Economic Conditions and Prospects

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Address to the Regional Business Leaders Forum, University of Southern Queensland and Toowoomba Chamber of Commerce and Industry, Toowoomba, 23 April 2010

Thank you for the invitation to visit Toowoomba.

In my remarks today I would like to provide an update on economic conditions and prospects. This will be from a national perspective, and set in an international context.

In so doing, I am mindful that next week we will receive some important data on prices. We, and everyone else, will have an opportunity to update our thinking on the current and likely future course of inflation. So my remarks today will be subject to that caveat. The Bank will publish a detailed overall analysis of the economy early next month.

The Global Economy

The latter part of 2008 and the first few months of 2009 saw what has come to be regarded as the most serious international recession in decades.

Global growth has since resumed, but with a rather uneven pattern: it is being led, in the first instance, by the emerging world.

It's worth asking why that pattern exists. At least part of the answer lies in the nature of the downturn and in the policy responses to it.

It is frequently claimed that the downturn was the worst since the 1930s. In the financial sectors of some major countries that seems clear, but for economic activity it is actually less clear than you might think. For several important countries individually, the increase in unemployment and loss of real output was certainly equal to those in the most severe post-War recessions, but not significantly greater.

Some respected scholars of US business cycles have suggested recently that it may be a bit soon to judge whether the recent period qualifies for the term 'great recession', at least in the US case. In east Asia, in most cases, the latest episode has turned out to be far *less* traumatic than the 1997–1998 Asian financial crisis.

What *was* striking about the recent downturn was the *simultaneity* of the collapse in demand for durable goods around the world at the end of 2008. Suddenly, everyone, everywhere, felt much more risk averse – understandably so, as they watched governments have to save major financial institutions in a number of countries. This affected consumption and saving decisions, firms' investment plans, hiring intentions and so on.

But equally remarkable was the simultaneity of the policy responses. There was a degree of formal co-ordination – for example, most G10 central banks reduced their interest rates by 50 basis points on 8 October 2008. Beyond that there was a fairly consistent set of responses stemming from a common assessment of the seriousness of the potential threat. So the global downturn *could have been* much worse than it eventually was, but policy-makers everywhere supported financial systems where needed, eased monetary policy and eased fiscal policy, to support demand. The responses, by and large, were quite quick.

In the countries at the centre of the crisis, these policy efforts have borne fruit. But they have been working against the powerful headwinds of private sector deleveraging. Hence in those cases the recovery thus far has been quite hesitant. Economic activity remains well below the peak level seen in 2007 or 2008, and in some of these economies it may not regain that level for another year or two. It is in *this* sense, actually, that the downturn in parts of the advanced world may well turn out to be the most costly in generations: the forecast slowness of the recovery implies a very large cumulative amount of lost income in some cases. In other episodes of serious recession, once conditions for recoveries were in place, they proceeded quite strongly. People are not confident of those sorts of outcomes this time (indeed many forecasters and financial markets will be seriously wrong-footed if a rapid recovery in the crisis-hit countries does occur). Observers in some countries even wonder whether their trend growth rate may have been impaired for a lengthy period by what has occurred.

But most countries did not have a bank solvency crisis. They had an acute *liquidity* crisis for a couple of months in September and October 2008 when the global financial system went into cardiac arrest, but thereafter those problems began to ease – mainly due, it must be said, to actions of governments and central banks in the major countries. Since in most countries banking systems were generally sound, the headwinds have not been blowing as strongly in Asia or Latin America as in some other regions. Accordingly, the policy stimulus applied in these countries appears to have been pretty effective in supporting demand. Once money markets and trade finance began to thaw, recovery proceeded at a very strong clip. In east Asia outside Japan and China, industrial production is now a little above its previous peak. In China, it surpassed the 2008 peak in the middle of last year and kept rising, while in India it never really fell.

Despite the slow growth of Asia's traditional export destinations – North America, Europe and Japan – trade in the region has bounced back remarkably strongly after a precipitous fall in late 2008. A large part of this rebound has been an increase in intra-region exports of final products, particularly to China. This suggests that demand within the region is playing a bigger role in this upswing, though Asian exports to the United States and Europe are recovering too.

Corresponding differences show up in other areas. Inflation in the euro area and United States is still trending downwards, and spare capacity could be expected to dampen price changes for some time yet, though rising commodity prices will work the other way. For much of Asia, on the other hand, the period of disinflation caused by the downturn may be past. Asset values also have moved up most quickly in these countries. Perhaps this is not altogether surprising given that no countries in the region have had seriously impaired banking systems, but most have had very expansionary monetary policy.

