Economics | November 30 2016

The Big Issues of 2017

.

BIG ISSUES OF 2017
US President Donald Trump
Inflation at an inflection point?
Fiscal versus Monetary Policy
Housing: Hard landing or soft landing?
Housing affordability
The global political environment
The state of the job market
The economic 'baton change' in China

The Big Issues of 2017

- For the past 15 years we have produced *"The Big Issues"* report – a report that has sought to highlight the issues that are expected to influence the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year's time. Rather the focus has been to highlight trends, issues and 'big picture' influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think and ask the 'so what' question – that is, to determine what this means for their own circumstances.
- And we undertake this analysis by providing a healthy amount of graphs and pictures in addition to the text to best highlight the issues we think will prove important in 2017. Certainly one of the great innovations over recent years has been the infographic and other developments that have sought to bring subject matter 'alive'. They say that a picture should tell a thousand words, and that should be the basis for all economic and financial commentaries – make the subject matter more alive and relevant to readers. The real value of economics is when people say 'so what?' and relate the commentary and forecasts to their own situation.

Craig James – Chief Economist
Twitter: @CommSec
Savanth Sebastian – Senior Economist
Twitter: @CommSec

…But First…The Economic 'State of Play'

Review of the Past Year

FORECASTS		
	2015	*2016*
Economic Growth	2.00-2.50%	2.50-3.00%
Underlying inflation	2.25-2.75%	2.50-3.00%
Unemployment	5.50-6.00%	5.50-6.00%
	mid 2016	***end 2016***
Cash rate	1.75-2.00%	1.75-2.00%
Sharemarket (All Ords)	5,200-5,400	5,500-5,700
Australian dollar	US64-72c	US68-75c

- In addition to our 'Big Picture' analysis of key economic issues we feature a recap of the past year's economic performance together with an outlook for the economy for the coming twelve months.
- This economic assessment largely sets the scene for the discussion of the *Big Issues*. Because there are themes and trends that have evolved over the past year or years to affect economic performance. And clearly each one of us wants to know whether the same factors or indeed new factors are likely to dominate in the coming year.
- Last year we wrote the following: *"If momentum continues into 2016 then economic growth should lift closer to the longer-term average pace. But much will depend on a continuation of solid home building activity*."
- It's nice to get the odd one correct. The economy did indeed grow at, or slightly above, the long-term average pace. The Reserve Bank has opaquely defined this as growth near 3 per cent. While economic growth looks to have been at or above our forecasts, inflation will end up lower-than-expected while unemployment met forecasts.
- The cash rate was a touch lower than we forecast in 2016 – not because the economy was weak or needed stimulus – but simply because inflation remained below the 2-3 per cent target band.
- The Aussie dollar looks to have met the end-year forecasts, although the currency was slightly firmer than forecast in mid-2016. The sharemarket met mid-year forecasts and should go close to fulfilling expectations for the end of the year.

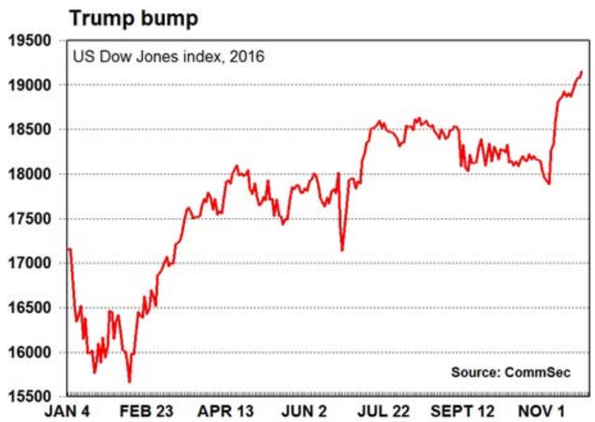
The Year Ahead

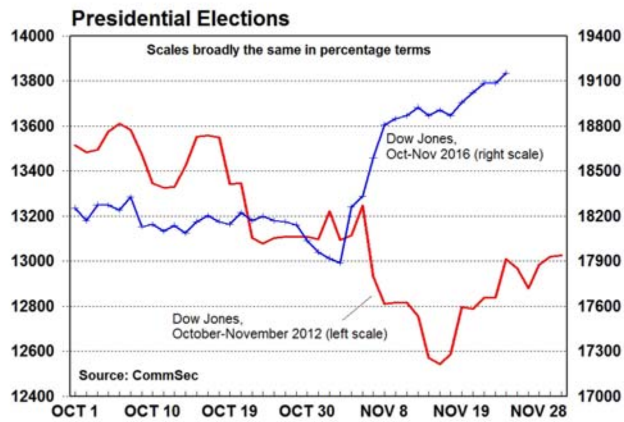
FORECASTS		
	2016	*2017*
Economic Growth	2.75-3.25%	2.75-3.25%
Underlying inflation	1.50%	1.50-2.00%
Unemployment	5.50-5.70%	5.25-5.75%
	mid 2017	***end 2017***
Cash rate	1.25-1.50%	1.25-1.50%
Sharemarket (All Ords)	5,700-5,900	5,850-6,100
Australian dollar	US71-77c	US73-79c

