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‘Tasmania’s economic performance of late – Where to from here?’

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[Information and analysis has been based on data from IMF, ABS and Commonwealth Budget Papers, plus a range of unpublished internal information]

As we move through 2010 we can look back on last year as one of the most challenging for a very long time. It has been challenging for business because, amongst other things, of the uncertainty of demand; the tight conditions and higher costs surrounding finance; and the need to find cost effective ways to retain good workers.

It has been challenging for governments because of severe reductions in revenue; the political difficulties associated with making responsible expenditure cutbacks; the risks associated with running budget deficits; and managing the expectations of their communities. And while these communities have been aware of events surrounding them, they seem not to be readily accepting of the need for associated austerity measures to remain in place while budgets are to now be repaired.

It has also been challenging for investors (big and small), because they have watched the value of their wealth fall (and in some instances plummet) as equity and financial markets went into a free-fall after a crisis of confidence and the collapse of some major international financial institutions. The hopeful, the hungry and the persistent are now beginning to see evidence of a revival – but global financial and economic impacts may not yet have passed completely.

There are definitive signs all around us that the Australian economy is picking up, but the nature of the recovery poses some interesting questions for policy makers, particularly at the national level. This is because there appear to be at least two distinct economic performance streams in play. One is the performance of the economies that are highly focused on the bulk export commodity markets and the emergence of what could become the next wave of what has been a long-term resources boom. The obvious examples of the stellar performers are of course WA and Queensland. These are the economies that rode the commodities boom through its peak and into the 2008-09 onset of the Global Financial Crisis (GFC). Then there are the so-called "also rans" that may have appreciable export activities, but in different market sectors and not nearly to the same extent as the big mining states.

For Australia, the impacts of the GFC have proven to be somewhat muted compared to many of our trading partners. Although Australia didn't escape many of the effects of the last year and a half, looking back we have been fortunate indeed (as a nation at least) as the Commonwealth Budget this week has shown. Having at this time last year forecast a contraction of the Australian economy for 2009-2010, various factors have contributed to an outcome in which the economy will have actually grown by about 1 $^{1/2}$ per cent over this period. This is in the face of most major economies having shrunk over the last year.

The Commonwealth Budget is now forecasting that the year ahead will be one in which real annual growth in the national economy will be well on the way to being over 3 per cent, which is close to the long-term trend rate for our national economic performance.

Figure 1:

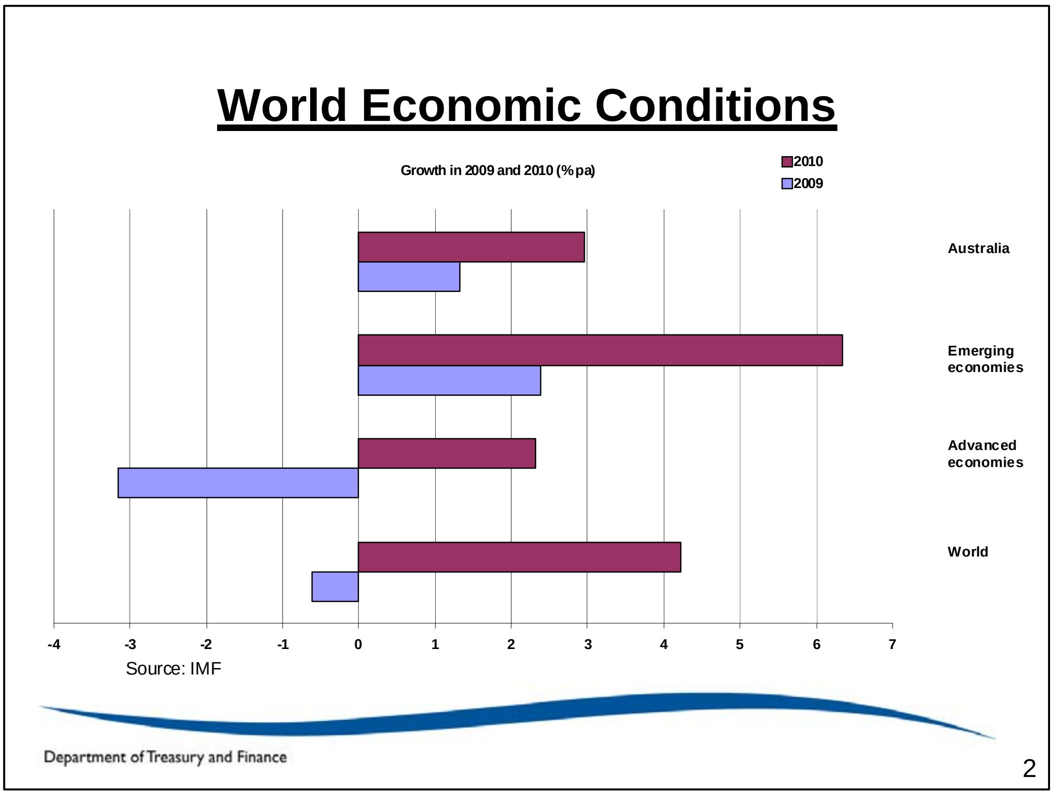


Figure 1 is based on IMF forecasts of economic growth for this year and Fiscal 2011. It compares Australia with the group of "Emerging economies" (including countries such as India, China and other Asian region countries); the "Advanced economies" (which includes many western European countries and the US), and a measure of the "Global economy". We can see that there has been a marked turnaround in the outlook between this year and the year ahead.