Australia and the 'Great Recession'

While several major countries have had one of their most, if not their most, serious recessions in the post-War period, Australia had arguably one of its mildest. We had a relatively sharp but very brief downturn in aggregate demand and economic activity late in 2008, and then returned to a path of expansion during the first half of 2009. As most recently estimated by the ABS, real GDP grew by 2¾ per cent through last year – a bit below average, but much higher than for most other high-income economies. This was supported by monetary and fiscal stimulus, the recovery in Asia, and a sound financial system. The sorts of things that typically accompany downturns – such as higher unemployment, increased loan losses for intermediaries, a fall in asset values – did happen to some extent. But because the downturn was brief, these deteriorations were rather mild, which meant that they did not then become part of a major feedback loop back to aggregate demand and output. That in turn meant that the economy was able to get onto the recovery path more quickly. And so on.

As a result, the rate of unemployment, at about 5¼ per cent, is more than 2 percentage points lower than we forecast a year ago. The level of employment is 3½ per cent, or some 350 000 jobs, higher than we expected a year ago. GDP growth of 2¾ per cent through 2009 compares with our forecast a year ago of –1 per cent. That is, the level of real GDP today is nearly 4 per cent higher than had been anticipated. For 2009 as a whole, we estimate that nominal GDP was about $45 billion higher than our forecast a year ago.

Measures of business confidence and conditions in most of the surveys carried out by private organisations have for some time been at levels that are suggestive of something like average rates of economic growth.

The Reserve Bank is of course aware that the picture is not uniform across every region or industry. Moreover, the upswing is likely to have particular features that mean that differences across sectors and regions may widen. Not everyone will feel its benefits in the same way or to the same extent, though this is true of all economic cycles. But it does not in any way diminish those concerns to say that there has been a good outcome for the national economy in a difficult international environment.

Managing the Upswing

Our task now is one of trying to ensure, so far as we can, that the new economic upswing turns out to be durable and stable. There are many factors about which we can do little. The speed and composition of global economic growth for example, or the behaviour of international financial markets as they grapple with uncertainty and risk – these and other factors may turn out to our benefit or detriment. We cannot change them; we can only try to be alert to them, and maintain some capacity to respond to them.

For the time being, at least, the global economy is growing again. Forecasters expect an outcome something like trend global growth in 2010 and 2011, which is much better than 2009 but not as strong as 2006 or 2007. Those were exceptional years for growth and that pace could not have been sustained for long, even absent the crisis. In the region to which the Australian economy is closely linked, growth has been very strong over the past year. Almost certainly it will need to slow somewhat in the coming year.

Demand for natural resources has returned and prices for those products are rising. We have all read of the recent developments in contract prices for iron ore. As a result of those and other developments, Australia's terms of trade will, it now appears, probably return during 2010 to something pretty close to the 50-year peak seen in 2008. As usual with these things, we cannot know to what extent this change is permanent, as opposed to being a temporary cyclical event. However, the fact that we will have reached that level twice in the space of three years suggests there is something more than just a temporary blip at work.

Financial markets have made a pretty good recovery from their cardiac arrest 18 months ago. Despite large budget deficits in major countries, long-term rates of interest remain remarkably low. Since risk spreads for most borrowers have also declined this means that overall borrowing costs for rated borrowers, corporate and most governments, are low by the standards of the past few decades. This has to be advantageous for well-run companies and countries looking to invest.

Of course, risks to this outlook do remain. In the middle of the crisis, the international focus was on private creditworthiness. Now it is more on sovereign creditworthiness. The euro area is working on a response to the problems of Greece, but we can expect that a focus on sovereign risk will be a feature for some time yet. Periodic surges in concern are likely to be a recurring theme, and not just about the sovereigns themselves but about banks that might have exposures to them. A credible path needs to be outlined for fiscal consolidation and debt stabilisation in the North Atlantic economies over the years ahead. In the meantime, banks in the countries with weak economies are absorbing the normal sorts of losses associated with recessions.

A different challenge for countries in other regions is managing the flows of capital that result from, on the one hand, the very low interest rates in major economies and, on the other, the solid growth performance in Asia and parts of Latin America. Setting monetary policy and managing exchange rates will be no easy task. More countries in the Asian region are starting to change policy settings to be less expansionary: at last count central banks in India, Malaysia, Singapore and China had all begun this process.

Having said all that, what sort of outcome might be expected for the Australian economy?

