Australia Has More Than Luck To Endure Downside Risks

Primary Contact:
Craig R Michaels, Melbourne (61) 3-9631-2082; craig_michaels@standardandpoors.com

Primary Credit Analyst:
KimEng Tan, Singapore (65) 6239-6350; kimeng_tan@standardandpoors.com

Table Of Contents

Australia's Credit Strengths

Australia Has Some Key Vulnerabilities

Downside Scenarios Could Put Pressure On The Sovereign Rating

Yet These Risks Are At Least Partly Mitigated

Base Case Is For Sound Economic Growth

Related Research

Australia Has More Than Luck To Endure Downside Risks

Australia's economic resilience is due to more than having lady luck on its side. Although the country has benefited substantially from its natural resource endowment, Standard & Poor's Ratings Services considers that the country possesses several robust credit fundamentals that support the top credit rating on the sovereign (unsolicited credit ratings AAA/Stable/A-1+). These include a wealthy and open economy, strong institutions, and low public debt.

Still, Australia is not without a number of vulnerabilities. The economy holds a large amount of offshore debt, households retain substantial debt mainly due to elevated property prices, and its banks are reliant on foreign investors for funding. Moreover, the country is increasingly sensitive to the pace of China's growth. In a downside scenario, these risks could lead us to lower the sovereign rating, although they appear to be largely mitigated for now.

Overview

- Australia's economy has been resilient because of its wealthy and open economy, and low public debt. In addition, it has benefited from a natural resources boom, driven largely by China's rapid expansion.
- However, the country faces a number of weaknesses, including significant offshore debt, elevated household debt, and a banking sector reliant on foreign investor funding.
- In a downside scenario, we believe these risks can pressure the sovereign ratings.
- Nevertheless, our base case is that economic growth will remain close to trend over coming years, with traditional sectors of the economy supporting growth as mining investment peaks.

Australia's Credit Strengths

Australia benefits from a wealthy, open and resilient economy, and a financial system that appears to be sound. The global financial crisis demonstrated the country's resilience, as the economy performed strongly relative to other advanced economies.

Moreover, fiscal flexibility is high, underpinned by the country's low public debt and strong fiscal discipline. Monetary policy is independent and highly credible, and the exchange rate is free-floating with a deep and liquid market. And Australia's political stability, mature and strong institutions, as well as transparency in economic decision-making, support the sovereign ratings on the country.

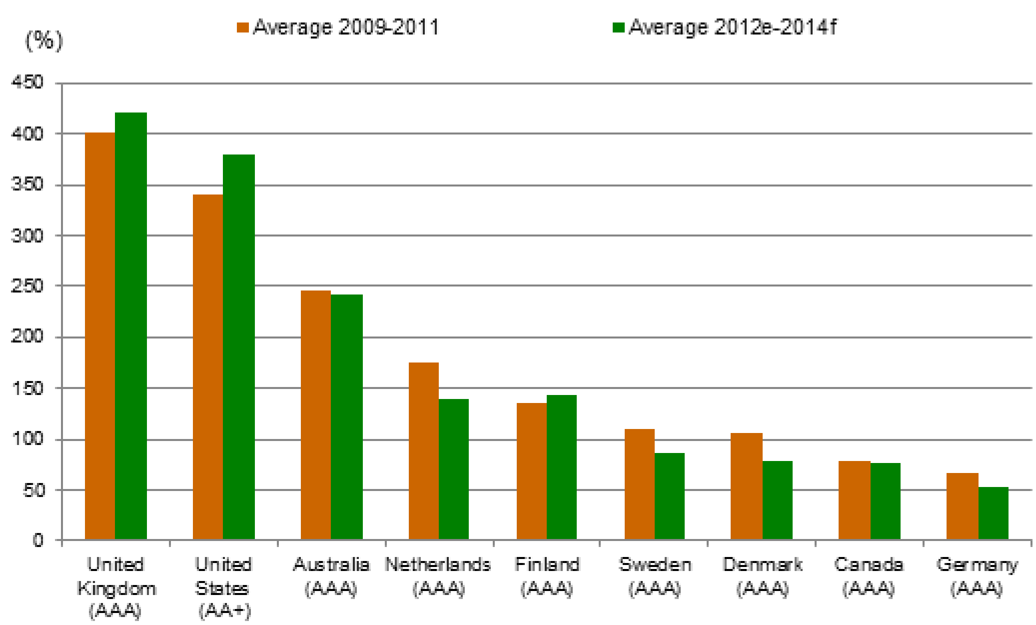
Our base case is that the Australian economy will track a sound growth trajectory. Growth in mining investment is expected to slow as it reaches its peak sometime in the next year or so, and we expect GDP growth to dip slightly below trend in 2013 as a result. Further ahead, we expect residential investment and nonmining business investment to gradually pick up in response to low interest rates and stronger global growth, supporting a return to trend economic expansion.

