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The Australian economy

By Chris Caton
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The Australian economy begins 2011 with a fair head of steam. Employment has increased by 3.7 per cent in the past 12 months, and the mining investment boom still has a long way to run.

Given that we are starting from a low 5.2 per cent unemployment rate, this boom can be accommodated only if growth elsewhere is restrained. The best forecast is, therefore, that the economy will continue to do well, but with interest rates rising further again.

Reserve Bank of Australia (RBA) governor Glenn Stevens has hinted strongly that the central bank still has a bias to raise rates further, but that it is in no hurry. It would be prudent to assume perhaps two more rate increases in 2011. Incidentally, the RBA is well aware consumers and businesses do not borrow at the official cash rate.

So when we get so-called out-of-cycle increases in the variable mortgage rate, as occurred in early-November, what this almost certainly means is that the RBA will need to increase the cash rate one fewer time than it otherwise would.

Of course, as always, there are risks. The international ones remain the same as in 2010: the possibility of a slowdown in China, the chance of a double-dip recession in the United States and some event emerging from the continuing debt problems in the eurozone.

It is my view that all three of these risks have been overstated. While there is always a chance of a slowdown in China, the authorities there have proved remarkably adept at getting that economy going again should it falter.

There was never much prospect of a double dip in the US, and the Fed's new program of quantitative easing should help that economy. And the euro-debt issue is very unlikely to morph into global financial crisis (GFC) mark two.

There are important differences from late-2008, when the full severity of the GFC struck. Back then, no-one knew who was holding what on their balance sheets or what the 'assets' were worth.

Now at least not only is the problem smaller but it is far more transparent. A default, full or partial, would hurt, but it would be a clearly survivable event.

The new domestic risk is, of course, the widespread flooding. As serious an event as this is, history suggests economists tend to overestimate the economy-wide effects of disasters, whether natural or manmade. There is no question the flooding will impede mining production and other economic activity, and it will clearly drive up the prices of many fruits and vegetables. However, the water will eventually recede, and production will resume. Indeed, reconstruction will add to measured gross domestic product. Importantly, the RBA will look through the extra inflation, which means the floods have probably postponed the next rate rise.

And that leaves the exchange rate. Australia is caught up in a currency skirmish going on around the world. Currency volatility will go on for some time yet. However, we all know the Australian dollar is currently overvalued and is likely to come down at some stage. By my reckoning, fair value is about 85 US cents, so that seems as good a forecast as any for end-2011.

At the moment, however, the rest of the world is on sale for Australians, be they travellers, on-line shoppers or investors.

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