

Chapter 6 External Economic Environment

Key Points

- » Global economic conditions are expected to be less stable and less predictable in 2008.
- » The outlook for the Australian economy remains favourable, primarily reflecting strong Chinese demand for commodities.
- » Risks to the generally positive outlook include the possibility of a greater than expected slowdown in the United States economy.

Northern Territory Economy

Demand for Territory goods both internationally and from other Australian states and territories is very important for the Territory economy. Overseas demand constitutes almost 25.3 per cent of Territory final demand, while interstate demand has averaged 12.3 per cent annually since 2002.

Exports to Asian markets are one of the key links through which global economic conditions affect the Territory economy. The main products exported from the Territory to Asian markets include crude oil, liquefied natural gas (LNG), mineral ores, live cattle and tourism-related services. The major destination markets for mineral ores are the United States (US), China and Japan. Under contractual arrangements, all LNG is exported to Japan. Live cattle are exported mainly to the Philippines and Indonesia. Oil is exported primarily to Singapore, China, the US and South Korea.

Services provided to international tourists, mainly from Europe, Japan and North America, also form an important export component of the Territory economy.

Table 6.1 provides a summary of the economic outlook for the major destinations of Territory exports.

Global Economy

After four years of robust gross domestic product (GDP) and trade growth, conditions in global financial markets have turned from favourable to less stable and less predictable. Global GDP growth eased to 3.6 per cent in 2007 from 3.9 per cent in 2006 and growth, particularly for high income countries, is forecast to moderate further in 2008. The deterioration in financial market sentiment has been associated with a weakening in the outlook for global economic growth, with some economic analysts forecasting a US recession. The US housing sector remains weak, with the fall-out from the sub-prime mortgage crisis likely to remain a dampening factor in the short to medium term. Growth in the Eurozone, defined as European Union member states that have adopted the Euro currency, and Japan is also slowing. The extent to which the weakness in the major industrial economies will affect the developing world is still unclear.

At the global level, the slowing demand for imports by the US has been offset in part by a strengthening of import demand across developing countries, driven by robust domestic demand from large emerging market economies such as China and India.

Conditions in China, India and the smaller east Asian economies remain strong. In China, GDP grew by 11 per cent in 2007. While Chinese export growth has moderated, domestic spending is expanding rapidly. In the rest of east Asia, production and export growth generally strengthened through most of 2007. Growth in developing countries should offer a cushion from recessionary conditions in the

key Organisation for Economic Co-operation and Development (OECD) economies over the 2008 period.

Overall, changes in recent economic indicators such as stock market volatility, a weakening US dollar, uncertainty in the financial sector and rising oil prices, appear to support the view that global growth is slowing. This is due to significant weakness in the major industrial economies despite relatively strong growth in the developing world. Despite weaker global conditions, inflation remains a source of concern for many countries, including Australia.

Australian Economy

In 2007, the Australian economy continued to operate close to full capacity, experiencing labour shortages and capacity constraints. In the year to September 2007, GDP increased 3.4 per cent, a solid increase but below the 10-year average GDP growth rate of 3.6 per cent.

Disparate Economic Growth

The Australian states and territories reported disparate economic growth in 2006-07 as measured by gross state product (GSP). Strong growth was reported for Western Australia, the Northern Territory, Queensland and the Australian Capital Territory, moderate growth in Victoria and Tasmania and weak growth in New South Wales and South Australia.

At the national level, both the private and public sectors made significant contributions to GDP with domestic demand expanding 5.25 per cent. Strong growth in consumer demand has been driven by rising employment and real wages, as well as cuts in income tax. Business investment spending also grew at a fast pace, reflecting investment in plant, equipment and infrastructure.

Productive Capacity

With demand continuing to grow strongly after a long period of expansion, domestic factors such as a shortage of skilled labour indicate that the economy is operating at close to full capacity. Business surveys, including the Sensis Business Index, have been reporting both high rates of capacity utilisation and high levels of concern about labour scarcity. Unemployment remains around a 30-year low, with the job vacancy rate increasing by 13.5 per cent from November 2006 to November 2007.