Australia Has Some Key Vulnerabilities

Australia is not without weaknesses, though. The country stands out among its 'AAA' peers for its weak external position, which is the result of persistent current account deficits over a number of decades. Narrow net external debt was 236% of current account receipts in 2011, well above most other 'AAA' sovereigns (see chart 1).

Chart 1

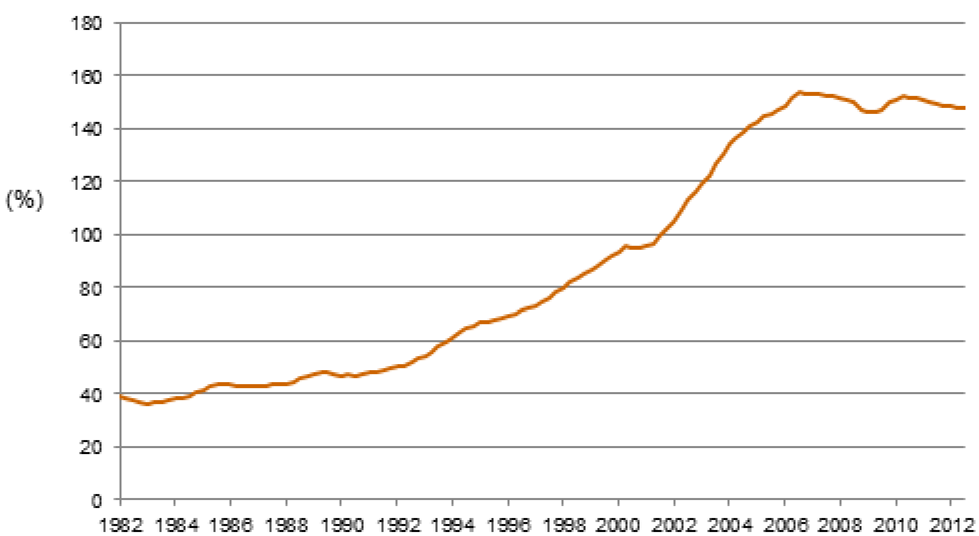
Ratio Of Narrow Net External Debt As % Of Current Account Receipts



*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents minus liquid nonequity external assets. e--estimate f--forecast.

Household indebtedness is also high. Household debt rose sharply through the 1990s and 2000s--largely to fund buoyant house prices--making household finances less resilient (see chart 2). On the positive side, households appear able to service these debt levels at present, with mortgage delinquency rates remaining low (at less than 1%). That said, the sustainability of high household debt levels has not been tested in an environment of high unemployment for a long time.

