HSBC Global Research

Australian Economics
January 2012

Australia in 2012

The ‘lucky country’ looks set for another solid year

After two decades of growth, Australia is expected to make it 21 years in a row

The mining investment boom is leading the way and sectors that are sensitive to interest rates are expected to benefit from lower RBA rates

But challenges remain. Weak productivity growth, the fiscal deficit, deleveraging households and the global slowdown will all test Australia's luck

By Paul Bloxham and Luke Hartigan

HSBC

Six macro themes for Australia in 2012

Australia is often referred to as the 'lucky country'. To some degree this is true. Proximity to Asia and a large resource endowment are certainly good fortune. However, good policy decisions are also part of the story. Australia has just ended its 20th year of continuous growth in 2011, a feat unmatched by any other developed country in that period. Not all of this is luck. We expect that Australia will make it to 21 years, in part because policymakers are well-equipped to deal with potential problems. This report sets out six key macro themes for Australia in the year ahead.

Elephant in the room

Global developments will continue to be front-and-centre in 2012. While Europe remains in focus, for Australia the focus should shift to Asia in 2012, which is already seeing spillover effects from the financial developments in the West. We are still optimistic on Asia, but the risks are skewed to the downside. Clearly, the biggest risk (the elephant, if you will) for the Australian economy is a larger-than-expected downturn in China. As always, much of the Australian outlook depends on the global performance. This is where the large risks lie.

Mining boom rolls on

Investment in the resources sector is expected to contribute around two-thirds of the growth in the economy in 2012. Much of this investment is "baked in", given that most of the projects are large, well-funded and multi-year. The resources sector will be a key support for growth, but it is also crowding out other sectors of the economy.

AUD and 'Dutch disease'

The 25% appreciation of the AUD against the USD in the past 2½ years has driven significant structural changes in the Australian economy and has held down inflation. We do not expect this to be repeated. As local businesses gradually adjust to the higher level of the AUD, we expect that the effect will wear off, which should help rebalance the economy somewhat. The AUD is expected to stay well above its post-float averages in 2012 and head towards USD0.95 by the end of the year.

Deleveraging continues

Households have increased their savings and have been deleveraging their balance sheets for a number of years now. With the global risks prominent, we expect that households will continue to be cautious, though lower rates should put a floor under house prices. Housing credit growth is expected to remain subdued and household consumption will likely slow in 2012, in response to a further modest weakening in the labour market, though this should be partly offset by lower interest rates.

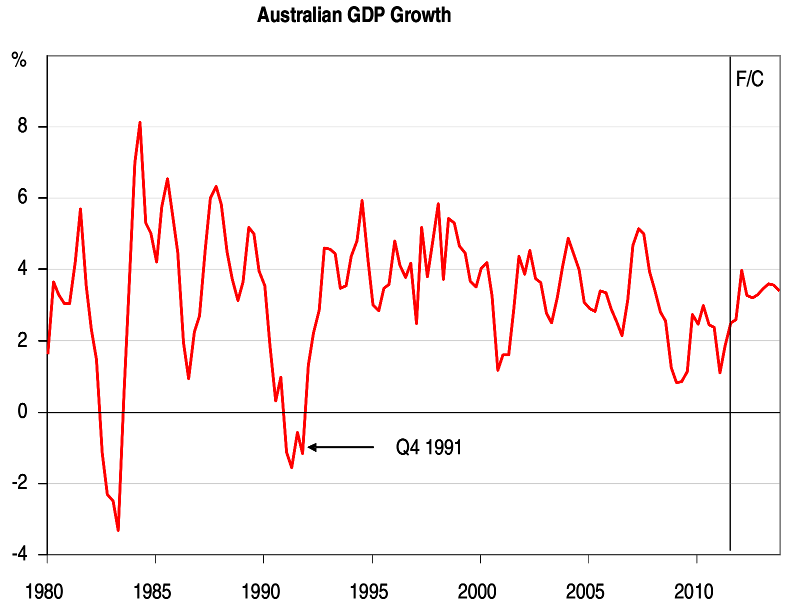
The productivity challenge

The economy got support in recent years from rising commodity prices. With commodity prices now having peaked, growing the economy will rely more on enhancing productivity, an area which has been lacklustre recently. This has implications for the inflation outlook because weak productivity growth means that the economy is unable to grow as quickly without generating rising inflation. In H1, we expect limited concerns about inflation, with the RBA more concerned about the global growth slowdown. However, by later in 2012, we expect that inflation will once again be on the radar screen, as the economy heads towards its capacity constraints.

Conventional policy works

With rates still at 4.25%, we believe Australia has plenty of scope to use conventional monetary policy to support the economy – unlike many other developed economies. Given the low level of government debt, a fiscal response to a sharper-than-expected global downturn could also be implemented if necessary – although the government would be forced to concede its political imperative to return to a surplus by 2012-13. The exchange rate could also provide support in the event of weaker growth.

1. Twenty years of continuous growth... will it be 21?



Source: ABS, HSBC estimates

2. Unemployment rate is still low, despite rising recently

Source: ABS, HSBC estimates

Contents

Elephant in the room

- Global developments will be front-and-centre in 2012, with financial channels and trade channels already squeezing growth
- Australia's major trading partners are in Asia meaning that much depends on developments there, particularly in China
- European stresses are increasing local banking sector funding costs and a disorderly European financial resolution is a clear risk

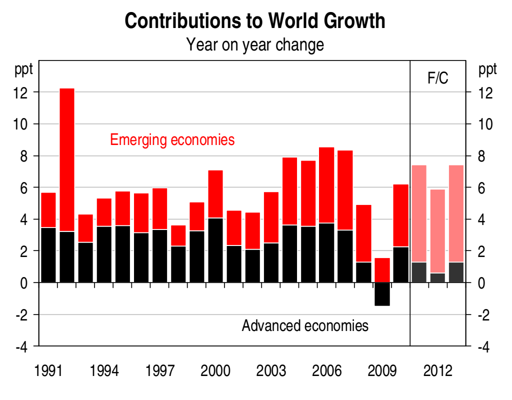
A rock and a hard place

We believe the developed world is between a rock and a hard place. High public debt levels in Europe and the US require that governments in these countries set out to improve their fiscal positions over the coming years. However, this is typically detrimental to growth; and, of course, weaker growth threatens to make the fiscal positions worse. Our global team calls this the 'arithmetic of doom' and have set it out in our recent global quarterly report, '*When the wheels fall off*', 21 December 2011.

While we are cautiously optimistic, it is clear that the risks to developed world growth are firmly to the downside, even with a European recession already our central case for 2012. In addition, the US faces significant fiscal challenges in 2012, as it seeks to improve its budget bottom line. It is also likely to be adversely affected by the European recession through reduced exports. This is expected to constrain US GDP growth to 1.5% in 2012, down from 1.8% in 2011, while we expect Europe to contract by -1.0% in 2012.

In turn, it seems that the emerging economies are unlikely to escape unscathed. However, we remain of the view that the emerging economies will still significantly outperform the developed world. Much more of their growth is now driven by domestic demand than previously, and they have ample scope for policy stimulus on both the monetary and fiscal side. While growth in the developed world is expected to slow to 0.6% in 2012, down from 1.3% in 2011, growth in the emerging economies should be solid at 5.3%, up from 6.1% in 2011 (Chart 3).

3. Emerging economies driving world growth



Source: IMF, HSBC estimates

For Australia, it is Asia that matters most – thankfully. While growth has slowed in Asia, reflecting slowing exports and a more inhibited flow of credit from abroad, Asian authorities have already started to loosen policies, which are expected to support growth.

While our Asia team expects that Q1 2012 will be 'challenging', we are generally optimistic about the broader outlook for Asia in 2012 (see Asia Quarterly, '*With a little boost*', 5 January 2012). Most importantly for Australia, we expect that China will still manage a 'soft landing', as Chinese authorities have already started to loosen the monetary taps and started to ease fiscal policy.

While there are domestically generated risks in Asia, it remains our view that these are manageable. Of particular prominence has been the risk of a property market correction in China. This could threaten Australian growth prospects, though our view remains that the Chinese authorities will be able to tread the thin line required to ease inflation, support growth and dis-inflate the property market this year.

While Asia is the main driver of Australia's growth performance, there are some more direct ways that developed world financial problems, particularly those in Europe, are impacting Australia. Most importantly, they are affecting the cost of funding for Australia's banks, which is still fairly reliant on foreign funding sources. However, with RBA rates still at 4.25%, we believe there is significant scope for the RBA to loosen local financial conditions if needed.

Of course, a further significant financial collapse in Europe or a faster slowdown in China than currently expected are clear downside risks to our outlook.

We take up these issues below.

Asia matters most

Over 70% of Australia's exports go to Asia. Indeed around half of Australia's exports go to just two countries – China and Japan (Table 4).

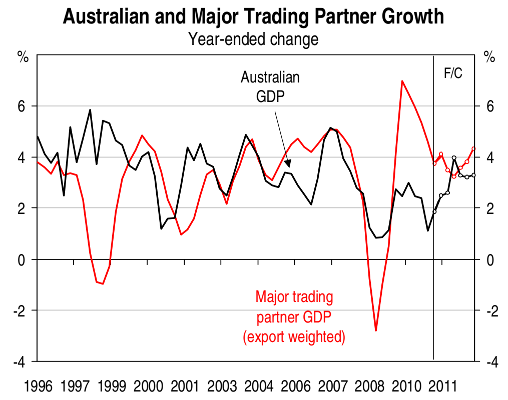
Weighting together our global forecasts based on Australia's export shares shows growth in Australia's major trading partners is expected to ease to 3.2% in early 2012 from 4.6% in 2011 (Chart 5). This is similar to the pace during the slowdown in 2005, though significantly better than during the Asian financial crisis, the Lehman Brothers event, and even the 'tech wreck'.

