# ECONOMIC UPDATE

*Address by Mr Glenn Stevens, Governor, to James Cook University's Business Excellence Series in the Tropics (BEST) Luncheon, Townsville, 4 June 2009.*

Thank you to James Cook University for organising this occasion and for the invitation to take part.

Townsville and the surrounding region boast a significant set of industries. Townsville provides a port and refining capacity for important parts of the mining sector. It is an export point for the live cattle industry, sugar and a range of other rural industries. For the tourist industry, it is an access point to the Great Barrier Reef and home to research into the marine environment. It is the base for an important part of Australia's defence capability. Of course, the University is also a strong centre for higher education. A number of the University's graduates in economics have become prominent in the world of finance and business.

So it is a pleasure to be here, to talk about how economic conditions are unfolding, including in countries and industries in which this region has more than a passing interest.

About a month ago, the Reserve Bank released its May *Statement on Monetary Policy*. I want to give an update on that material, though developments have not caused us greatly to change our views.

I will start with the international economy.

The current global recession is being widely referred to as the most significant of the post-War period. There is, by now, little debate about that description.

It is not necessarily the case, however, that it will be the biggest recession for all individual economies. It will be for many, but quite a few have seen larger recessions at some point in the previous six decades than they appear to be experiencing now. For some countries in Asia and Latin America, other episodes, with other causes, were more damaging than what has been observed, at least so far, this time. I do not think it will be the biggest recession of the post-War period in Australia either, though of course we will not know for sure for a while yet.

Rather, it is the exceptional synchronicity of the international downturn that has been so remarkable.

It is well known, of course, that the financial crisis had its genesis in lax lending in some of the major economies, and cheap credit generally, earlier in this decade. This has been well covered before, so I will not go over it today.

Rather, I would like to focus on the sharp deterioration in global demand for goods and services that occurred late in 2008 and early this year. There are some important features of this event that help us to understand both our own experiences in Australia and those of other countries.

Historians will study this episode for years to come. They may find additional nuances, but one very clear trigger for the sharp collapse in demand was the heightening of stress in financial markets.

A sequence of extraordinary events occurred in September and October last year. These included:

- the US Government taking over the two largest housing finance entities;
- the bankruptcy of one of the four remaining large US investment banks, which people had presumed was 'too big to fail';
- the US Government taking over one of the world's largest insurance companies; and
- in short order, pressure on systemically important institutions across the United States and Europe.

Combined, this previously almost-unthinkable sequence resulted in a sharp increase in perceived systemic risk in financial markets and systems everywhere. Stock prices fell sharply around the world. Risk spreads on all sorts of debt instruments blew out, and capital markets for issuing (or rolling over) debt and equity essentially closed.

It was the most turbulent period in international finance any current banker, economist, market trader or policy-maker has lived through or, we hope, ever will.

Unlike most previous financial crises, moreover, the news about this set of events reached people all over the world very quickly. They did not learn about it the way they once might have: sequentially, with varying lags, via delayed print media, word of mouth, high-brow publications and so on. Instead, they learned about it simultaneously, via the 24-hour news cycle, in every country, more or less in real time.

Not surprisingly, people everywhere suddenly became much more fearful of the future.

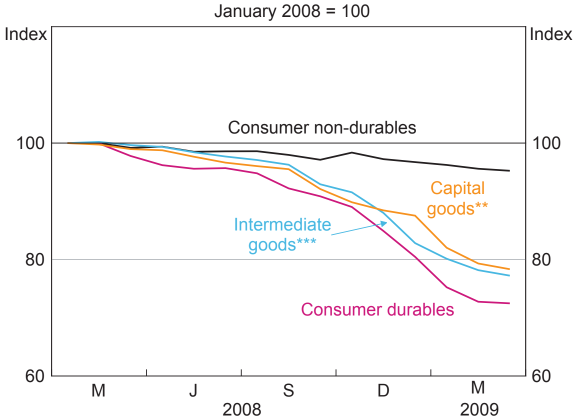
In the face of this acute uncertainty, firms and households across the world did what you would expect. They acted in a precautionary way. They postponed discretionary purchases, shelved expansion plans and did what they could to consolidate their balance sheets.

The result was a highly synchronised slump in demand especially for consumer durables and investment goods. Production and consumption of more 'everyday' non-durable goods and services did fall, but by much less than for those products that could easily be purchased tomorrow rather than today (Graph 1).