Chart 2



Ratio Of Australia's Household Debt To Disposable Income
1982-2012*

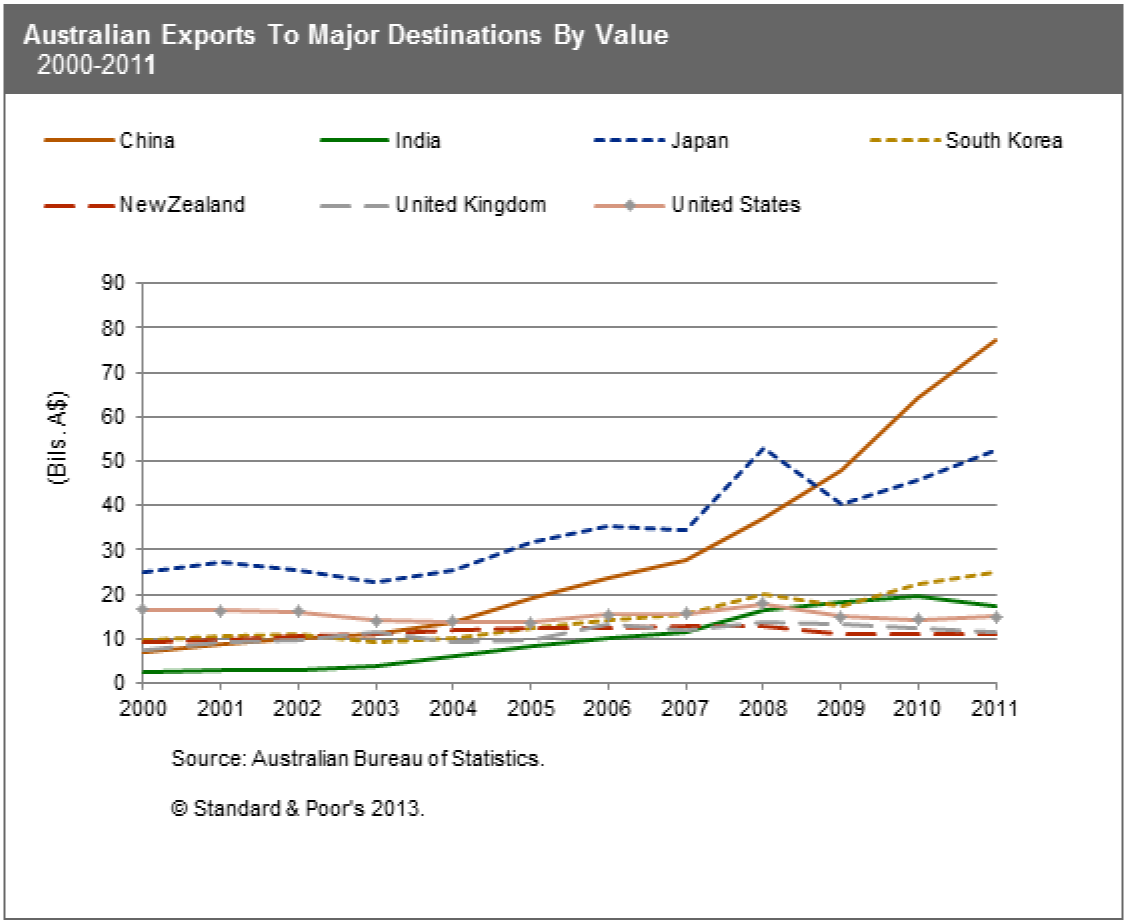
*First nine months to September. Source: Reserve Bank of Australia.

Australian house prices, relative to household incomes, are also elevated. While there has not been a buildup of aggregate excess supply, the housing market continues to appear somewhat vulnerable to a downturn, in our view.

Australia's banks lie at the nexus between the twin vulnerabilities of large external and household debts. Banks funded much of the rise in household credit through borrowing from offshore. The banking system is therefore vulnerable to shifts in foreign investor sentiment, as well as a sharp downturn in the domestic housing market and household finances.

A further key risk for the Australian economy is its substantial exposure to China's business cycle—a trend that has increased dramatically over the past few years (see chart 3). The growing trade exposure to China--which relates largely to iron ore and coal exports--has undoubtedly been a strength over the last decade, and particularly during the global recession in 2009. But the flip-side to this growing trade dependence is that the Australian economy is now more vulnerable to the risk of a sharp slowdown in Chinese growth.

Chart 3



Downside Scenarios Could Put Pressure On The Sovereign Rating

A number of plausible scenarios could exert downward pressure on the sovereign credit rating. In our view, these scenarios are unlikely to happen. However, should they eventuate, they would expose the vulnerabilities discussed above and potentially lead to a marked weakening in Australia's economy and sovereign fiscal position.

A shift in foreign investor sentiment

Global investors might reassess the sustainability of the country's external debt should its current account deficit widen significantly. This would likely lead to a rapid depreciation of the local currency, triggering an abrupt capital outflow and higher interest rates. Banks would raise interest rates in an effort to attract higher domestic savings to replace funding from offshore markets, while monetary policy would likely seek to address higher imported inflation. Meanwhile, corporations and governments would face rising interest rates in capital markets. Coupled with sharp declines in foreign direct investment, economic growth would contract or soften.