4. Trade Shares and GDP Growth (%)

Country	Trade share Jun-11	Trade share Jun-01	GDP 10 year CAGR
China	28.5	6.5	10.6
Japan	19.6	19.7	4.3
Korea	9.5	6.9	7.7
India	7.3	2.1	5.4
Euro-27	6.1	14.6	0.5
US	3.2	10.1	4.1
Taiwan	3.1	4.6	5.0
NZ	2.8	5.4	2.2
Thailand	2.5	2.1	6.1
Indonesia	2.4	2.4	4.5
Malaysia	1.8	1.8	4.4
Singapore	1.5	3.8	1.6
HK	1.0	3.1	1.1
Viet Nam	0.7	0.4	7.1

Source: ABS, CEIC, RBA, HSBC

5. Australia's trading partner growth forecast to be solid



Source: ABS, CEIC, RBA, HSBC estimates

Importantly, much of what Australia produces is also for domestic demand in Asia, rather than for on-sale to other countries via exports. Australia's two biggest exports are iron ore and coal. Together they account for around 30% of the value of Australia's exports. These two commodities are used for the production of steel and energy, which is largely used to meet domestic demand in these countries, rather than for foreign demand.

China's challenges

China has a thin path to tread in 2012. The economy needs to balance continued easing of inflation pressures, a price correction in the property market, and maintaining growth in the face of weaker demand for exports.

To do this, Chinese authorities have placed 'growth stability' at the top of the policy agenda in 2012. This is a significant shift in China's policy priorities, after focusing on fighting inflation through most of 2011.

Policy levers in China have therefore already been shifted, with the reserve requirement ratio (RRR) lowered by 50bp in early December 2011 to 21% for big banks (and 19% for smaller ones). Our Chief China economist, Qu Hongbin, expects that the RRR will be cut by a further 150bp by mid-2012, and he expects rate cuts when CPI inflation falls below 3% (currently forecast for Q3 2012).

GDP growth in China is expected to ease further in Q1 2012, before rising to 8.8% over the year to Q4 2012. For the year as a whole, we expect growth to slow to 8.6%, down from 8.9% in 2011 (Chart 6).

6. China forecast to have a 'soft landing'

Data seasonally adjusted by HSBC using the X-12 (additive) technique
Source: CEIC

The 'trick' pulled last time around in the face of a global recession (in 2008-09) – to boost credit growth substantially – is not really available this time, given the authorities' goal to ease property prices and keep inflation contained. However, China's authorities do have a large toolkit, which they can use to control economic conditions, and they have already started to use it in earnest.

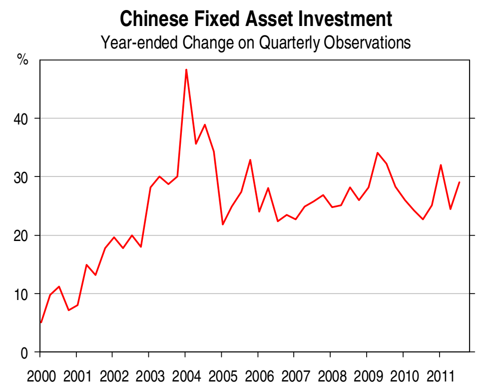
On the monetary side, HSBC's view is that quantitative easing using the RRR will be the Chinese authorities' primary tool, with interest rates a secondary instrument. Fiscal policy is also expected to be used to counterbalance weaker external demand. Chinese authorities have significant scope for expansionary fiscal policy, given that the total debt-to-GDP ratio is manageable at 55% (keeping in mind that the debt arithmetic is quite different for an economy that is growing at double-digit rates in nominal terms).

We expect fiscal adjustments will be tilted towards small- and medium-sized enterprises, service industries and public housing construction. The government has already introduced personal tax cuts and has raised the threshold for VAT and business tax for small companies, leaving 63% of small, privately owned businesses exempt from these taxes. Further tax cuts are due in early 2012 (see '*Asia quarterly: With a little boost*', 6 January 2012).

Importantly, fiscal spending on construction works remains the most important tool to counterbalance the external shocks. This is good news for Australia, given that commodities are a key input into the ongoing infrastructure projects that are being funded by Beijing (Chart 7).

As our Chief China economist points out, public housing construction will likely move to the centre stage this year. Public housing is expected to grow by at least 15% in 2012, adding at least 0.5ppts to GDP growth and helping to increase the availability of affordable housing in China, which is currently low.

7. Fixed asset investment the main engine of Chinese growth



Source: CEIC, HSBC estimates

The key risk that is often discussed is that China's local debt problem looks something like the US sub-prime problem. Our view remains that this is not the case, as local government areas have borrowed to buy and build infrastructure assets that have commercial value.

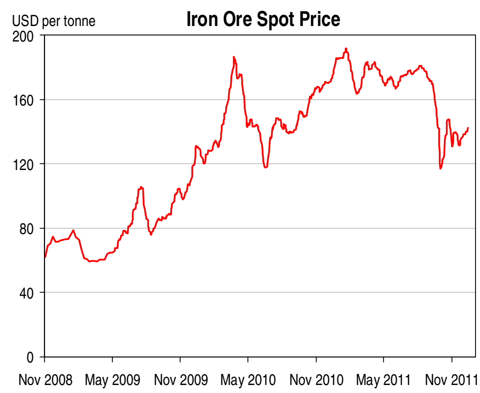
Another risk is that the property market tightening has been overdone. This is important, as the property sector accounts for around 25% of fixed asset investment (15% of nominal GDP).

Our central case is that China's property prices will correct by 20-30% in the top tier cities and 10-15% in the second tier cities. However, this is expected to have limited effects on household behaviour and the banking system, as mortgage loans are less that 15% of all lending and less than 10% of urban households have a mortgage. Plus, more than 60% of mortgage loans were taken out before the middle of 2009 and the down payment has always been above 20%.

A key channel through which these developments affect Australia is through their impact on commodity prices.

While the current slowdown has already seen commodity prices decline from their very high levels in mid-2011, it is worth keeping in mind that commodity prices are still well above their historical levels. The iron ore spot price fell sharply in October (-30%), but has since stabilised at around USD130 per tonne, which is still well above its level of USD70 per tonne back in 2008 and significantly higher than its level of around USD30 at the beginning of the century (Chart 8).

8. Iron ore prices have fallen, but are still at high levels



Source: Bloomberg

Other Asia matters too

Australia's next largest export recipient is Japan (20%). While growth in Japan has been lacklustre for a number of years, compounded by the terrible natural disasters in early 2011, the fact remains it is still the world's third largest economy (in terms of GDP).

Unlike other developed economies, Japan has tended to rely more on the external sector for growth. However, reconstruction in the wake of 2011's earthquake and tsunami will provide some support for growth in Japan this year. The rebuilding will both boost activity in the local economy and should support demand for Australian resources used in the reconstruction.

More broadly, increased concerns surrounding the use of nuclear power, as a result of the Fukushima disaster, will continue to see a shift in energy demand away from nuclear power towards alternative sources, including traditional fossil fuels and LNG, of which Australia could potentially be a significant supplier (although it is worth noting that Australia also has extensive uranium reserves).

Of course, conditions in the rest of Asia are important for Australia's trade prospects. Korea remains Australia's third largest export recipient, with thermal coal a key export to Korea. While we expect only modest growth in Korea this year, the fact that Australia's key export is a product for which demand is highly inelastic means that Australia's prospects are still better than others. To a large degree the same argument applies to India, which has been rapidly climbing in the ranks of Australia's major trading partners in recent years and is currently ranked fourth.

It is also worth keeping in mind that with Asia having been tightening policy settings over recent years, in a fight against rising inflation, there is significant scope for monetary and fiscal support for growth across Asia. Indeed, a number of countries in the region have already started to loosen their policy settings.

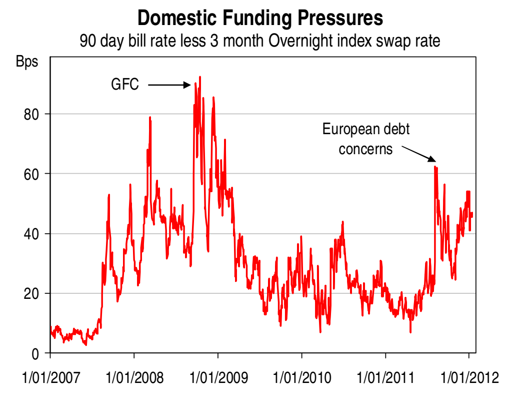
Europe's financial effect

European deleveraging is driving up the cost of funding for Australian financial institutions. While direct exposure of Australian banks to Europe is very low on the asset side of the balance sheet, local bank funding is still fairly reliant on international markets.

Australian banks' claims on European banks are only around 2% of total assets, of which the bulk is exposure to France, Germany and the Netherlands (exposure to the peripheral nations is around 0.3% of total assets).

However, offshore funding is still a significant share of Australian banks' liabilities. While this funding source has fallen in recent years, it is still around 20% of bank funding, down from 30% in 2008. The tenor of issuances has also lengthened over that period, and as such, Australian banks are unlikely to face the same extreme liquidity pressures as they did in 2008, and Australian banks are now allowed to issue covered bonds. Nonetheless, European financial market turmoil has made issuances more challenging and expensive (Chart 9).

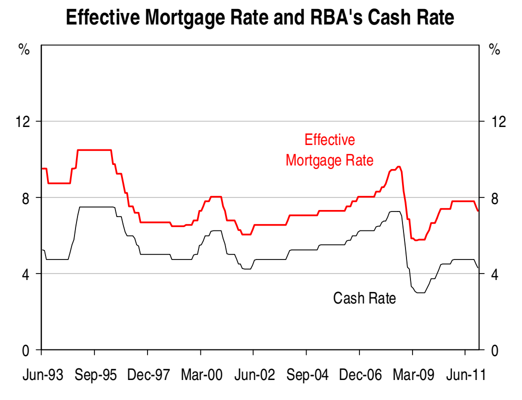
9. Funding costs impacted by European debt concerns



Source: Thomson Reuters Datastream

The increased cost of funding over recent years has seen a larger spread emerge between the cash rate and the effective mortgage rate (Chart 10). The spread increased from around 120bp in 2007 to around 225bp at the end of 2011. It is worth keeping in mind, however, that the RBA sets its policy rate on the basis of effective rates that households and businesses face, so it will most likely seek to offset any margin expansion with a lower cash rate setting.