High levels of business investment under way should assist in alleviating bottlenecks and over time add to the economy's productive capacity.

Agriculture and Cropping

The majority of winter cropping areas in southern Western Australia, South Australia, Victoria, New South Wales and central Queensland had an excellent start to the 2007-08 season. However, dry conditions over the remainder of the growing period meant that winter crop production was significantly lower than expectations. Although production of major winter grains in 2007-08 was significantly higher than 2006-07, production remained well below average.

Free Trade Agreements

Bilateral free trade agreements are expanding market opportunities for Australian exporters and facilitating greater investment in Australia, which has free trade agreements with New Zealand, Singapore, Thailand and the US.

Outlook

Global Economy

Global growth is expected to slow further in 2008, as the effective cost of capital remains elevated for financial institutions, firms, households and governments. This is primarily associated with the US sub-prime mortgage crisis, the effects of which have been felt in Australia with the major banks increasing interest rates independent of the Reserve Bank of Australia (RBA). As well, the RBA increased the cash rate from 6.75 to 7.25 per cent in March 2008. Despite these challenges, an upturn in global growth is projected in 2009 underpinned by continued demand for commodity

resources to fuel China's domestic demand, a US Government \$171 billion plan to stimulate the US economy, and a bottoming out of the US housing downturn.

From a global perspective, China and India have increased the supply of unskilled labour into the industrial sectors of these two previously less developed economies. This substantial increase in supply of low-skilled labour reduces the price of labour-intensive industrial outputs relative to other inputs, notably raw materials. India and China should continue to benefit from their large workforces, at least until the additional labour is absorbed or real wages for their workers improve.

Inflation poses a risk to the global economy in 2008, in particular wage pressure due to labour shortages and capacity constraints in the developed economies. Instability in some oil-producing nations, particularly Venezuela, could mean supply shortages resulting in increased oil prices.

Consensus Economics has forecast global growth in 2008 to ease to 3.2 per cent and the US economy is expected to slow. The world economy, however, is becoming more resilient and less vulnerable to a greater than expected slowdown in the US economy as a larger number of countries are contributing greater proportions to global growth. Economic growth in 2008 is expected to be strong in China, India and many South East Asian countries.

Australia Australia's international trade is dominated by the export of minerals and the import of manufactured goods. As such, Australia's terms of trade (that is, the ratio of export prices to import prices) will be significantly impacted by global prices of resource commodities relative to those of traded industrial goods.

Despite the slowing in the world economy, Australia's terms of trade are forecast to rise in the near term. This outlook is largely driven by expected large increases in coal and iron ore contract prices in mid-2008, reflecting ongoing strength in commodity demand from Asian countries, particularly China. The effect of these increases is forecast to be partially offset by declines in base metals and rural export prices from their recent high levels. Together, these developments suggest that the terms of trade will reach new highs in mid-2008, before declining somewhat due to the slowing in global growth and as demand and supply respond to the current high commodity price levels.

The Chinese and Indian economies are going to be increasingly important buyers of raw materials. China's demand for iron ore has increased from 11 per cent to 37 per cent of the total global supply of iron ore in less than a decade. China already demands a significant proportion of world commodities, with the potential for increases, as does India. This has significant implications for Australia's commodity-rich economy.

Australia's agricultural commodity sector has been under increasing pressure from drought in a rapidly evolving world economy. Challenges include uncertainty about irrigation water, climate change and high oil prices, as well as the availability and cost of labour. However, heavy rains across many drought-affected areas in late 2007 and early 2008 have improved prospects for the rural sector.

Consensus Economics forecasts Australian GDP growth of 3.4 per cent in 2008 led by the resource-rich states of Western Australia, Queensland and the Northern Territory. It also forecasts Australian inflation to be 3.1 per cent in 2008, above the upper end of the RBA's target band of 2.0 to 3.0 per cent. This indicates future interest rate rises are possible in 2008.

