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Spending Surge Changes Australia's Economic Outlook

September 8, 2008

THE boom in business investment does not fit into anyone's economic jigsaw. The Government and the Reserve Bank both expected weak business investment to drag the economy either into contraction or, at best, a flat result in the June quarter.

Both business and consumer confidence had collapsed and the flow of credit to households and the corporate sector had slowed from last year's flood to a trickle.

The business surveys conducted by National Australia Bank, the Australian Industry Group and ACCI had all shown that the slide in business confidence was affecting both forward orders and investment plans.

Private sector economists were more optimistic than the Government about economic growth, but only because they did not pick the extent of the consumer downturn. They also tipped a downturn in business investment.

Its strength, if continued, changes the economic outlook. It means employment will remain stronger and income growth will continue. The result may be a revival in consumer spending. But, for now, computation of the year ahead has been left in the air.

If the 5.7 per cent growth in investment in the June quarter and 14.6 per cent growth for the year was unexpected, the planned growth in spending for 2008-09 beggared belief.

The ABS survey said business would raise investment by 15.6 per cent to $100 billion, but companies habitually underestimate their spending. Adjusting for their conservatism, investment growth could be 34 per cent.

The RBA and the Government had both expected investment intentions to be downgraded in the face of the souring world economy. The consensus among market economists was that investment growth in the year ahead would be no more than 5 per cent. Instead, the survey revealed the biggest upgrade to investment intentions in the 21 years it has been conducted by the Australian Bureau of Statistics.

If it were just the mining industry and related infrastructure that failed to notice the global downturn, it would not have been so hard to understand. Indeed, adjusting for the conservatism of estimates, the mining industry is planning a 57.7 per cent lift in investment in 2008-09.

However, the strength was widespread, with manufacturing expected to raise investment by 9.2 per cent, despite having been clobbered by a high exchange rate and Chinese competition. The trade and services industries are looking at a 25.9 per cent lift in investment. Of course, the latest estimates of spending plans may be overestimates, not underestimates. Extrapolating from the past five years' experience is likely to be an unreliable guide to performance this year, when the world economy is stalling.

The ABS survey was conducted over July and August when you would think nobody following world business news would have been wearing rose-tinted glasses.

However, ABN AMRO chief economist Kieran Davies notes that in 1989, firms began the year expecting a 36 per cent lift in investment, but ended up spending only 3 per cent more. In the next year, as the economy contracted, a planned 24 per cent lift in spending translated into a 5 per cent actual fall. He expects a similar scaling back in investment, particularly outside mining, as business finds itself no longer working at full capacity and while confidence remains at a low ebb.

However, the character of the investment boom now is very different from that of the late 1980s. When central banks responded to the 1987 share crash by flooding markets with liquidity, there was a plunge into massively leveraged commercial property and a last bout of debt-funded corporate mega-deals. When business lending rates shot from 15 per cent to 20 per cent over 1989-90, the house of cards collapsed and nobody was surprised that business investment fell with it.

Commercial property development is certainly a vulnerability in the investment outlook today, but it is a relatively small component of the investment total compared with the 1980s (indeed, it is not actually counted in the official business investment figures).

Resource investment is not likely to fall over quickly. Nor is the surge in government infrastructure spending. Sectors such as construction, business services and metals manufacturing are likely to keep growing.

Growth in capital spending is taking place from a high platform. The growth in spending in many industries has now been extremely rapid for several years. It has been tepid in manufacturing, retail and finance sectors, but has been rising at more than 10 per cent a year in most other industries for the past five years.

The most coherent explanation for the investment surge is provided by Goldman Sachs JB Were chief economist Tim Toohey. He explores the estimates made by Treasury of the expected real rate of return from a marginal dollar of business investment, comparing them to the required minimum rate of return, calculated using real interest costs, depreciation and an adjustment for risk.

This is a version of the "Q ratio" developed in the late 1960s by Nobel Prize-winning economist James Tobin. The higher the marginal rate of return is, relative to the required minimum rate, the more attractive are the expected returns from investment.

As Toohey explains, "The best rationale ... for the ongoing rise in investment intentions despite economic headwinds is that the real expected rate of return from an extra unit of investment remains historically high compared to the real required rate of return of that investment."

Access Economics, which compiles a "bottom-up" count of investment projects, confirms that business investment will continue rising at a healthy double-digit rate through the year ahead.

Analyst David Rumbens says there has been some toll on investment from economic turbulence, with the doubts hanging over the $1.9 billion Gunns pulp mill in Tasmania being the most obvious example. But, in general, projects announced are still going through the pipeline to approval and construction. The strongest growth has been in resources and government infrastructure.

The trend is that the number of projects being announced in areas other than resources and government spending has been falling. In manufacturing, retail, tourism and commercial property, jobs already committed are likely to keep the level of activity high over 2008-09, but the pipeline of work will start to thin out after that.

Source: The Australian