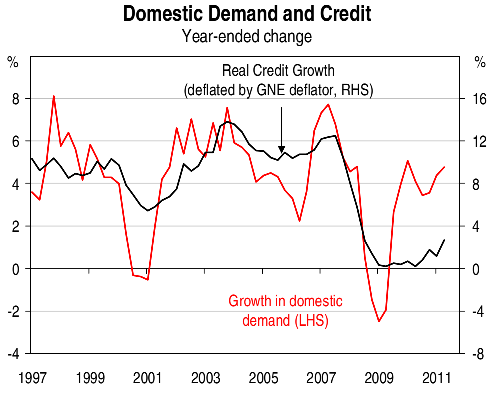
10. But the RBA sets policy on the effective rates



Source: RBA

Stepping back, it is also worth reminding ourselves that the credit cycle has not been driving growth in Australia recently, unlike in Asia (for a discussion of Asia's credit dependence see '*Hard numbers: How credit intensive is Asia's growth?*', 18 January 2012). While weak credit growth would typically be a sign of weaker economic conditions, the Australian economy is being driven by a sector that does not borrow much from local banks – the mining industry (Chart 11). The large mining companies working on the bulk of these projects have also reduced their gearing and have been funding much of their investments from retained earnings.

11. Economic growth is not being driven by credit growth



Source: RBA

Aside from the bank funding channel, financial conditions also affect households and businesses directly.

Equities account for around 15% of household wealth in Australia (a large part of which is in indirect holdings through superannuation funds). Australian stock prices have fallen by around -15% over the past year. Most empirical estimates generally suggest that every one AUD fall in stock prices knocks around AUD0.06-0.09 off household consumption.

A 15% fall therefore implies consumption could be 0.9-1.3% lower than otherwise in the long run. Estimates of pass-through are similar for the impact of housing prices, which have fallen 4% over the past year, so together these may have taken about 1.1-1.6% off household consumption. The bottom line is that the negative wealth effect in Australia is noticeable.

Volatility in financial markets has also ground down household and business confidence. Hiring intentions by firms in Australia have eased in recent months, as have job advertisements, which are likely to reflect weaker business confidence. Consumer sentiment has fallen to below average, and households have been reporting concerns about the condition of their household finances. The longer the financial volatility continues, the more it will negatively affect spending and investment decisions.

Mining boom rolls on

- Mining investment is expected to be a key driver of the economy in 2012, accounting for around two-thirds of GDP growth
- Many of these projects are large, multi-year and well-funded, so unlikely to stop
- Mining continues to crowd out other sectors; though with rates coming down, this may be lessened

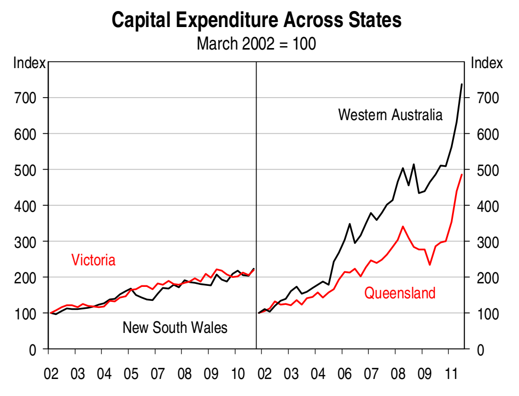
Investment takes off

The mining investment story got underway in a big way during the second half of 2011, with a significant increase in capital expenditure (Chart 12). Business investments grew by a rapid 22% over the year to Q3 2011.

This is just the beginning. As is by now well-known, Australia is in the midst of the largest mining boom in its history. Mining investments are projected to rise from around 4.5% of GDP to an historically unprecedented 7% of GDP over the next couple of years and are forecast to contribute around two-thirds of GDP growth in 2012 (Chart 13).

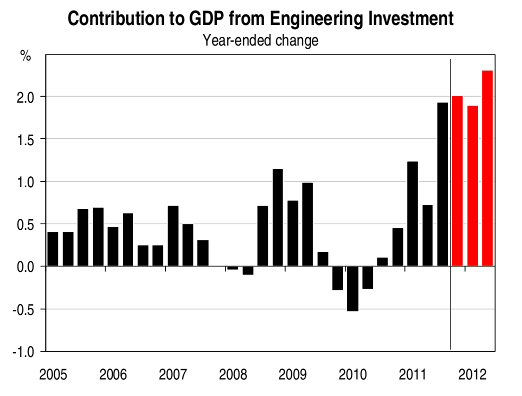
Importantly, much of the growth is expected to be concentrated in a small number of very large projects. There are around AUD232 billion worth of projects (102 projects) at an advanced stage of development (Chart 14). Of these, seven projects are worth over half this amount (AUD140 billion), with one project, the Gorgon LNG project in Western Australia, having an estimated cost of AUD40 billion alone. This concentration of activity limits the chances that the investments will stop, or be wound back.

12. Surging capital expenditure... especially in mining states



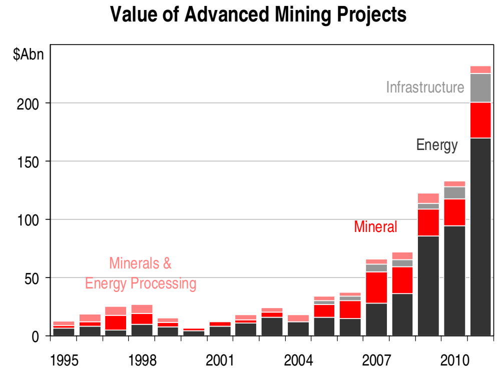
Source: ABS

13. Over two-thirds of GDP growth in 2012 due to mining



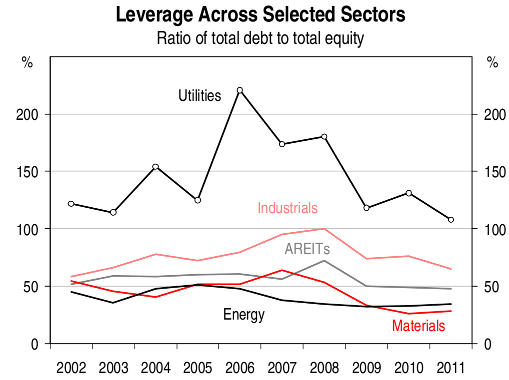
Source: ABS, HSBC estimates

14. Significant pipeline of projects... particularly in energy



Source: BREE, HSBC

15. Materials sector has low levels of debt



Source: Bloomberg

‘Baked in’

While it is hard to say anything is truly ‘unstoppable’, we think that the mining investment boom comes pretty close. We believe much of Australia’s mining investment boom is largely ‘baked in’, so to speak. There are a number of reasons for this.

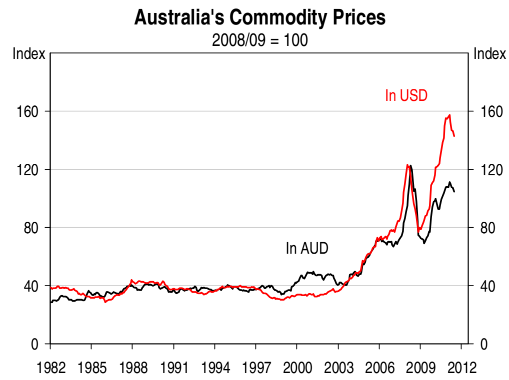
First, the bulk of the construction spend is on large, multi-year projects. In fact, the average duration of the seven largest projects is around five years.

Second, the projects are mostly being undertaken by syndicates of large global multinational corporations that have sound balance sheets and are therefore less susceptible to funding concerns. Figures for Australian listed companies highlight that most sectors, including the materials sector (which includes the minerals sector), increased their leverage in the period before the global financial crisis in 2007; however, with the rapid bounce-back in commodity prices, as well as profitability, the minerals sector was able to deleverage in 2009-10 (Chart 15).

Third, much of the recent investments have been funded from retained earnings. In many cases, the projects have forward sold the product on contract and were given the green light to begin construction at much lower levels of commodity prices. While it appears that commodity prices have since passed their peak, most of the projects’ hurdle rates are well below current commodity price levels (Chart 16).

Finally, and more fundamentally, long-term demand from Asia for Australia’s energy exports is expected to remain elevated.

16. Commodity prices have peaked, but still at high levels



Source: RBA

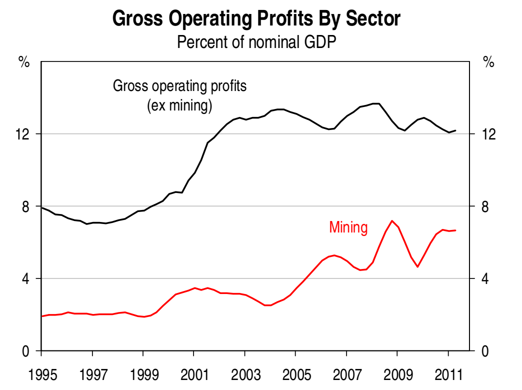
One potential risk to growth in Australia from the mining investment boom is that more of the capital equipment used in these projects is imported than currently assumed. That could result in further demand leakage offshore through stronger imports and weaker employment growth domestically. While some leakage would be beneficial, too much could be detrimental to the growth prospects of the local economy.