In an alternative scenario, global financial markets could become highly risk-averse for a sustained period—e.g. triggered by an event in European markets. In this scenario, interbank lending could seize up, with Australia's highly exposed banking sector facing a liquidity crunch. Even if Australian banks' access to capital markets were to remain open, funding costs could increase sharply, affecting the price and availability of credit in the domestic economy.

A sharp slowdown in China's economic growth

A pronounced weakening in China's growth would sharply reduce demand for bulk commodities and other Australian exports. Australia's terms of trade would drop, likely dampening mining investment and related activity. Given the mining sector's current importance to economic growth and employment, reduced activity in the sector would significantly affect the aggregate economy's performance.

A vulnerable household sector amplifies an economic downturn

An economic recession that causes unemployment to spike could trigger a sharp drop in house prices. The negative wealth effect from these price falls would reduce consumer demand even further, reinforcing the economic downturn. Bank balance sheets may also be stressed, leading to lower credit availability to businesses and households, which would further drag economic growth.

Such scenarios would weaken the sovereign's fiscal position

In each of the scenarios above, the sovereign's fiscal position would worsen. Slower economic growth and lower global commodity prices would both crimp government revenues. At the same time, government expenditure would rise, particularly through higher unemployment payments to households. The sovereign may also seek to stabilize the economy through discretionary fiscal policy, increasing the budget deficit further. We may also reassess the level of contingent liabilities of the sovereign if the banking system faced significant strain.

Yet These Risks Are At Least Partly Mitigated

While the scenarios discussed above are plausible, a number of factors would, in our view, either reduce the risk of a downside scenario occurring or limit its severity should it occur.

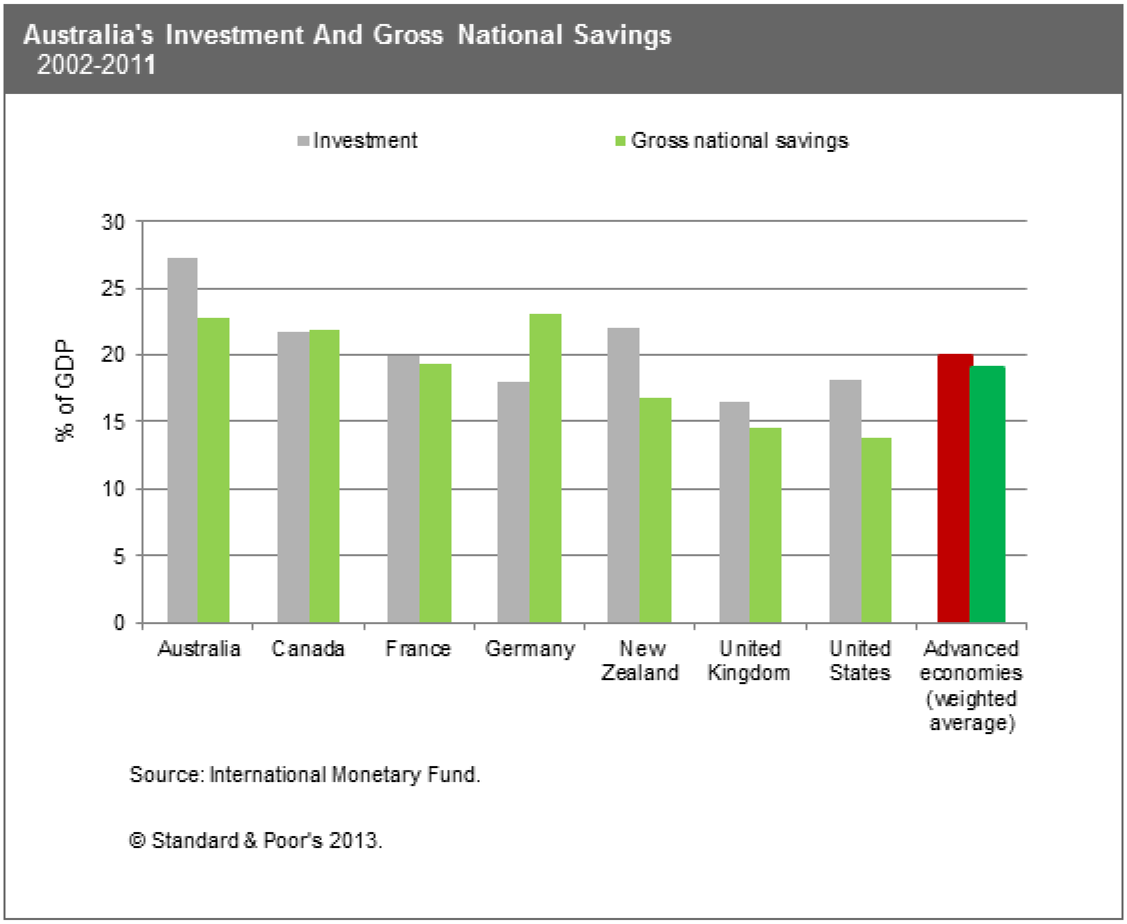
Fundamentals may continue to support capital inflows