This year the "Global economy" will have contracted by about a half a per cent, compared with positive growth of 0.9 per cent and 1.5 per cent in the global downturns of the early 1980s and 1990s respectively. This is a good indicator of the severity and reach of the fall-out from the GFC. The major contributors to this outcome will have been from the "Advanced economies", consisting of most of Europe, Japan and the US. Next year, however, the "Global economy" is expected to return to growth of just over 4 per cent. This also, is a notable turnaround.

But while the world economy is forecast to return to trend expansion, concerns are increasing about the implications of very large and growing public debt of Euro-zone countries such as Greece, Portugal and Spain. In particular, the current situation in Greece has negatively impacted confidence and markets and it may be some time before we can be confident that the IMF rescue package that is to be available to selected Euro-zone countries will quell the unease surrounding the possibility of these countries defaulting on their massive debts.

It is also too early to tell whether the communities of these countries will accept the commitment to spending and taxation measures that their governments will need to maintain in order to meet the requirements of the safety net on offer, and to undertake the long-term underlying budget repair that is required to bring their fiscal circumstances back towards a sustainable position.

Global economic growth in Fiscal 2011 is expected to be driven by the so-called "Emerging economies", such as in the Asian region – they were not as seriously affected by the economic slowdown as expected. The IMF is projecting a collective expansion of these "Emerging economies" of over 6 per cent for Fiscal 2011 – from which there will be substantial contributions by the big powerhouse economies such as China, which could itself return to growth of 10 per cent or even more. For China, this would represent about a halfway ‘clawback’ to the GDP growth of 13 per cent or more it experienced two years ago.

In contrast, the “Advanced economies” are estimated to have declined by around 3.2 per cent in 2009, with growth of only 2.3 per cent forecast for the coming year. The forecasts for both are around their long-term trend levels, suggesting that for most of the world an emergence from the depths of the GFC will have been fairly rapid indeed.

Returning to the situation for Australia specifically, unemployment is expected to be back down to around 4 ½ per cent within two years, which the Commonwealth argues is close to a level that could be considered to be associated with full employment. This is a remarkable turnaround from a situation a year ago in which unemployment was forecast to be between 8-10 per cent at its peak. The prospect of this of course was extremely dire in the face of falling consumer confidence and tightening financial conditions that had, without doubt, constrained the outlook for consumer spending and the residential building sector.

However, the most direct negative impacts on the Australian economy have been through severe contractions in our export markets, the mining sector probably being the worst hit and the highest profile decline. These effects have been most felt as a result of the rapidly dwindling demand for our mining exports to China in particular.

Now to some extent a falling exchange rate acted as a hedge against declining demand for exports, but this of course had varying effects across industry sectors. In recent times the Australian dollar has been quite high and while this serves to increase our overseas purchasing power, particularly at a time when investment in offshore plant and equipment may be the order of the day, it will nonetheless take the shine off the attractiveness of our exports.

The other main impact on Australia was through the severe contraction in financial market liquidity, which squeezed bank margins and made it harder for those looking to invest to do so. Due to a number of measures, including the Commonwealth’s offer to guarantee offshore borrowing by our banks, this situation has eased; but the cost of borrowing is now back on the way up. Expectations for the moment however are that the relaxation of the liquidity constraints will tend to outweigh the price effects and the private sector will once again pick up the task of investment as the Commonwealth in particular continues to withdraw its stimulus spending.

In an overall sense however, China still remains one of the single biggest influences on the magnitude and timing of a recovery for Australia.

While there are a number of important factors that will impact the speed and extent of a global recovery generally, even continued modest growth in domestic demand in China will benefit Australia more than many other countries. This is because about 80 per cent of Australian exports to China remain in China. Together with the fact that our domestic financial sector has proven to be more robust than those of other countries (in particular the US and Europe), this highlights why Australia has not only weathered the GFC well, but has been an early leader in the recovery phase.

On a final note with respect to the national economy, it seems well placed to continue building the momentum of recovery and the resurgence in key exports will be aided by rising commodity prices. In fact the underlying buoyancy in the 2010-11 Commonwealth Budget would seem to be heavily predicated on a strengthening in Australia’s terms of trade, this being forecast to reach the highest experienced in many decades.