Make way, coming through

Our long-running theme has been that the mining investment boom was going to require other parts of the economy to grow more slowly to make way (see '*Does Australia has a resources curse?*', 18 August 2011). This is what happened in 2011, with some parts of the economy particularly weak, including the housing, retail and manufacturing sectors.

The effect on the economy from the diverging forces is apparent in a number of areas. For starters, the profitability of mining firms and non-mining firms as a share of the economy has been heading in opposing directions (Chart 17).

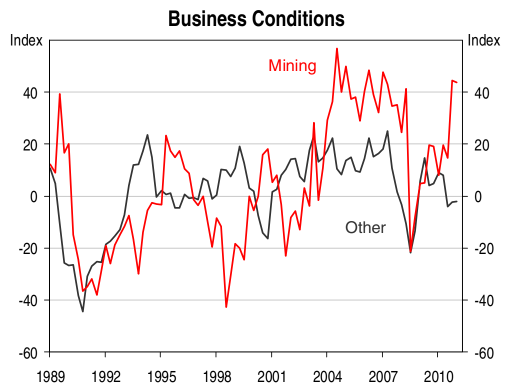
17. Profits in non-mining sectors are sagging



Source: ABS

Weaker profit growth in the non-mining parts of the economy is reflected in subdued measures of business sentiment and conditions (Chart 18).

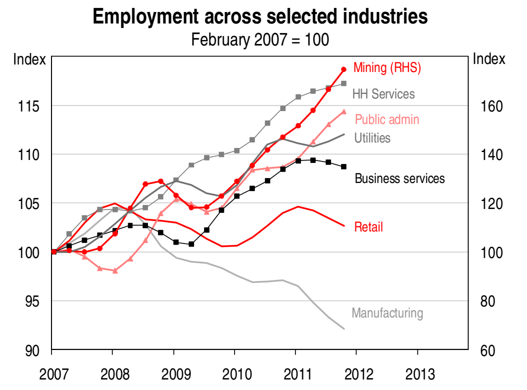
18. Non-mining businesses not so happy



Source: Thomson Reuters Datastream, NAB

Subdued business conditions are impacting employment prospects across the various sectors of the economy as well (Chart 19). The manufacturing sector is finding it particularly tough, although in some cases the reduction in labour is not due to weaker demand, but reflects firms substituting capital for labour. Besides mining, the other sectors that are faring well are those linked to consumer services and public administration.

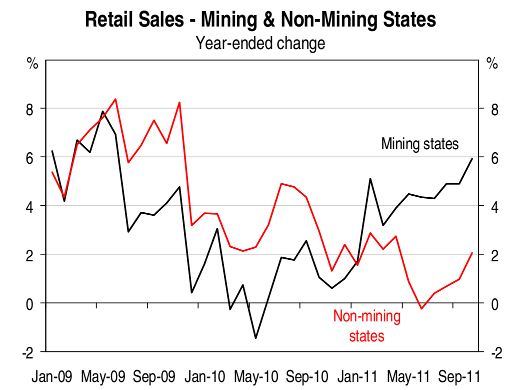
19. Employment across industries has diverged



Source: ABS

This year, the reduction in rates should help offset some of the pressure on the non-mining sectors – especially housing construction and retail turnover (discussed further below). Lower interest rates should also provide some support for the non-mining states, where conditions have been weaker recently (Chart 20).

20. Mining-intensive states also have strong retail sales



Source: ABS

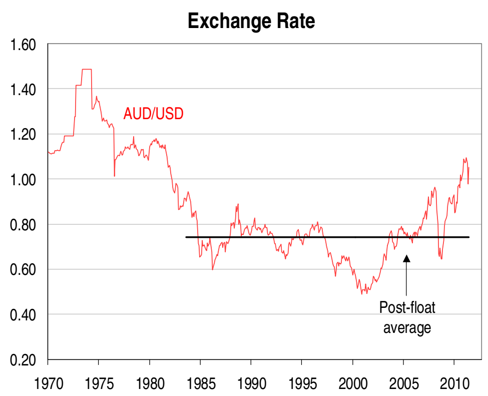
AUD and 'Dutch disease'

- The significant appreciation of the AUD in recent years is expected to be partly reversed in 2012
- The appreciation had a profound effect: holding down inflation and slowing the exchange rate-sensitive sectors
- As the effect gradually wears off, the exchange rate-sensitive industries should stabilise and inflation should trend up modestly

Post-float highs

The AUD has acted as a shock absorber for the Australian economy since its float in late 1983. Indeed, in recent years the AUD has been a key mechanism, allowing the Australian economy to absorb the massive mining investment boom without excessive inflation (Chart 21). Greater demand leakage than expected, as a result of the persistent strength of the exchange rate, is a key reason why underlying inflation was more benign than forecast in 2011.

21. AUD has appreciated significantly in recent years



Source: RBA

While the AUD has come down from its exceptionally high levels of around USD1.10 in July 2011, it is still well above its post-float average of USD0.75 and has comfortably sat above parity against the USD for the bulk of the past year or so. The AUD has averaged 1.02 with the USD since it rose above parity in late 2010.

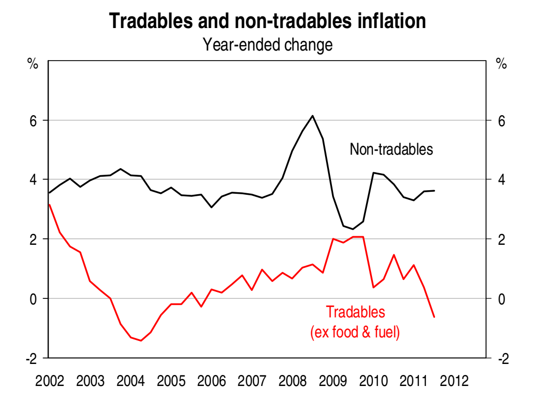
The rise of the AUD has not been solely against the USD. Since the GFC low, at the start of February 2009, the AUD has increased by 62% against the USD, 61% against the EUR, 50% against the GBP and 39% against the JPY. True, some of the reason for the rise may have been relative weakness in those economies (the AUD has only appreciated 4.4% against the NZD for the same period), but it partly reflects the shift in the drivers of global growth towards China, and as a result, for greater demand for Australia's resources.

This year, our currency strategists suggest that the backdrop for the AUD has weakened and expect it to depreciate through 2012, reaching USD0.95 by Q4 2012.

Dampening inflationary pressures

One impact of the structurally higher AUD on the domestic economy has been its effect on "tradables" goods prices. A large proportion of tradable goods are imported, so a higher AUD has helped to keep a lid on this form of price pressure. Indeed, since the start of 2009 tradable inflation has averaged only 1.1% in year-ended terms. By comparison, non-tradable inflation (which includes a lot of services) has averaged 3.4% for the same period (Chart 22).

22. Tradable inflation held down by the strong AUD

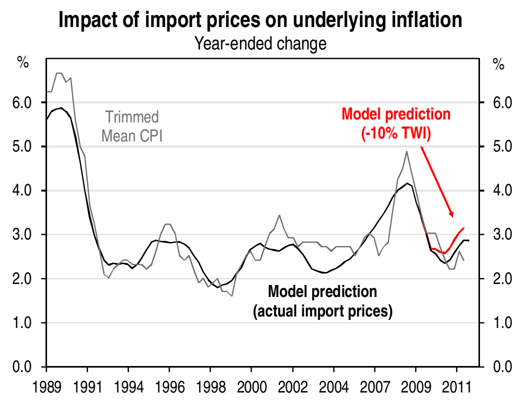


Source: ABS

To get a feel for the sensitivity of inflation to movements in the AUD we have updated two models favoured by the RBA, which explicitly account for the effect of import prices on inflation. Our analysis showed that the higher AUD had helped to hold down import prices; therefore, contributing to lower inflation (Chart 23).

Our modelling shows that if the TWI had been 10% lower than it has been starting in March 2009, then import prices were estimated to have fallen by only 13% compared to 19% as was the actual case. The models indicate the flow-on effect to inflation would have seen prices 2.4% higher by September 2011. (For model details see Downunder Digest, '*AUD doing its job on inflation*', 14 November 2011.) The bottom line is that much of the work in containing inflation in the past year has been done by the strong AUD.

23. Offshore demand leakage held back inflation



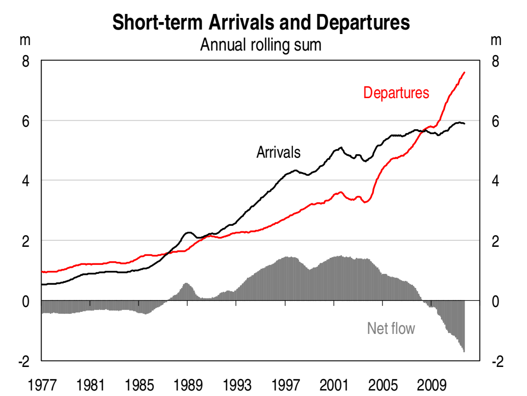
Source: ABS, RBA, HSBC estimates

Demand leakage offshore

The AUD has been acting to moderate inflation by driving a significant amount of domestic demand leakage offshore.

A key example of this is that Australians have been travelling overseas like never before. Over the past year, a record 7.6 million local residents left the country on a short-term departure (Chart 24). As a share of the population (33%), this is the highest level of external departures recorded. Travel was one of the fastest growing components of household consumption in 2011.

24. High AUD prompted an increase in travel by Australians



Source: ABS

The stronger AUD has also kept the growth in the number of international visitors subdued over the same period. Less tourism locally means less spending in domestic stores. Additionally, the rise in internet commerce has meant that local retailers now face competition from overseas. The stronger AUD has motivated many locals to take the plunge into the online shopping world.

Overall, the stronger AUD is having deep effects on the structure of the economy, as it motivates capital and labour to move towards the industries associated with the mining sector and away from other less mining-exposed industries.

