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Beyond the Terms of Trade Boom:
Creating a New Narrative for Growth

Beyond the Terms of Trade Boom: Creating a New Narrative for Growth

Introduction

Over the decade to 2011, Australia experienced its longest sustained boom in the terms of trade as commodity prices surged. The mining sector attracted labour and capital from other sectors, while the positive income shock allowed the non-mining economy to benefit through increased spending. The commodity price decline of 37% since September 2011[1], however, has resulted in mining companies cutting capital expenditure, with mining investment peaking at 8% of GDP in 2013 (ABS, 5204.0). As such, the mining sector's demand for labour and capital resources will decline. This will allow the non-mining and trade-exposed sectors to grow faster, as they benefit from improved competitiveness via a lower real exchange rate caused by a falling terms of trade.

In the long run, market forces will transition the economy away from mining led growth, but policy still needs to smooth this process. With the economy entering the third year of sub-trend GDP (RBA Aug-SoMP, 2015), stimulatory economic policy will need to play a greater role to boost growth in the non-mining and trade-exposed sectors. With monetary policy the most accommodative ever, fiscal policy should play a larger role in assisting the medium-term transition process through increased spending on infrastructure. Coupled with structural reform, this will help to create a new 'narrative' for growth, beyond the terms of trade boom.

Mining

The mining sector has responded to sharp declines in commodity prices by reducing investment (RBA Feb-SoMP, 2015, p.14). The latest ABS capital expenditure survey[2] indicates a 19% year on year (herein y/y) fall in capital expenditure (sixth estimate) in 2014/15 followed by a larger 34% y/y decline in 2015/16[3] (second estimate). Looking ahead, it is likely that this trend will continue given RBA forecasts for lower commodity prices (RBA Aug-SoMP, 2015, p.65). In the long run, mining investment is expected to decline to around 2% of nominal GDP (Figure 1). Therefore, mining investment should continue to subtract substantially from domestic demand growth. Increasingly, however, mining will drive GDP through a growth in production. Figure 2 shows the effect of falling mining investment and rising production on real GDP, with recent growth being led by strong net exports, largely due to rises in commodity export volumes.

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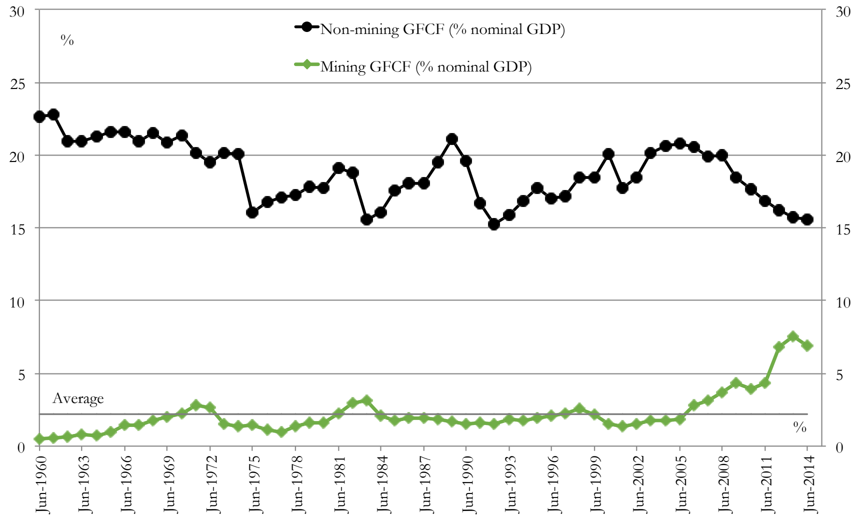
[1] RBA Australian dollar index of commodity prices
[2] ABS (5625.0)
[3] Estimates derived with a five-year realisation ratio (Cassidy, Doherty and Gill, 2012)