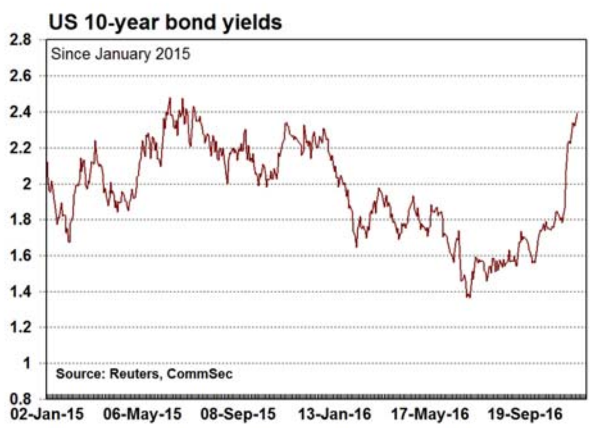
- The Australian economy is in good shape. Home building activity is solid in most states and this is, in turn, is supporting the job market and consumer spending. Mining production remains strong although investment continues to ease.
- The other support for the economy is coming from infrastructure spending by federal and state governments. The Reserve Bank believes governments have scope for even greater spending.
- Economic growth is expected to hold in a 2.75-3.25 per cent band over 2017.
- The Reserve Bank expects inflation to gradually lift back towards the 2-3 per cent target band. Firm domestic economic growth and an improvement in global economic growth should lead to a modest uptrend in inflation. But at the other end of the equation, technology and globalisation will continue to cap inflationary pressures.
- At present we think the Reserve Bank will stay on the interest rate sidelines for much of 2017. The Reserve Bank still has the ability to cut rates if underlying inflation stubbornly remains below the low end of the 2-3 per cent target band. But the Reserve Bank Governor has made it clear that he is not inclined to cut rates again. It still seems a little too early to contemplate rate hikes.
- Unemployment is expected to slowly edge lower over the year, easing towards 5.25 per cent, especially if economic growth remains firm as we expect.
- The Australian dollar has ebbed and flowed over 2016, responding to a raft of influences. These influences include higher commodity prices, lower Australian interest rates and varying expectations on US interest rates. Over 2017 these same influences will dominate together with the fleshing out of economic policies by the new US administration.

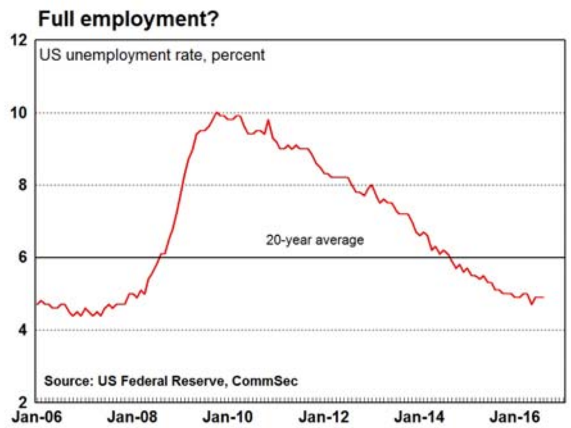
US President Donald Trump

- Well, what can we say? Donald Trump wasn't expected to get through the primaries to become the Republican candidate. But he did. And then there were a number of controversies with political analysts zeroing in on his views on women, immigrants and trade policy. And the Federal Bureau of Investigation indicated late in the Presidential campaign that it wouldn't be proceeding with further inquiries into Hillary Clinton's email practices. Analysts thought that decision would be enough to put Secretary Clinton into the White House.
- But it wasn't to be. Against all odds, the President-elect is Donald Trump. This is the election effectively of a 'non-politician' – a business person. And the early indications suggest that Trump will indeed attempt to run the United States as a business.
- While there are some concerns on the policies that will be adopted, the governing principle is likely to be "America First". Rather than adopting a protectionist policy, Trump believes that agreements like NAFTA and the Trans Pacific Partnership aren't in the best interests of the US. So rather than ditching agreements, Trump may pursue modifications. Same goes for how energy policy is pursued. Now whether these changes will be seen as 'reasonable' is the key uncertainty. Much will depend on the advisers and Cabinet that are appointed by Donald Trump. And much will depend on the views of the Republican Congress.
- If the election of Donald Trump was seen as a surprise, so has been the initial reaction of financial markets. In Asian trade on election-day the expectation was that the Dow Jones would slump by as much as 900 points. But instead, investors decided to focus on the businesses and industries that will likely benefit from the Trump victory. And the centre of attention has been the Trump policies of lower tax rates and increased infrastructure. The perception is that fiscal policy will be stimulatory. Importantly though markets are running on expectations. As to what actually is implemented remains to be seen.



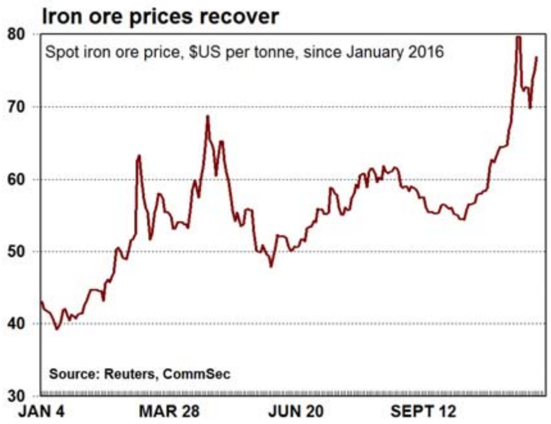


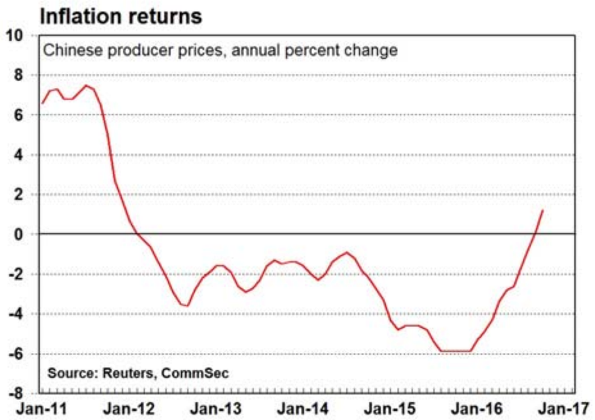


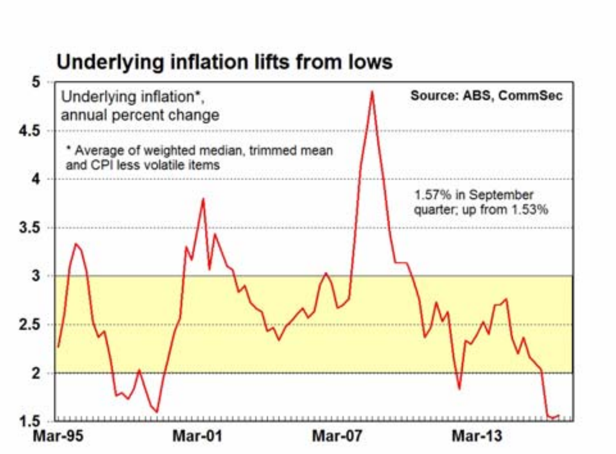


Is Inflation at an inflection point?