Of course, not all industries have benefitted, with some sectors negatively affected by the high AUD. Predominately these have the trade-exposed sectors, such as manufacturing (though some manufacturers have benefited from the ability to substitute cheaper foreign components used as inputs in the manufacturing process). Local tourism, as noted above, is feeling the pinch, as is the education sector because the higher exchange rate has reduced the competitiveness of local universities. However, this has also been partly due to policy changes to reduce the issuance of student visas.

Effect gradually wears off

The disinflationary impact of the higher AUD on inflation is largest just after the appreciation and should gradually wear off over time. As we expect that the AUD appreciation is over (indeed, our currency strategists expect it to depreciate during 2012), the downward pressure on import prices from the AUD is also expected to abate.

This year we also expect that some of the initial impact of the high AUD on the economy, in terms of weakening some sectors at the expense of others, will begin to wear off.

This is because the persistence of the high level of the AUD will mean that businesses have been making adjustments to their business models. Of course, not all business models can do this and some will have ceased to work. However, on the other hand, other business models that flourish at a high exchange rate will have benefitted from the AUD's strength.

This leads neatly into the question of whether Australia has the 'Dutch disease'. In short, Dutch disease is where the high level of the exchange rate (driven by a resources discovery) sees some industries – such as manufacturing – become less competitive, leaving the economy 'hollowed out' when the exchange rate depreciates (or the mining boom is over). See '*Does Australia have a resources curse'*, 18 August 2011, for a fuller discussion.

As we argued last year, we do not think Australia has the 'Dutch disease', but instead is just adjusting the structure of its economy to better meet global demand and the shift in the centre of the gravity of the global economy towards Asia. Indeed, the exchange rate has assisted in this adjustment process. In Australia's case this has involved a large shift of resources towards the production of commodities, particularly energy. Along the way not everyone wins; however, in our view, the overall economy is better off.

For this year though, our view is that the effect of the appreciation will start to wear off, as businesses get used to the idea of an elevated exchange rate. This should help to see some modest rebalancing of growth.

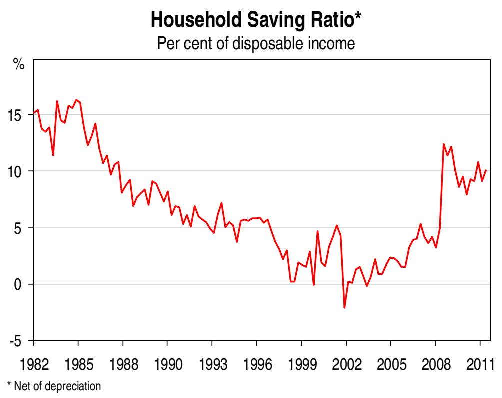
Deleveraging continues

- Households have been deleveraging in recent years in Australia, and we expect this to continue into 2012
- We expect the housing market to remain subdued, although it should improve a bit from 2011 as a result of lower rates
- Credit growth is likely to remain weak, but bank asset quality should remain sound, as households have been shoring up their balance sheets

High saving, good timing

Australian households have increased their savings ratio in recent years to its highest level in over 20 years (Chart 25). While increased savings can often be seen as a bad thing for the economy, especially when everyone does it at once, in Australia's case it has occurred just at the right time: that is, at a time when household income growth has been strong.

25. Saving is in favour with households

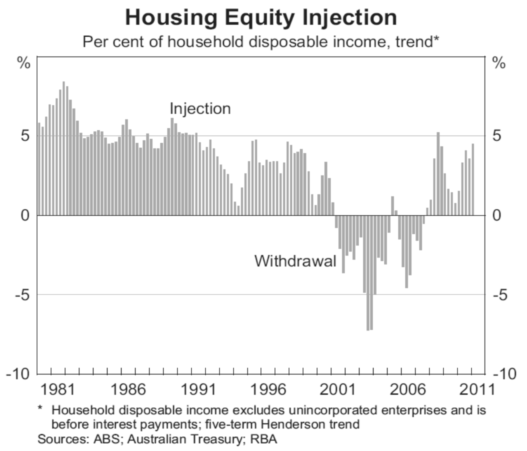


Source: ABS

Indeed, while higher savings often mean reduced consumer spending, which can be detrimental to growth, this has happened at a time when a large amount of spending is being done by the mining sector (as discussed above). Household income has also been strong enough that households have been able to both increased their savings and grow consumption at around its average pace over the past year.

Much of the savings has been used to pay down debt. While back in the early part of last decade households were withdrawing significant equity from their houses, by borrowing against rising asset prices, in recent years this trend has reversed (Chart 26).

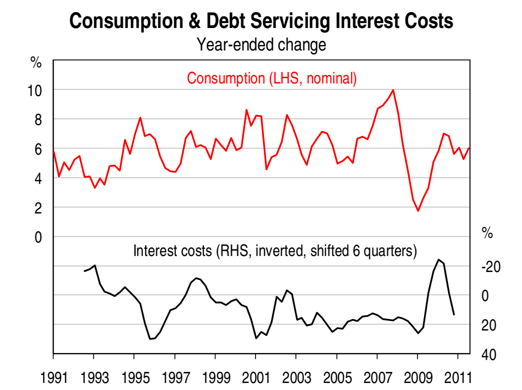
26. Households are rebuilding their buffers



Source: RBA

We expect these broad trends to continue in 2012. The household savings ratio is expected to remain elevated in 2012, albeit we do not expect it to keep rising (in fact, some fall may be possible, as lower interest rates provide less incentives to take up bank deposits). Household consumption is expected to ease modestly due to a slowdown in income growth, as the labour market softens, although this should be partly offset by the impact of lower interest rates. Consumption growth is quite sensitive to interest rate changes in Australia, given elevated levels of household debt (Chart 27).

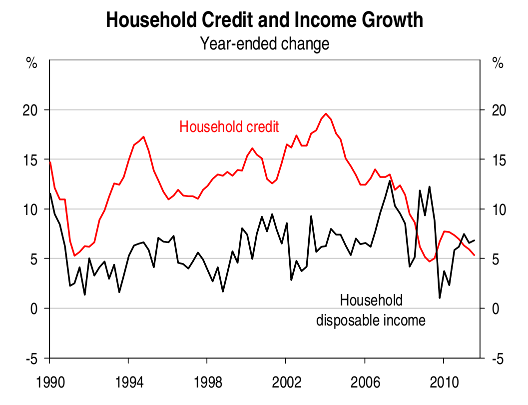
27. Household consumption will be supported by lower rates



Source: ABS, HSBC

Household credit growth is expected to remain modest in 2012, as households continue to shore up their balance sheets. Indeed, given household credit growth has grown in line with household disposable income for the past three years, at around 6% per annum, we believe it is reasonable to expect a similar trend to continue in 2012 (Chart 28).

28. Growth in credit is broadly in line with incomes

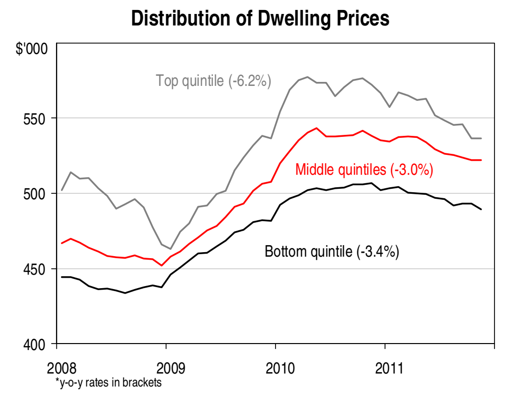


Source: ABS, RBA

Housing market supported

Housing prices have fallen over the past year – down by around 4%. The decline has been largest at the top end of the housing market, though there have also been falls in the middle and bottom quintiles (Chart 29).

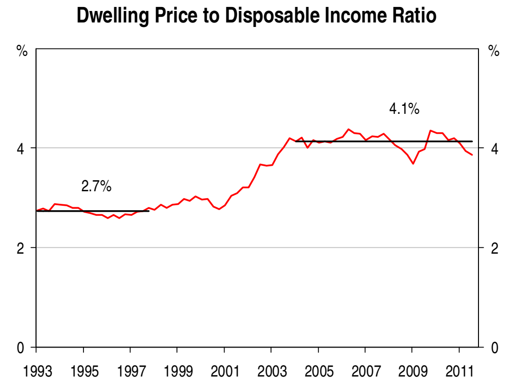
29. Housing market has been weakest at the top end



Source: RP Data/Rismark

This modest correction in housing prices, combined with strong income growth, has seen the dwelling price-to-income measure ease through the year. However, it is worth keeping in mind that the dwelling price-to-income ratio has already been steady for almost a decade, as housing prices have been growing in line with disposable income over that period (Chart 30).

30. House prices have grown in line with income for past nine years

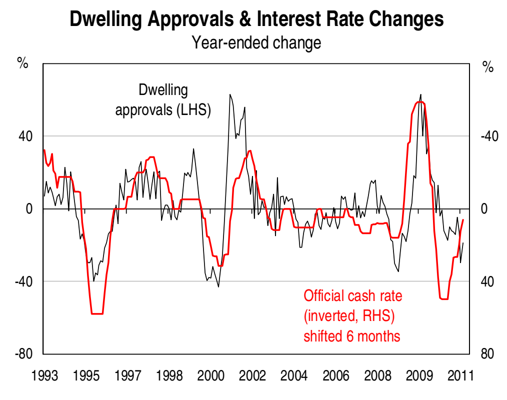


Source: RP data/Rismark

We expect that the rate cuts by the RBA in late 2011, plus further expected cuts in early 2012, will provide support for the housing market in 2012, with house prices expected to rise modestly.

Housing construction activity is also sensitive to changes in interest rates (Chart 31). In Australia, housing construction activity has recently fallen to around historically low levels – partly as it has been crowded out by mine construction – but recent cuts to interest rates should see some recovery in construction later this year.

