



Effects of drought won't stunt overall growth

The wider economy has been cushioned from the worst of the drought, writes

Tim Harcourt.

The poet Dorothea Mackellar seemed to have got it half right when she wrote about the sunburnt country of "drought and flooding rains".

In southern Australia at the moment, we seem to be living in a land of drought and more drought, with most of the rain falling in the northern half of the continent.

Although the non-farm sector is chugging along quite nicely thanks to the resources boom, there is still concern about the impact of the drought on the rural sector and any further ramifications it may have for the rest of the economy.

There is also concern for the plight of the rural communities themselves because despite the fact Australia is a relatively urbanised country, the bush still plays a unique role in our national psyche.

So how bad is the drought? There's certainly been a lot of talk about it being "the worst drought in a century" and with climate change issues prominent, the drought has received a lot of media and community attention.

In fact, the Reserve Bank of Australia devoted a section of its recent statement on monetary policy to the drought and its economic implication in a historical context.

According to the RBA, when the share of prime agricultural land with a rainfall deficiency this year is compared with previous years, the current drought is not as severe as the droughts at the time of federation, in the 1940s, early 1980s, and in 2002.

However, the main difference is that this drought has come so soon after another severe drought in 2002, so there's been limited recovery time in between for growing conditions to improve and for farmers to store water.

As a result, the area of agricultural land recording a rainfall deficiency is now higher than at any time since the drought of the 1940s.

In addition, with the steady increase in temperature that the world faces, water evaporation is faster and this reduces sub-soil moisture. Throw in the El Niño effects and you can see why there is additional concern as it makes it harder for the land to recover even when a drought breaks.

So we know from the Bureau of Meteorology that this is serious stuff. But what do we know about the economic effects?

The RBA and most economists have anticipated that the drought will directly knock off between 0.3 and 0.5 percentage point of growth in gross domestic product this financial year; some worst-case scenarios put it at a full percentage point. This is mainly because of the reduction in agricultural supply rather than demand. The RBA expects farm incomes to fall by about 20 per cent in 2006-07, and a smaller fall in livestock production compared with the previous drought.

The Australian Bureau of Agricultural and Resource Economics anticipates that most of the reduction in farm output will come from crop production — with big falls in wheat output in NSW and Western Australia.

However, a large build-up of inventories will ensure that wheat exports will not fall as much as production. In the case of livestock, a faster slaughter rate will mean a

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temporary boost in meat production, although this will mean it will take longer to build up livestock numbers in the next year or so.

According to ABARE, the build-up of stocks, particularly in crops

like wheat, may lessen the impact on rural exports of the drought, which can usually shave 15 to 25 per cent off rural export values.

In terms of other macroeconomic impacts, there is likely to be a minimal effect on inflation and employment. Macquarie Bank has estimated that the average of the past two droughts suggests food inflation picks up just over 1 percentage point, adding about 0.2 percentage points to headline inflation.

In addition, as the Australian farm sector is one of the most efficient in the world and highly capital intensive, the employment implications of the drought are not as bad as they otherwise would be. As a result, rural employment does not always follow rural production. In fact, during the 1994-95 drought, there was no fall in employment despite sagging production levels.

So the news is not good although the wider economic impacts are better than might be expected at first glance. There seem to be five things going in our favour.

First, we are experiencing a drought at the same time as a resources boom. Hence, the fall in rural exports is coinciding with strong growth in resource exports.

Second, the rural sector is not as large as it used to be in Australian economic history. According to Commonwealth Bank of Australia research, the farm sector accounts for about 3 per cent of total output with a similar share of total national employment, although it still accounts for a fifth of exports (with over two-thirds of farm sector output now exported).

Third, the flip-side of the reduction of the farm sector's share of national economic output and employment is that it has made significant gains in efficiency and productivity. Accordingly, it has been able to survive past droughts as well as sharp swings in exchange rates and commodity prices.

Fourth, the financial fallout has not been as large as in the past. Programs such as the farm



management deposit scheme allow farmers to make deposits when earnings are high, so they can draw them down when earnings are low. Transport subsidies and drought-relief schemes are also helping the worse-affected areas.

Fifth, the economic diversity of rural and regional Australia has helped. While there are obvious knock-on effects for rural businesses that service the farm sector, many regional economies have a range of

export-orientated industries that service mining, manufacturing and professional services businesses as well.

In conclusion, the drought is having only a minimal impact on output, inflation and employment but with a significant impact on rural exports.

Fortunately, there is significant momentum in the overall economy to carry us through the worst effects of the drought. But there's no doubt

that the drought is making it tough for farmers and others in the bush.

Fortunately, the overall efficiency of the farm sector and its past resilience means it can bounce back, but better weather conditions and improved market access in world trade would certainly make a difference.

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Australian farms are among the most efficient in the world and highly capital intensive.