As I noted earlier, the effects of this recovery are not going to be spread evenly across the nation and the big mining regions will once again lead Australia into what many are predicting will be the next round of a resources boom.

As the big export commodity economies take-off again, this will generate inflationary pressure (which will in turn lean on the need for tightening monetary policy through interest rate rises); it will put pressure on Australia’s terms of trade (through holding the Australian dollar high); and it will create a strong drain on skills from other parts of the economy, once again leading to wages pressure, regional skill shortages and a host of lost opportunities.

How Tasmania manages through this next phase will be interesting given that the household community (and in turn consumer spending) is vulnerable to rising interest rates, the business community has pulled back on private investment (and this is linked to confidence and interest rates); a strong Australian dollar tends to weaken the demand for our exports; and it is not clear the extent to which business here can cope with rising wage pressures right now, or a drain on the pool of available skilled labour.

While it is true that there has been noticeable job shedding in Tasmania (to the extent that the level of employment now is about 4,000 jobs lower than was the case in 2007-08), this has been accompanied by an unwelcome fall in the participation rate, such that it is now at about 61 per cent, compared with a national rate of just over 65 per cent. And while this has kept the unemployment rate in check over the period of the GFC, we will want the participation rate to now be rising, bringing more people into the workforce as our local recovery takes hold. To the extent that skilled workers are not stepping forward as part of the workforce, this will make it harder for business as they use up their capacity to increase output through converting part-time back to full time jobs and in turn look to put on new workers.

In fact recent ABS data suggest that the impacts of the GFC were mostly felt by males who have tended to dominate the industry sectors most affected, such as mining, manufacturing and construction. The aggregate hours worked per week in the year to March of this year declined by 6.4 per cent of which only 0.4 per cent of that was due to a reduction in the aggregate hours worked by females. Over the same period, the number of part-time hours worked <u>increased</u> by 5.4 per cent. This highlights the job switching effect of full to part-time employment as many employers chose to retain employees, but have them work less hours as they scaled back production to weather the downturn in demand. At the same time they were able to minimise the costs of gearing up as the recovery began by avoiding the need to take on new workers who may have required training or time on the job before they became fully productive.

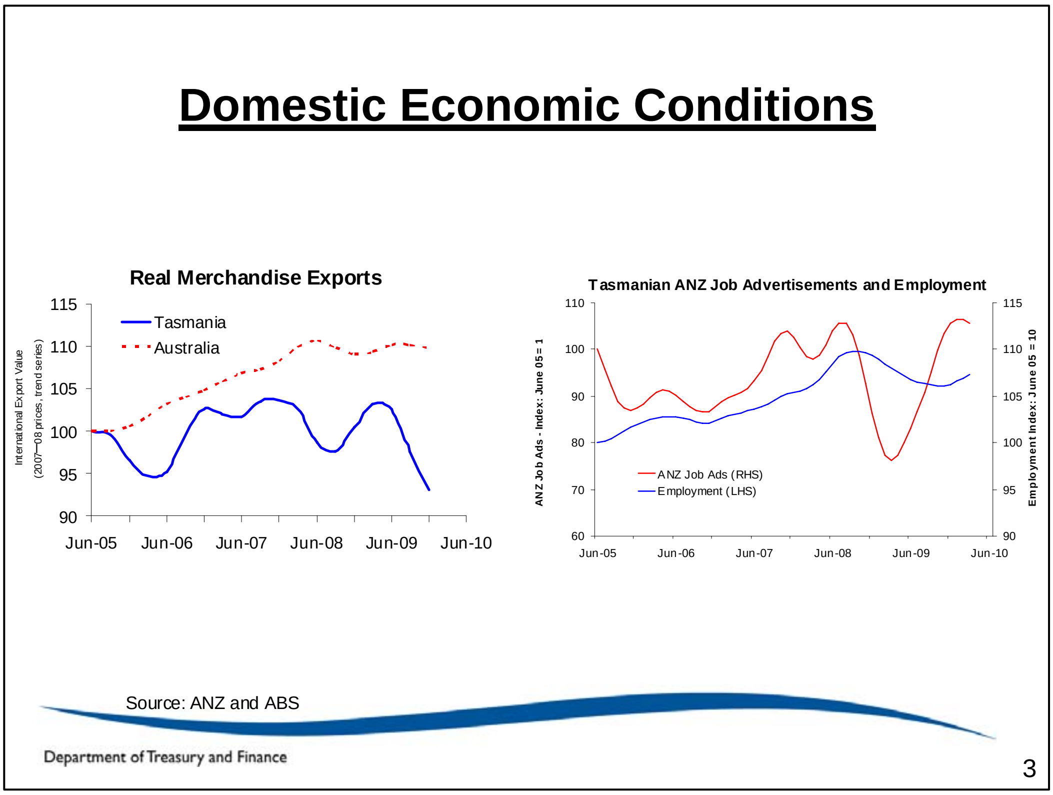
But overall Tasmania has weathered the circumstances relatively well, even though as I have just noted there has been appreciable job shedding; there has been a significant drop-off in private investment; and the Government has found itself in tight fiscal circumstances.

