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Winter 2012

Economic update

Winter is with us again, and on the economic front, it may have arrived early.

From a global perspective, Australia remains a strong economy. While USA, China and Japan are all growing, Europe's unresolved problems, especially in Greece and Spain, overshadow both market sentiment and the immediate future.

A roller coaster ride for shares in May was therefore no surprise. After a strong first quarter, the ASX 200 touched 4,500 points in early May before falling back. In line with other major markets, it dropped around 8 per cent within the month, giving up the gains of 2012.

Seen from a local perspective, the Australian economy is uneven; strong in areas related to resources and weaker where the high Australian dollar has an impact.

With no inflationary pressures to speak of, the RBA cut rates by 0.5 per cent in May to boost growth and confidence. If the recent fall in the AUD$ below parity with the US$ persists, sectors hit hard over the past few years, like tourism and manufacturing, should benefit.

Housing remains flat overall, but despite job losses in some areas, the unemployment rate has stayed around 5 per cent, buoyed by demand flowing from strong commodities and a massive investment pipeline.

All eyes remain on Europe in the months ahead.

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IS IT GREXIT STAGE RIGHT?

The European debt crisis and the problems in Greece continue to spook global financial markets and have given rise to a new word: Grexit, or 'Greek-exit'.

Of course, this new word refers to Greece's possible exit from the Eurozone and re-adoption of a much-devalued drachma. However, this sort of national exit strategy was not contemplated when the European Union and the euro were established.

Having a single currency across many countries – including the likes of Germany with a very strong economy, and Greece and Portugal with weaker economies – has its problems. Critically, the traditional option of devaluing a currency to kick-start a struggling national economy is not possible with a single currency.

Contagion – a real fear?

Greek's debt crisis began years ago but now it's crunch time with foreign debt of E422 billion. While this is no doubt a staggering sum, it is important to put Greece into some perspective. It is the world's 38th largest economy — Australia is ranked No.12 — which puts Greece on a par with Chile and Nigeria.

But there is no precedent or neat solution for the current situation, giving rise to the fear that a disorderly Greek exit could cost $US1 trillion and the European economy could contract 5 per cent. It is not possible to estimate the various knock-on effects, particularly considering a weakened banking system among countries already in recession.

The Eurozone would need to establish a 'firewall of confidence' so the contagion does not spread to Portugal, Spain and even Italy. While Portugal only accounts for 1.6 per cent of Eurozone deposits, Spain constitutes 10.7 per cent and Italy 10.1 per cent.

The crunch comes on June 17 when Greece goes back to the polls after the inconclusive May 6 elections. While anti-austerity votes were on the rise then, many believe it was a protest vote and the pro-austerity factions will win in June.

Whatever the outcome, the fear associated with this crisis has rocked global financial markets. Global shares have dropped around 10 per cent from their highs in April 2012, while Asian and Australian shares have been down by a similar amount.

Against this backdrop, the global economy is in much better shape than it was this time last year. China remains strong, while both the huge US and Japanese economies are stronger than 12 months ago. There is also some easing in monetary policy in China, other emerging countries and in Australia, and this should stimulate further growth.

A weaker Australian dollar is positive for many local businesses, particularly those in hard-hit industries such as tourism and manufacturing. It also increases the chance of lower interest rates and, in turn, lower mortgage repayments.

Former Treasury head Dr Ken Henry says Australia will be seen as a safe haven and this is being reflected in the growing demand for Australian bonds. The yield for Australian bonds is now at historical post-war lows of less than 3.2 per cent. With such low returns from bonds, high-yielding companies, paying solid franked dividends, will ultimately prove more attractive for investors, and this should help improve sentiment.

Impact on Australia

While Australia is not directly affected by the fallout, if Greece were to exit the Eurozone in a disorderly fashion and other European economies weaken further, this would impact China and in turn would knock demand for Australian commodities. Shane Oliver, Head of Investment Strategy & Chief Economist at AMP, estimates that a 5 per cent fall in Eurozone GDP would knock roughly 0.4 per cent off Australian economic growth.

Much of the problem in Europe is the discrepancy between the strong and the weak economies. Some argue that rather than have Greece leave the Eurozone, the country to exit should be Germany, the strongest. The consequential devaluation in the euro, without Germany, would make the exports of remaining Eurozone countries more competitive and enable these countries to better deal with debt.

While this scenario is unlikely, Grexit is also not a foregone conclusion.

PLAN NOW FOR AGED CARE REFORMS

The recent announcement of the Federal Government's Living Longer Living Better policy is an important step towards meeting one of the nation's major economic and social challenges. It is designed to create an environment in which older Australians can expect a decent and comfortable retirement which the nation can afford.

This will not be an easy goal to achieve. As Mark Butler, Minister for Aged Care, pointed out, "there are now more Australians who reach retirement age each year than reach working age."

A key feature of the new policy is the way it tries to meet the different needs of older Australians. Some people simply want assistance to remain in their own home (home-care) while others require either a low level of care or a high level of care in residential aged care accommodation.