A significantly wider current account deficit may not necessarily alarm global investors, as the fundamentals may remain supportive of capital inflows.

In recent years, Australia's current account deficits have largely reflected strong growth in investment in the mining and energy sectors, with domestic savings insufficient to fund all of this investment. This is despite Australia being a high-saving economy: Australia's national savings rate is currently about 25% of GDP, and has averaged 23% over the past decade--well above the average for advanced economies of 19% of GDP (see chart 4). Opportunities for profitable investment nonetheless outweigh the economy's savings capacity, due to the country's large endowment of mineral and gas deposits but small population of only 22.7 million people.

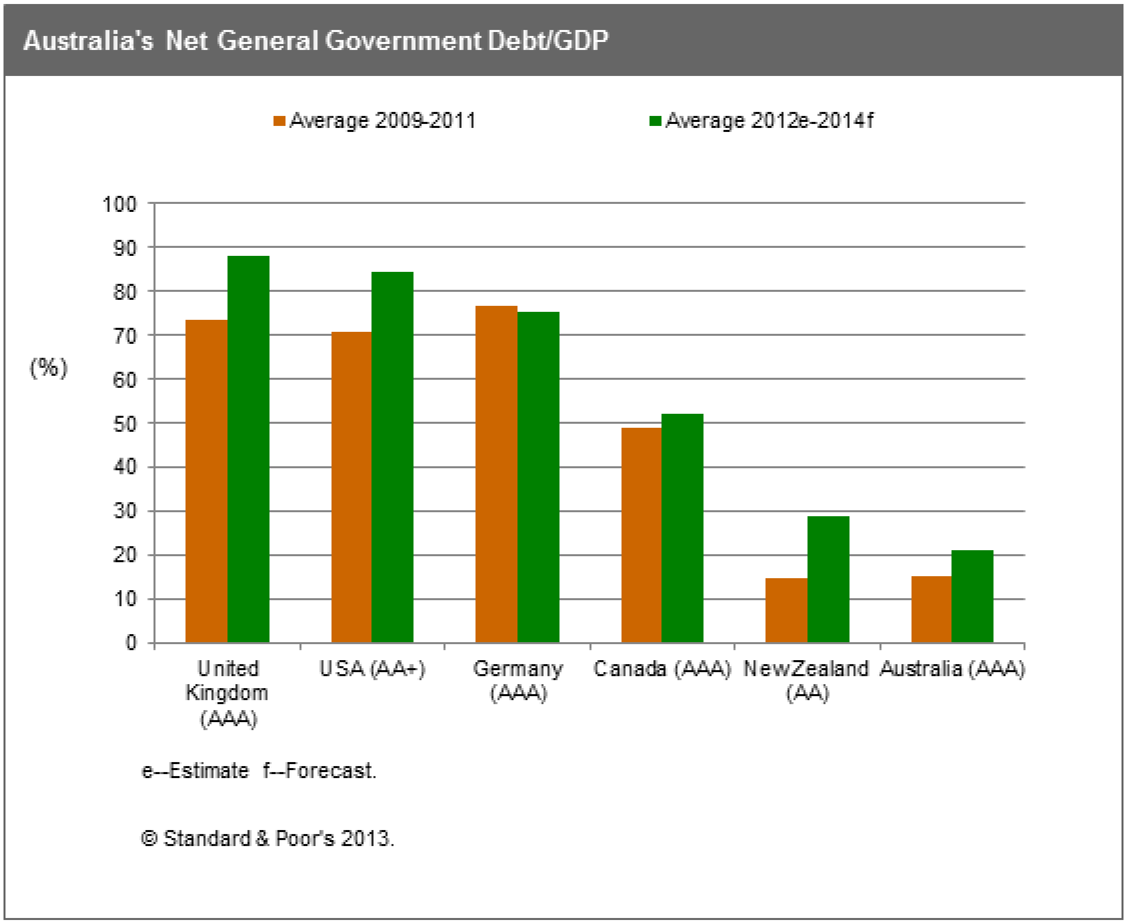
Assuming that global demand for iron ore, coal, and natural gas remains sufficiently high in the medium term, the current wave of externally funded investment in resources will generate positive returns and foreign exchange to support future debt-servicing capacity.