31. Housing construction is highly sensitive to interest rates



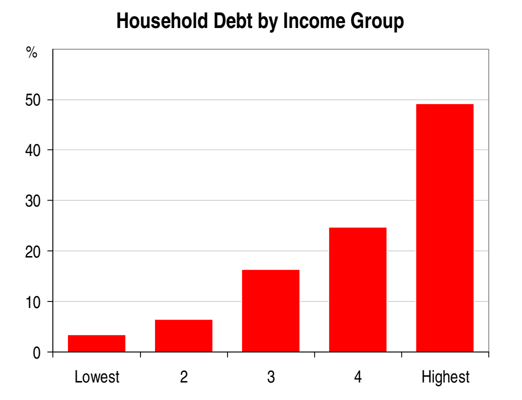
Source: ABS, RBA

No housing bubble

We remain unconcerned about the possibility of a large decline in housing prices this year, for many of the same reasons, which we articulated last year (see page 21 in '*Australia's place in the world*', 15 March 2011). The three main points are these.

First, although aggregate household debt is high in Australia, it is well-allocated to households that can afford to service it. Around three-quarters of household debt in Australia is held by the top two income quintiles (Chart 32). These households also typically have significant equity built up in their properties and assets. Indeed, a significant proportion of this debt is held against a second property, to take advantage of the mortgage deductibility on investment properties. Around one-fifth of Australian households have a second dwelling.

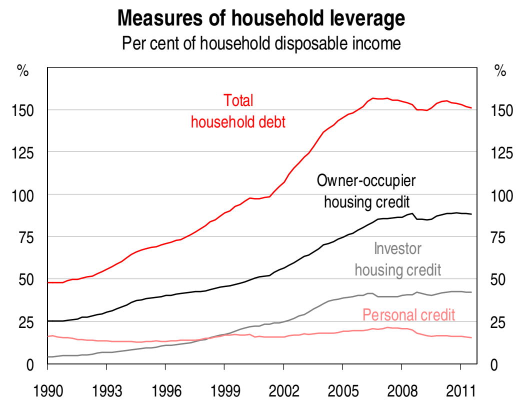
32. Higher income groups hold the most debt



Source: RBA

As the tax system favours these investment properties (in Australia interest on owner-occupied dwelling loans are not tax deductible), around one-quarter of all household credit is for the purpose of holding an investment property (Chart 33). Indeed, when making international comparisons of household debt levels, this is a critical point to keep in mind.

33. A significant proportion of debt is for investors

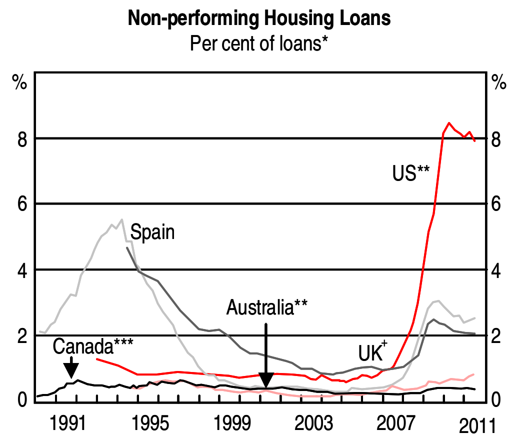


Source: ABS, RBA

In countries where the owner-occupancy rate is lower and the tax system does not favour investment properties, more of the housing stock is owned by the corporate sector. In Australia, this debt for the rented part of the housing stock shows up directly on the household balance sheet (rather than indirectly through their ownership of the corporate sector). The bottom line is: naïve comparisons of total household debt across countries can be misleading, so it is important to understand the distributional detail.

Besides this, it is important to note that the debt-to-income rate has been broadly steady for the past five years, and has been declining modestly over the past year. Despite the decline in housing prices last year, non-performing housing loans also remained a very small share of total loans, and significantly lower than in other developed countries (Chart 34).

34. Much better placed than other developed economies

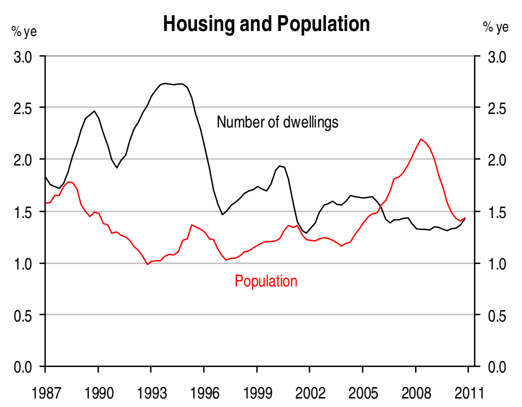


* Per cent of loans by value; includes 'impaired' loans unless otherwise stated; for Australia, only includes loans 90+ days in arrears prior to September 2003
** Banks only
\+ Per cent of loans by number that are 90+ days in arrears
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

Source: RBA

Second, there is still an undersupply of houses in Australia, despite slower growth in the population over the past year (Chart 35). Construction of housing is still well below the cumulative demand that exists. Most industry estimates suggest a shortage of around 100,000 homes, which is over two-thirds of one year's production. While population growth has slowed to be in line with growth in the number of dwellings, construction has yet to catch up with the demand overhang.

35. Australia is not building enough houses to meet demand



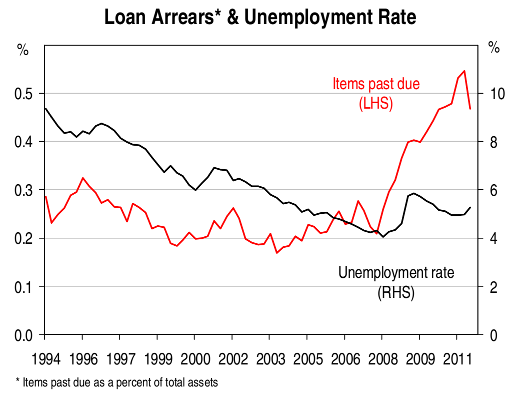
Source: ABS, HSBC estimates

Third, there are significant constraints in the supply of additional dwellings close to the urban centres, and thus within a reasonable distance to employment in the urban centres. For these 'high quality' dwellings there is strong demand and limited supply. Supply is constrained by zoning regulations, a lack of willingness of local governments to allow further urban infill in the major cities, and the lack of quality transport infrastructure. Despite its artificial nature, this is still a constraint. Unless this constraint is lifted – which seems unlikely to occur rapidly – the supply of dwellings close to urban centres will remain low relative to demand, supporting prices.

Risks

The main risk to the housing market and to asset quality in the banking sector is a sharper rise in the unemployment rate. Higher unemployment is the typical trigger of rising loan arrears (Chart 36). Importantly, as we discuss in the final section below, the RBA has a powerful tool for providing support for the housing market and employment. While we expect the unemployment rate to rise further from here, we expect it to peak around the middle of the year, before falling as expected RBA rate cuts provide support for the economy.

36. Labour market conditions are the key loan arrears



Source: ABS, RBA

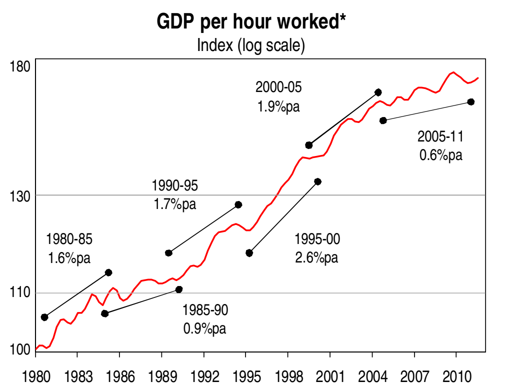
The productivity challenge

- Problems of weak productivity growth should become clearer in 2012, as commodity prices peaked in 2011, so the support is over
- Stymied reform is a cost of the long boom and policymakers need to make greater headway with productivity-enhancing reforms
- Weak productivity growth means inflation is structurally higher, with inflation concerns back on the agenda in late 2012

Starting to notice

The Australian economy may soon discover that without productivity growth it is left exposed. In the long run, of course, productivity growth is pretty much the only thing that matters for lifting living standards. In recent years, Australia's productivity performance has been dismal (Chart 37).

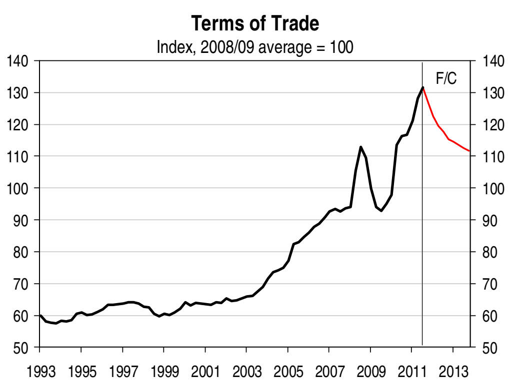
37. Productivity growth has slowed in recent years



Source: ABS

So why haven't we noticed yet? The key reason is that commodity prices have been rising for most of the past decade, boosting Australia's terms of trade and lifting incomes. However, as we forecast that the terms of trade have now peaked, income growth should no longer get support from rising commodity prices (Chart 38). As the tide runs out, the weak productivity performance will be exposed.

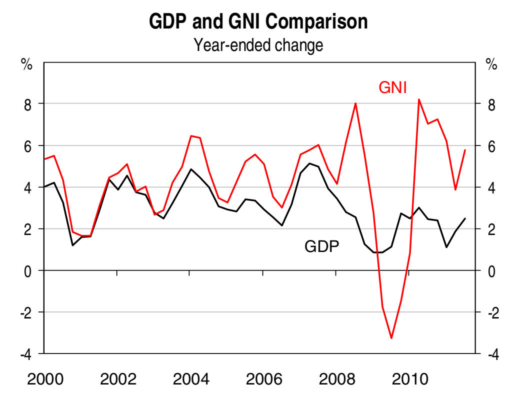
38. Boost to income growth from the terms of trade to end



Source: ABS, HSBC estimates

One way to measure the effect the terms of trade has had on the economy is to look at gross national income (GNI), which abstracts from the impact that the terms of trade has on GDP. The gap between growth in GNI and GDP gives a sense of the massive impact that the run-up in the terms of trade has had on Australian income growth and the broader economy (Chart 39). As the terms of trade peak, we expect this gap to close, which means that growth will rely more on productivity improvements.