- Inflation has featured in our *Big Issues* for a number of years. Last year we asked '*Will we need to worry about inflation again?'* The previous year we posed the question *'Is Inflation dead?'* – clearly tempting fate. And in the 2013 edition of *Big Issues* we questioned: *"Inflation or Deflation?"*
- We have continued to find it remarkable, that with interest rates close to zero across many parts of the world and some central banks still injecting stimulus via bond buying, that concerns about deflation still abound. And we don't think we have been alone. Central banks, governments, consumers and businesses have focussed on 'disinflation' – falling annual rates of inflation; and deflation – falling prices.
- But there are good reasons to think that inflation is at an inflection point. Now some will point to the expected stimulatory policies of Donald Trump. The view is that lower taxes and increased government spending will lead to stronger investment, spending and hiring. And with economies like the US and Australia arguably getting closer to 'full employment', the risk is that will lead to higher rates of inflation.
- But the US Federal Reserve has been on course to lift rates for a number of months. The Fed has just had the luxury of stubbornly low inflation rates to allow it to wait. The expectation of stronger fiscal policy has probably given US policymakers that extra assurance needed to decide that another rate hike is appropriate.
- There have been other signs that the days of super-low inflation rates are numbered. Chinese demand for commodities has lifted, boosting prices of iron ore, coking coal and thermal coal. Iron ore prices have lifted almost 80 per cent in 2016 with coal prices doubling. The deflation in Chinese producer prices has also ended.
- In Australia, the Reserve Bank is working on the belief that inflation has bottomed. And as a consequence, interest rates have probably bottomed. But it also has to be remembered that there are still other influences acting to cap inflationary forces. Advances in technology are keeping production costs down, as well as prices. Competition is increasingly global. And 'disruption' has meant there are more businesses competing against incumbents. And those forces will continue to keep prices low.