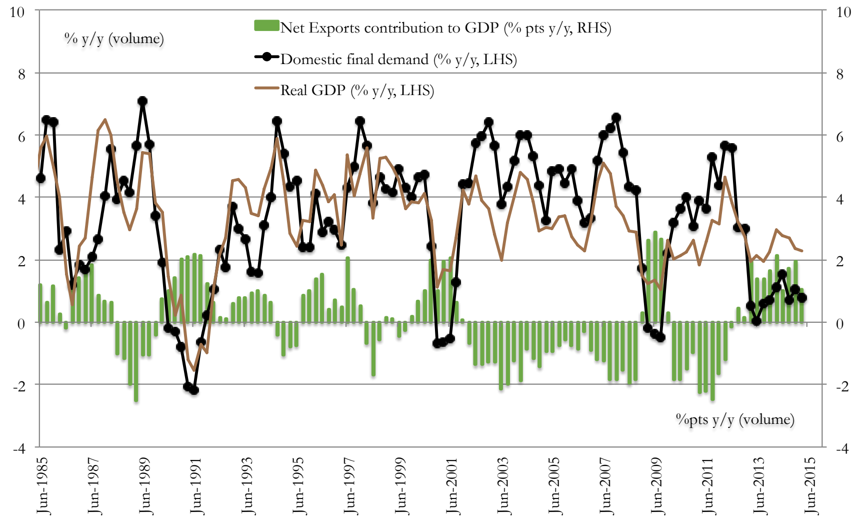
Ahead, growth should continue to shift to stronger export volumes with liquefied natural gas alone expected to contribute ¾%pts y/y in 2016/17 to real GDP (RBA May-SoMP, 2015, p.65).

