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AUSTRALIA UPDATE

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THE ECONOMIC MIRACLE CONTINUES, BUT LONG-TERM RISKS LOOM

The 25-year expansion is set to continue at healthy rates in 2017 and 2018

Australia's economic expansion marked its 25th anniversary in the third quarter, cementing its position as the longest economic expansion in the developed world. The mining boom that propelled the "Lucky Country" through the global financial crisis is over but household spending is picking up the slack, allowing Australia to defy the odds faced by other commodity-driven economies that are struggling with low prices. Though the economic miracle is unlikely to end soon, the risks to Australia's long-term growth are mounting as an evolving global economy changes the economy's foundation.

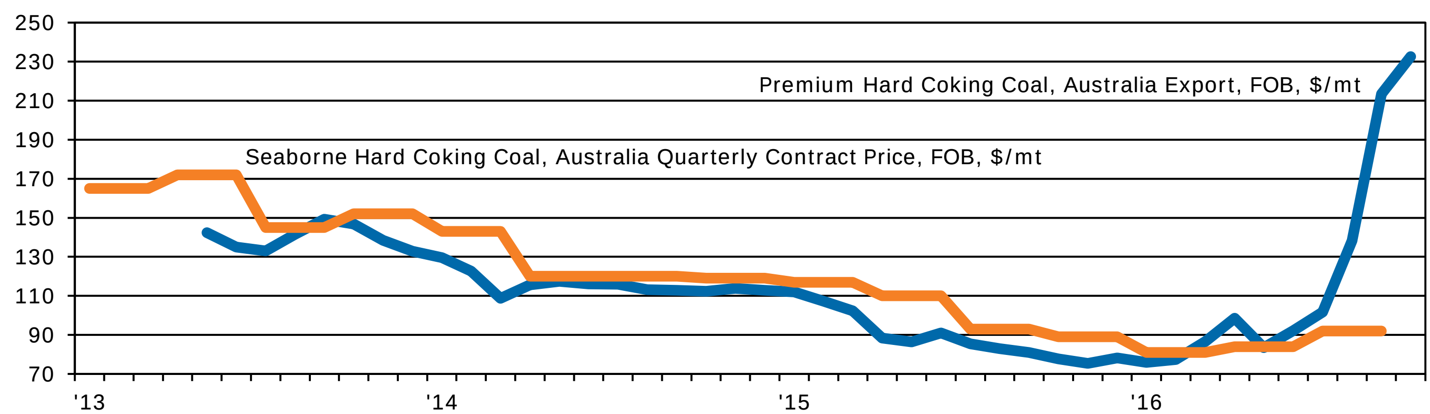
Real GDP growth of 2.8 percent is in store for Australia in 2016. This is about a percentage point above the average OECD growth rate. Australia's economy will likely grow by 2.4 percent in 2017 and 2.5 percent in 2018. Though slower, these are still relatively healthy rates of growth for an advanced, high-income economy.

Several forces will extend Australia's lengthy economic expansion. First, consumer spending will remain the prime impetus for growth. Household spending has accounted for nearly 60 percent of real GDP growth since 2014, thanks to a high rate of in-migration that boosts population growth. This supports aggregate demand and keeps the housing market hot. Low borrowing costs, healthy rates of credit growth and cheap energy also support spending.

Consumer spending and rising commodity prices support growth

Second, commodity prices are rising, turning around the four-year slide in the country's terms of trade (the price of a country's exports relative to its imports). Spot prices for Australian premium hard coking coal for export surged to more than $230 per metric ton in October, a 150 percent increase since June when prices were near $92 per metric ton (Chart 1). Reduced Chinese production squeezed global supplies and elevated prices. Contract prices, which follow spot prices with a lag, are likely to increase to at least $115 per metric ton in the months ahead. Most non-U.S. coke producers are profitable when prices are over $115 per ton. Besides coal, iron ore prices rose by more than 70 percent between December 2015 and October 2016. Together, coking coal and iron ore account for 40 percent of

CHART 1: TIGHT MARKET WILL LIFT COKING COAL CONTRACT PRICES



Sources: The Steel Index; Bloomberg Intelligence

China's economic transition and underemployment threaten to weaken the expansion

Australia's exports. The outlook for prices and production of these key steelmaking ingredients is favorable. Global steel demand and production are set to improve in 2017 as India's government accelerates infrastructure investment. As export prices increase, higher terms of trade will lead to stronger purchasing power and higher national income and living standards. Higher mineral prices will also halt the extended slump in mining investment.