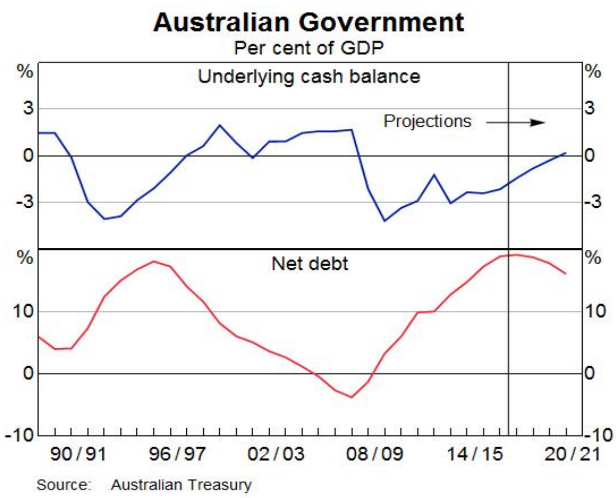


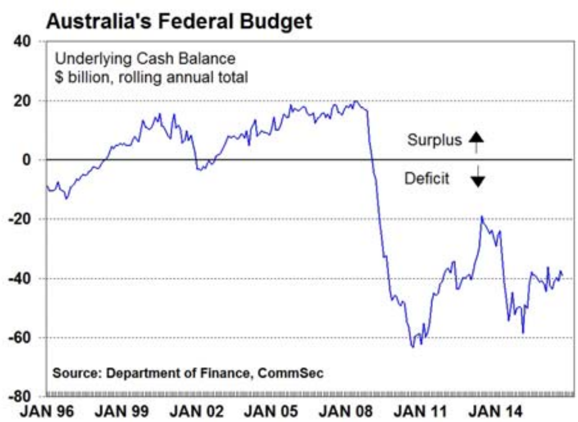


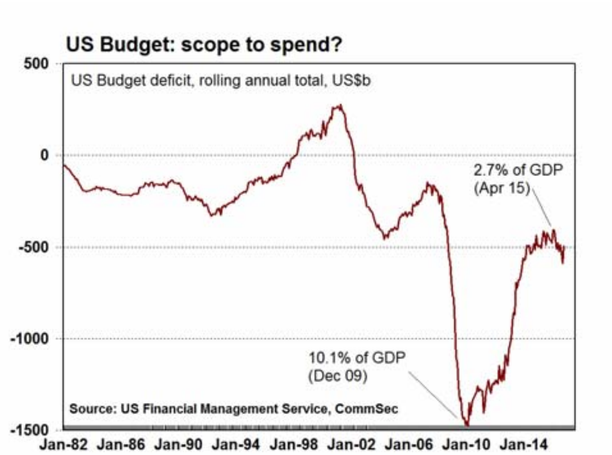


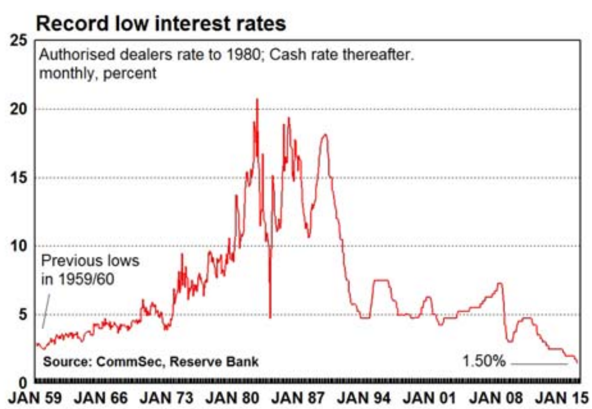
Fiscal versus Monetary Policy

- Have central banks run out of options? Central banks would say ‘no’ – there are always things we can do they would say. Indeed central banks have been inventive in recent years with ‘Quantitative Easing’ and numerous variants. Essentially QE means printing money. But the economic purists would argue that there are subtle differences. Bonds have been purchased from the private sector in exchange for cash. But other assets have been similarly purchased although with the same intent to get more money into the economy, hopefully encouraging people to spend and invest. And if too much money is looking to buy goods, the result may be higher prices (inflation).
- Still, when interest rates are effectively at zero or even negative, there are limits about what central banks can do. The problem has been that there has been a weakening of budget positions across the globe as a result of the Global Financial Crisis, weak economic recoveries, low prices and low wages. So with budgets in deficit, there has been a lessening of political will to spend more, in order to boost economic activity.
- It hasn’t helped that some policymakers, economic advisers and ratings agencies are still using the old mentality that increased borrowing and spending is somehow risky or a negative policy development. Governments and businesses have good reason to borrow when interest rates are low provided the economic return exceeds to cost of borrowing.
- The current Reserve Bank Governor Philip Lowe as well as his predecessor has been active in calling for increased government spending, specifically on infrastructure with the proviso: “*where this is backed by a strong business case. Such spending can provide support for the economy and can help generate the productive assets that a prosperous economy needs.*”
- Incoming US President Donald Trump also believes that fiscal policy should support monetary policy, aiming to cut taxes and increase spending on infrastructure in order to boost economic growth. The hope is that more central banks and governments will also support a bigger role from fiscal policy and change some misguided views on the topic.



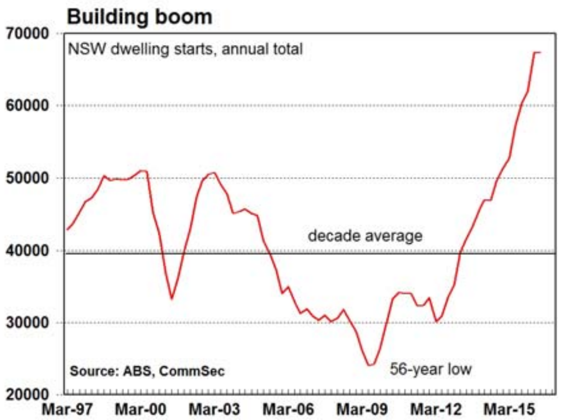


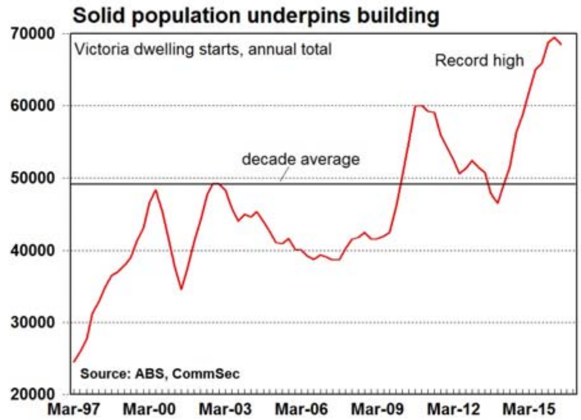


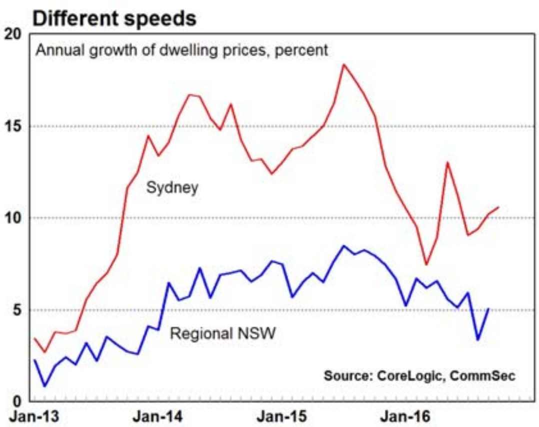


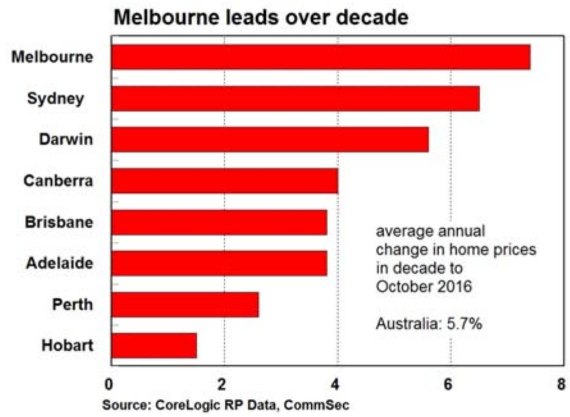
Housing: Hard or soft landing?

- Have we cheated by bringing back one of our *Big Issues* from last year? Perhaps. But the simple reason is that the issue wasn't settled as we expected this year. Last year we stated the view that *"the answer will be revealed over 2016."* Clearly the issue wasn't settled at all. And we believe that discussion will continue to swirl about what sort of landing the housing market will experience.
- As we noted last year, some would question whether the issue should indeed be listed amongst the *Big Issues.* Because in many parts of Australia, it is not an issue. It is hard to identify a housing boom outside of Sydney or Melbourne. Although many would add Brisbane to the list of cities to watch.
- What actually is the issue in contention? Well, a hard landing would be characterised by a housing market moving from under-supply to over-supply. Simply, too many homes get built on the perception that high and rising home prices will reward developers and speculators. Rather than home prices rising strongly, the excess of supply compared with demand causes home prices to fall. And if rental properties are in abundance, that may cause other investors to sell up their properties, adding to the oversupply. Think of the US or European economies in the Global Financial Crisis.
- At present Sydney and Melbourne home prices are rising strongly with annual growth rates above longer-term averages. Sydney home prices are up 10.6 per cent on a year ago, well above the 6.5 per cent decade average. Melbourne prices are up 9.1 per cent on a year ago, whereas the decade average is 7.4 per cent.
- In response to high prices, more homes are being built – especially apartments. Demand for property has been exceeding supply, driving prices higher. Over the next year or two, more homes will be available to buy or rent. The question is whether too many homes will be built.
- It is important to remember though that strong population growth is underpinning Sydney and Melbourne property markets. Not enough homes were built a few years ago. In fact in 2009, NSW dwelling commencements hit 56-year lows. Also it is important to note that finance for new apartment buildings tends to be dependent on almost all properties being sold "off plan".