Figure 1



Source: ABS

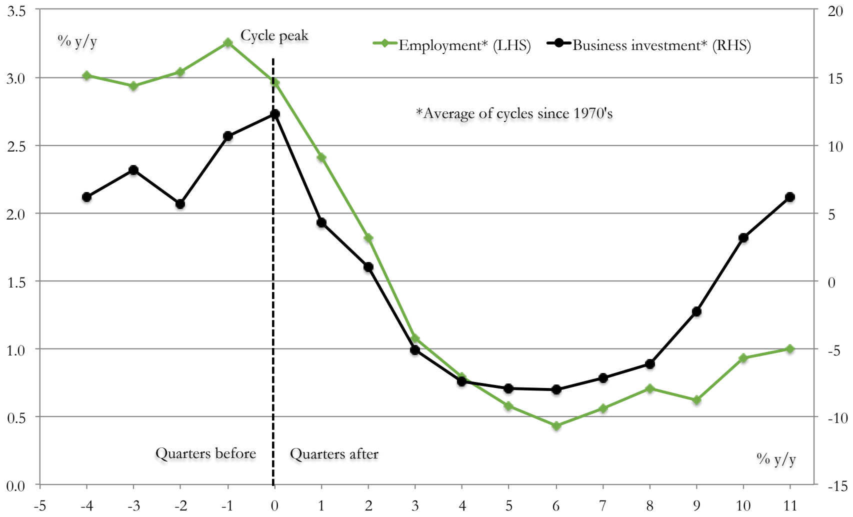
Figure 2



Source: ABS

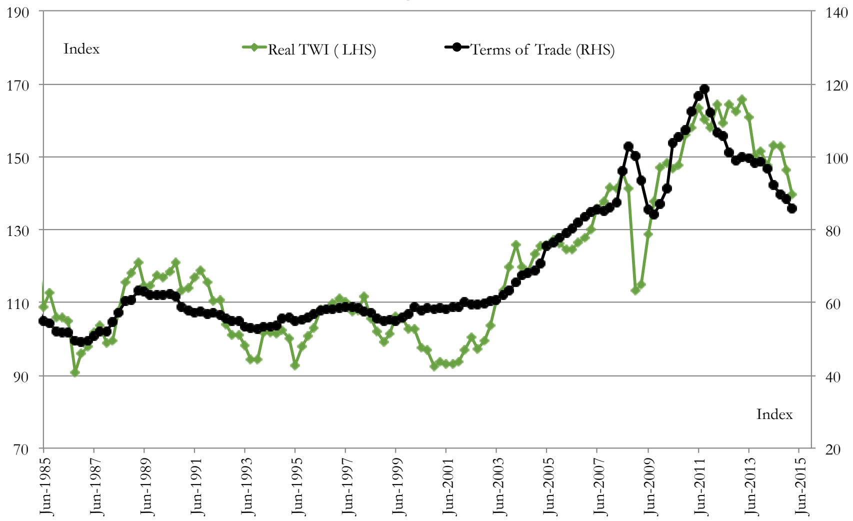
As mining investment is forecast to fall further (RBA Aug-SoMP, 2015, p.67), domestic demand will remain weak. Economic policy therefore needs to encourage investment in the non-mining sector to boost domestic demand. Reducing uncertainty in the growth outlook through sustaining accommodative monetary and fiscal conditions can encourage higher investment. This is because when demand uncertainty increases by one standard deviation, investment drops by 8.4% (Fuss & Vermeulen, 2004). Providing the conditions for growth in non-mining sector investment is important given the high correlation between employment growth and business investment (Figure 3).

Figure 3



Source: ABS

Figure 4



Source: ABS, RBA

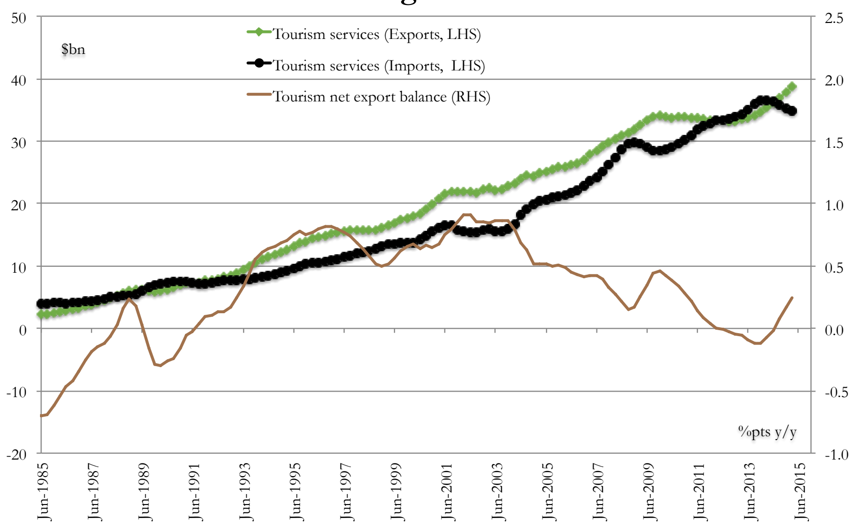
Trade-exposed

As commodity prices decline and the terms of trade falls, the trade-exposed sectors should grow faster as a falling currency, measured by the real TWI (Figure 4), boosts competitiveness[4]. This is because the trade-exposed sector is most affected by the exchange rate (Manalo, Perera & Rees, 2014, p.2). The trade-exposed service sector, for example, has become more competitive due to the falling currency, and as a result, the net export of services contribution to real GDP was almost equal to iron ore in the year to Q1-15 (RBA Aug-SoMP, 2015, p.36). Recent data also show better conditions for tourism, one of the most currency sensitive sectors (Manalo et al, 2014, p.10). The fall in the real TWI allowed the tourism net service balance to add ~¼%pts y/y to nominal GDP in the year to Q1-15. Figure 5 shows that the balance turned positive as the

[4] Albeit historically, the depreciation of the currency has failed to fully insulate the economy from the decline in the terms of trade. (Atkin et al, 2014, p. 59)

falling currency encouraged foreign consumption of domestic services (higher export values) as well as a substitution of consumption by Australians from foreign to domestic services, as shown by the fall in import values (Dobson & Hooper, 2015). The tourism sector shows how a falling currency helps the trade-exposed sector by increasing the competitiveness of exports and encouraging a substitution of consumption.

