

Chapter 6 External Economic Environment

Key Points

- Global economic conditions are expected to remain favourable for the Australian economy.
- Countries that are key destinations for Territory exports are expected to continue to experience robust economic growth.
- Risks to the generally positive outlook include the possibility of inflationary pressures leading to an increase in interest rates.

Demand for Territory goods both internationally and from other Australian states and territories is very important for the Territory economy. Overseas demand constitutes almost 20 per cent of Territory final demand, while interstate demand accounts for a further 10 per cent.

Major Territory exports include crude oil, mineral ores, live cattle and tourism-related services. Liquefied natural gas (LNG) is a new major export for the Territory, with the first shipment to Japan in February 2006. 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 exported primarily to Singapore, China, the US and South Korea. International visitors come primarily from Europe, Japan and North America. Table 6.1 provides a summary of the economic outlook for the major destinations of Territory exports.

The Australia-US Free Trade Agreement signed on 1 January 2005 is expected to benefit the Australian economy with increased opportunities for Australian exporters and increased investment in the Australian economy. Many of the Territory's primary products are exported to Asia for use in the manufacture of goods that are subsequently exported worldwide. Exports to Asia are one of the key links through which global economic conditions affect the Territory economy. Expanded market opportunities also continue to be explored under the free trade agreements with both Singapore (agreement began in 2003) and Thailand (agreement began in 2005).

Global Economy

Global economic conditions remained favourable throughout 2005, with strong growth in the US, China and India, while the situation in Japan appears to be improving following several years of deflation and sluggish growth. Consensus Economics estimates world economic growth of 3.3 per cent in 2005.

The strength of the global economy has led to a significant and sustained increase in commodity prices, which is largely responsible for the current strength of the Australian and Territory economies. The impact of the significant increase in oil prices in recent years has been less than the increases in the 1970s, reflecting more efficient energy use in most major industrial nations.

Risks Potential risks to the global economy include major terrorist attacks, avian influenza and political instability in the Middle East and other major oil-producing countries. The magnitude of the US current account deficit is a medium-term risk for the US economy.

In the longer term, demographic changes and the ageing of the population are risks for many European countries, particularly as they impact on the dependency ratio, that is, the number of people aged over 65 years compared to the working age population.

Australian Economy

Domestic Environment

In 2005, gross domestic product (GDP) grew by 2.5 per cent. This was less than the growth in domestic final demand of 4.1 per cent over the same period. The difference in these two measures of growth is mainly due to the trade deficit, and as a result annual GDP growth has not fully reflected the strength of the domestic economy.

Record low unemployment was reported throughout 2005, along with solid employment growth. Inflation remained within the Reserve Bank's target range of 2 to 3 per cent, helped by the appreciation of the Australian dollar making imports more affordable and offsetting prices growth in domestically-produced goods and services. Interest rates have remained unchanged since the 0.25 per cent increase in March 2005.

Although still a drag on the domestic economy, the trade deficit retreated from the historic high recorded in the first quarter of 2005, benefiting from record high commodity prices that supported the value of exports.

The housing market continued to weaken, particularly in New South Wales, and increased oil and fuel prices kept consumer confidence subdued. However, businesses benefited from the global resources boom, and growth in business investment was a key contributor to GDP growth in 2005.

International Environment

The international environment has been extremely favourable, particularly in relation to Australia's terms of trade (that is, the ratio of export prices to import prices), which in 2005 were at their highest level since 1974, in line with booming commodity prices and the continued strength of the currency. The strong Australian dollar has impacted negatively on competitiveness in the manufacturing sector and Australia's export performance, while at the same time contributing to strong import demand.

Australia's Current Account

In 2005, the current account deficit reached an historic high driven by strong growth in income debits from direct investments in the resource sector. Export volumes are expected to improve in 2006 with new mining projects coming on line and substantial investment in the resources sector and related infrastructure projects. Moderation in the housing market and high energy costs are forecast to bring domestic demand to more sustainable levels. These factors should combine to narrow both the trade and current account deficits from the record levels of 2005.

Risks

There are 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, these price and wage pressures are expected to flow through to stronger inflationary pressures. There is the potential for a further interest rate rise in 2006 which may put downward pressure on domestic demand and growth. The interest rate differential between Australia and its major trading partners has narrowed and the Australian dollar has weakened.