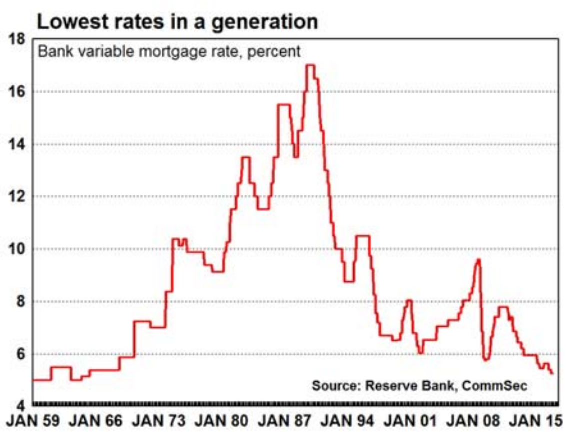


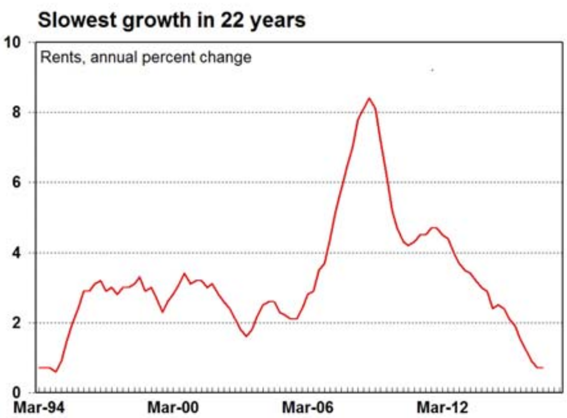


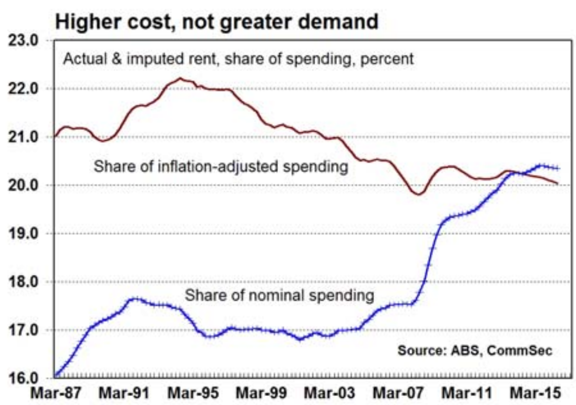


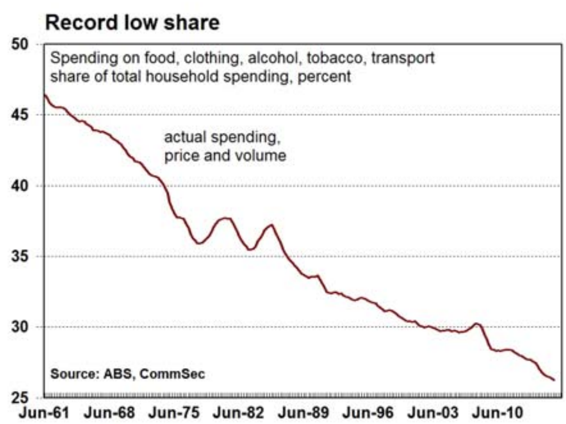
Housing affordability

- If some question whether *'Housing: Hard or soft landing'* should be included in the *Big Issues of 2017*, perhaps the same could be said for the issue of '*Housing affordability*'.
- Again, many may say that this is more of an issue for Sydney or Melbourne. And certainly in those cities, when home prices are rising strongly, have been for some time, and exceeding the growth of wages, many will question whether buying a home is getting out of the reach of the average first-home buyer.
- But the issues facing Australia's two biggest cities are important. Because if too many homes are built in those cities and soaring home prices cause retail spending to be trimmed, then the economies will suffer and the downturn will have knock-on effects across Australia.
- Housing affordability will indeed be a key issue in 2017, receiving plenty of discussion and debate. And the issue may affect state and federal government policies including planning and taxation.
- It's important to remember that housing affordability has been an issue that has come into and out of vogue for decades. A clipping from the Canberra Times in March 1968 refers to the West Australian state election. Both major parties *"have promised to stop the spiralling cost of housing sites."*
- While homes are relatively more expensive now in some cities, that means that budding buyers just need to alter their preferences. Some may stay at home longer, others rent, others may seek to buy properties in cheaper suburbs than their preferred areas.
- It is also the case that the issue of housing affordability must be seen in a broader context. Other goods and services have been getting more affordable over time. Cars, travel, food and clothing occupy smaller shares of the household budget than in the past. As a result more people are channelling extra dollars into housing. That is another factor underpinning demand for homes, boosting prices and causing buyers with smaller deposits and incomes to move to option two, or option three.
- And with low interest rates and changes to household budgets, more of the wage will be devoted to housing. As a result old norms of housing stress need to be re-evaluated.