If the outlook involves a combination of solid-to-strong growth overall among trading partners, a high level of the terms of trade pushing up national income, reasonably confident firms and households and strong population increase, we are not likely to see persistently weak economic growth. This big picture view is why we expect that, short of something serious going wrong in the global economy, Australian growth in 2010 will be a bit faster than in 2009 – at something close to trend. The reason I say 'a bit faster' is that while some factors are building up in an expansionary direction, and might be quite powerful, at the same time the impact of earlier expansionary policy measures is starting to unwind. So what happens to growth depends on the net effect of the two sets of forces.

It is noteworthy that, although measures of consumer and business confidence suggest that people are essentially quite optimistic about the future, a degree of caution still characterises consumer spending decisions. Some areas of retail sales are quite soft. In the period ahead, moreover, we might expect to see households inclined to save a higher share of current income, and perhaps to be more cautious about the amount of debt they take on, than in the preceding upswing. On the whole, taking a longer-term perspective, this is probably not a bad thing.

A similar caution is in evidence, at this stage, in some firms' investment intentions, though overall investment as a share of GDP remained fairly high through the downturn.

But of course there is also a once-in-a-century build-up in resource sector investment, which could see that investment, already high, rise by another 1–2 percentage points of GDP over the next four or five years. There are also high levels of public sector infrastructure investment planned in coming quarters and the housing needs of a rapidly growing population are likely to see demand for new dwellings remain quite strong over time.

So the outlook for demand seems likely to be driven more by investment, both private and public, and less by consumption than in some previous periods. Even before the downturn, the relative share of consumer spending in total demand was tending to diminish and that of investment spending to increase. There will presumably be corresponding shifts in the industry composition and geographical location of output and employment. Such effects could well be seen in and around Toowoomba itself, depending on the outcomes of proposed gas and coal projects in the region. The key will be, and not just in Toowoomba, to retain flexibility in the face of such changes.

Let me now make some observations about inflation and monetary policy. Inflation has fallen from its peak of 5 per cent in 2008. Measured on a CPI basis it fell to about 2 per cent in 2009, but that figure flatters us a bit as it was partly a result of some temporary factors. Underlying inflation ran at around 3¼ per cent for the year, and at an annualised pace of about 2¾ per cent in the second half of the year. Our forecast a few months ago for 2010 was that inflation, measured either in headline or underlying terms, would be in line with our 2–3 per cent target. Next week's figure will provide an insight into how things are tracking relative to that forecast.

A year ago, when we thought we might be going into a significant recession, there seemed to be the possibility that inflation could fall noticeably below the target. That doesn't seem very likely now, though, with a recovering economy, rising raw material prices, the labour market having stabilised and with some firms even beginning to worry again about skill shortages.

Given all of the above, one would not expect the setting of interest rates to be unusually low. If the economy is growing close to trend, and inflation is close to target, one would expect interest rates to be pretty close to average. The Reserve Bank has moved early to raise the cash rate to levels that deliver interest rates for borrowers and depositors more like those that have been the average experience over the past 10 to 12 years. Those interest rates are now pretty close to that average.

These increases have been fairly close together but then so were the preceding reductions. It is important to recall that the cash rate was reduced by 75 or 100 basis points at each meeting of the Board in late 2008 and early 2009, for a total of 375 basis points in five months after the Lehman failure in September. This was the biggest proportional decline in interest rates, delivering the biggest reduction in the debt-servicing burden of the household sector, seen in Australia's modern history. It was an appropriate response to the situation.

These changes were newsworthy, as interest rate changes always are. But as I have said before, while the *changes* in interest rates make the news, it is the *level* of interest rates that matters most for economic behaviour. Eighteen months ago, the Board moved quickly to establish a much lower *level* of interest rates in the face of a serious threat to economic activity. But interest rates couldn't stay at those 'emergency' lows if the threat did not materialise. The aggressive reduction in interest rates needed to be complemented by timely movement in the other direction, once the emergency had passed, to establish a general level of interest rates more in keeping with the better economic outlook. Hence the cash rate has risen by 125 basis points over seven months – which is still only about a third the pace of the earlier declines.

The Board's reasoning for those decisions has been set out in the various statements, minutes and so on. The question of what happens from here, of course, remains an open one, as it always must. The Board's focus will be on doing our part to secure a durable expansion and on achieving the medium-term target for inflation of 2–3 per cent on average.

Conclusion

Australia has survived what some have labelled 'the great recession' in the global economy. So, as it turns out, have a number of countries that are of importance to us in our region. The common ingredient seems to have been reasonably healthy financial systems accompanied by liberal doses of policy stimulus.

Our task, and theirs, is now to manage a new economic upswing. This will be just as challenging, in its own way, as managing the downturn. But it's a challenge plenty of other countries would like to have. ✠