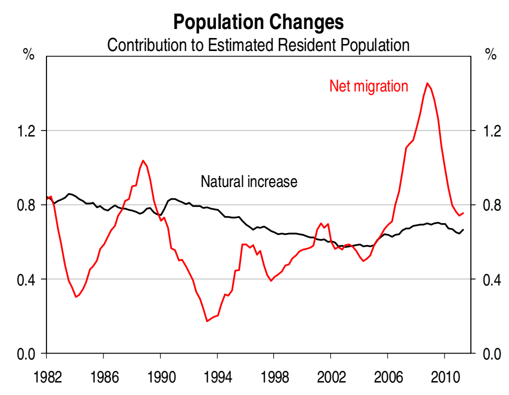
39. Incomes have been growing much faster than output



Source: ABS

Another factor, which has helped hide the relatively lacklustre productivity story, has been very strong population growth, particularly net migration (Chart 40). This was a key factor that supported growth during the early stages of the global financial crisis and saw Australia only record one quarter of negative GDP growth (in Q4 2008). While GDP per capita fell during 2008-09, GDP did not, thanks to rising population growth.

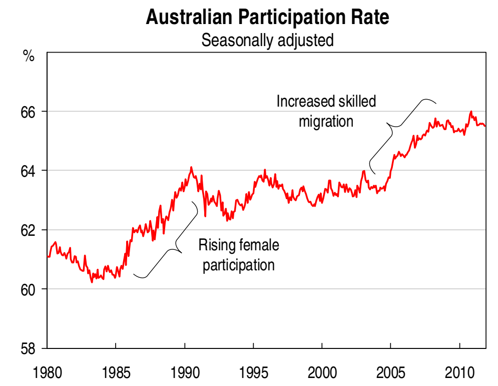
40. Population growth helped mask declining productivity



Source: ABS

Increased migration has been reflected in increased participation in the labour market in recent years (Chart 41). This has helped to support growth much as an increase in female participation in the workforce supported growth in the late 1980s and early 1990s.

41. Where will the next wave of workers come from?



Source: ABS, HSBC estimates

With slower growth in migration and commodity prices having peaked, more focus on productivity growth this coming year seems needed.

Productivity challenge

While productivity has been weakest in the mining and utilities industries, when all is said and done, it is fair to say that weakness in productivity has actually been fairly broad-based across industries (Table 42).

At the industry level, there are a number of reasons for the weak productivity performance. However, the big picture story is the lack of reforms in recent years. As we have argued before, this is a one of the costs of commodity price-driven success – a stymied reform agenda. For previous discussion see '*Does Australia have a resources curse?*', 18 August 2011.

42. Multi-factor productivity growth

% average annual	1996-2005	2006-2011
Agriculture, Forestry and Fishing	6.4	2.5
Mining	-0.1	-6.4
Manufacturing	0.8	-0.6
Electricity, Gas, Water and Waste Services	-0.8	-4.6
Construction	2.0	0.9
Wholesale Trade	2.2	-0.6
Retail Trade	1.6	0.8
Accommodation and Food Services	1.6	-1.5
Transport, Postal and Warehousing	1.9	-0.4
Information, Media and Telecommunications	0.2	0.7
Financial and Insurance Services	3.4	2.2
Rental, Hiring and Real Estate Services	-2.7	-4.6
Professional, Scientific and Technical Services	0.9	-0.1
Administrative and Support Services	-0.4	0.3
Arts and Recreation Services	0.1	-0.7
Other Services	0.2	-2.6
Selected industries	1.6	-0.5
Market Sector industries	1.3	-0.7

Source: ABS

Industry-level explanations

Two key areas that have shown weak productivity growth are mining and utilities.

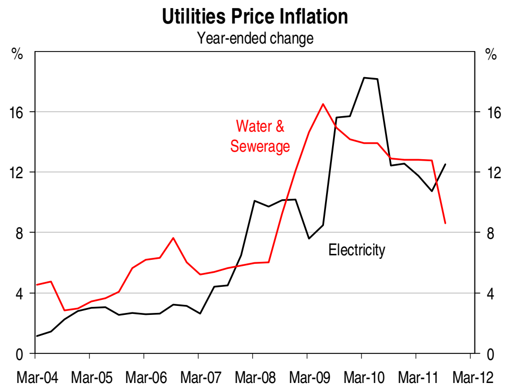
Mining industry productivity growth has been held back by a number of factors.

First, the very high level of commodity prices has made it profitable to extract lower quality ores, such that that less measured output is received for a given level of input. This includes that Australia's oil basins have become less productive as oil reserves have been run down.

Second, a large amount of investment is currently being undertaken in the mining industry, which yields very little additional output in the short run. Indeed, while the investments are taking place, mine production is often disrupted, which reduces production. So growth in mining output has not kept pace with growth in inputs, thus implying weak productivity growth.

The utilities sector has also displayed very weak growth in productivity. Part of this reflects that there has been significant investment in electricity generation capacity to meet peak demand, but while this is good for maintaining continuity of supply, it does not boost out output in a commensurate way. A similar development has occurred in water supply. There has been significant investment in desalination plants to ensure water supply during droughts, but this does not boost measured output growth by much. Overall, there has in fact been underinvestment in utility and transport infrastructure, which has seen persistently high utilities inflation in recent years (Chart 43).

43. Under investment in infrastructure leading to price rises



Source: ABS

Broader explanations

The broad-based nature of the productivity weakness suggests the explanation may lie beyond industry-specific issues.

Indeed, a key reason for the overall slowdown in productivity growth, in our view, is the lack of reforms. The last broad-based reform to the Australian economy was the introduction of the Good and Services Tax (GST) over a decade ago, in 2000. This followed significant reforms of the Australian economy in the 1980s and 1990s, including the deregulation of the financial and labour markets. The lack of any large reforms partly reflects that Australia has had it so good for so long: with commodity prices giving Australia support and because Australia has not had a recession for 20 years.

What to do?

There are a number of areas of reform, which could see improved productivity growth. However, there has been limited political appetite for these reforms in recent years, and even a programme of reforms put in place now would not yield immediate benefits.

Potential areas of reform include:

First: tax reform. There are a significant number of areas of tax reform that deserve further consideration by policymakers. A significant review of the tax system, which was undertaken in 2009 – The Henry Tax Review – contains a long list of possible tax reform initiatives, few of which have been addressed by policymakers. In particular, the distortion of incentives created by state tax systems and the interaction with the Federal tax system is a key area of needed reform.

Second: regulatory reform. The last major efforts at regulatory reform in Australia occurred over a decade ago. In recent years the labour market, in particular, has, arguably, become less flexible due to the unwinding of some of the earlier more flexible arrangements. The government has recently announced a review of its Fair Work Act as it seeks to determine whether the industrial relations environment remains flexible enough. In many cases there has also been a creeping increase in regulation – partly reflecting increased security arrangements – which is likely to have reduced productivity growth in the economy.

Third: skills and infrastructure. There is a need for a continued focus on training and education programmes to ensure the workforce is well-equipped to meet the ever changing demands of the global economy. Infrastructure is also a key area where national initiatives need to better recognise that congestion and inefficient allocation of infrastructure constrain the efficient operation of the economy.

Structural inflation persists

An implication of low productivity growth is that the economy cannot grow as quickly as it used to be able to without building inflationary pressures.

If the weaker productivity performance is structural – as seems likely, given its persistence – then it is reasonable to assume that structural inflation is also higher. This issue is one we see across Asia, though the explanations differ (for a discussion about the rise in structural inflation Asia, see '*Hard Numbers – The Structural Rise of Asian Inflation'*, 11 January 2012).

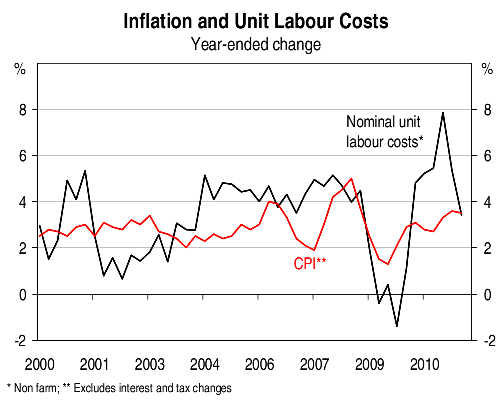
One result of this is that wage growth needs to be slower than it has been in the past. Simple arithmetic suggests that wages grow at around 4% per annum, assuming average inflation of 2.5% and productivity growth of 1.5% per annum. If productivity growth is now persistently less than 1%, then wage growth also needs to be contained at under 3.5% per annum to meet the RBA's inflation target (on average).

One way to observe this is by looking at measures of unit labour costs. Unit labour costs have averaged around 3.5% since 2005, up from an average of around 1.75% in the decade or so prior (since the beginning of inflation targeting) (Chart 44). At the same time, CPI inflation has picked up from 2.5% in the earlier period to 3.1% in the latter period. Suffice to say, the weaker productivity performance means that the wage growth that has been observed in Australia in the past six years is probably too rapid to be consistent with the RBA's inflation target if it persists. It has been sustainable during the period because the AUD has appreciated, though, as we pointed out above, we do not expect further AUD appreciation.

Either expectations for wage growth need to be adjusted lower or productivity growth needs to rise in order that the demand-side of the economy grows in line with the supply-side of the economy, consistent with the RBA's inflation target.

The bottom line is that without further AUD appreciation productivity growth is what will be needed if Australia's wage growth of recent years is to be sustained.