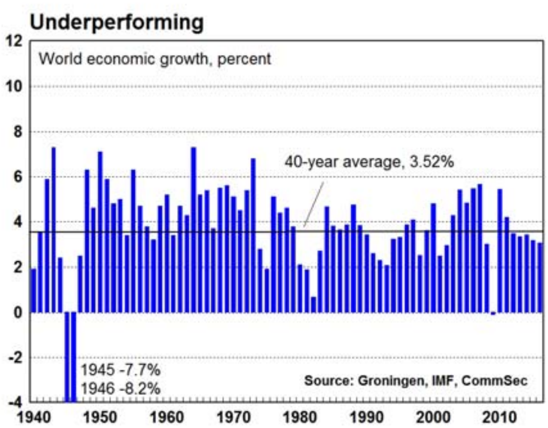


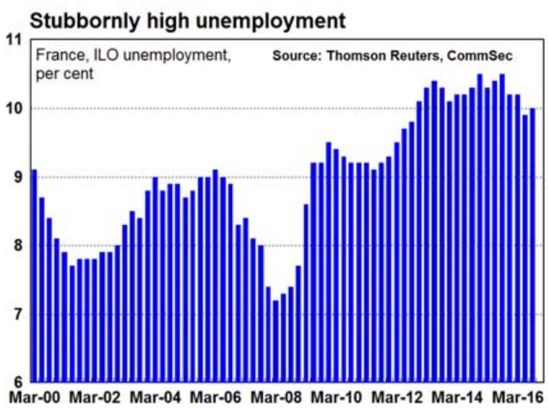


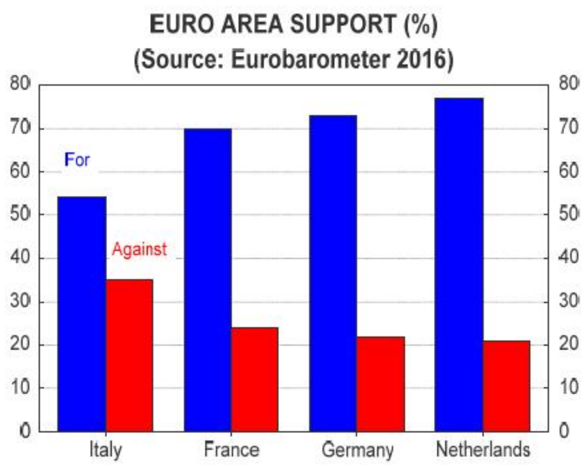


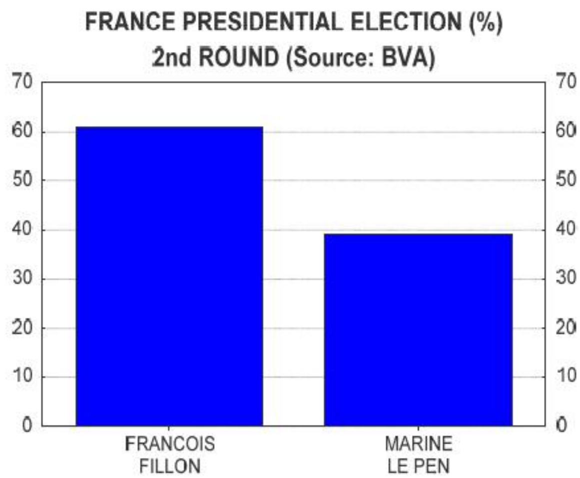
The global political environment

- World politics has clearly changed in recent years. The question is why. The so-called 'Brexit' vote in the UK didn't go as many in financial markets had thought. Polling suggested the UK would narrowly vote to remain in the European Union. But the UK voted to leave. Some would say that it was a protest vote that went too far. Perhaps.
- In the US, Donald Trump wasn't favoured to win the Republican presidential candidacy. But he did. Then he went on to win the Presidential vote.
- Some would blame the Global Financial Crisis. And clearly the GFC changed attitudes. The GFC has also been termed the Great Recession. And indeed the 0.1 per cent fall in global growth in 2009 was the weakest result since the Second World War.
- In the aftermath, consumers and businesses have become more conservative. Interest rates may be close to zero but there is a reluctance to borrow. Instead most want to reduce debt. Wealth levels were have been affected. Jobs have been lost. And while the US economy has recovered, a number of European economies and Japan are still locked in recovery-mode.
- The GFC led many to distrust their political and economic leaders and politics more generally. There has been a trend to embrace the far left and far right parties or candidates.
- Importantly, the past decade hasn't just been a time of political and economic change but technological change. A time of globalisation, internet shopping, social media and 'disruption'. Older people have been challenged with jobs lost and businesses threatened by new competitors.
- The Italian referendum on December 4 could lead to fresh elections. And the fresh elections may result in anti-EU parties taking control. In France, while far right National Front leader Marie Le Pen is currently not favoured to win the presidency, our CommBank analysts say *"the risk Le Pen wins the French Presidential elections on 7 May 2017 is not negligible."*
- Dutch elections are held on March 15 2017. The first round of the French presidential election is April 23 2017. German elections are expected in September 2017.