**Graph 1**

**Industrial Production in Selected Economies***

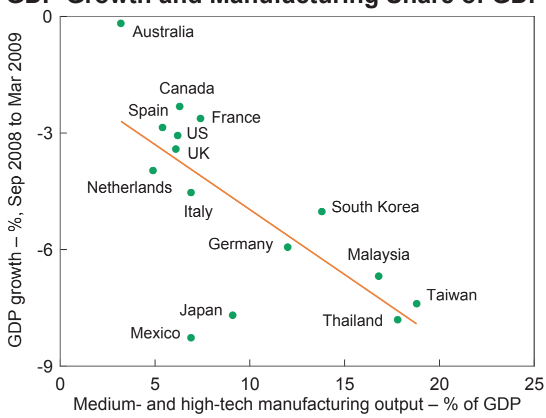
January 2008 = 100




* Euro area, Japan, South Korea, UK and US
** Business equipment for the US
*** Business supplies and materials for the US; producer goods for Japan
Sources: CEIC; IMF; RBA; Thomson Reuters

**Graph 2**

**GDP Growth and Manufacturing Share of GDP**




Sources: IMF (for manufacturing shares); CEIC; RBA; Thomson Reuters

The nature of this slump helps us to understand both the relative performance of various national economies and the subsequent behaviour of production generally.

It has become much clearer over the past month or two, for example, that the countries hardest hit have been those that are most involved in the production and export of these high-value goods (Graph 2). Among the major economies, Japan and Germany have seen the biggest falls in output. Among emerging market countries, some of the biggest contractions were among the Asian nations that are an integral part of the production chain for consumer durables.

If the fall in global demand in late 2008 was rapid, the cut in production was even more aggressive as firms sought to reduce inventories. In many countries, these had tended to rise a little going into the crisis. As demand fell away, firms were faced with further increases in stocks of unsold items, at a time when the cost of funding them was moving up. Hence, they sought to get inventories down quickly as part of their strategy of surviving the downturn. To achieve a reduction in inventories, firms must cut production by more than demand, so that the level of production falls below the level of demand for a time. This is indeed what seems to have occurred in many cases.

Once inventories are back under control, production will rise, back up to the level of demand. This is what we seem to be seeing now in some countries, particularly around Asia. Industrial production has risen quite sharply over the past few months, and in some cases has retraced a good deal of the earlier fall.

The clearest signs of growth are in China, where our estimates are that industrial production had recovered all the losses by March. China does not publish quarterly GDP growth rates, but our best estimates are that the March quarter growth rate picked up relative to the weak outcome in the December quarter.

The improvement in conditions in other emerging economies in Asia may be partly related to the pick-up in China. Quite a marked bounce in industrial output has occurred in Korea and Taiwan, and a similar pattern looks to be emerging in several other countries in the region. Even Japan's production now seems to be rising, though from extremely weak levels.

Across the leading industrial economies, the best we can say at present is that while the contraction in overall output in the March quarter was broadly similar to that in the December quarter, recent data suggest that the rate of contraction in the June quarter will be significantly smaller.

Now while the initial pick-up in output is coming from this inventory cycle running its course, that only lifts production to the level of demand, which remains lower than it was before. An ongoing rise in output will depend on demand starting to increase.

Again, the clearest indication of stronger demand is in some of the emerging economies, particularly China. The improvement in China's growth does not seem to be coming from Chinese exports to the developed world, but from stronger demand at home. The reversal of earlier restrictive policies designed to slow the Chinese economy because of inflation concerns, together with a government spending package that by any standards has been very large, have both contributed. To date, the recovery has been led by increased spending on infrastructure. What is not yet clear is the extent to which Chinese private-sector demand is accelerating.

A pick-up in China is relatively beneficial to Australia, as I will discuss in a moment. For the world economy, it will also be beneficial if the emerging world relies more on domestic demand for growth than it has in the past decade. A durable expansion will be one that is more balanced than the last one.

That said, prospects for demand in the developed world obviously remain very important because of the still very large size of those economies. Most observers expect that demand in the United States and Europe (including the United Kingdom) will be quite subdued for a few years.

One might, of course, ask whether the striking speed and simultaneity of the downturn could be seen again in the upswing. The reason people think such an outcome is unlikely is that the loss of wealth during 2008 and the need for private-sector balance sheets to be deleveraged are thought likely to constrain both household demand and the ability of the banking sector to expand credit, for some time.

This is a reasonable reading of the history of most financial crises, and underpins the consensus forecast that global growth, when it resumes, will be pretty modest initially.

Yet the speed and size of the responses to the downturn by policy-makers around the world is just as unprecedented as the speed and size of the downturn itself. If there were an upside surprise on global growth, it would most likely be because the collective effects of all those policy responses turned out to be bigger than expected, perhaps because those expectations were formed by looking at a history where such simultaneous responses rarely occurred.