By the time the Tasmanian Mid-Year Financial Report was released just prior to Christmas, the picture as foreshadowed at Budget time last year wasn’t so grim – although it most certainly wasn’t as strong as it was looking in the previous year.

GST, which is Tasmania's largest single source of revenue, had not declined to the extent expected and state own-source revenues had also held up much better than had been expected. In particular property prices have avoided a decline (for reasons that remain difficult to isolate) meaning that conveyance receipts were stronger than estimated; payroll tax receipts were higher than forecast and land values maintained land tax receipts.

As we look forward into the 2010-11 Budget year we see a very different picture from last year, although the detail of Treasury's outlook for the economy won't be revealed until the State Budget on 17 June.

Figure 2:



Focusing for a moment on the labour market, Figure 2 shows indicators for the Tasmanian market. One is an employment level index and this indicates the strong steady growth in jobs over the years leading into 2008-09. The mining and manufacturing industries were among the first to be affected, due to falling international demand and commodity prices. A large number of jobs have also been lost from the manufacturing industry, such as those from the two North-West paper mills.

The ANZ job advertisements for Tasmania can be used as a leading indicator of employment. Job ads fell sharply in mid-2008, but have recovered to pre-crisis levels, indicating that employment has 'bottomed out' in the current cycle. This also signals that there has been a return to the demand for skilled labour. What happens from the last point on the chart will obviously be described in the forthcoming state Budget, but without giving too much away I can tell you that Treasury views the medium-term outlook as positive.

The other chart maps an index for each of Tasmania's and Australia's merchandise exports. Merchandise exports have declined sharply in Tasmania through the GFC compared to a plateau that was experienced at the national level. This reflects the differing mix of commodities, with national exports reflecting strong demand for minerals. As I said earlier, the high Australian dollar has adversely affected Tasmanian exports and it this effect is clear from Figure 2.

<u>Figure 3:</u>

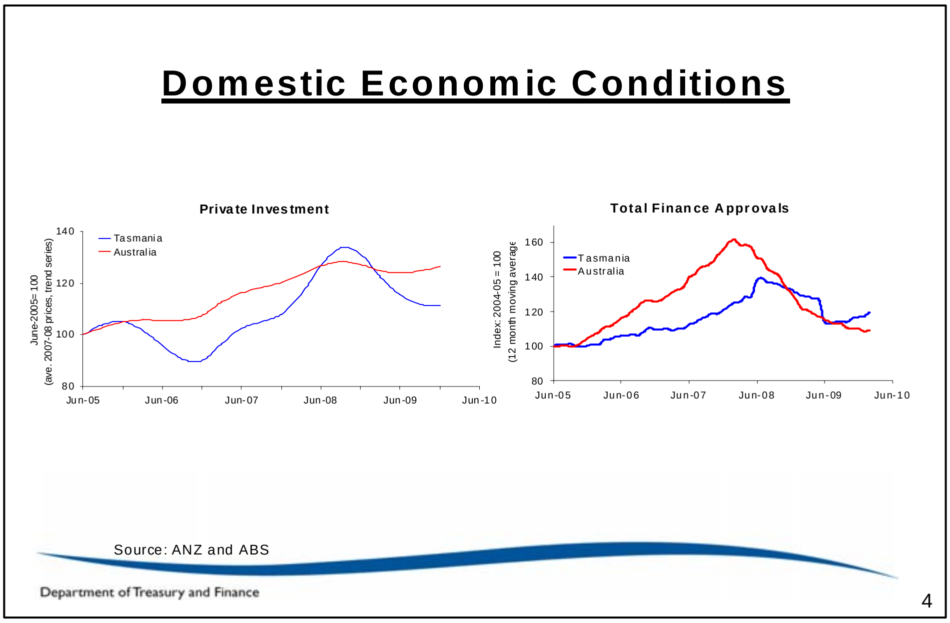


Figure 3 shows an index for private investment, together with total finance approvals.

The Tasmanian economy experienced very strong growth over the years going into the GFC, and this growth was led largely by consumption, to be followed more recently by private and public investment. Together, these impacts resulted in very strong employment growth. However, economic growth more recently has been negatively impacted by sharp declines in private investment. As we can see from Figure 3, Tasmania has suffered a far greater decline in private investment compared to the national experience. The gap here has been filled in the interim with an increase in government spending and investment, much of which has been directed by the Commonwealth through its national stimulus and associated programs.