Chart 4



With private-sector borrowing appearing broadly sound, investors are similarly unlikely to be concerned about public debt, which remains low. Public borrowing has risen in recent years, although this mainly reflects deficits used to support the economy during the 2009 global recession. Even with this fiscal stimulus, net general government debt is expected to peak at about 21% of GDP in Australia, well below most of its peers (see chart 5).

Chart 5

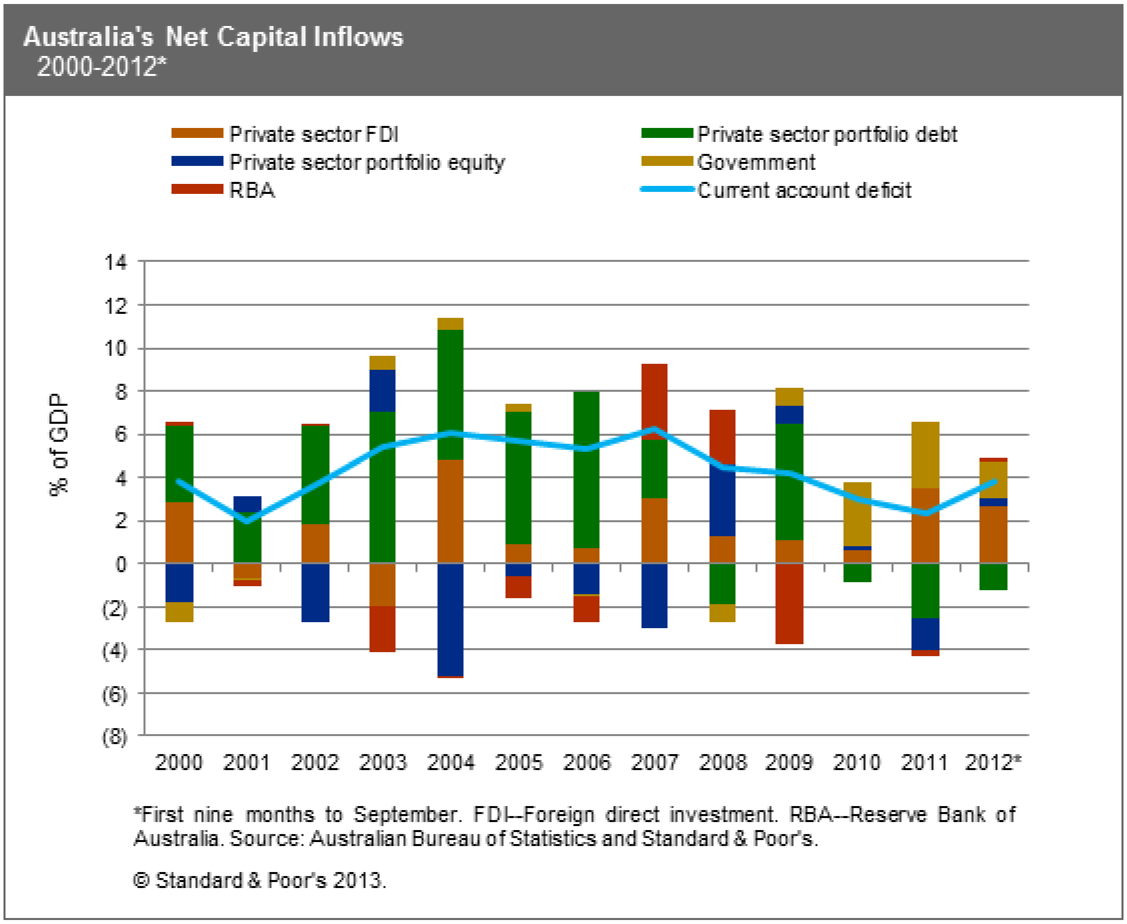


Inbound capital flows appear less at risk of sudden shifts than previously

The rise in mining and energy investment has likewise seen a shift in net capital inflows toward foreign direct investment (FDI) in recent years (see chart 6). These FDI flows are likely to be less susceptible to sudden shifts in investor sentiment than portfolio flows. Mining and liquefied natural gas (LNG) projects are underpinned by medium-to-long term payoffs, so these investors will probably focus more on longer-term demand fundamentals than short-term volatility. The very large LNG projects that are under construction also have long-term contracts with customers in place.