Figure 5



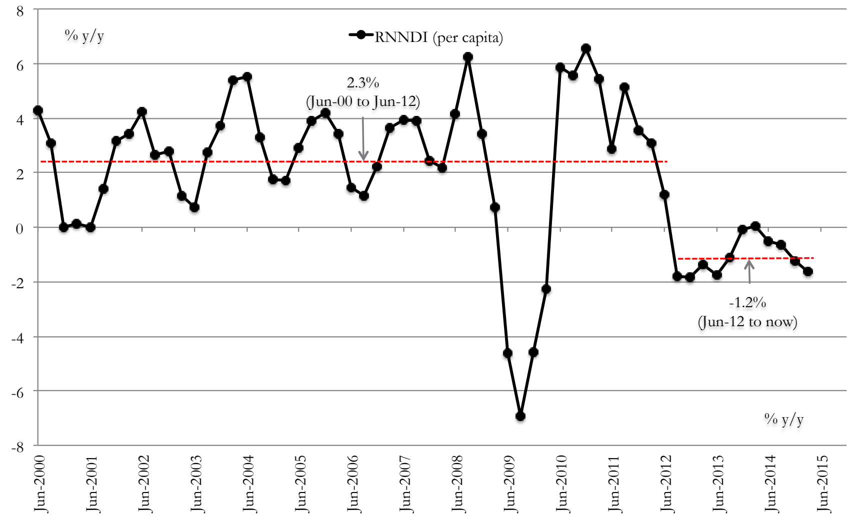
Source: ABS

For economic policy, sustaining a lower real TWI will boost competiveness and encourage a transition of growth towards the trade-exposed sector. This is because a permanent 10% fall in the real exchange rate (beyond the decline expected from a fall in the terms of trade) boosts real GDP by 1% in two to three years, with the trade-exposed mining and manufacturing sectors most positively affected (Kohler, Manalo & Perera, 2014).

<u>Non-mining and economic policy</u>

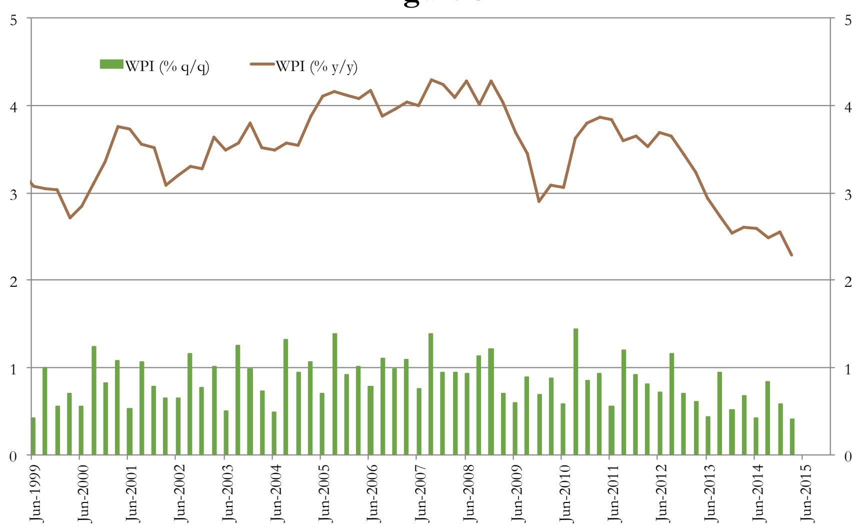
For the non-mining sector, the fall in incomes due to the decline in the terms of trade has major implications. The terms of trade boom boosted real incomes by 13%, with non-mining services, such as education and financial services benefitting through increased spending (Downes et al, 2014, Thompson et al, 2012). However, the fall in the terms of trade has placed pressures on national income, with per capita real net national disposable income (RNNDI) growth averaging -1.2% y/y since June 2012 (Figure 6). This is consistent with soft domestic demand growth and episodes following a terms of trade boom (Atkin et al, 2014, p.60). An extended period of weak domestic demand growth has resulted in wages ex-bonuses growing just 2.3% y/y in Q1-15, an indication of deteriorating labour market conditions (Figure 7). This is negative for consumption given more than 60% of household income is derived from wages (Wilkins, 2014).