Having said that, the size of the build-up in government debt in some of the major economies will surely become much more of a constraint on their fiscal room for manoeuvre over the next decade. **Let me be clear that I am not talking about Australia here**; rather, I have in mind countries where public debt could approach 100 per cent of annual GDP over the next few years. It is not that these magnitudes are completely unmanageable, but they will constrain choices to an extent these countries have not been accustomed to for a long time. For example, their capacity to cushion the impact of another downturn, were one to occur in six or seven years' time, would be limited.

The developments in the world economy over the past year have had a significant effect on our economy. One key channel has been the impact on commodity markets, where prices fell sharply in the second half of last year. It has been apparent for some time from developments in markets for coal and iron ore that there would be large downward adjustments to the contract prices for those commodities when they were renegotiated this year. Those falls have now largely been realised, broadly in line with what was expected. Compared with last year, there will be a lot less revenue coming in.

But it is important to remember that commodity prices remain high by historical standards. Even with falls of 45–60 per cent for coal and around 35 per cent for iron ore, the 2009/10 prices are the second highest on record in US dollar terms. Five or six years ago, these sorts of prices would have seemed extraordinary. As the outlook for resources demand becomes clearer, and the uncertainty in financial markets continues to lift, it would not be surprising if plans for new mining projects that are being deferred at present were re-activated at some point, though this, even if it occurred, would presumably take some time to flow through into actual spending.

The volume of Australian exports, moreover, has so far held up remarkably well, especially compared with those of some other countries (Table 1). Even people who were relatively optimistic, as I was, have been a bit surprised by this strength.

**Table 1: Export Growth – Selected Economies**
Volumes, percentage change

| | December quarter 2008 | March quarter 2009 | Six months to March quarter 2009 |
|---|---|---|---|
| Japan | –14.7 | –26.0 | –36.9 |
| Taiwan[a] | –17.3 | –8.4 | –24.2 |
| Singapore[a] | –10.2 | –10.8 | –19.9 |
| Indonesia[a] | –4.7 | –15.6 | –19.6 |
| China[b] | –7.5 | –11.4 | –18.1 |
| Malaysia[a] | –13.6 | –4.5 | –17.5 |
| Hong Kong[a] | –3.3 | –14.6 | –17.4 |
| Thailand[a] | –11.1 | –6.9 | –17.2 |
| Germany | –8.1 | –9.7 | –17.0 |
| United States | –6.5 | –8.1 | –14.1 |
| Canada | –4.8 | –8.7 | –13.0 |
| South Korea[a] | –8.9 | –4.2 | –12.7 |
| India[a] | –10.1 | –2.3 | –12.2 |
| France | –4.6 | –6.0 | –10.3 |
| United Kingdom | –3.9 | –6.1 | –9.8 |
| South Africa | –3.5 | – | – |
| Brazil | –2.9 | – | – |
| **Australia** | **–0.8** | **2.7** | **1.8** |
| *Excluding rural exports* | – 1.3 | 0.9 | –0.4 |

(a) Seasonally adjusted by the RBA
(b) Merchandise only
Sources: CEIC; RBA; Thomson Reuters

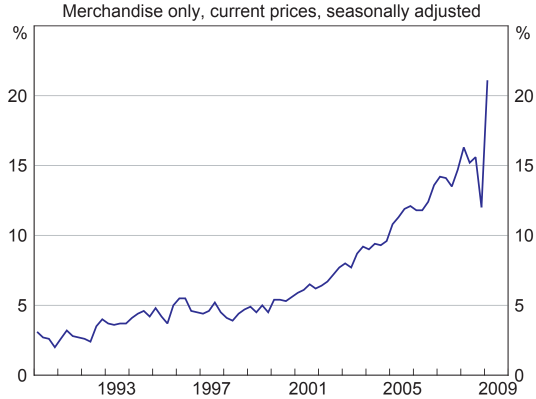
Part of the relative strength may reflect supply-side factors: a larger wheat crop in 2008 and the commencement of operation of an additional LNG compression train have both added to supply.

There are, however, some particularly interesting developments in the pattern of demand for coal and iron ore. A large proportion of Australian iron ore goes to China and very little goes to Europe. Chinese demand has actually increased as infrastructure spending has picked up, whereas in Europe demand has fallen sharply. In the coal market, Australia's exports have traditionally gone to Japan, Korea and Taiwan, where demand has softened. But increased demand in China (which traditionally imported very little coal) has partly offset the falls elsewhere. Indeed, in the past year, China's share of Australia's merchandise exports has risen sharply, and is approaching that of Japan (Graph 3). Part of the increased demand from China can be explained by the construction-intensive activity taking place there, and part by reduced Chinese production of iron ore and coal, as the fall in prices has seen some of the high-cost mines in China being closed. For both iron ore and coal, Australian companies are among the lowest-cost producers and so gain when higher-cost firms exit the scene. Factors such as this have kept Australian exports doing relatively well so far, and would seem to offer significant long-term opportunities, including for this region.

