to output growth. Consensus Economics expects growth of 2.0 per cent in 2005, with the strong Euro and slowing global activity impacting negatively on export growth. Growth is forecast to increase to 2.2 per cent in 2006.

Germany German economic growth is set to slow to just 1.2 per cent in 2005, following growth of 1.7 per cent in 2004. Growth in 2004 was driven largely by exports as private consumption remained stagnant, declining by 0.3 per cent, and machinery and equipment investment showed only modest growth of 1.2 per cent, despite stronger corporate profit growth and continuing low interest rates.

Growth in 2005 will be affected by the slowing world economy and the strength of the Euro. The outlook for the German economy continues to be affected by large fiscal deficits and labour market rigidities. Consensus forecasts growth to remain weak, but strengthen to 1.6 per cent in 2006.

United Kingdom Consensus predicts that growth in the United Kingdom (UK) will weaken to 2.5 per cent in 2005, following growth of 3.1 per cent in 2004. Economic activity is expected to moderate to 2.4 per cent in 2006.

Growth in recent years has been stronger than in other major European economies, with domestic demand a key factor. The year 2004 saw strong growth in gross fixed investment, increasing by 6.0 per cent, as well as solid household consumption growth of 3.3 per cent. Tightening monetary policy is beginning to affect growth, particularly in the housing market, which should flow through to weaker household consumption in 2005.

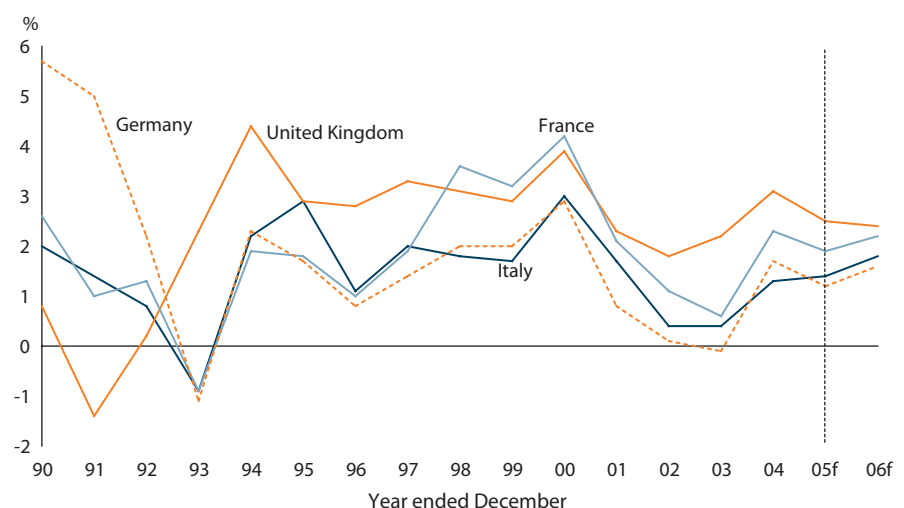
France Economic growth in France strengthened to 2.3 per cent in 2004, up from 0.6 per cent in 2003. Consensus Economics is estimating GDP growth of 1.9 per cent in 2005 and 2.2 per cent in 2006.

Domestic demand has supported growth, with business investment increasing by 2.9 per cent and household consumption by 2.1 per cent in 2004. Like other European nations, economic activity in France is expected to moderate in 2005 in line with weaker global growth.

Italy As in Germany, the Italian economy has experienced weaker growth than the other major European economies in recent years. Following growth of 1.3 per cent in 2004, Consensus Economics forecasts output to strengthen marginally to 1.4 per cent in 2005 and to 1.8 per cent in 2006.

While growth remains weak, Italy's economy has been recovering gradually over the past two years, with investment and exports making solid gains in the first half of 2004. Industrial production has been sluggish, however, contracting by 0.2 per cent in 2004, with falling productivity impacting on the competitiveness of Italian goods. While GDP growth is expected to strengthen in 2005, slower global growth and the continuing strength of the Euro pose significant downside risks.

Chart 6.3: Real GDP Growth – Germany, UK, France, Italy (year on year percentage change)



e: estimate; f: forecast
Source: Consensus Economics, IMF

North East Asia

Many countries in the North East Asian region depend heavily on demand from the US, Japan and, increasingly, China. With slower growth predicted for these economies in 2005, GDP growth in the region is likely to decelerate from 5.5 per cent in 2004 to 4.3 per cent in 2005. While external demand is expected to weaken, the outlook for domestic activity in 2005 appears generally positive.

Hong Kong Following strong growth of 7.8 per cent in 2004, Consensus Economics predicts Hong Kong's economic growth will slow to 4.7 per cent in 2005 and 4.5 per cent in 2006. Strong growth in China and the global economy provided solid support for Hong Kong's external sector over 2004. The year 2005 should see a moderation in economic activity in line with slowing domestic and external demand.