Figure 6



Source: ABS

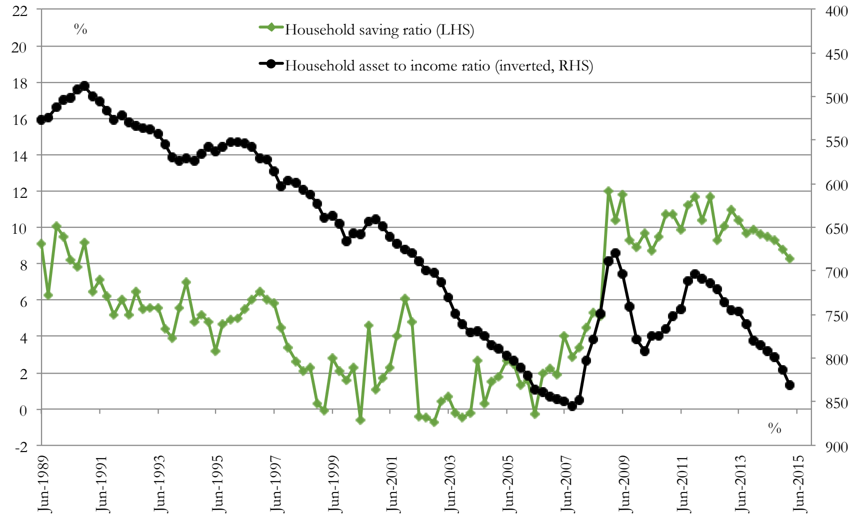
Figure 7



Source: ABS

Soft domestic demand and lower incomes are therefore hindering the economy's transition from mining to non-mining led growth. Economic policy needs to be stimulatory to allow the non-mining sectors of the economy to absorb the labour and capital resources freed by the decline in mining investment. As such, monetary policy needs to remain accommodative. This is because low interest rates stimulate the economy via the transmission mechanism, through effects such as inter-temporal substitution, the wealth effect, the cash-flow channel and the balance sheet channel (Kent, 2015). Indeed, as the household asset to income ratio has widened, the household saving ratio has declined to a post financial crisis low of 8.3% (Figure 8). This has allowed households to keep a moderate pace of consumption despite weak income; evidence the wealth effect is working.

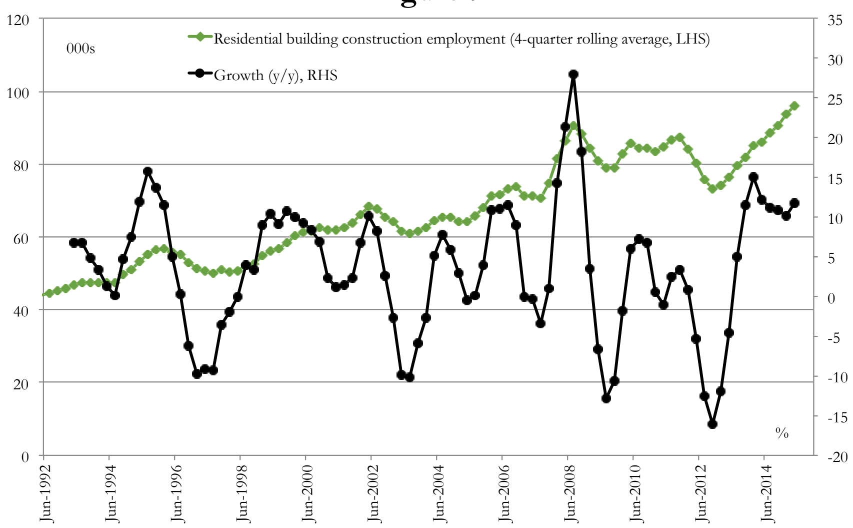
Figure 8



Source: ABS, RBA

Residential building construction is a good example of how monetary policy is assisting the transition process. With the production phase of mining one-third as labour intensive as the investment phase, 40,000 job losses are expected in mining by 2018 (Doyle, 2014). To partially offset this decline in employment, accommodative monetary policy has resulted in the expansion of residential dwelling construction, the most interest rate sensitive sector of the economy (Kent, 2015). Since resource construction workers have experience that is transferable to residential building construction (Doyle, 2014), lower interest rates have allowed labour to shift away from mining to a sector where employment grew over 10% y/y (Figure 9).

