Economic Conditions and Prospects

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Thank you for the invitation to visit Brisbane today and to join with the Economic Society here in Queensland to talk about our economic situation.

It is barely five months since the flooding that inundated parts of Brisbane and had such a tragic impact only a couple of hours west of here in Toowoomba and the Lockyer Valley. It is only four months since Cyclone Yasi wrought havoc on some northern coastal communities and flattened key crops. The people of Brisbane, and of Queensland, have shown their resilience and adaptability in the face of these disasters.

The economic effects of those events, and of the Western Australian cyclones over the summer, have been seen at the national level. Falls in coal and iron ore production more than fully explained the decline in measured economic output in the March quarter, which occurred not because demand slumped but because the economy's capacity to supply output was temporarily curtailed. There was also a sharp rise in some prices, which tends to happen when supply is suddenly disrupted. Bananas are the most celebrated manifestation of this. With 75 per cent of the crop more or less destroyed, and few sources of alternative supply available, prices to the consumer have quadrupled.

The effects of these natural disasters are now gradually abating. Information on coal mining suggests that it is gradually recovering, though more slowly than had been expected initially owing to the difficulties of getting water out of the pits. Iron ore production has fully recovered. The banana plants are regenerating. Most other crops are also getting back to normal supply levels. As this occurs, we should see the impact of these events on prices start to reverse. For Queensland, the scars from last summer's events remain – and always will. The destruction of capital stock is a loss of wealth, but capital can ultimately be rebuilt; lives lost cannot.

But despite the tragedy, Queenslanders are getting on with things.

The broader context in which these events have occurred is well known. The proverbial pet-shop galah can by now recite the facts on Australia's trade with China and our terms of trade, which are at a level not seen in over a century. It was already clear by about 2006 that something quite profound was happening in the continuing rapid growth of China, India and other emerging countries.[1] This upward trajectory continued, and even accelerated in some cases, in the subsequent period. Then the crisis occurred, and the Chinese economy slowed abruptly. But the authorities responded forcefully and China's economy returned to very strong growth quite quickly. And so the trends in place up to the middle of 2008 had resumed within a year.

The rapid growth in Chinese, Indian and other emerging world demand has been stimulating demand in the global economy, despite the weakness in demand from the 'north Atlantic' group of countries. This gives a boost to a country

1 At that time, my predecessor noted that structural factors such as the industrialisation of China had led to 'the largest cumulative increase in our terms of trade since the early 1970s'. See Macfarlane IJ, 'Opening Statement to the House of Representatives Standing Committee on Economics, Finance and Public Administration', Canberra, 17 February 2006. Available at <http://www.rba.gov.au/speeches/2006/sp-gov-170206.html>.

like Australia: our economy's increased exposure to Asia – the part of the world where much of the growth is occurring – plus the high terms of trade make for an expansionary macroeconomic event. At present Australia's terms of trade are about 85 per cent above their 20th century average. The amount of additional income accruing to production in Australia from that is 15 per cent or more of annual GDP. Even allowing for the fact that a substantial fraction of this income accrues to foreign investors that own large stakes in many of Australia's resources companies, this represents a very large boost to national income.

These expansionary forces are at work on an Australian economy that was widely regarded as very fully employed by early 2008, and that experienced only a fairly mild and short downturn thereafter. As of today, measures of capacity utilisation are not as high as at the end of 2007, and unemployment is not as low as it was then. Nonetheless, the degree of slack in the economy overall does not seem large in comparison with the apparent size of the expansion in resources sector income and investment now under way.

With that general outlook, it follows that macroeconomic policies must be configured in the expectation that there will need to be some degree of restraint. Monetary policy has already been exerting some restraint for a while. Looking ahead, our most recent analysis (as published in early May) concluded that the underlying rate of inflation is more likely to rise than fall over the next couple of years. This central expectation – subject to all the usual uncertainties inherent in forecasting – suggests, as we said at the time, that 'further tightening of monetary policy is likely to be required at some point for inflation to remain consistent with the 2–3 per cent medium-term target'. It remains, though, a matter for judgement by the Board as to whether that point has been reached. At its most recent meeting, the Board's view was that it had not been. New information will, as always, be important in our monthly assessments of what monetary policy needs to do. As far as prices are concerned, we will get another comprehensive round of data in late July.