**Graph 3**

**China's Share of Australian Exports**

Merchandise only, current prices, seasonally adjusted




Sources: ABS; RBA

The Australian economy has, nonetheless, been affected by the global recession, with real GDP, on the latest estimates, posting a small net decline over the past couple of quarters. The major driver of the slowdown has been weaker private domestic demand, most prominently a sharp decline in business investment spending, with a fall-off in housing construction. The fall in investment is best seen as the same understandable precautionary behaviour by Australian businesses as displayed by their counterparts around the world. A decline in business investment spending of about 8 to 10 per cent in the December quarter seems to have been a pretty standard result around the world.

Macroeconomic policies have not been able to prevent an economic downturn. They rarely can, especially in the face of a global recession of this magnitude. Indeed, attempts to do so have as often as not run into trouble by stoking up bigger problems a few years down the track. But it is reasonable to think that policies can have the effect of making the downturn shallower than would otherwise have been the case, and that they can help to establish conditions conducive to recovery. The scope to implement such policy changes has to be earned during the expansion phase of the cycle. But Australia did earn that scope, and has been prepared to use it during the last six months.

What has the Reserve Bank been doing?

The Bank made a number of changes to its operations in financial markets to help keep them functioning through the worst of the crisis. Measures the Government took in this sphere were also important for confidence and access to funding.

The Board also moved quickly to ease monetary policy after the events of mid September, with interest rates being reduced significantly. At 3 per cent, the overnight rate is at the lowest level seen since the early 1960s. This has fed through into significant declines in the rates paid by borrowers, especially, but not only, households. The debt-servicing costs of households have fallen faster and further than in previous cyclical episodes.

The Board has not felt the need to cut our policy rate to the very low levels – effectively zero – seen in some other countries. There are two reasons. The first is that the situation we face is not as dire. The second is that the reduction in interest rates we have implemented has had a more direct effect on borrowers than in many other countries.

The combined impact of the easing of fiscal and monetary policy is likely to be substantial. Quantification of the effects is very much a matter of informed judgment. The fact that Australia is experiencing, so far, a smaller downturn than most countries reflects in part the relatively smaller extent of the sort of financial excesses that have been the problem in some other countries, as well as the good fortune of our position in relation to China. But significant macroeconomic policy responses will have also played a role. Fiscal initiatives were not only sizeable by global standards, but implemented quickly. The impact of monetary policy easing in terms of reducing debt-servicing burdens for borrowers has been greater than in the major northern hemisphere countries.

The relevant question now is: what are the prospects for a durable expansion?

It is likely that activity has remained subdued in the June quarter. The rapid decline in business investment is almost certainly continuing. While consumer spending has held up quite well so far, it may be weaker over the next few months, as the one-off government payments pass and rising unemployment starts to weigh on incomes and willingness to spend.

On the other hand, we are likely to see significant growth in public spending over the year ahead, reflecting fiscal policy decisions. Moreover, while it will be a while yet before the effects of lower interest rates and the boost to grants to first-home buyers are seen in data on construction work done, the pick-up in borrowing for housing that we have been seeing for about six months is what would be expected if an upturn in residential investment spending is to begin later in the year.

Overall, then, our expectation remains that the economy will be well placed for expansion towards the end of this year. Initially it will be fairly gradual, in part because of the global factors to which I referred earlier. If so, the degree of spare capacity in the economy will tend to be increasing for a while, and inflation will most likely continue to decline for some time. That in turn means, as the statement following this week's Board meeting indicated, that some scope remains to ease monetary policy further, if that were to be helpful to securing a durable upswing.

The emphasis on 'durable' is important. It is the intention of current monetary policy settings to lower debt-servicing costs, assist efforts to reduce leverage and support demand. It would be counterproductive, though, if further reductions in interest rates induced a large number of marginal borrowers into debts they could service only at unusually low interest rates. This is a reason for care, both by the Reserve Bank and private lenders, and I note that lenders are being a bit more conservative on non-price loan conditions for households.

Picking cyclical turning points is notoriously hard – even in hindsight, let alone ahead of time. But I think Australia is as well positioned as any country, and better than most, to enjoy a new expansion.

Longer term, there also is plenty to be positive about. There are good grounds to think that we can emerge from the current global recession with our economy largely free of the problems in the financial sector, the stresses on public finances and the general disillusionment facing a number of other economies. Keeping to prudent policy frameworks and settings, maintaining flexibility, focusing on productivity and pursuing the opportunities arising from the growing engagement with the Asian region will all be part of a prosperous future.

This part of Australia is as well placed as any to play its part in that future.