With plans to increase the number of home-care packages from 58,000 to around 100,000, the new policy makes it easier for older people to stay in their own homes. However, even with this increase, demand is expected to exceed supply.

To cope with the increased demand, Australia has to find an alternative to the current system where many home-care recipients pay only a modest fee for services including bathing and dressing, meals, housework, gardening and shopping. The government plans to introduce a means-tested fee for people whose assets and income are above the Age Pension cut-offs.

Another important change is to the residential care policy; in particular, the method of charging fees for daily care. Currently, fees are subject to only an income test but from July 2014 some fees will also be subject to a means test (which includes both an income test and an assets test).

For most retirees the most important asset is the family home. Currently the government policy does not include the value of the family home in the assets test as long as a spouse or dependent is still living there. This is not expected to change in the near future.

Greater transparency and consistency

Importantly, the policy seeks to ensure all Australians are treated fairly and consistently, particularly those more vulnerable people requiring residential care. To help achieve this goal, the way in which the users of residential care pay the accommodation bonds will change.

From July 2014 everyone in aged care accommodation will be required to pay a bond or 'accommodation' payment, either as a lump sum, periodic payment or a combination of the two. The amount of these bonds will need to be approved by a central financing authority rather than being individually negotiated as they are now.

These changes could dramatically alter the strategies people are currently using to get the best possible trade-off between the size of their bond, the daily fees they pay for care and their Age Pension.

New payment strategies

All potential retirees will now be faced with a range of issues requiring professional financial advice, with many factors to consider.

How will they treat the family home? Will they keep it, rent it out, or sell it? Should the accommodation bond be paid as an upfront lump sum or by instalments or a combination of both?

What is the trade-off between the daily care fee versus the amount of the accommodation bond a retiree is prepared to pay? How important will superannuation and investments outside of super be in balancing assets and income needs? Should retirees consider reducing assets by gifting money to their children and arranging for the children to pay for their aged care later on?

The proposed aged care reforms will be phased in over the next five years and there may be some tinkering around the edges. But if you or family members are planning a move into aged care in the near future, it will pay to sit down with us sooner rather than later to help achieve the best financial and lifestyle outcome.

Waiter,

there's an economist in my soup!

You probably wouldn't ask Jenny Craig to comment on Australia's balance of trade figures, so why would you ask an economist to advise you on weight loss and a healthier lifestyle? Yet economists happily dish out nutritional advice these days and some of them directly challenge accepted beliefs about food and eating.

Consider the familiar view that people in lower socio-economic groups are more prone to obesity than wealthier people because they lack the money and knowledge to make wiser food choices.

But is this the full story? Dr Richard McKenzie, a UCLA Business School professor and author of HEAVY The Surprising Reasons America is the Land of the Free – And the Home of the Fat, suggests America's obesity problem is a result of prosperity, not poverty. In his view, it is fuelled by income growth and technology which has made most food, including unhealthy fast food, cheaper to manufacture and buy.

Dishing up controversy

So how do our food choices go beyond the family budget and interact with the wider economy? Tyler Cowan, a US economist and foodie who has just published An Economist Gets Lunch, believes because we grow it, make it, choose it, buy it and eat it every day, all food has a money angle.

He is a great defender of capitalism and believes the free market should be thanked for the wide variety of food choices available in western countries today. He also approves of modern agribusiness and genetically modified food. He doesn't support organic and pro-environment foods and criticises the slow-food, eat-local, and eat-fresh movements as expensive and snobbish, rather than healthy and friendly to the environment.

Food and money — inseparable twins

Is there real nutritional value in studying the economics of food? "Yes" say many economists. What we eat has economic consequences because poor eating choices place a financial burden on the economy as a whole, increasing health and other costs, and affecting our balance of trade — the agricultural commodities and processed foods we import and export.

Deborah Cobb-Clarke of the Melbourne Institute of Applied Economics and Social Research, believes economists bring a different and useful mindset to the study of health and nutrition. While nutritionists concentrate on what we eat, economists and other scientists concentrate on why we eat it.

She also believes the factors which influence our eating decisions are the same ones that influence our money decisions. In her view, people who are careful with money and investments tend to also be careful about what they eat.

Perhaps this is why one of the major Australian banks currently funds a community program which gives low-income families training in financial planning and supports them to make food choices which improve health and quality of life.

Our future food

Growing rates of obesity and spiralling public health costs make it inevitable that the role of economists in health, diet and family budgets will grow. If it emerges that public health education falls short of making the changes needed, legislation and taxation become the only effective ways to counter mounting bills from poor health and its global economic cost.

If this happens, stand by for sugar taxes on soft drinks and even fat and salt taxes on snacks and fast foods. Seems unlikely? Such taxes are already in place in Hungary and have support from Australian medical researchers.

Future decisions about what goes onto the supermarket shelves, into our pantries, and onto our plates, may well be influenced as much by tax and regulation as by our taste buds and household budget.