At present there are some signs that private investment is going to recover in Tasmania, with business confidence surveys indicating a modestly positive outlook and as the right-hand chart in Figure 3 indicates the bottom of the decline in finance approvals seems to have been reached. What is not clear is how quickly any such recovery in investment will occur. As the various government stimulus programs are wound back, it is hoped that private investment will take up the slack in a timely manner; otherwise the Tasmanian recovery could begin to stall. Although this does not appear likely, it is certainly one risk for Tasmania that sits on the near horizon.

Given the small open economy nature of Tasmania, it is heavily dependent on external national and international markets for its prosperity. Therefore, no consideration of Tasmania's economic performance or prospects could avoid a closer look at the composition of its merchandise exports.

In the year to March 2010 China (including Hong Kong) was the single largest importer of Tasmanian goods, accounting for over 25 per cent of the state's total exports. Furthermore, over this same period Tasmania's exports to China increased by over 8 per cent. This is in stark contrast to the decline in exports to Korea of 52 per cent; and the decline in exports to Japan of 42 per cent. The decline in wood and woodchip products to Japan in particular is a reflection of the state of the markets for the forest industry, given that over half of these products have in the past been exported to Japan alone. As Tasmania's second largest trading partner, the languishing Japanese economy has had a major impact locally and exports to Japan are now at the lowest point that have been since 1988 when the ABS commenced this statistical series. The outlook for exports could therefore be seen as relatively weak, particularly given Tasmania's traditional reliance on pulp and paper exports, the demand and price for both of which is also very weak at present.

If we look at the mining sector however, we can see where there has been a role for the increased importance of China, India and Korea as trading partners for Tasmania. Taking the base mining industry alone in Tasmania, it is relatively small in terms of its contribution to GSP and employment, especially when compared to the national share. In 2008-09 the mining industry's share of total industry gross value added was just over 2 per cent, employing 2 300 people (about 1.0 per cent of Tasmania's total employment). At the national level, the mining industry contributed 7.4 per cent to Australia's total industry gross value added in 2008-09.

However, if mineral processing is included, the estimated value of mineral production (including processing) was $2.45 billion in 2008-09. This is around 11 per cent of Tasmania's GSP. Therefore together, the two sectors constitute an important source of output and income for Tasmania.

As you would know, the State's major metallic mineral products are copper, iron, zinc, gold and lead. The major non-metallic mineral product is limestone.

In terms of exports, the mining sector plays a very significant role.

Figure 4:

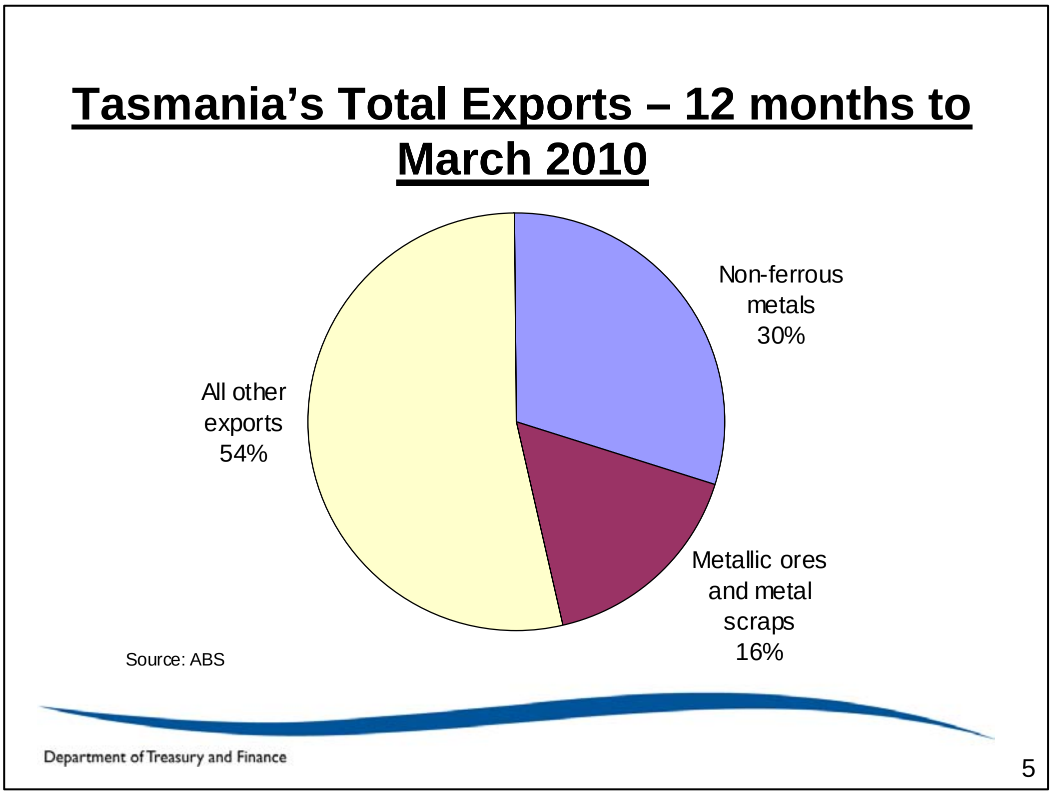


Figure 4 shows that mineral products are a large component of Tasmania's exports and accounted for around 46 per cent of Tasmania's exports in the year to March 2010. Of this, non-ferrous metals accounted for around 30 per cent of Tasmanian exports, despite the total value of these exports decreasing by 17 per cent over the same period.