Taiwan Consensus Economics predicts Taiwanese economic growth of 4.2 per cent in 2005 and 4.3 per cent in 2006. This follows growth of 5.9 per cent in 2004. The slowdown in Taiwan's economy is being driven by weaker export growth, set to decline further as manufacturing production growth is estimated to fall from 10.1 per cent in 2004 to 5.8 per cent in 2005. Taiwan's economy is heavily dependent on information technology exports, particularly to China, Hong Kong and the US. A rapid downturn in any of these countries could pose a significant risk to Taiwan's growth outlook.

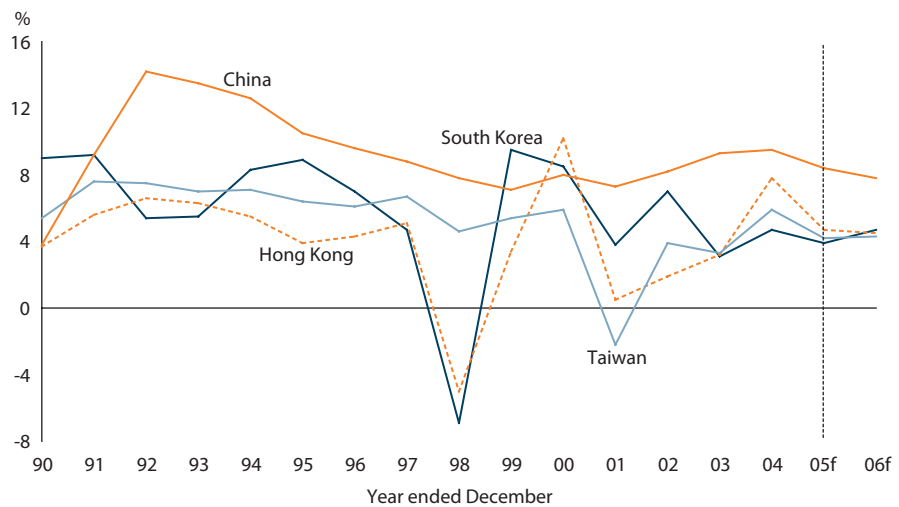
South Korea After solid growth of 4.7 per cent in 2004, Consensus Economics expects South Korean GDP growth to fall to 3.9 per cent in 2005 before recovering to 4.7 per cent in 2006.

Like Taiwan, weaker export growth is a key factor in weaker growth in 2005 as domestic consumption growth, which was weak in 2004, is unlikely to cushion the slowdown in export growth. South Korea's outlook in the medium term appears positive, with growth expected to return to 4.7 per cent in 2006. However, this is dependent on external conditions, in particular China's ability to achieve a 'soft landing'.

South East Asia

The economies of South East Asia experienced strong growth of 6.2 per cent in 2004, driven largely by the positive international environment and strong growth in China. The tsunami disaster of December 2004 is unlikely to have a major economic impact on GDP growth in the region, however lower growth in the US, China and Japan in 2005 will have a negative impact on growth which is expected to moderate to 5.3 per cent.

Chart 6.4: Real GDP Growth – China, Hong Kong, Taiwan and South Korea (year on year percentage change)



e: estimate; f: forecast

Source: Consensus Economics, IMF

Singapore Economic activity in Singapore recovered strongly from the SARS crisis of 2003, with GDP growth of 8.1 per cent in 2004. Consensus Economics predicts growth to slow to 4.2 per cent in 2005 before strengthening to 4.8 per cent in 2006.

A buoyant export sector and solid levels of investment were behind the upturn in 2004, assisted by tax and labour market reforms. Softer export demand, consistent with slowdowns in China, Malaysia and the US, will see growth moderate in 2005. In addition, Singapore's electronics dominated manufacturing sector is facing intense competition from China and India. Despite this, manufacturing production growth is expected to remain strong at around 7.5 per cent per annum in 2005 and 2006.

Indonesia Consensus Economics predicts Indonesian GDP growth of 5.2 per cent in 2005, up slightly from 4.9 per cent in 2004. Further out, growth of 5.5 per cent is forecast for 2006. Consumption and investment finished strongly in 2004, growing by 5.0 per cent and 8.5 per cent respectively. The Australian Government has committed \$33 million dollars in aid toward the tsunami relief effort in Aceh and North Sumatra. As part of a broader aid initiative, the Australian Government has also committed \$1 billion to reconstruction and development in Indonesia.

