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What is next for Australia following the end of the commodity boom?

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Author: Dr. Detlef Rehn, freelance economics journalist

For many years, Australia benefitted from demand for raw materials elsewhere in the world. There was an uninterrupted increase in economic output from 1992 to 2015 and even the international financial crisis of 2008/2009 was unable to deter the country's progress. Yet times have changed. In particular, development in China, which is Australia's most important buyer of raw materials by far, has had a significant impact on the country. Particularly since 2014, growth in China has been slowing down more and more, which has led to a significant decline in international commodity prices and a general slowdown of the global economy. It is uncertain when recovery is likely to take place and, even then, it is unlikely that conditions will go back to how they were.

Against this backdrop, Australia has been in talks for several years now about how economic growth and high living standards can be secured in the future in the face of low revenues from the sale of iron ore, coal and other raw materials. Although mining will remain an important pillar of the economy in the future, the general consensus is that additional drivers of growth will be needed. To this end, several areas have been selected that are to be developed as a priority over the coming years. In terms of exports, Australia is hoping that various free trade agreements will provide a powerful boost to the economy.

2015: Australia defies global economic downturn

Australia's economic output increased more than it was expected to in 2015 by 3.0 per cent (Australian Bureau of Statistics, "Australian National Accounts: National Income, Expenditure and Product, December 2015", 3 February 2016, www.abs.gov.au). Private consumption was pivotal to this good result, rising by 2.9 per cent, along with a stable labour market and low interest rates and petrol prices, among other factors. Private housing and residential investment, supported by low interest rates, saw an even greater increase of 9.8 per cent. On the other hand, fixed asset investments fell by twelve per cent. This was mainly due to hardly any projects being launched in the mining industry because of global overcapacities and price decreases. However, companies' tendency to invest was not very strong in other sectors either. Exports increased by six per cent, mainly thanks to good results achieved for commodities and in particular, liquefied natural gas, as well as services and agricultural products (Reserve Bank of Australia, "Statement on Monetary Policy - May 2016", "Domestic Economic Conditions" extract, www.rba.gov.au/publications). The decline of the Australian dollar also played a major role here alongside the drop in commodity prices; the currency depreciated by almost ten per cent against the US dollar between January and December 2015.

Growth prospects for 2016 remain uncertain

Whether or not the economy will be able to make gains of the same scale in 2016 remains uncertain. The Central Bank is forecasting growth between 2.5 and 3.5 per cent and expects the development pattern to correspond broadly to that of the previous year, with solid private consumption, strong levels of investment in residential construction, even if these are expected to decline, reluctance among companies to spend money on new plants and equipment, as well as a largely stable export market (ibid., "Economic Outlook" extract).

Despite this relatively positive outlook, there are still some factors of uncertainty which could quickly call some of the forecasts into question (ibid.). One of these factors is the very low inflation rate. The inflation rate slowed down more drastically than expected in the first months of 2016. In the service (non-tradables) sector, for example, the inflation rate dropped in March 2016 to the lowest level since the end of the 1990s, as a result of only a moderate rise in labour costs, among other factors. In order to counteract the downward spiral of prices and improve the outlook for sustained growth, the Central Bank lowered the base rate to 1.75 per cent at the beginning of May 2016 (Reserve Bank of Australia, "Minutes of the Monetary Policy Meeting of the Reserve Bank Board", 3 May 2016, www.rba.gob.au/monetary-policy/).

The exchange rate of the Australian dollar is another factor for uncertainty. The currency's development is heavily dependent on the price of commodities but is also influenced by monetary policies in the USA and other important countries, for example. The first months of 2016 revealed how quickly the exchange rate can change, with a sudden resurgence in iron ore prices and a temporary 4 per cent appreciation in the value of the Australian dollar against the US dollar.

China and Australia: A close partnership

Development in China and the outlook for the commodity and energy sector are the two most important – and closely liked – factors due to the far-reaching implications of both for prosperity and downturn in the Australian economy. Until 2013, Australian exports of goods to China knew only one direction: Upwards. During that year, exports of goods soared to a record value of almost AUD 94.7 billion. This accounted for 36 per cent of all exports.