Metal ores and metal scrap accounted for approximately 16 per cent of exports in the year to March 2010. This share has risen over time in line with increased demand from India and North Asian countries.

Figure 5:

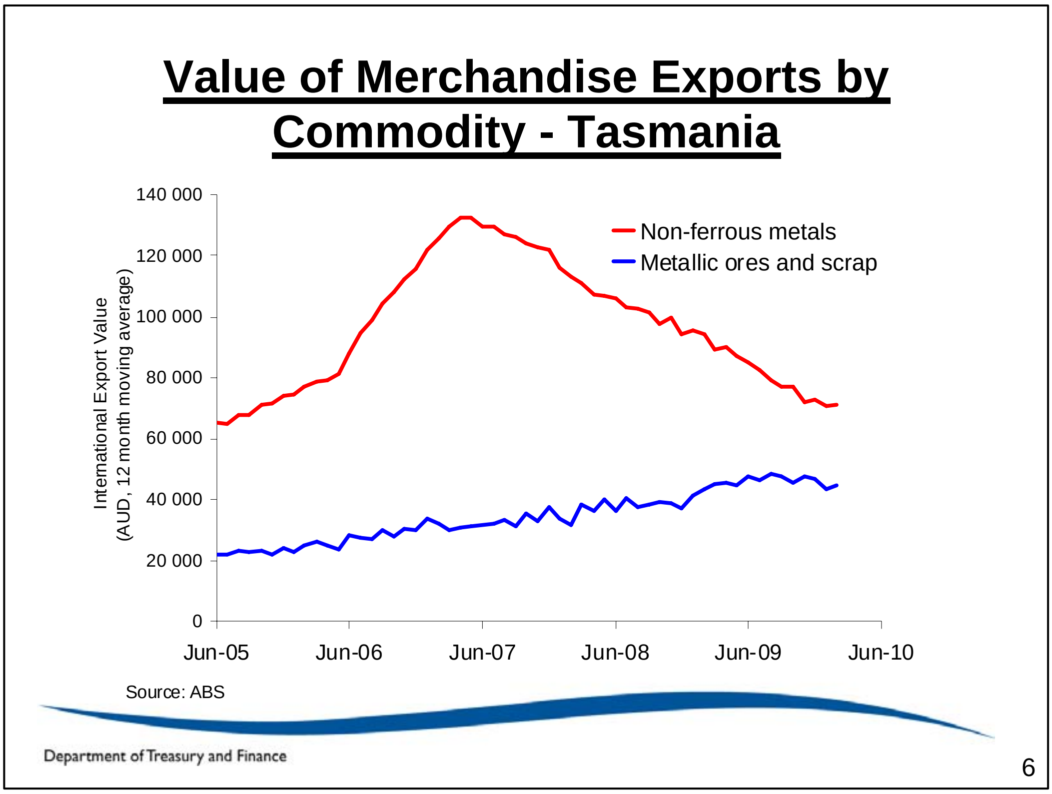
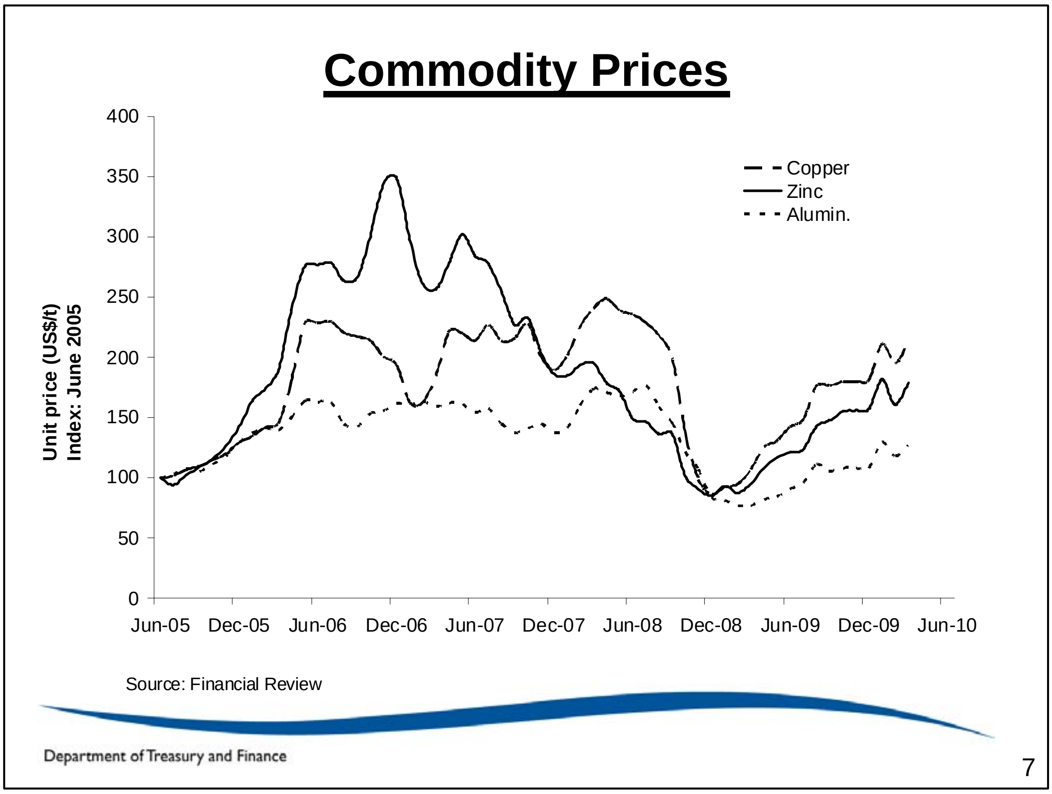