Figure 9



Source: ABS

However, stimulatory monetary policy needs to be balanced against excessive financial risk taking. An environment of sustained low interest rates may lead to long-term financial instability with credit driven asset price inflation especially harmful for growth (Mishkin, 2011). As such further cuts to interest rates may not be appropriate unless the economy weakens further (Stevens, 2015b). More importantly, the transition needed in the economy requires growth in non-mining sector business investment. Lower interest rates may not help as the investment decisions of firms are not particularly sensitive to interest rates. This is because firms set high hurdle rates that are not regularly revised and sentiment plays a large role in a firm's decision to invest (Lane & Rosewall, 2015, p.5).

In periods of sub-trend growth, fiscal policy also needs to be expansionary. Yet despite Treasury forecasts for sub-trend GDP growth (Commonwealth of Australia, 2015), fiscal policy is expected to have a contractionary effect ahead. Standard & Poor's (S&P) measure of the budget deficit[5] should improve by 0.5%pts of GDP by 2015-16 (Michaels & Tan, 2015). With S&P's measure of the Government net debt at just 18.3% of GDP in 2014/15, fiscal policy should be loosened through increased public investment to encourage further growth. This is because fiscal policy dampens volatility; thus annual growth could be boosted by up to 0.3%pts with greater fiscal stabilisation (IMF, 2015).

Increased investment in infrastructure should also boost growth as the multiplier effect of Government investment in Australia is 0.9 in the first year and 1.3 in the second year (OECD, 2009, p.138). While it will increase debt and the budget deficit[6], it is sensible to borrow to fund investments that generate a positive return (Stevens, 2015a). More importantly, a sustained period of public investment will assist in the recovery of sentiment. This will help create a new 'narrative' for growth, which will influence the instincts and emotions behind the decisions of people, the spark that reignites the economy's 'animal spirits'.

The long-run transition of the economy, however, will require a combination of accommodative fiscal and monetary policy as well as a renewed emphasis on taxation reform. A shift in the composition of tax in Australia will encourage higher levels of business investment and boost overall GDP growth. For example, a revenue-neutral shift of 1% of tax revenues from income tax to taxes on immovable property would increase GDP by 2.47% (Johansson et al., 2008). A

[5] The budget deficit refers to the General Government sector balance, which includes local, state and Commonwealth Governments.

[6] Capital expenditure beyond depreciation (and changes in inventory and other transactions in non-financial assets) contributes directly to the Government's net lending requirements (AASB 1049).

more comprehensive reform of the taxation system (reduction in corporate tax rate, improved taxation of land, cash flow based tax and better structure of taxes aimed at improving social outcomes) would raise the real wage rate by between 3 to 5% (Commonwealth of Australia, 2010).

Conclusion

Despite experiencing its largest negative income shock in nearly 40 years, Australia is nevertheless expected to enter its 24th consecutive year of GDP growth (RBA Aug-SoMP, 2015, p. 67). As labour and capital resources are freed by declining mining investment, growth should transition to the non-mining and trade-exposed sectors as these benefit from improved competitiveness via a lower real exchange rate caused by a falling terms of trade. Economic policy will still need to play a role in smoothing this transition. With monetary policy already the most accommodative on record, fiscal policy should play a larger role. With Australia's public sector debt amongst the lowest in OECD nations (OECD, 2015, p.59), targeted public investment in infrastructure can easily be funded (Stevens, 2015a). This public investment will assist in the recovery of the economy's 'animal spirits'. Ultimately, sound economic policy combined with a renewed emphasis on taxation reform will help to create a new 'narrative' for growth, beyond the terms of trade boom.

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