Exports of mineral raw materials in particular significantly increased, thanks to China's investment-driven and export-driven development model. From 2006 to 2013, the export value of raw minerals increased sixfold to AUD 68.8 billion. Iron ore and concentrate (2013: AUD 52.6 billion) constituted by far the biggest proportion of exports, followed by coal with just over AUD 9 billion (Department of Foreign Affairs and Trade (DFAT), "Trade time series data, Country and commodity pivot tables", http://dfat.gov.au/trade/resources/).

In the past years, growth in China has significantly decreased. Exports decreased in the wake of the international financial crisis of 2008/2009 and the country has also lost its appeal for many foreign manufacturers of inexpensive, mass products due to increasing costs. At the same time, huge overcapacities emerged in the steel industry, for example. The sharp decline of international commodity prices is largely due to the economic slowdown in China.

As a result of this development, the value of Australian goods shipments to China fell in 2015 by 14 per cent in comparison to the record result of 2013 to just short of AUD 81.5 billion. Mineral raw materials contributed only AUD 50.6 billion to this total, 26.5 per cent less than two years prior. Nevertheless, China still remained by far the most important purchaser of Australian goods overall, with a share of 32.5 per cent of the country's exports (DFAT, "Country and commodity pivot tables", loc. cit.).

This is not set to fundamentally change in the coming years either. However, China is preparing to change its development model: The aim is to achieve future growth primarily through private consumption, innovation and services. Reduced spending on investments and more for consumption is the aim here, but this is also likely to have consequences for Australia given a high import intensity for investments. The mining sector in particular, which benefitted greatly from the Chinese investment boom, will likely suffer. In contrast, exports of consumer-related products such as foodstuffs, drinks and services for China's affluent middle class will sharply increase, although this will not be enough to make up for the losses of iron ore and coal exports (M. Thirwell, Chief Economist, Australian Trade and Investment Commission, "Australian exports and China's transition", Economic Analysis, 28 April 2016, www.austrade.gov.au).

The first, subtle signs of this shift are already becoming apparent. In 2015, for example, exports of foodstuffs, drinks and tobacco increased by almost 40 per cent in comparison to the previous year, rising to approximately AUD 5.8 billion. Beef exports rose by more than 53 per cent and alcoholic beverages by over 70 per cent (own calculations based on DFAT, "Country and commodity pivot tables", loc. cit.). Services exports increased in the 2014-2015 fiscal year (1 July - 30 June) by just over 17 per cent to AUD 8.8 billion. Travel services comprised almost 88 per cent of this figure (DFAT, "Trade Services in Australia 2014-15", 19 February 2016, http://dfat.gov.au/trade/resources).

Australia is especially popular in China within the education sector. From 2011 to 2014 (latest data), over 90,000 new students enrolled for courses in Australia per year, making Chinese students the highest foreign student population before all other countries (Institute of International Education, "Project Atlas Australia - International Students in Australia", www.iee.org/Services/Project-Atlas/Australia/).

China is not only Australia's most important trading partner, it also plays an increasingly important role as an investor. The American Enterprise Institute (AEI) estimates that China invested over 12 billion US dollars in Australia in 2015, 21 per cent more than in the previous year. Only the USA had a more active role, investing 22.4 billion dollars. According to calculations by the AEI, Chinese investments in Australia between 2005 and 2015 amounted to almost 84 billion US dollars in total. Over 78 per cent of this total went into the raw materials and energy sector. Recently, China has been focusing its investment mainly on real estate and agriculture (AEI figures quoted by E. Tang, "Australia remains the second most favoured country for China's outbound investors", Australian Trade and Investment Commission, Economic Analysis, 19 April 2016, www.austrade.gov.au/news/economic-analysis/).