Fiscal policy is also playing a significant role. The 'fiscal impact', calculated as the shift in the Federal budget position from one year to the next, is forecast to be minus 2 per cent of GDP in the 2011/12 fiscal year. A further, though slightly smaller, effect is forecast by the Treasury in the following year.

There remain, of course, differences in economic performance around the country. Given movements in commodity prices over the past year and the stated investment intentions of major resources companies, these differences are more likely to increase than decrease over the coming period. More generally, while everyone understands that there is a 'mining boom', many people would say that they themselves cannot directly feel the effects. We have seen widespread re-emergence of talk of 'two-speed' or 'multi-speed' economies. Within the state of Queensland itself there were differences in performance, even before the floods, let alone after them.

How then do we make sense of these phenomena?

It is a complex story, and I do not wish to make light of any of the legitimate concerns that people have about the differing economic conditions – actual and potential – across regions or industries. But there are three observations worth making.

The first is that the impact of the resources sector expansion does get spread around, in more ways than might immediately be apparent. Obviously mining employs only a small share of the workforce directly – less than 2 per cent. But to produce a dollar of revenue, companies spend about 40 cents on acquiring non-labour intermediate inputs, primarily from the domestic sector. Apart from the direct physical inputs, there are effects on utilities, transport, business services such as engineering, accounting, legal, exploration and other industries. It is noteworthy that a number of these areas are growing quickly at present.

Once the costs of producing the output and other factors – such as taxes – are taken into account, the remaining revenue is distributed to shareholders or retained. While a significant proportion of the earnings distributed goes offshore, local shareholders also benefit. In fact, most of us are shareholders in the mining industry through our superannuation schemes.[2] We don't get this income directly to spend now – it is in our superannuation. Nonetheless, it is genuine income and a genuine increase in wealth.

A good proportion of the earnings retained by companies is used to fund a further build-up of physical investment, which imparts demand to construction and manufacturing. Based on the industry liaison the Bank has done, around half – give or take – of the demand generated by these projects is typically filled locally, though, of course, this amount varies with the nature and details of any specific project.

So there are effects that spill over, even though it is not always easy to spot them. In the end the combination of the resources sector strength and all the other factors at work in the economy has, to date, produced a national rate of unemployment of around 5 per cent, and in Queensland only a bit over 5 per cent. There are regional variations in unemployment rates, but at this point these look comparable to what has been seen at most times in the past 10 years – a period that has seen both lower average unemployment rates and lower variation in unemployment rates than the preceding decade.

Secondly, some of the undoubted differences in performance observable at present look like the inverse of earlier differences. Take housing prices and population growth, which are of course quite closely related. It surely is no coincidence that the two state capitals that have had the clearest evidence of declining house prices over the past couple of years – Brisbane and Perth – are the two that previously had the highest rate of population growth and that have since had the biggest decline in population growth. Moreover, it is hard to avoid the conclusion that changes in relative housing costs between states, while certainly not the only factor at work, have played an important role. Relative costs are affected by interstate population flows, but those costs then in turn have a feed-back effect on population flows. This is particularly so for Queensland.

Historically, Queensland has had faster population growth than the southern states, as it has seen a slightly higher natural increase, a rate of net international migration on par with other states and a very substantial net positive flow of interstate migrants. Net interstate migration to Queensland peaked around 2003 – not long after Sydney dwelling prices had reached a new high relative to other cities. Interstate migration at that time was contributing a full percentage point a year to Queensland's population growth. By 2008 this flow had slowed a bit, but international migration had picked up and Queensland's population growth increased, peaking at nearly 3 per cent. Western Australia's population growth was even higher, peaking at almost 3½ per cent.