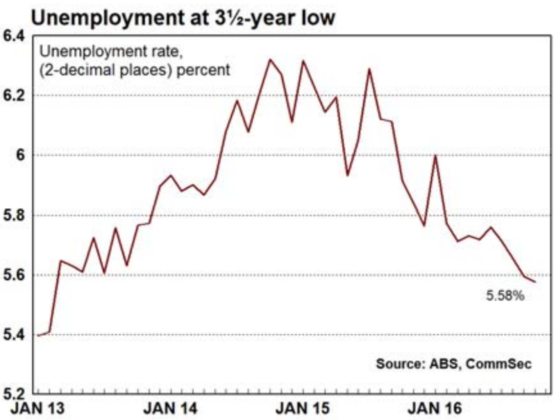


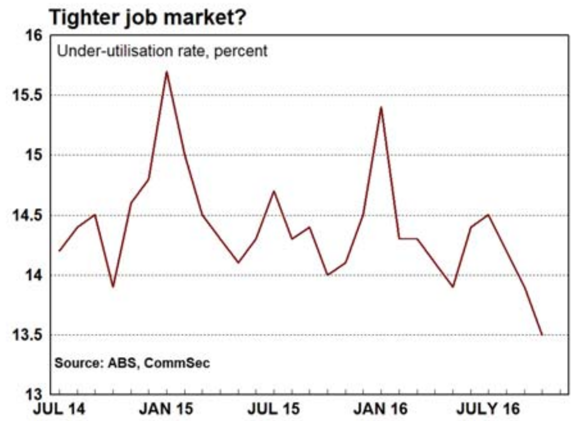


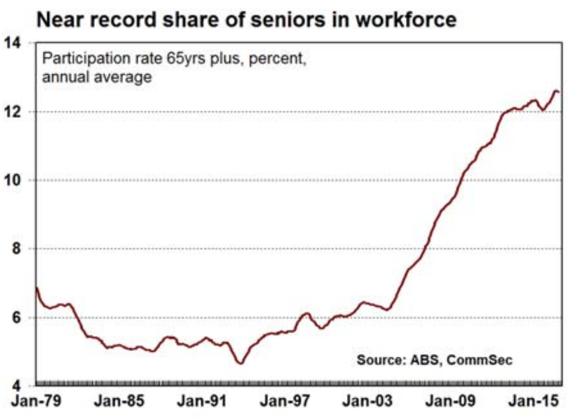


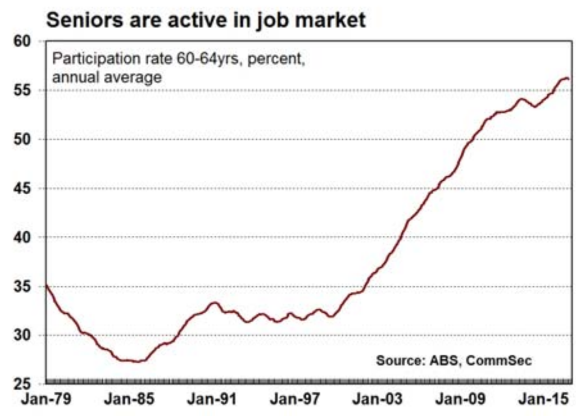
The state of the job market

- Is the job market getting tighter or has labour market slack expanded in recent months? It is not an easy question to answer. Some will point to the unemployment rate – now down to a 3½-year low of 5.6 per cent. In fact a third of all labour market regions have unemployment rates of 5 per cent or below.
- But others will point to the slowdown of full-time job growth over the past year. Or the rise in the under-employment rate. This rate basically picks up the proportion of people who want to work full-time rather than part-time or perhaps want to work longer hours.
- The under-utilisation rate is *"the sum of the number of persons unemployed and the number of persons in underemployment, expressed as a proportion of the labour force."* The rate seems high, with the October result recorded at 13.5 per cent. But the monthly series only goes back two years, which raises a question about what is 'normal'. In fact the 13.5 per cent rate was the lowest rate recorded.
- But then there is the discussion of changes in economic performance across industries and regions. Clearly there has been a slowdown in mining regions, causing job losses and reducing the number of hours available for work. If other industries are operating 'normally' but there is a major downturn in a small number of industries, then that could give a wrong impression about the state of the job market.
- And then there is the issue of which workers are claiming that they are under-employed and want to work longer hours. More employees may say they would like to work more hours, but that in itself is not an indication of labour market slack – especially if data continues to show record numbers of seniors in the workforce. It is a competitive job market and employers will always seek the best mix of workers, skills and hours to achieve the most profitable result.
- The bottom-line is that central bank officials and analysts need to spend more time in examining job market trends. The job market is indeed improving but wages aren't yet rising, capping inflation pressures.