Finally, businesses are confident about economic prospects, which bodes well for hiring and investment in the coming year. Profitability is improving as consumers continue to spend and commodity prices rise. Also, exports have been remarkably resilient in 2016, even as the Aussie dollar appreciated by more than 7 percent on a trade-weighted basis. Services, especially tourism and education, are partially filling the hole left by the drop in mining exports.

However, the nearly 3 percent real GDP growth expected in 2016 is unsustainable and the economy's growth will likely downshift in 2017. Although the jobless rate continues to inch down, the economy shed 112,000 full-time jobs in the first nine months of 2016 while it added nearly 163,000 part-time jobs. This surge in underemployment will temper consumption spending by restraining wage growth to a record low pace (Chart 2).

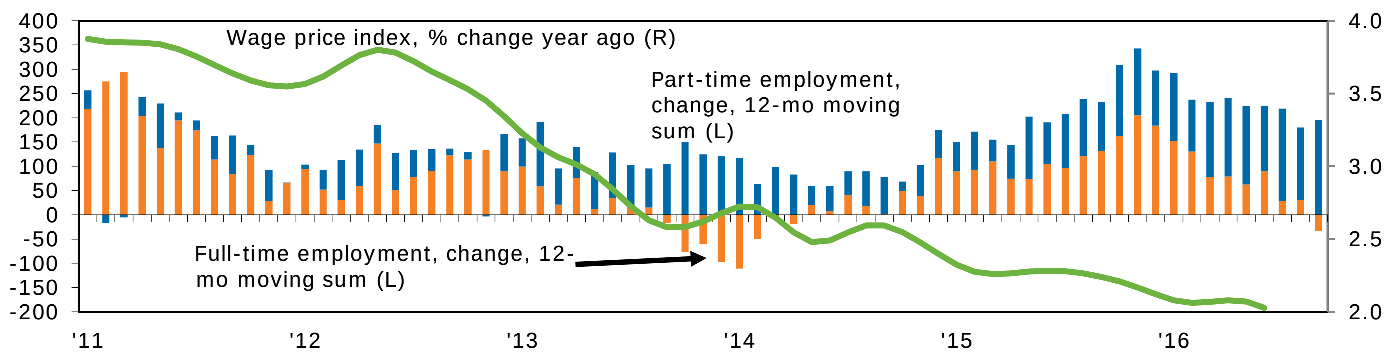
Looking further ahead, downside risks to Australia's economic miracle are mounting. China's economic growth is slowing as it transforms into a more consumer-driven economy. This will limit the high-income mining sector's growth potential. Also, considering that housing is unaffordable in many major cities and households carry debt worth more than 120 percent of GDP, the consumer-driven growth seen recently is more vulnerable than at first glance.

The Aussie dollar will hold its value as the U.S. Fed raises rates and commodity prices trend up

That the economy is growing at a healthy rate while the labor market is softening is a puzzle that will motivate the Reserve Bank of Australia to hold its target cash rate at a historic low of 1.50 percent through the end of 2017. The RBA is reserving the option to ease monetary conditions if economic growth falters or inflation weakens but the bar is set high. Even with risks from weaker trade and high consumer debt, there are no obvious catalysts for a recession. For this reason, Governor Philip Lowe took the helm at the RBA in September with a focus on financial stability, especially regarding the frothy housing market. His predecessor had already cut the target cash rate by 25 basis points in May and again in August to stimulate the economy. Additional cuts would only provide marginally smaller boosts to economic growth. Labor market slack will keep consumer price inflation averaging slightly less than the RBA's 2 to 3 percent target range but inflation should climb back up into the Bank's target range by 2018.

PNC Economics expects the Australian dollar to hold its value at 0.76 USD through the end of 2017. The U.S. Federal Reserve is expected to hike its policy rate in December 2016 and twice more in 2017. At the same time, commodity prices are trending up. These two forces will counteract each other to keep the currency stable on balance.

CHART 2: SHIFTING BALANCE TOWARD PART-TIME EMPLOYMENT WILL WEAKEN INCOME GORWTH



Source: Australian Bureau of Statistics

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