As more detailed studies of Chinese investment behaviour suggest, strategic considerations clearly play a very important role in investments (J. Hill, "Chinese Foreign Investment Or Acquisition", blog, May 2016, http://towardsthefinalhour.com/2016/05). This may be one of the reasons why China has also incorporated the development of Northern Australia into its new "Silk Road Strategy" (One Belt, One Road). Various infrastructure projects are designed to help the north of the continent become a main export region for agricultural products ("One Belt, One Road China advisory group launches in Melbourne", The Australian, 27 May 2016). The Darwin port lease agreement, which the Chinese company Landbridge entered into with the government of the Northern Territory in October 2015 for 99 years, fits perfectly into China's "Silk Road Strategy". The agreement has been met with criticism, particularly in the USA, because of neighbouring US military facilities ("U.S. Casts Wary Eye on Australian Port Leased by Chinese", International New York Times, 20 March 2016).

Not all Chinese investment projects go down particularly well in Australia either. For example, two Chinese offers made in autumn 2015 to buy the largest cattle farm in the west of the country as well as a power distribution company in New South Wales were both unsuccessful. There is speculation that "national security concerns" are the main factor in the decision to reject the proposals (H.Clark, "Chinese Investment and Australia's National Security", The Diplomat, 2 December 2015, http://thediplomat.com).

A very active free trade policy

Relations between Australia and China are set to become even closer in the coming years as a result of a bilateral free trade agreement (FTA) that came into effect on 20 December 2015. Canberra has high hopes for this agreement: For example, Australia has an advantage over the USA, the EU and Canada in terms of trading agricultural goods, as these countries are yet to sign an FTA with China. In the case of Chile and New Zealand, Australia's two other main competitors in the agricultural sector which have already signed an agreement with China, Australia will now be in a position to narrow their lead. Furthermore, the FTA has opened up new business opportunities for Australia in a range of services, such as in the finance and banking sector, telecommunications, education, tourism and health services.

The FTA also provides China with opportunities: The country will now be able to benefit from the facilitation of investment in non-sensitive areas. As a result, the threshold for private investments that do not require approval is set to rise from the current value of AUD 252 million to AUD 1.09 billion (DFAT, "China-Australia Free Trade Agreement - Outcomes at a Glance", December 2015, http://dfat.gov.au/trade/agreements/chafta).

Although China is the number one country for Canberra from an economic perspective, relations with other countries will not be neglected. An FTA has been in force with the USA since 2005 and bilateral agreements with Thailand, Singapore and Malaysia have subsequently been put in place, along with a trilateral FTA with the ASEAN states of South-East Asia and New Zealand. Australia has intensified its free trade policies, particularly with North Asia, over the last few years. An FTA was entered into with South Korea in December 2014 and an economic partnership with Japan was established in January 2015. Furthermore, Australia is one of the countries that has signed up to the Trans-Pacific Partnership (TPP). In the coming years, the Regional Comprehensive Economic Partnership (RCEP), linking Australia to the ASEAN states, India, China, South Korea, Japan and New Zealand via FTAs, will be added to

Australia's various agreements. Negotiations on the partnership are currently in progress.

Commodities and the diversification of the economy

Despite the decline in global market prices, raw materials and energy will remain a very important sector for Australia's economy in the future. The forecasts for exports are looking positive. The government is predicting a 3 per cent average annual increase in exports from 2014-2015 to 2020-2021, rising to almost AUD 208 billion (Department of Industry, Innovation and Science, Office of the Chief Economist, "Resources and Energy Quarterly", April 2016, www.industry.gov.au/office-of-the-chief-economist/publications/). Raw materials and energy sources combined are therefore expected to continue to make up a significant proportion of exports. In 2015, the two sectors were already contributing more than 42 per cent (M. Thirwell, "Australia's export performance in 2015", Australian Trade and Investment Commission, Economic Analysis, 27 May 2016, www.austrade.gov.au). Iron ore and liquefied natural gas will be the country's main export products in the future. Urbanisation and industrialisation of emerging countries are sustaining external demand ("Resources and Energy Quarterly", loc. cit.).

However, even the government admits that these optimistic assumptions could change. It is precisely those forecasts relating to the development of demand in emerging countries that are uncertain. Due to the fact that many of these countries export more raw materials than they import, their capacity depends on the development of prices on the global market. However, if prices do not recover, many countries may face major financial problems which will in turn be exacerbated by already high levels of debt (ibid.).

