

What is rumbling Australia's economy ahead of MYEFO

Written by The Conversation

The Turnbull government's [Mid-Year Economic and Fiscal Outlook](#) (MYEFO) takes place in a dramatically different environment from 2015-16.

The dual shocks of Brexit, and the promulgation of a protectionist Trump administration in 2017, present major challenges to the global economy. In late 2015, few predicted either of these scenarios emerging. The US and British economies, and stable US-China economic relations, are critical to Australia's growth, wealth and living standards. As Britain prepares for Brexit, and the Trump administration awaits inauguration in January, what impact will these dramatic developments have on Australia's economic outlook?

There's an old saying: "America sneezes and Australia gets a cold."

If you believe that Australia's dependence upon the American economy is so 20th century, think again. Despite China's centrality to Australia's present and future growth, the world economy is inextricably linked with US economic power, policies and performance. The Trump administration's management of Washington-Beijing relations, together with its declared intention to [withdraw from international trade agreements](#), threaten the structure of the liberal global economic order.

Last week, the national accounts showed that Australia was half way towards a technical recession, with a 0.5% contraction in the September 2016 quarter. Troubling figures emerged in the December unemployment numbers, with South Australia again occupying the unenviable top ranking for November, [with 7.0% of the labour force](#) out of work. Nationally, unemployment is up fractionally, [to 5.7%](#).

Business investment has [also declined consistently](#) over the last 18 months, with construction down significantly, while mining has fallen off the cliff since 2014. Manufacturing investment is also down, as new investment in the automotive industry evaporates, intensifying the unemployment problem in South Australia. Non-mining and non-manufacturing investment is trending downwards slightly.

The bright spot on the commodity front is coking coal, which [spiked up to around US\\$100 per](#)

What is rumbling Australia's economy ahead of MYEFO

Written by The Conversation

[tonne](#) in November, a price it hasn't seen at since early 2013. Nevertheless, in November, [Treasurer Scott Morrison admitted that](#) wages were growing at a glacial pace and corporate profitability had fallen, in the face of much weaker terms of trade and fluctuating commodity prices.

Why has this occurred, even as [iron ore and coal prices](#) have strengthened considerably? Most of the changes in demand have been stoked by Chinese domestic policies (and the steel market's [outlook in Tangshan, China](#) can change in a blink of an eye).

Despite a high level of trade interdependence, there has been essentially [no correlation between Chinese and Australian GDP growth](#) for the past six years. Conversely, there has been a relatively close correlation between US GDP expansion and contraction and Australia's economic performance. This was disrupted, briefly, by the global financial crisis in 2008-09, but the US's traditional influence upon Australian economic growth has been restored.

Consequently, the decisions of the incoming Trump administration will have a significant impact upon Australia's economic performance. More importantly, Trump's fiscal expansionist agenda is now on a direct collision course with that set by Fed chair Janet Yellen. The US Federal Reserve (Fed), which still effectively sets global interest rates, raised interest rates on December 15, delivering its first rate hike in 12 months, and only the second since the global financial crisis struck. The increase is small, raising the Fed funds rate to 0.5-0.75%, but the signal that Yellen is sending demonstrates zero interest-rate policy ([ZIRP](#)) is well and truly over.

Bond markets are predicting two more Fed rate rises for 2017, while the Fed itself has signalled three. The bottom line? Funds are flooding to US dollar-denominated assets, while the Australian dollar is falling against the greenback.

But that's positive, isn't it? A depreciating Australian dollar will help drive exports.

Not so fast.

Of debt and US dollars

The problem is that weakness against the greenback hides the Australian dollar's strength relative to its major Asian trading partners – its key export markets. [James McIntyre at Macquarie Bank argues](#) that the dollar has, in fact, appreciated against the yuan and the yen.

Fact: the US holds more Australian debt than any other country. As Treasurer Scott Morrison noted this week, American bond holders own almost [A\\$600 billion in Australian debt](#), with the UK owning another A\$400 million.

Why? Australian debt is AAA-rated and typically pays a [relatively high coupon rate](#). That makes it an attractive and safe investment asset.

Bear in mind that the US and UK are Australia's two biggest sources of foreign direct investment. But investors are notoriously flighty; consequently, how the Trump and May governments negotiate the next few months will have a profound longer-term impact on Australia's growth.