Table 6.1: Growth (annual percentage change)

	GDP Growth (%)					Comment
	2005	2006	2007	2008e	2009f	
North East Asia						
China	10.2	11.1	11.4	10.2	9.6	Continued focus on development needs in rural areas to address widening inequality with more funds disbursed to regions for welfare. Pressure to revalue the currency as a way to lower the country's growing trade surplus.
Korea	4.0	5.0	4.9	4.9	5.1	Inflationary pressures to remain subdued in 2008. This will partly reflect the continued appreciation of the won against the US dollar and the impact of further economic restructuring.
Japan	1.9	2.4	2.0	1.3	1.8	Government economic policy to prioritise growth over fiscal reform with general elections in 2008 and commitments for increased public works spending in the countryside.
Taiwan	4.0	4.9	5.7	4.3	4.6	Real GDP growth forecast of around 4 per cent in 2008 driven by domestic demand as unemployment continues downward trend. The government will seek to limit Taiwan's economic reliance on China yet benefit from the mainland's strong growth.
Hong Kong	7.3	6.8	6.3	4.8	5.1	Hong Kong, as a globally important trade centre port, will benefit from China's rising levels of international trade by forging closer economic ties and partnership with mainland China in terms of people and resources.
South East Asia						
Philippines	4.9	5.4	6.3	5.8	5.8	Improvement in government's finances is expected to lead to a decline in total government debt which should in turn lead to greater economic stability and modest acceleration in investment growth.
Indonesia	5.6	5.2	6.3	6.2	6.0	Greatly reduced public debt has given the government more freedom in fiscal policy decisions. The central bank is likely to remain prudent, with a firm focus on keeping inflation low. Foreign investment inflows are expected to continue in 2008.
Malaysia	5.2	5.9	6.3	5.6	5.8	A major challenge for Malaysia will be coping with competition from China. However China presents opportunity as well as threat and Malaysia's exports to China are likely to grow rapidly over the next five years.
Thailand	4.5	5.1	4.8	4.6	4.9	Following a military coup in 2006, a democratically elected government has been returned in early 2008. Domestic demand has been weakened by uncertainty but positive external trade has propped up the overall economy.
Singapore	6.4	7.9	7.7	5.2	5.9	Fiscal policy will be used to improve the country's appeal as a destination for foreign direct investment. A similar motive will drive its pursuit of free trade agreements with its main trading partners.
North America						
United States	3.2	2.9	2.2	1.4	2.3	After substantial slowing in 2007, GDP is forecast to weaken further with growth expected to fall to 1.4 per cent in 2008. The main concern is that consumer spending will be impacted more seriously than factored into forecasts. A partial reversal is expected in 2009 with real GDP growth of 2.3 per cent.
Canada	2.9	2.8	2.7	1.5	2.3	Government budget surplus will deteriorate in 2008 and 2009 as a result of tax cuts introduced in October 2007 and a weakening economy. The Canadian dollar will remain strong against the US dollar due to a weakening US economy. Canada's medium-term economic fundamentals remain strong.
Eurozone						
	1.5	2.9	2.6	1.5	1.8	The European Central Bank has faced mounting political pressure to prioritise growth prospects over inflation targeting. Oil and food prices have shown little sign of decelerating and the central bank has raised the possibility of rate hikes.
Russia						
	5.5	6.5	7.0	6.8	6.3	Capacity constraints, the slow pace of institutional change and the impact of an appreciating rouble will lead to a decelerating pace of economic expansion. Nevertheless GDP growth will continue to be boosted by high oil export prices.
India						
	8.4	8.4	7.8	8.1	8.4	India's economic boom will continue albeit at a slightly slower pace. The government is committed to increase spending on health, education and rural welfare projects in a bid to improve living standards outside urban areas.
Australia						
	2.8	2.8	3.9	3.3	3.2	Continued strength of domestic demand, a tight labour market and capacity constraints mean that inflationary pressures are likely to remain strong in 2008-09.
New Zealand						
	2.1	1.7	3.1	2.0	2.5	The government has backed up its goal of making the country carbon-neutral with a firm plan to meet its greenhouse emission targets. Market opportunities are limited by geographical location, small population and a tight labour market.

e: estimate; f: forecast

n.a: not available

Source: Consensus Economics Consensus Forecasts March 2008 (India: financial year reported) (Russia, Philippines: International Monetary Fund)