

The implications of the floods for Australia



Key points

- Like the bushfires of two years ago, the floods have wrought terrible tragedy in terms of loss of life and disruption to people's lives. Beyond the human suffering there will also be significant implications for the Australian economy and investment markets.
- Expect the floods to knock around 1% (or \$13 billion on an annualised basis) off the Australian economy in the December and March quarters. Rebuilding should see 0.5% of this recouped by year end and a further modest boost to growth through 2012.
- Higher food prices, notably for fruit and vegetables, will add around 0.5% to 0.75% to inflation in the March quarter.
- In terms of damage to physical assets – property and infrastructure – the flood could cost \$15 billion with rebuilding likely to be spread over several years.
- The Reserve Bank of Australia (RBA) is likely to look through the short-term boost to inflation and focus more on the short-term hit to growth, leaving rates on hold until around mid-year. However, once production rebounds and rebuilding kicks in it is likely to return to raising rates from around mid-year to head off an overheating in the economy.
- While the floods have led to earnings downgrades, the impact on markets overall should be minor, in part offset by higher coal prices. Australian shares are cheap, having lagged global markets over the last year, and we remain of the view that, notwithstanding short-term uncertainties, they will head to around 5500 for the ASX 200 by year end.

Introduction

Two years ago it was bushfires ravaging parts of Australia with devastating consequences. Now it's floods, with most states affected. Even Tasmania, where I spent last week on holiday, was affected, with Railton in the state's north-west coping it a day or so after I passed through it. However, so far Queensland has been hit the hardest with an area the size of Germany and France going underwater and Brisbane seeing its worst flood since 1974. Unfortunately the crisis is not over with almost one third of Victoria now flood-affected. Like the bushfires of two years ago the floods have wrought terrible tragedy in terms of loss of life and disruption to people's lives.

Beyond the human suffering there will also be significant implications for the Australian economy and investment markets. There will be three key economic impacts from the floods: the obvious damage to wealth and associated repair and rebuilding costs; the impact on production or gross domestic product (GDP) growth; and the impact on inflation.

Damage from the floods

Getting a clear handle on the damage bill from the floods is obviously difficult with flooding continuing in many areas. However, there is no doubt that it will be immense:

- Assuming that 40,000 houses suffered partial or total inundation with an average repair cost of \$50,000 implies a total repair bill for damaged housing of around \$2 billion
- Damage to commercial property, mines, farming equipment etc, could amount to another \$2 billion, and
- Given the extent of the flooding, damage to public infrastructure such as roads, railways, bridges, electricity and water supply could easily exceed \$10 billion to repair. The Queensland roads minister has already estimated \$1.5 billion worth of damage to state-controlled roads. However given that the state only controls 20% of Queensland roads, the total damage bill will be well in excess of this.

This suggests a total damage bill of around \$15 billion, which is similar to the damage caused by the 1989 Newcastle earthquake which amounted to around \$13 billion in today's prices and Cyclone Tracy in Darwin in 1974 which caused around \$15.5 billion of damage in today's prices.

As rebuilding and reconstruction commences it will provide a boost to economic activity, but this is unlikely to become evident until the June quarter, at the earliest, and it will be spread over several years.

Much of this repair bill will fall to federal and state budgets, and to a lesser degree, insurance companies and individuals. Fortunately, Australia's relatively low level of public debt means that Australian governments are well placed to cover the bill. Net public debt in Australia is near zero in contrast to many other OECD countries where it is at exorbitant levels. So even if federal and state governments have to run up extra debt of \$13 billion or 1% of GDP, it is not a major financial concern.

A negative supply shock – the worst kind

Physical crises like floods initially amount to negative supply shocks as they cut into an economy's ability to produce. This is the worst kind of shock as it reduces economic activity at the same time that it adds to inflation.

In terms of the impact on economic activity, the major negative impact will come from the following:

- Lost coal production - Queensland normally exports about \$2.8 billion worth of coal per month. It's estimated that \$2.3 billion of coal sales has already been lost. With only 15% of coal mines operating at full capacity, due to flooding or lack of transport, and likely to take 3-6 weeks, and possibly months in some cases, to get back to normal, it's likely that coal exports will be reduced, possibly by around \$5 billion spread over December to February. This is equivalent to around 0.4% of annual GDP alone
- Reduced agricultural production, particularly in terms of fruit and vegetable production, sugar cane, cotton and, to a lesser extent, wheat and meat, could amount to another 0.1% to 0.2% knocked off GDP

- Reduced activity, mainly in tourism, transport and retailing, due to disruption caused by the floods, could easily take another 0.4% off GDP. A 5.7% nationwide fall in consumer confidence in January, presumably largely due to the blanket coverage of the floods, suggests that the short-term hit to retailing might extend beyond flood-affected areas, and
- The disruptive effects associated with floods may also result in a delay to the start-up of some mining related projects.

