Non-technical summary for 'How Do Global Shocks Affect Australia?'

By Patrick Hendy and Benjamin Beckers

What did we set out to do?

Economists tend to believe that small economies that are open to foreign investment and trade such as Australia are affected considerably by economic and financial conditions overseas. Business conditions and demand from consumers overseas matter for Australian exports and the price of our imports. Global investors increase or reduce their investment in Australia depending on the expected returns and perceived risks of Australian investments relative to opportunities overseas. And, in turn, global economic and financial conditions can move the Australian dollar exchange rate, which also affects the price of Australian exports and imports. In addition, over the past 10 years or so, some economists have increasingly argued that international banks can be an important link that transmits global financial conditions across countries by extending or pulling back their lending in countries like Australia depending on changing conditions in key financial markets such as the United States.

However, it is not clear which of these so-called 'channels' matter the most given the structure of the Australian economy and its financial system, and whether there are certain parts of the economy and financial system that are affected more than others by global conditions. Our research seeks to explore these questions, as deeper insights into the extent and mechanisms through which global shocks affect Australia may help policymakers to better understand how to respond to such shocks.

We examine how much of the variation in Australian economic and financial variables – such as economic growth, inflation, the exchange rate and interest rates – can be explained by changes in global economic and financial conditions. The fact that some Australian economic and financial variables are driven to a greater extent by overseas developments rather than domestic developments can tell us something about how global economic and financial movements are likely to affect the Australian economy.

What did we learn?

Our research reveals two key findings:

1. Some Australian economic and financial variables are affected more than others by movements in the global economy and financial markets. In particular, more of the variation in the exchange rate and the cash rate can be explained by global economic movements than is the case for variables like economic growth and inflation. This is consistent with the idea that the exchange rate and the RBA's monetary policy act as 'buffers' – adjusting in such a way that they 'cushion' the domestic economy from changes in global economic or financial conditions.
2. Banking-related Australian financial variables such as deposit and loan volumes and lending spreads respond relatively little to movements in global economic and financial markets. That is, there is no strong evidence that the Australian banking system passes on global economic and financial movements to the Australian economy. We hypothesise that this is because foreign banks make up only a small share of the Australian banking landscape, and Australian banks are relatively domestically focused and are engaged more in traditional activities like home lending, compared with major banks in other jurisdictions like the euro area.

What was our key takeaway?

We find evidence to support the idea that the Australian economy is affected significantly by movements in the global economy and financial system, but that variables such as the exchange rate and cash rate appear to have buffered the domestic economic variables from global shocks to a degree. So far, the Australian banking system has not been a material transmitter of global shocks to the Australian economy.

However, our results need to be interpreted with care. Our analysis is based on the 1990–2019 period, which was a period of relative global macroeconomic stability with few disruptive supply shocks (like after the COVID-19 pandemic) and only one major global financial crisis. It is possible that the kinds of global shocks could change in the future, with more frequent or more severe supply-side shocks such as those originating from geopolitical tensions or climate change. Such shocks could have a greater effect on the domestic economy and the exchange rate or monetary policy may not be able to cushion the economy as effectively.