Along with FDI, foreign investment flows into government bonds have been strong in recent years, with the share of foreign ownership rising to more than 70%. This capital is probably more vulnerable to a sharp withdrawal than FDI. But we note that, anecdotally, foreign central banks have been among the main buyers of this debt; these investors are unlikely to quickly alter their portfolios in response to swings in broader investor sentiment. In any event, the government will become much less exposed to capital markets should the budget balance shift to surplus in the next year or so as we expect.

Chart 6



Macroeconomic policy levers remain flexible

Importantly, Australia retains flexibility to use macroeconomic policy tools as needed. Low public debt continues to provide the sovereign with budget flexibility. This is unlike in a number of major advanced economies at present, where monetary and fiscal policies are constrained.

Australia's free-floating exchange rate would likely cushion the economy from large shocks. While a sudden, sharp depreciation would have some negative economic consequences (as discussed earlier), more generally, a lower exchange rate would improve Australia's international competitiveness, and thereby assist a faster economic recovery.

An emerging risk, though, is that the Australian dollar doesn't adjust even if the terms of trade weaken substantially. Persistent portfolio and direct-investment flows into Australia may sustain a high currency, putting downward pressure on the economy. In an extreme case, official interest rates may approach the zero bound, and the central bank may engage in unconventional monetary easing. Over time, together with investors turning more pessimistic about Australian economic prospects, this could cause the currency to adjust in a disorderly manner.

Australia's financial system appears relatively resilient

Australia's banking sector appears currently able to withstand large shocks, with low contingent risk to the sovereign, while it remains in overall good shape by international standards. Australia's Banking Industry Country Risk

Assessment is '2' (with '1' being the lowest risk on a scale of one to 10). This reflects, in part, the banking system's conservative regulations, strong regulatory track record, and conservative risk appetite. However, the banking sector's reliance on offshore funding and its vulnerability to a sharp correction in property prices temper these strengths.

Stress-testing of the banking system by the International Monetary Fund and the domestic regulator indicate that major banks could withstand severe shocks, including a downside scenario of a 5% contraction in GDP , unemployment rapidly rising to 12%, house prices falling 35% peak-to-trough, and commercial property prices falling 40%.

In recent years, there has been a reduction in Australian banks' dependence on external borrowings. The banking sector's net external debt, as a share of domestic loans, has reduced from 30% in 2008 to about 17% in 2012. This improvement reflects slower credit growth and higher customer deposits. Should access to global funding markets close, we expect that the Reserve Bank of Australia would provide emergency liquidity to the banking system, as it did during the 2008 crisis.

Further, banks' and other borrowers' exposures to sharp falls in the currency are very limited, with almost all external debt either issued in Australian dollars or hedged. All central government and most state government debt is issued in local currency, and Australian banks hedge 95% of foreign currency liabilities.