Figure 5 shows a 12 month moving average of the international export value of Tasmania's two main mining exports, measured in Australian dollars. The value of non-ferrous metals (including copper, lead, zinc, tin and gold) increased from June 2004 to a peak in mid-2007, after which it has declined significantly. This decrease in value is due to a reduction in both price and export volumes.

On the other hand, there has been volatility in the value of metallic ores and metal scrap (which includes iron ore), but the overall trend has been one that is steadily increasing.

Figure 6:



However, if we look at commodity prices for the metallic ores over the same period (Figure 6), we see that international prices for zinc, aluminium and copper ores and concentrates have actually been quite volatile, which has been a driving factor in the variations observed in the export value of these commodities. While they all been through sharp declines during 2008, they have since recovered to levels about equivalent to what they were just prior to the onset of the GFC.

ABARE forecasts that the value of Australia's total commodity exports will decline by 18 per cent in 2009-10, followed by growth of around 15 per cent this year. If we were to isolate mineral resources from this picture, exports are forecast to decline by around 20 per cent in 2009-10, with growth of 19 per cent in the coming year.

The demand for zinc is closely linked to its end use in galvanized steel and around 70 per cent of galvanized steel is used in construction and automobile manufacturing.

Although construction activity in Tasmania's trading partners, such as China is strong, the automobile industry globally remains sluggish. Therefore the overall outlook for the mining sector alone is mixed.

Although extremely topical, I had wanted to avoid creating a lengthy debate today on the merits, or otherwise of the Commonwealth's response to the *Australian Financial System Review* (better known as the "Henry Report"). This would require a session in its own right. However, to think that it won't come up would be totally naïve of me! So I will chance my arm on a brief comment.

By way of some context, in Tasmania wages and salaries comprise around half of total factor income for the mining industry, while nationally the share is only around 20 per cent. The higher share of gross operating surplus and gross mixed income of total factor income for the mining industry nationally reflects the mainland industry's larger scale operations, which are better able to achieve economies of scale, than is the case in Tasmania. Of course the large scale iron ore and coal mining projects are key to driving this result and this highlights the differences between the Tasmanian mining sector and those of WA and Queensland in particular.

Furthermore, the greater focus in Tasmanian on base metals, which have experienced less dramatic price rises over the past decade than for coal and iron ore, is also likely to result in comparably lower profits for these operations.

Given the varying profitability between the Tasmanian and mainland sectors, this seems to us an important starting point to consider the proposed new resource rent tax arrangements.

On the face of it, you could think that a purely profits based tax would benefit the Tasmanian mining sector over the current (mixed) royalty arrangement, but current indications suggest that the state's major mines are likely to end up paying more to governments under the new arrangements, in some cases possibly up double, than their payments for current Tasmanian based royalties. However, the impact on new versus existing projects will be a major consideration and I imagine this is where a lot of the coming debate between the industry and the Commonwealth about implementation of the proposed new arrangements could be focused.

But as a partial offset to the increased taxation receipts from mining, the proposed arrangements include an exploration rebate, at the company tax rate, which is to commence from 1 July 2011. This will result in the Australian Government effectively paying slightly more than half the cost of exploration activities through the combination of this rebate and the deductibility of exploration expenses for the proposed resource rent tax. One would think that this should encourage firms to undertake more exploration activity in the State, particularly from smaller operators.