Meanwhile, at least up to 2007, people were confident and finance was readily available. Brisbane housing prices, which had been a bit over half of the average level of Sydney and Melbourne prices in 2002, had risen to be almost the same by 2008, which was unusually high.

The rate of interstate migration to Queensland then slowed further, to be at its lowest in at least a decade. The effects of that on state population growth were compounded by a decline in international migration, something seen in all states. At the same time, finance became more difficult to obtain and lenders and borrowers alike became more risk averse. This happened everywhere, but its effects in Queensland seem to have been more pronounced.

2 If the allocation of super funds' equity assets to resources companies is broadly similar to that of the Australian share market, then around 10 per cent – or $130 billion – of Australians' superannuation assets are invested in resources companies. And this 10 per cent has been providing a healthy return; over the past year alone, the average return on resources company stocks has been around 20 per cent.

Since then, Brisbane housing prices have been declining relative to those in the southern capitals and the construction sector here has found it tough going.

So a complex interaction of forces – the commodity price cycle, the financial cycle, population flows, endogenous responses of housing prices that then feed back to population flows and so on – has been occurring. The ebb and flow of these forces has made for differences in performance, first in one direction, then the other.

Thirdly, the industry make-up of our economy is continually changing. While this is often a slow process – almost imperceptible in most years – these shifts have been significant over time. There is little doubt that trade-exposed manufacturing firms not linked to the resources sector are facing tough conditions at present. But many people might be surprised to learn that the peak in manufacturing's share of Australia's GDP was in the late 1950s – more than five decades ago. Its fastest rate of relative decline, so far, was probably in the second half of the 1970s. On the other hand 'business services' – including things such as accountancy, legal and numerous other services – have grown fairly steadily and now are credited with more than twice the share of GDP of manufacturing.[3] Several of these sectors are being boosted by the flow-on effects of the resources boom at present.

As for the mining sector itself, its share of GDP has tended to rise since the late 1960s, having been quite low in the mid 20th century. But in 2010, the mining sector's share of GDP was still only about the same as it was in 1910. It will surely increase noticeably over the next five years, though will remain much smaller than it was in the gold rush era.

3 We define 'business services' as those where the end user is more often a business than a household. The category encompasses the following sectors: Information, Media and Telecommunications; Financial and Insurance Services; Rental, Hiring and Real Estate Services; Professional, Scientific and Technical Services; and Administrative and Support Services.

Again, none of this is to deny that there are differences in performance by industry and region. It is simply to give some perspective on what we see.

The point about long-term shifts reminds us to look beyond the immediate conjuncture, and to think about the magnitude of the event through which we are living. For a good part of the change in our terms of trade is a manifestation of a large and persistent *change in global relative prices*. Let me be clear here: there *is* a cyclical dimension to the China story, and it is important that we remember that. But there is *also a structural* dimension. And the associated change in relative prices constitutes a force for significant structural change in the economy. I think we have all only begun to grasp its implications relatively recently.

For a long time, the world price of foodstuffs and raw materials tended to decline relative to the prices of manufactures, services and assets. But for some years now the prices of things that are grown, dug up or otherwise extracted have been rising relative to those other prices. This is mainly due to trends in global demand. At any point in time for a particular product we can appeal to supply-side issues – a drought, a flood or a mine or well closure, or some geo-political event that is seen as pushing up prices. But stepping back, the main supply problem is really that there has simply been more demand than suppliers were prepared or able to meet at the old prices.

We do not have to look far for the cause: hundreds of millions of people in the emerging world have seen growth in their incomes and associated changes in their living standards, and they want to live much more like we have been living for decades. This means they are moving towards a more energy- and steel-intensive way of life and a more protein-rich diet. That fact is fundamentally changing the shape of the world economy. Even if China's growth rate moderates this year, as it seems to be doing, these structural forces almost certainly will continue.

It is worth noting in this connection that many commentators have for years been calling on policymakers in the emerging world to adopt growth strategies that rely more on domestic demand and less on exports to major countries. This is happening. It carries the implication though that, first, more of the marginal global spending dollar is going to products that are steel-, energy- and protein-intensive for the emerging world's consumers and less on other things like, say, luxury property in western countries.