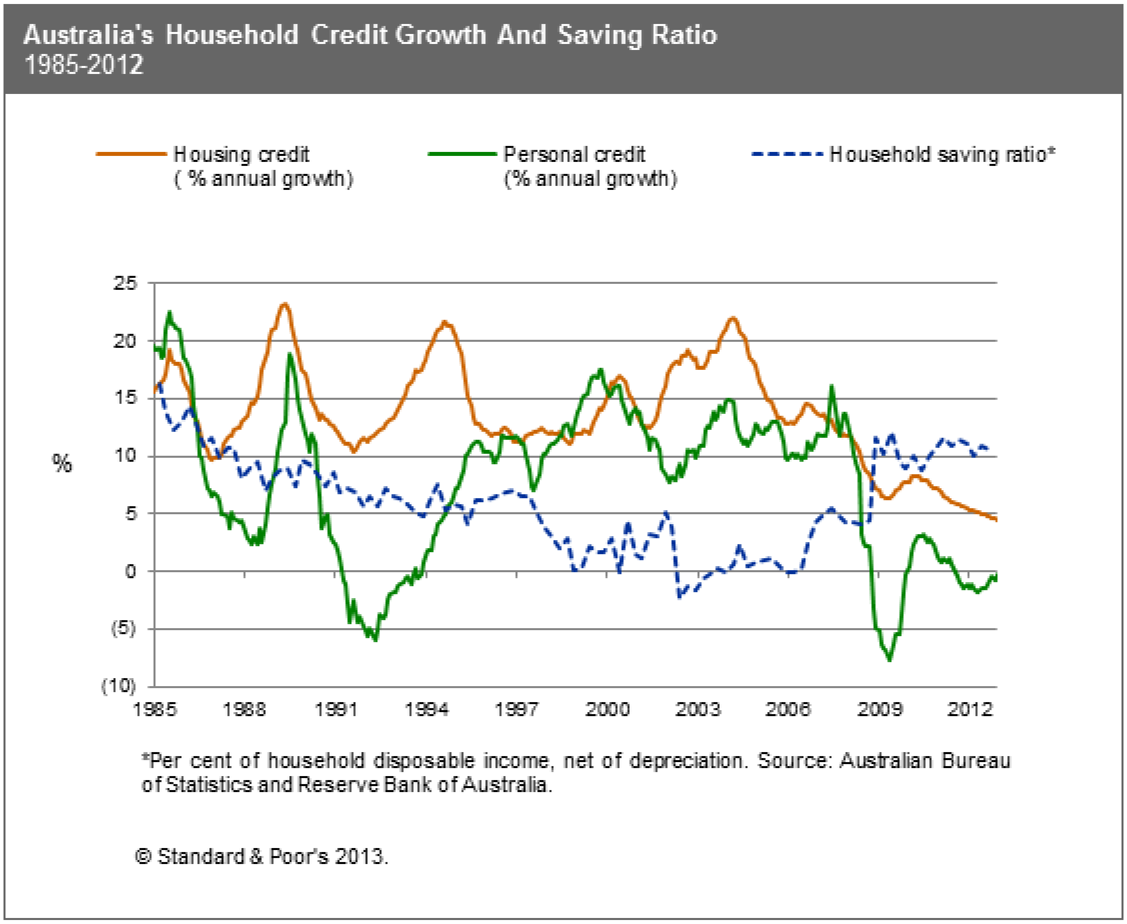
The household sector has reduced its risk exposure modestly

Households have increased their rate of savings from income since the global financial crisis. The household saving rate, which declined to around zero during the mid-2000s, rose sharply in 2008, and has remained broadly stable at about 10% of disposable income (see chart 7).

Growth in housing debt has slowed sharply since 2007 to record low rates, while household debt for other purposes has generally been scaled back over the past few years. The Reserve Bank indicates that around half of borrowers are ahead of schedule on their mortgage (with a quarter more than six months ahead), providing a buffer should household incomes dip.

With these changes in saving and borrowing behavior, household debt relative to income has dropped modestly, although it remains high (see chart 2). If this more prudent behavior persists, households' financial resilience will continue to improve.

Chart 7



Base Case Is For Sound Economic Growth

In summary, Australia remains on a sound path in our base-case scenario, with a number of key strengths supporting the 'AAA' rating. Yet there are risks, albeit low-probability ones, that could cause the sovereign credit rating to fall. Australia is not immune to a number of downside scenarios which, if they eventuate, would likely cause higher public debt levels and put downward pressure on the rating. Further, we could lower the ratings if external imbalances were to grow more than we currently expect, either because the exchange rate no longer adjusts to terms of trade movements, the terms of trade deteriorate quickly and markedly, or the banking sector's cost of external funding increases sharply.

That said, a number of mitigating factors would assist the Australian economy to withstand such potential shocks and limit the sovereign's financial exposure. Australia's strong fundamentals also make steep falls in the sovereign credit rating highly unlikely, barring major policy errors.

Related Research

- The Investment Overhang: Despite China's Economic Rebound, US$800 Billion Of Downside Risk Abounds, Feb. 20, 2013
- An Asia-Pacific Credit Crisis Remains Unlikely—But The Signs Are There, Feb. 17, 2013