Falling investment, rising debt

Australian economy hits troubled waters

Mike Head
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Recently-released statistics have dented claims by business commentators and the Howard government that the Australian economy has weathered the storm of the Asian and international financial crisis. A series of reports sent the Australian dollar tumbling to a two-month low, falling below the US62 cent level. The currency has now lost about US2 cents in the past week and a half.

Over the past year the economy has seemed to defy world trends, with the Gross Domestic Product growing by 4.7 percent and corporate profits booming--up 17.3 percent in 1998. The latest indicators, however, point to an underlying crisis. The growth has been largely driven by rising debt--both consumer and business debt--and capital inflow. These processes now appear to be reaching their limits.

First came the news last week that business investment plunged dramatically in the December quarter of 1998, with expectations of a greater fall for the 1999-2000 financial year. The Australian Bureau of Statistics reported that business capital spending fell 11.2 percent in the last three months of 1998, driven by falling investment in plant, equipment and machinery. Mining investment fell most sharply--down 19.4 percent, the greatest fall since the statistical series began.

Business investment plans for 1999-2000 slumped 16.4 percent, compared to 12 months earlier, and are now at their lowest levels for three years. Depending on the methodology used to translate corporate expectations into forecasts of actual spending, investment is likely to fall by between 5 and 15 percent in the coming financial year, on top of a drop of around 4 percent in 1998-99.

Next came the announcement of the country's largest ever trade deficit--$A1.38 billion for January. The result was also the biggest-ever monthly increase in the goods and services deficit--$870 million worse than in December. January was the 14th consecutive month of deficit.

January's result was caused primarily by a 5 percent fall in exports, reflecting a slowing world economy. Exports dropped not only to Asia, but also Europe, where sales initially increased last year, partly offsetting the loss of Asian markets. Deutsche Bank senior economist Richard Yetsenga said the weakness evident in exports to Europe and Japan was worrying. "The European trend is particularly worrying given that that has been the market that has been so successful for us in the last year," he said. "Exports to Europe are now only up about 6 percent over the year when a couple of months ago they were up over 60 percent over the year."

There was also a 4 percent rise in imports, the result of increased domestic spending. Nigel Stabledon, the chief economist for Westpac, a leading bank, said the higher imports indicated that "the domestic side of the economy remains robust". Yet figures released the same day confirmed that the rise in internal spending has been sustained by a blowout in consumer and business debt. The Reserve Bank said credit to individuals rose to a record $64.5 billion in January, up 15 percent on a year earlier. Much of the increase was due to higher credit card usage.

Housing credit--loans for home purchases--also soared. It rose by 12.5 percent to $218.5 billion in the 12 months to the end of January. Other credit, mainly business lending, jumped by 9.7 percent to $289.3 billion.

The following day, the latest balance of payments statistics revealed a sharp rise in foreign debt as well. They showed a new record deficit of almost $8 billion on the current account in the December quarter, a 9 percent rise. Twelve months earlier, in the December quarter of 1997, the deficit was just $5.7 billion. This growing gap, chiefly the result of declining exports and rising imports, now represents 5.5 percent of GDP, which is very close to the 6 percent level regarded by financial markets as potentially dangerous.

On an annual basis, the deficit has mushroomed from $17 billion in 1997 to $28.6 billion in 1998, with the government predicting $32 billion for 1999. The shortfall has been covered by an inflow of capital from Asia and other depressed markets. Net foreign liabilities--the total amount owed offshore by businesses and government--increased by $8.6 billion to $343.8 billion in January. This figure, now almost 60 percent of GDP, has increased by 18 percent in three years.

Another sign of the debt crisis were statistics pointing to a weakening in domestic spending. Retail sales rose by 5.2 percent in January, the traditional month for post-Christmas sales, but the rise was only 0.5 percent on a yearly trend basis. There was a sharp 8.1 percent drop in building approvals. New motor vehicle registrations fell 3.4 percent in January, after a 1.9 percent decline in December.

These indicators contradict Prime Minister John Howard's statement earlier last week that "the current outlook for the economy remains very strong and I haven't seen fundamentals in the Australian economy as strong as they have been now since the late 1960s".

In reality, the latest data does reflect the "fundamentals" of the economic situation. In the first place, falling world commodity prices are undermining the Australian economy, which depends on raw produce such as coal, gold, sugar and wheat for two-thirds of exports. Global commodity prices dropped to the lowest level in 24 years last week, according to the Bridge-Commodity Research Bureau index. Referring to the implications for Australia, one financial commentator referred to this as a "suicide dive".

Both long-term and immediate factors are at work. Global commodity prices have slumped by more than 40 percent over the past three decades (from 175 to 75 on the Metallgesellschaft Commodity Index). This reflects the protracted effect of technological changes, both in boosting production of agricultural and many other raw materials and in lessening the relative industrial demand for metals and other inputs.

In the short-term this trend has accelerated under the impact of the Asian meltdown, the ongoing Japanese recession, the collapse of the Russian market, and stagnation across Europe. By one index, Australian commodity prices fell 25 percent between September 1997 and September 1998.

A second fundamental factor is also operating. Australia's ballooning current account deficit is part of a wider imbalance in the world economy. A new study of international capital flows by Morgan Stanley Dean Witter shows that several countries, including Australia and the United States, will contribute to a net global capital shortfall in 1999, leading to higher world interest rates within two years.

Those countries still experiencing economic growth, above all the US, are presently sucking in capital. Their current account deficits are soaring--the US deficit was $US225 billion last year. The study predicts that this year the resulting shortfall in global capital will be $US15 billion, rising to $US71 billion next year. This will put upward pressure on interest rates, possibly triggering a wider world slump.

Taken together, these underlying trends and recent shocks leave Australian business vulnerable to any sudden withdrawal of international capital. This threat was highlighted this week when the lobby group representing the plastics and chemical industry warned that its members could scrap investment plans if the Howard government adopted recommendations for eliminating certain business taxation concessions. The Plastics and Chemicals Industry Association said the removal of accelerated depreciation allowances could be the "final disincentive" for upgrading plant in Australia.

In a bid to further boost profits and attract capital, Treasurer Peter Costello has called for a lowering of the general company tax rate to 30 percent. However the government's recently published Ralph business tax review proposed the removal of specific investment subsidies to offset the overall rate cut. The response of the plastics and chemical giants, which have some $33 billion invested in Australia, shows that the flow of capital into the country could quickly reverse if profit rates are not continuously driven upwards.

Business and government leaders are now stepping up calls for further cuts in the living standards of the working class. In its front-page report on the current account deficit, the *Australian Financial Review* referred to the crisis that erupted in 1986, when Paul Keating, then the Treasurer in the Labor Party government, responded to a plunge in the value of the Australian dollar by declaring that the country could become a "banana republic". In the words of the newspaper: "The deficit blowout raised fears of financial markets reacting to a 'banana republic' scenario..."

In 1986 Keating's remarks became the basis for sweeping government spending cuts and other austerity measures by the Hawke government. There are sure signs that today's Treasurer, Costello, will follow suit. He said the current account blowout underlined the importance of remaining vigilant in managing federal spending, and indicated that the annual May budget would be a tough one.