While investment in the commodity sector was a main driver of growth until a few years ago, Australia will now, after the end of the boom, need to develop other means by which to boost its economy that can supplement revenue from the commodity and energy sectors and ensure long-term economic growth and prosperity. High productivity and competitiveness on an international scale will be crucial here. However, diversification has long been neglected in the country as a result of the raw materials boom (R. Green, "How Australia got left behind in manufacturing and innovation", 23 February 2015, www.abc.net.au/radionational/programs/ockhamsrazor).

In the first official "Australian Industry Report 2014", the necessary structural changes are discussed in detail (Department of Industry, Innovation and Science, Office of the Chief Economist, "Australian Industry Report 2014", www.industry.gov.au). The report presents five sectors that are of "strategical importance" and in which Australia is considered to be particularly competitive. These are foodstuffs and agriculture; equipment, technologies and mining services; oil, gas and energy resources; advanced manufacturing, as well as medical technology and pharmaceutical products. On average, these areas outperform other sectors, sometimes significantly, in terms of gross value added, exports, productivity and spending on industrial research and development, for instance.

In the coming years, these five sectors are set to be developed as a priority, alongside grid security. Non-profit organisations known as Industry Growth Centres have been created for this purpose. Generally speaking, their aim in each of their sectors is to facilitate closer cooperation between research and industry, identify regulations that inhibit development, improve access to international markets and global supply chains and improve the skills of managers and employees. The Australian government has allocated AUD 248 million for supporting the centres in the 2015-2016 to 2018-2019 fiscal years.

Another prerequisite for more productivity and growth is the most favourable business environment possible. In this context, it is worth focusing on services, without which production, sales and supply become impossible for businesses. These include professional services, IT technologies and logistics, to name some examples. This sector, known as "enabling services" employed over 3 million people in 2014-2015 and produced services with a total value of around AUD 465 billion, amounting to 29 per cent of GDP (Department of Industry, Innovation and Science, Office of the Chief Economist, "Australian Industry Report 2015", www.industry.gov.au).

Infrastructure is another important area. In February 2016, the first national development plan was unveiled. It spans over 15 years and includes almost 80 recommendations on how to solve existing problems, such as transport in large cities. Some examples of important projects include the construction of new train lines in Sydney and Melbourne and better water supply in Darwin ("Australian Infrastructure Plan", http://infrastructureaustralia.gov.au).

Whether or not all these factors will be sufficient, and whether or not Australia will be able to retain and improve its competitiveness on the international market, will become apparent in the next few years. In this context, some observers indicate concerns regarding deficits in industrial production. Roy Green, Dean of the UTS Business School writes that the best economies have innovative and efficient industrial sectors ("How Australia got left behind in manufacturing and innovation", loc. cit.). In Australia, on the other hand, manufacturing at a low or middle technological level is more dominant. However, this is coming increasingly under threat from emerging countries (ibid.). The fate of the domestic automotive industry which, after 90 years, is set to discontinue the production of complete motor vehicles in 2017 at the latest should really provide food for thought.

About the author: Dr. Detlef Rehn lives and works in Japan as a freelance economics journalist. After studying in both Bonn and Beijing and subsequently holding the position of research associate at the Bonn East Asia Institute, from 1990 until his retirement in May 2014 the graduate economist worked as a correspondent in Taipei, Seoul and Tokyo for the German Office for Foreign Trade (Bundesagentur für Außenwirtschaft, BFAI), which subsequently became Germany Trade and Invest (GTaI).

Konrad Adenauer Stiftung

Social and Economic Governance Programme Asia / Japan Office

OAG-Haus 4F
7-5-56 Akasaka, Minato-ku
Tokyo, 107 0052 Japan
Tel. +81 3 6426 5041
Fax. +81 3 6426 5047
KAS-Tokyo@kas.de
www.kas.de/japan/en
www.facebook.com/KAS.Japan