So, overall economic activity could be reduced by around 1%, with part of this showing up in last year's December quarter, but the bulk of the impact, around 0.8%, occurring in the current quarter. As such, there is a chance that March quarter GDP growth could actually be negative.

However, the net impact on GDP from the floods is likely to be less because rebuilding and reconstruction will start to provide a boost to economic activity from the June quarter. By year end it's likely rebuilding and reconstruction will have resulted in a 0.5% boost to GDP, and as a result the net impact on GDP growth this year will be to the order of -0.5%. In other words, rather than 3.5% GDP growth through the course of 2011 as we had originally assumed, this will now likely be around 3%, with much, if not all, of this growth concentrated in the second half of the year.

An additional factor which will help reduce the negative impact on economic activity is that the disruption to the production of coal and some agricultural commodities will be partly offset by higher prices received for those who are still producing, e.g. spot coal prices are up more than 20% from their December quarter average and wheat prices are up 14% from their December quarter average. The associated boost to national incomes may help reduce the short-term negative impact on economic activity.

Inflation is also likely to see a short-term boost in the March quarter, possibly to the order of 0.5% to 0.75%, mainly due to higher prices for fruit, vegetables, cereals and bread. Fruit and vegetable prices are likely to have been boosted by 20% or more.

Implications for economic policy

Just as it did with the surge in banana prices resulting from Cyclone Larry in 2006, we expect the RBA to look through the short-term boost to inflation from higher food prices associated with the floods. The RBA's short-term focus is likely to be more on the negative impact on economic growth and the pressure this will take off productive capacity in the economy. As a result, we expect the RBA to leave interest rates on hold until at least May.

Thereafter we expect the RBA to resume tightening and still see the cash rate rising to around 5.5% by year end. While the near-term concern may be a lack of economic growth, from mid year onwards there is a risk that the economy will start to overheat as reconstruction following the floods and a boost in replacement spending by consumers combines with a continuing surge in mining investment. There's a serious risk that demand for skilled construction and engineering workers to help in the rebuilding

activity, at the same time that the mining boom is taking off, will boost wages and add to inflationary pressures. The TD Securities/Melbourne Institutes' Inflation Gauge for December highlights that, even before the floods hit in earnest, inflation was a bit of a problem.

Obviously, the costs associated with the floods will put pressure on state and federal budgets. While the impact on public debt is not a major concern and a short-term blow out in the budget deficit is understandable, reflecting one-off short-term payments to victims, the Federal Government should ideally seek to offset increased spending associated with rebuilding from the floods by cutting back or delaying spending in other areas (such as infrastructure or the "cash for clunkers" program). Failure to do so could risk adding to skill shortages and wages pressures later this year.

Implications for Australian shares

So far this year, worries about the impact of the floods on the Australian economy and profits have seen the Australian share market underperform global shares. This comes on the back of underperformance last year which appears to reflect worries about the impact of rising interest rates locally, the strong Australian dollar and Chinese tightening. However, while the floods still have the potential to add to short-term uncertainty, we see no reason to alter our view that the Australian ASX 200 share market index will rise to around 5500 by year end.

- Australian shares are not expensive – trading on a forward price-to-earnings multiple of 13 times, compared to 15 times a year ago and an average of 14.5 times over the last 15 years.
- The profit implications from the flood are likely to be less than feared, reflecting the benefit of higher prices, particularly for coal. As a result, profit growth is still likely to be solid this year at around 10-15%.
- A pause in the interest rate tightening cycle is likely to be positive for consumer spending, housing construction activity and credit growth, helping retailers, builders and banks in the short term once the flood is over.
- Building material, construction and engineering companies, and ultimately retailers, could be key beneficiaries of the rebuilding after the floods.

Concluding comments

The floods have had a devastating and heartbreaking impact. However, as with all natural disasters there is a danger in exaggerating the economic impact. While the initial effect is certainly negative, rebuilding ultimately results in a boost to growth. And to the extent that the floods underline the ending of the long running drought in Australia and the arrival of the La Nina weather pattern, they should usher in better growing conditions for farmers in the years ahead.

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