44. Rising unit labour costs feed into inflation



Source: ABS, RBA

While this year the global cyclical downturn is allaying concerns about inflation, we think these will reappear later in 2012.

HSBC

Conventional policy works

- Australia's continued growth over the past 20 years has been part luck and part good policy
- Importantly, the difference between Australia and the rest of the developed world is that conventional policy tools remain potent
- Monetary policy is expected to do much of the work required to support the economy in the face of a global cyclical slowdown

Cyclical downturn

Global growth is slowing down. And while Australia's structural story is strong – with mining investments expected to support growth – Australia is not entirely immune to the global slowdown.

Without policy adjustment, this would be expected to put further downward pressure on the non-mining parts of the Australian economy. To some extent this is already occurring, as the weakening global economy has slowed, which has impacted business confidence and hiring intentions. Consumer confidence has also been weak as a result of the decline in financial markets and wealth effects.

Importantly, those parts of the economy that are weakest are also the ones that are most interest-rate sensitive. We expect that cuts by the RBA will provide some support for those sectors in 2012.

Conventional policy works

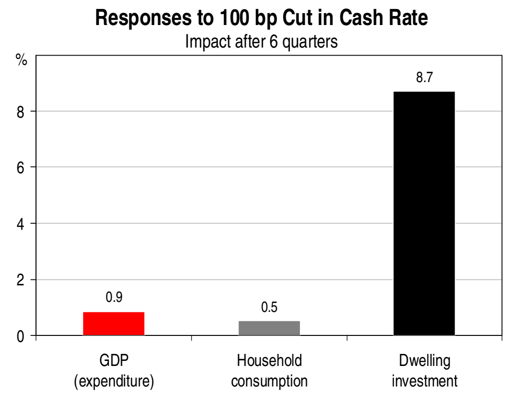
Unlike many developed economies, which are sailing into uncharted waters, Australia's conventional policy options are available. And the tools at policymakers' disposal are powerful. Also unlike many other developed nations, Australia is far from being in uncharted territory – a cash rate of 4.25%, budget deficit of 2.5% of GDP, and net public debt of 9% of GDP is somewhere we have been before.

Cuts to local interest rates by the RBA last year, prompted by global risks, should start to see a modest rebalancing of growth, with some of the weakest parts of the economy last year also the ones that are most interest-rate sensitive – in particular, housing and retail sales. We expect these sectors to stabilise in 2012.

Our own estimates using a structural vector autoregressive (SVAR) model of the economy (detailed here, '*Downunder digest*', 13 January 2012) suggest that monetary policy is still a potent tool for supporting growth in the economy.

Using the SVAR model we estimate that a 100bp cut to rates would boost GDP by around 0.9ppts over 18 months (Chart 45). At the sector level, changes in rates have a noticeable effect on housing and consumer spending. We estimate that a 100bp cut would boost housing construction activity by around 9ppts and consumption by 0.5ppts over 18 months. The impact of rate cuts on consumption is greater for durable goods, so this could support retail sales, which have a greater durable component.

45. Modelling shows that rates are a potent tool



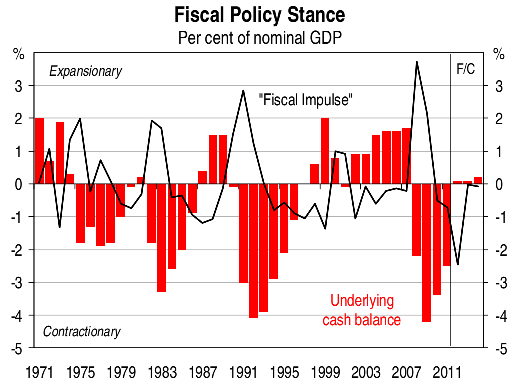
Source: HSBC estimates

Of course, the fact that the cash rate is still at 4.25% means that there is plenty of room to move if needed. Also working in Australia's favour is that households have already done significant balance sheet repair, with the savings rate around a 20-year high for the past three years. Lower rates will encourage less savings, and thus a boost to household spending.

Fiscal unwind ongoing

The government's current plans suggest a return to a budget surplus by 2012-13. This will require a significant amount of heavy lifting this year. Indeed, the fiscal unwind required should see budget swing subtract 2.6ppts from GDP growth in 2012-13. This would be the largest fiscal contraction in a single year in at least 40 years (Chart 46).

46. Government plans biggest fiscal contraction in 40 years

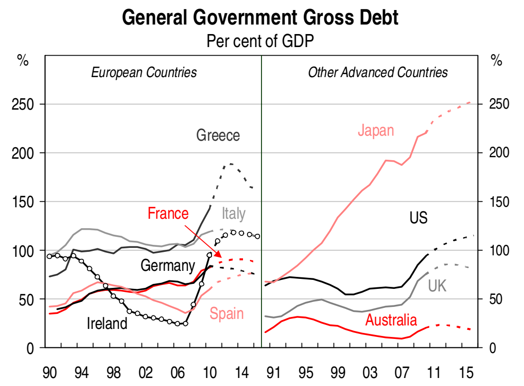


Source: Australian Treasury

This quite ambitious programme of fiscal unwind has helped to protect Australia's very strong sovereign debt position and is likely to be (at least implicitly) supporting the availability of international funds to local banks (albeit the cost of these funds has risen). Importantly, however, slippage in the plans to return to budget surplus is a key risk, particularly if growth is weaker than currently expected.

On the flip side of this argument, however, there is still room for the fiscal position to provide more support for the economy if needed this year, and still head back to surplus somewhere down the track. Low levels of government debt also allow significant scope for emergency support if required (Chart 47).

47. Lowest government debt of all OECD economies



Source: IMF

AUD shock absorber

Finally, the exchange rate is a significant part of the Australian economic armoury. A 26% depreciation of the exchange rate (on a trade-weighted (TWI) basis) during the Lehman Brothers episode provided significant support for the economy in the early period of the global financial crisis. In fact, our SVAR modelling suggests that a 10% depreciation of the TWI exchange rate boosts the economy by 0.1-0.2ppts over two quarters.

Of course, an important risk this year is that the exchange rate might behave differently. The global search for lower risk assets and their limited supply has seen high demand for triple AAA rated assets and has provided support for the AUD. In the face of a larger global slowdown than currently expected, perhaps due to a European financial shock, a key risk for Australian financial conditions is that the AUD might not depreciate as much as previously, and thus might provide less support.

Of course, some of this could be offset by lower RBA rates than otherwise, which would close the interest rate differential and may see further depreciation. At some point this argument is somewhat circular, though it is fair to say that the AUD may not provide as much protection as in the past.

Will it be a happy 21st?

We think so.

If the Australian economy manages to grow in 2012, it will be the 21st consecutive year of growth.

While there are clear downside risks to the global outlook for 2012, Australia's economy is well-placed, in our view.

Supporting growth will be a mining investment boom that is largely 'baked in' and expected to account for two-thirds of GDP growth in 2012. In addition, the remaining parts of the economy are more interest rate-sensitive than the mining sector, and the RBA has ample scope to cut rates. Given our central case for world growth of 1.9% in 2012 (down from 2.6% in 2011), we think the RBA will cut rates further, but it will not need to return to emergency levels reached after the Lehman Brothers failure.

With this support and a still weak supply-side of the economy due to weak productivity growth, we expect that the inflation threat will once again rear its head later in 2012.

Forecast table

1. HSBC forecasts for Australia

	Year-average			Year-ended						
	2011e	2012e	2013e	Q311	Q411e	Q112e	Q212e	Q312e	Q412e	Q113e
%*										
GDP	2.0	3.4	3.5	2.5	2.6	4.0	3.3	3.2	3.3	3.5
Consumption	3.5	2.7	2.6	3.8	3.7	3.4	2.8	2.2	2.3	2.4
Govt consumption	1.6	1.9	2.8	0.9	1.0	1.1	0.8	2.7	2.8	2.8
Investment	6.8	9.2	6.9	9.2	9.6	9.1	11.9	7.8	7.9	7.7
- Dwelling	-1.6	1.0	6.1	-2.9	-1.1	-0.4	0.5	1.2	2.9	5.2
- Business	16.0	17.1	8.5	21.9	21.3	19.6	23.7	13.3	12.9	10.9
- Public	-7.4	-6.7	1.5	-10.2	-9.6	-10.0	-9.4	-3.5	-3.5	-1.0
Final domestic demand	4.0	4.3	3.9	4.6	4.8	4.5	4.9	3.8	4.0	4.0
Domestic demand	4.3	4.1	3.9	4.7	4.4	4.4	4.0	3.8	4.0	4.0
Exports	-1.5	10.3	10.6	0.8	1.1	10.4	9.9	10.5	10.3	10.6
Imports	11.4	12.8	10.8	13.8	13.3	13.9	13.4	12.0	12.0	11.5
GDP (% quarter sa)	-	-	-	1.0	0.9	0.6	0.7	0.9	1.0	0.8
CPI	3.6	3.1	3.2	3.5	3.7	2.8	2.6	3.4	3.6	3.6
Trimmed mean	2.4	2.6	2.8	2.4	2.5	2.4	2.3	2.7	2.8	2.8
Unemployment rate	5.1	5.4	5.1	5.2	5.3	5.4	5.5	5.4	5.3	5.2
Labour price index	3.7	3.4	3.6	3.6	3.4	3.3	3.3	3.4	3.5	3.6
Current A/C (%GDP)	-2.2	-3.9	-4.8	-1.6	-2.2	-3.1	-3.8	-3.0	-3.3	-3.3
Terms of trade	14.2	-6.5	-4.8	13.2	8.8	1.1	-6.8	-10.5	-9.1	-6.6
Cash rate (end period)	4.25	3.75	4.25	4.75	4.25	3.75	3.75	3.75	3.75	4.00

*Unless otherwise specified
Source: ABS, RBA, HSBC forecasts

Disclosure appendix

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