Secondly, more of the marginal production of the world economy has to be in those raw material-intensive products – and in the raw materials themselves – and less in the production of the other things. Ultimately there will be enough steel, energy, food and so on to meet demand – supply is responding. But considerable adjustment is needed to get there (and Australia is a very prominent part of that adjustment).

The average consumer in an advanced economy is effectively experiencing a decline in purchasing power over food, energy, and raw material-intensive manufactures. Australian consumers face this to some extent as well. Were Australia not a producer of raw materials, we would be experiencing a good deal more of it. In such a world, there would be no resources sector build up. Our currency would be much lower. We would be paying much more for petrol at the pump, for our daily coffee and for a wide range of other consumer products. We would not be holidaying overseas in our current numbers.

We would have more of some other forms of economic activity that we currently have less of – we would, perhaps, be less of a 'multi-speed' economy. But it's unlikely our economy overall would be stronger. As it is, the rate of unemployment has seldom, in the past few decades, been much lower than it has been recently. Moreover, in that alternative world the real income of Australians in aggregate would be a good deal smaller.

But Australia *is* a resource producer, so we have the advantage of being able to take part in the additional supply of things that are in strong demand. This helps our incomes. Mining companies are doing their best to capitalise on the increase in demand, and the effects of this will flow through the economy, but other producers are also enjoying a boost to their income. Rises in the global prices of rural commodities over the past couple of years have been sufficient to deliver higher prices to most farmers despite the appreciation of the Australian dollar.

As consumers, the rise in our currency means that we take some of that higher income in the form of greater command over tradeable goods and services. The foreign exchange market being what it is – namely an asset market – it has looked a long way forward into the resources boom and pushed up the currency quite quickly. This is having significant effects. While consumers do seem to be continuing their more cautious mindset overall, many seem over the past year to have had the confidence to leave the country to experience foreign travel at prices more attractive than any seen for a long time. Australia's tourism sector is feeling the resultant loss of business, particularly in Queensland where the floods also had a separate impact on confidence. That latter effect will pass – Queensland's set of natural endowments that attract tourists remains in place. But the need to adapt to the high exchange rate may continue.

For as well as conveying a rise in purchasing power to consumers, the high exchange rate is exerting a powerful force for structural change. I think we are seeing this in the retail sector. The rapid growth of internet commerce – from a very small base – has been the topic of considerable discussion. This was bound to happen anyway with technology. But with the higher Australian dollar, the component of the retail 'product' that is added in Australia – the local distribution and retailing overheads that are required to provide the retail 'experience' – has become both much more visible, and much higher *relative to* the production cost of the good itself. So the incentive for the consumer to avoid those overhead costs has increased quite noticeably. The retail sector is therefore under pressure to reduce those costs.

These are just some of the structural adjustment forces at work. Of course it is easy to talk about structural change in the abstract. It is another thing to cope with it in practice. There are no magic-pill solutions, nor are there any real alternatives to adjustment. What solutions there are, though, are likely to involve a refocusing on productivity performance after a period in which, at least at a national level, our productivity growth has been disappointing.

Yet, as I have said before, this is a much better problem to have than those we see in many advanced countries. The event to which we have to adjust is inherently income-increasing for Australia. Moreover, we do not carry the legacies of the past several years in our banks' or public-sector balance sheets that are such an impediment in other places.

Conclusion

Queenslanders have shown their resilience and adaptability this year in the face of extraordinary events. People from elsewhere in Australia have nothing but admiration for you.

Resilience and adaptability are among the characteristics we will all need in order to cope with a global environment that is growing more complex rather than less, and that presents both economic challenges and opportunities greater than those we have seen for many years.

The task for the economics profession – all of us here today and in like gatherings and institutions around the country – is to do our part in trying to understand these challenges and opportunities, to explain them to our communities, and to articulate the responses that are most likely to see our country prosper.