Table 6.1: GDP Growth (annual percentage change)

	GDP Growth (%)					Comment
	2003	2004	2005	2006	2007	
North East Asia						
China	10.0	10.1	9.9	9.1	8.7	In 2005, the government announced a 'managed' float of its currency. Productivity growth is expected to increase with production becoming less labour intensive and more value added.
Korea	3.1	4.6	4.0	5.0	4.7	Growth is expected to be supported by increased household consumption and industrial production, particularly in the automotive and information technology industries.
Japan	1.8	2.3	2.7	2.9	2.1	Price deflation is expected to end. Sustained economic growth remains dependent on economic restructuring. Risks include the ageing population and shrinking workforce.
Taiwan	3.4	6.1	4.1	4.1	4.1	Growth has been led by solid expansion in the information technology sector and strong export performance.
Hong Kong	3.2	8.6	7.3	5.3	4.5	Hong Kong has benefited from China's solid growth with increases in external trade, and the finance and transport/communication industries.
South East Asia						
Philippines	4.9	6.0	5.1	4.7	4.7	Growth is expected to be supported by solid investment and household consumption. Risks include potential political instability.
Indonesia	4.7	5.1	5.6	5.1	5.5	Infrastructure investment is expected to assist structural reform. The removal of the substantial fuel subsidy and subsequent fuel price increases and interest rate rises may undermine consumption.
Malaysia	5.4	7.1	5.3	5.4	5.2	Trade has been dominated by the manufacturing sector, in particular, electrical goods. Household consumption is expected to increase prior to the introduction of a goods and services tax in 2007.
Thailand	7.0	6.2	4.5	4.8	5.0	A large government infrastructure development planned for 2006 is expected to boost activity and investment. Current political uncertainty is a risk.
Singapore	2.9	8.7	6.4	6.0	5.2	Projected growth is driven by an expected increase in manufacturing production with both private consumption and total investment expected to increase strongly in 2006.
North America						
United States	2.7	4.2	3.5	3.3	3.0	The economy began to recover in 2003 supported by low interest rates and tax cuts. Risks include growth in household consumption related to rising housing values, shortages in oil refining capacity, the trade and current account deficits and a possible fall in the dollar.
Canada	2.0	2.9	2.9	3.0	2.7	Business investment, particularly in the energy sector, has provided momentum to growth. The strong Canadian dollar has supported consumer expenditure, but also contributed to a growing trade deficit. The economy is operating near full capacity. Proposed tax cuts will further support consumer spending.
European Union						
	1.0	2.3	1.6	2.2	2.0	Europe's major economies have been experiencing relatively high unemployment and low growth since about 2002. Demographic changes are expected to lead to a decline in the labour force. Much of Europe is expected to continue to experience relatively slow growth and high unemployment with the exception of the United Kingdom.
Russia						
	7.3	7.2	5.5	5.2	na	Growth has been driven by consumption, influenced by rising incomes and a growth in credit. Some moderation in manufacturing and resource extraction has occurred.
India						
	8.5	7.5	7.9	7.3	na	Growth is supported by increased industrial production, greater openness to foreign investment and trade liberalisation. Major exports include information technology and telecommunications. Risks include high levels of government debt and large trade and foreign account deficits.
Australia						
	3.1	3.6	2.5	3.2	3.4	

na: not available

Source: Consensus Economics Forecasts (for India, financial year is reported) (for Russia, data is from the International Monetary Fund)

Outlook

Global economic conditions are expected to remain favourable throughout 2006-07. The outlook beyond 2006-07 is less certain, and will depend heavily on the extent to which the very strong growth seen in China in recent years can be maintained. Another important influence will be the strength of the US economy, which has recorded steady growth since moving into a recovery phase in 2003, and the Japanese economy, which is emerging from a sustained period of low growth and price deflation.

Consensus Economics forecasts world economic growth of 3.4 per cent in 2006 and 3.1 per cent in 2007.

Negotiations on a free trade agreement between China and Australia are continuing and, if successful, will provide further impetus to the already strong trade links between the two countries.

Australian economic growth in 2006-07 is expected to be supported by continuing strong commodity demand and high prices, strong demand for exports from China and solid household consumption. Consensus Economics forecasts growth of 3.2 per cent in 2006 and 3.4 per cent in 2007.