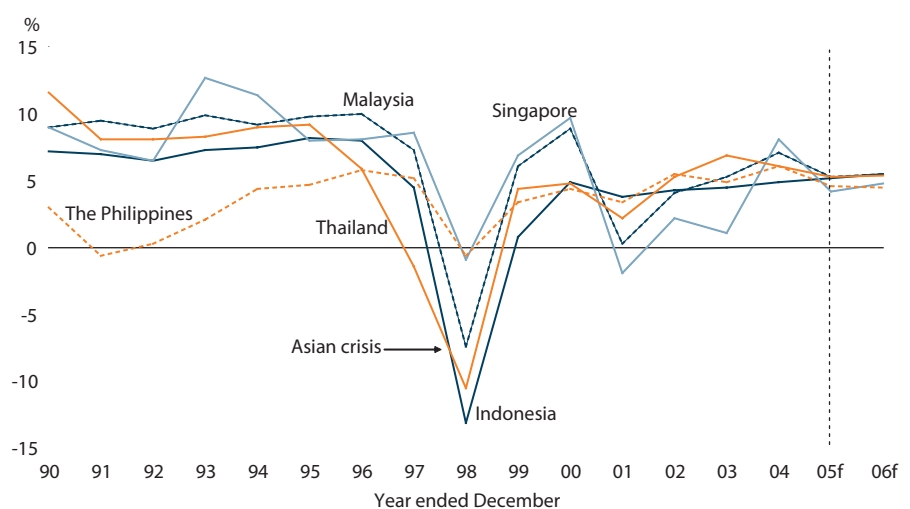
Growth in 2005 is expected to benefit from reduced political uncertainty following Susilo Bambang Yudhoyono's landslide victory in national elections in October 2004, on a platform of fighting corruption and introducing free market reforms. The national economic effects of the tsunami disaster will be relatively minor, despite its enormous impact on the province of Aceh.

Malaysia Malaysian GDP growth is forecast to be 5.3 per cent for 2005 and 5.5 per cent for 2006, following from 7.1 per cent in 2004. Growth was driven largely by the export oriented manufacturing sector, which expanded by almost 12 per cent in 2004. Despite a predicted deceleration in export growth in 2005, associated with the China-led slowdown in regional activity, trade surpluses are expected to continue increasing for the next few years.

Further out, inflation risks and international pressures may force a revaluation of the ringgit, which has been pegged to the US dollar since the 1998 Asian financial crisis, negatively impacting on Malaysia's export competitiveness.

The Philippines Consensus Economics expects GDP growth of 4.6 per cent and 4.5 per cent in the Philippines in 2005 and 2006 respectively. Stronger than expected growth of 6.1 per cent in 2004 was associated with a solid increase in private consumption as well as growth in the farm and services sectors.

Chart 6.5: Real GDP Growth – Indonesia, Malaysia, The Philippines and Thailand (year on year percentage change)



e: estimate; f: forecast
Source: Consensus Economics, IMF

While recent growth has been strong, the Philippines' large level of public debt continues to pose significant downside risks to the country's economic outlook. Debt servicing accounts for a significant proportion of the budget, and while the government is making progress in reforming public finances, rising domestic and international interest rates may mean that, in the short term, public debt levels may be largely unchanged.

Thailand The Thai economy recorded GDP growth of 6.1 per cent in 2004. Slower growth of 5.3 per cent is forecast for 2005, increasing to 5.4 per cent in 2006. The Thai economy will suffer more from the tsunami disaster than the other major countries in South East Asia. The tourism sector, which accounts for around 10 per cent of employment has suffered a major drop in visitor numbers as a result of the disaster and faces significant reconstruction costs.

The government has committed funds for reconstruction, and is offering tax concessions and cheap loans to affected businesses. Growth should be subdued in the first quarter of 2005, but is expected to rebound quickly.

Australia

After solid growth in the first half of 2004, the Australian economy slowed markedly in the September and December quarters, influenced by rising oil prices, the softening in the housing sector and the moderating world economic growth in the second half of 2004. Nevertheless, year-on-year GDP expanded by 3.5 per cent in 2004, driven largely by strong domestic spending. Consensus forecasts growth of 3.1 per cent in 2005 and 3.4 per cent in 2006.

Domestic demand has been supported by solid employment growth and historically low unemployment rates in 2004. However, despite the relatively tight labour market and the emergence of skills shortages in many sectors, inflation has remained reasonably contained. However, this has largely been associated with the strong appreciation of the Australian dollar, with solid prices growth experienced for non-traded goods and services. Both household consumption and business investment performed strongly in 2004, expanding by 5.4 per cent and 7.1 per cent respectively.

The international environment has been extremely favourable, especially in relation to Australia's terms of trade (that is, the ratio of export prices to import prices), which improved dramatically over the year in line with booming commodity prices and the appreciation of the currency. Despite this, Australia's export performance has been subdued as capacity constraints in the resource sector have limited growth and the strong Australian dollar has impacted on competitiveness in the manufacturing sector. These factors, combined with strong import demand, resulted in a substantial increase in Australia's current account deficit over the year.

The outlook for 2005 remains positive, as the growth balance shifts slightly from the domestic to the external sector. Export performance is expected to improve as infrastructure investment comes online, while moderation in the housing market and higher interest rates should bring domestic demand to more sustainable levels. These factors should combine to narrow the current account deficit from the record levels of 2004.

There are however risks to the outlook for sustained growth. Oil prices remain at historically high levels, and combined with the tight labour market and continuing capacity constraints, are expected to flow through to stronger inflationary pressures. In light of this, the Reserve Bank lifted rates by 0.25 percentage points in March, with further rate rises likely during the year, putting downward pressure on domestic demand and growth.