So there are likely to be overall offsetting effects, with the life of some existing mines possibly being extended while some existing operations might close sooner than would otherwise have been the case; and there could be some currently planned projects being deferred (particularly while the detail is being finalised), while other projects could be encouraged to be pulled forward. We are only just beginning to get our minds around these issues and are planning to use preliminary work, together with discussions with Commonwealth Treasury and other jurisdictions to better understand the potential impacts for Tasmania as more detail becomes available. Enough from me on the Resource Super Profits Tax.

Before I raise one further issue, let me summarise comments on the recent performance of the Tasmanian economy.

It experienced very strong growth in the lead up to the GFC. The strength of this growth was a reflection of high levels of consumer spending, and in more recent years through considerable private and public investment. High levels of investment in turn resulted in very strong employment growth.

However, Tasmania was not, as we predicted at this time last year, immune to the deteriorating national and international conditions. The impacts of evaporating confidence were felt here as they were elsewhere, but the extent to which this is actually occurred was not as bad as it was first thought going into Fiscal 2010.

As a small open economy, Tasmania is highly dependent on international export markets and the performance of the national economy.

The mining and manufacturing industries were among the first to be affected, due to falling international demand and falling commodity prices.

Somewhat surprisingly, the residential property sector has experienced price maintenance, particularly in the lower to middle price brackets. Most of the activity in the past 8-10 months, however, has been in the first-home-buyer segment of the market. At the same time, Tasmanians overall have been spared the negative wealth effects of falling house prices that were experienced elsewhere. This will help to underpin consumer spending in the recovery period.

Lead indicators of employment, such as the ANZ employment advertisements series, are now suggesting a positive employment outlook. ABS data on the labour market in Tasmania show that employment rose by 900 persons in April of this year alone, this being the sixth consecutive increase following 13 monthly decreases. Together with an increasing shift back towards full-time employment, this will reverse the trend Tasmania has experienced during the impact of the GFC.

Finance approvals have reduced significantly at the national and Tasmanian levels. This has reflected a tightening of available credit and reduced commercial profitability. With the prospect of rising interest rates this is one area that could possibly work to suppress a recovery in residential and commercial confidence.

The increase in private levels of investment over the 5 years leading into the GFC have been key to driving the transformation of the Tasmanian economy, and to not recover this momentum now could result in a stalling of economic activity.

Merchandise exports have declined substantially at the state level, just as they have at the national level. As has been the case with most trade globally, the outlook for Tasmanian exports is weak immediately, but as all of Tasmania's major trading partners (Japan aside) are beginning to recover, the outlook is more positive.

In summary, Tasmania's economic performance has to date remained resilient. Tasmania has a relatively diversified economic base, with local consumption, exports to the rest of Australia and international exports all playing a substantive role in the take-up our production – this is to some extent acting as a sort of natural hedge as we aren't totally reliant on the performance of any one of these sectors alone for recovery.

The fundamentals of the GFC were laid down over a long period of time in which there was widespread complacency about 'risk' and the ability of the market place to self-correct in a periodic and timely manner.

Whether you believe what has happened is the result of a breakdown in private sector banking and other institutional roles; or our regulatory and governance arrangements, this is a matter that is still being debated and will continue to be debated for some time to come.

However, what will be interesting is the impact that the sovereign debt crisis that is developing in Europe will have on financial and equity markets again – and more to the point, what this might mean for Australia.

The result of the corporate collapses washed through financial markets and stock markets generally, sending confidence plummeting and sapping markets of the healthy amount of risk taking behaviour. The impact on confidence everywhere is widely acknowledged as central to the second and third-round impacts that followed, not only in the corporate sector, but in the broader community more generally. Therefore, maintaining a continued restoration of confidence that has been gradually re-building after the GFC will be a key factor in these latest events having a minimal impact on global markets and thus, the outlook for the year ahead.

The issue of burgeoning government debt was always going to be the next major issue to emerge. What we are seeing in places like Greece is symptomatic of a long period of governments over spending and over borrowing. Unfortunately this behaviour has not been contained to just a few countries, but there are lessons here for us all. As our population ages and our welfare and health expenditures continue to grow, the issue of living within our means will confront us as an issue on a wide scale. Fortunately in Australia we have very low levels of public debt compared with the rest of the world – we can therefore say with confidence that our 'house is in order' and governments here are very conscious of the need to avoid amassing large debts or running long-term deficits. This means that we won't be the cause of future nervousness of sovereign debt default. The more interesting question though is how much we get caught up in the mistakes of other nations – if at all.

For now we can hope that the next potential global crisis has been averted, but that would be the subject of a completely separate discussion.

Thank you.