President-elect Trump has foreshadowed a [massive US\\$1 trillion reinvestment](#) in US infrastructure, utilising public-private partnership and tax breaks. Trump's promises, if implemented, would increase [the fiscal deficit by US\\$5.1 trillion](#), according to one estimate.

If Trump does cut taxes and increase US fiscal deficits, that amounts to a significant expansion of the US bond market. And, in a world of rising interest rates and relative investment scarcity, that means two things. First, the Australian capital market pool (where banks obtain their wholesale funding) will get a little shallower; and, second, the cost of capital is going up in 2017. And you can take that to the bank.

Rogue Trump: A trade wars story

What is rumbling Australia's economy ahead of MYEFO

Written by The Conversation

If Trump's behaviour as President-elect is any indication of how he'll conduct his presidency, expect shambles and chaos. In a mere matter of weeks since November 8, Trump has:

1. Called Taiwan
2. Queried US adherence to the "One-China" policy
3. Threatened to cancel the Trans-Pacific Partnership (TPP)
4. Threatened to renegotiate the North American Free Trade Agreement (NAFTA)
5. Threatened to deport [millions of unlawful immigrants](#) (ironically, non-unionised, immigrant labour, is essential to keeping a lid on infrastructure costs)
6. Criticised the cost of the F35 Joint Strike Fighter, [slashing Lockheed shares](#) by US\$4 billion and sending [defence firms's stocks plummeting](#)

Trade wars are negative-sum games: everybody loses. However, for the first time [since Herbert Hoover](#)

, America now has a president-elect in Trump who apparently believes in zero-sum trade: for one side to gain, the other has to lose.

China, the US and Britain rank first, third and seventh, respectively, among Australia's trade partners. How adroitly policy makers in London and Washington handle issues such as Brexit and US-China relations will determine whether the Australian economy stays on the boil or gets frozen out.

Heading for a Brexit

If you're confused by Brexit, you're not alone; so is the British government. Six months after the seismic shock ushered in on 23 June, Theresa May's government has pondered various Brexits: hard, soft, black, white, grey and now, finally, ["red, white and blue"](#);

Yes, that's right: a patriotic Brexit. I prefer another term: Phony Brexit. Phony because the British government has swallowed the EU Single Market rules hook, line and sinker with the [in appropriately-named Great Repeal Bill](#)

What is rumbling Australia's economy ahead of MYEFO

Written by The Conversation

The UK will likely end up in a “pay and obey with no say” situation, at a [cost to the budget](#) of £100 billion.

Britain's economic performance for the foreseeable future really depends upon how optimal a deal it manages to strike with the EU. The UK ranks second only to the US among Australia's biggest foreign investors, and decreases in capital flows from London to Sydney are almost inevitable throughout the next 10 years. But the City of London's position as the world's premier centre for financial services is also under pressure, even under a “soft” Brexit.

London does more euro currency-denominated business than Paris and Frankfurt combined. Foreign direct investment and short-term capital investment flows from the EU, via London, to Australia's relatively liberal capital markets. London is a global conduit for outward foreign direct and portfolio investment, irrespective of the capital's origin.

Britain's position as a global financial services centre is not threatened, but it will be diminished by a sub-optimal Brexit outcome. In combination with tighter US monetary policy over the next 12 months, and uncertainty over the incoming Trump administration's trade policies, the Australian economy is increasingly vulnerable to trade shocks in 2017.

In this respect, how Trump handles China trade issues, in view of his “[45% tariffs](#)” promise, will prove a critical test of his presidency. And [how Beijing chooses to retaliate](#) will have a profound impact upon the two economies.

In 2015-16, the MYEFO [stated](#) that, “The transition is being supported by historically low interest rates, the fall in the Australian dollar and low oil prices”.

That was then; this is now. Both Brexit and Trump have ensured there is absolutely no certainty about any of those variables in 2017.

Remy Davison's Chair is funded by the EU Commission.

What is rumbling Australia's economy ahead of MYEFO

Written by The Conversation

Read more <http://theconversation.com/what-is-rumbling-australias-economy-ahead-of-myefo-70344>