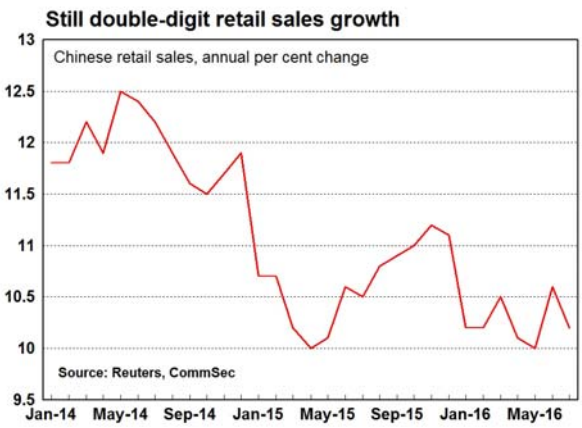


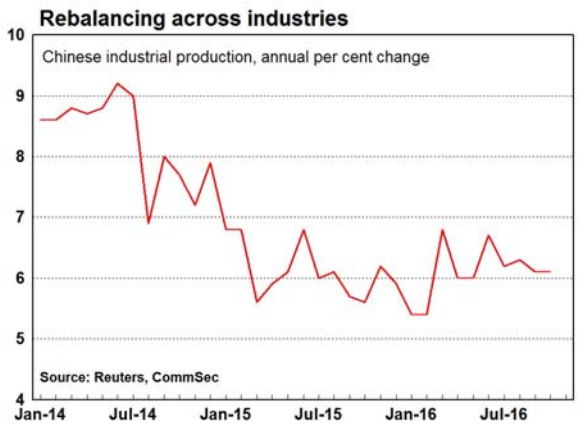


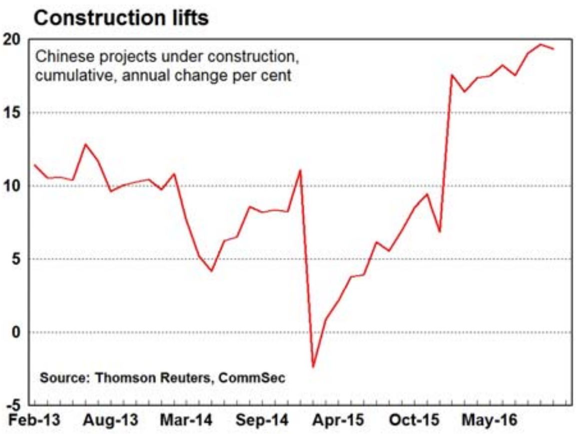


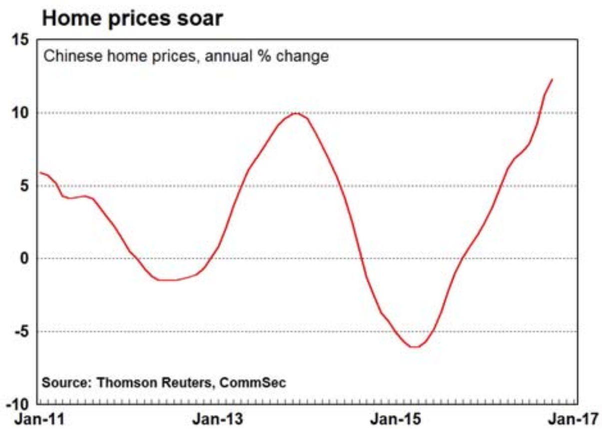
The economic 'baton change' in China

- China is never too far away from our thinking. China is still the largest driver of the global economy. And China is the major trading partner for a raft of countries across the globe.
- In recent years there have been fears of a hard landing in China. If not a recession in the technical sense, at least super-slow economic growth, causing knock-on effects across the globe.
- But against the odds, China continues to growth at a healthy clip. And that is despite the growth drivers changing – the political leadership wants the Chinese consumer to play a greater role in driving the economy rather than industrial production and the export sector.
- From 2000-2013 industrial production grew at an average annual rate of 13.8 per cent. But since 2013 the growth rate has halved – averaging 6.9 per cent. And indeed this year the growth rate has averaged just 6.1 per cent.
- Interestingly, from 2000-2013 retail sales also grew at an average annual rate near 14 per cent. But since 2013, growth has eased only marginally to 11 per cent. A nation of 1.4 billion people is still spending at double-digit annual growth rates.
- But while consumer spending remains a mainstay of growth, the other key development over the past year has been a revival of building activity. In April 2015, house prices were falling at a 6.1 per cent annual rate. In October 2016, house prices were growing at a 12.3 per cent annual rate. And the value of projects under construction is currently growing at a near 20 per cent annual rate.
- Australia is very much interested in the economic 'baton change' in China, something the Reserve Bank Governor calls *"a difficult economic transition".* Governor Lowe noted *"It remains a work in progress, and we all have a strong interest in their managing this trade-off as smoothly as they can."* It is a case of so good, so far.
- Will it be one of the *Big Issues* in 2017? We would argue that China has to always be on the Big Issues for every year – at least not until an economy like India starts its industrialisation process.









Rewind: The Big Issues for 2016

BIG ISSUES OF 2016

Will we need to worry about inflation again?
China: Hard landing or soft landing?
How aggressive will the US be in lifting interest rates?
What is 'normal' economic growth in Australia?
When will 'animal spirits' return?
Housing: Hard landing or soft landing?
What will our tax system look like in five years' time?
Will oil prices ever see US$100 a barrel again?

- As we noted at the start of this report, we have been producing the ***Big Issues*** report for the past 15 years. And it is interesting – and perhaps even instructive – to rewind over the past year and assess what we had on the radar screen in December 2015.
- Looking ahead into 2016, we highlighted eight issues. And the first issue was "*Will we need to worry about inflation again?"* Inflation has featured on the 'Big list' for a number of years. And with good reason – disinflation (falling rates of inflation) and deflation (falling prices) have tended to replace inflation as a concern for consumers, businesses and central banks. Many did expect that we wouldn't need to worry about inflation for a while. But higher commodity prices and expansionary fiscal policy are now causing people to re-assess views.
- Somewhat related were the issues: "*How aggressive will the US be in lifting interest rates?"* and "*Will oil prices ever see US$100 a barrel again?* Clearly the US Federal Reserve has dragged its heels on lifting rates because inflation has proved tame. And the Australian Reserve Bank has cut rates in response to low inflation. But if oil nations are successful in freezing or cutting output, higher oil prices will add more inflation to the mix.
- Housing has also dominated our 'Big List' for a few years. Last year we questioned: *"Housing: Hard landing or soft landing?"* Interestingly, while plenty of people worried about the outlook for housing, the actual issue of the 'landing' has been put off for a year. Thus the question of the housing landing makes a return for 2017.
- China is never too far away from our consciousness. That makes sense given that China is the major driver of the global economy as well as being Australia's trading partner. Over the early part of 2016, many did question *"China: Hard landing or soft landing?"* but with the year was drawing to a close, most observers conclude that the Chinese economy remains in good shape. In fact it is in such good shape that iron ore and coal are back in vogue, driving prices higher.
- There were two domestic issues that we put on the *Big Issues* for 2016: *"What is 'normal' economic growth in Australia?"* and *"When will 'animal spirits' return?"* Essentially we have had an answer to the first question although the last question still had the Reserve Bank elite scratching their heads.
- The Reserve Bank has made it clear that the 'speed limit' of the economy, or the 'potential' growth rate is at or slightly below 3 per cent. And clearly that is interesting given the fact that the economy has grown at or above 3 per cent for the last six months. It is also the Reserve Bank's expectation that the economy will keep growing near its 'potential' rate over 2017. And that has led the Reserve Bank to conclude that inflation has bottomed together with interest rates.
- So when will the 'animal spirits' of investment, innovation, spending and hiring return? Well businesses are indeed doing all those activities – it's just that there is still a healthy degree of caution despite the super-low rates on offer.
- And finally we posed the question: *"What will our tax system look like in five years' time?"* And this issue came quickly to the fore in late January with NSW Premier, Mike Baird, again making the case for a 15 per cent GST to address gaps in health and education. Clearly there will be more discussion in coming years with the Government finding it difficult to move the deficit back towards balance.

Craig James, Chief Economist, CommSec
Twitter: @CommSec

Savanth Sebastian, Senior Economist, CommSec
Twitter: @CommSec