THE EVOLVING ECONOMIC OUTLOOK

Address by Dr Malcolm Edey, Assistant Governor (Economic), to the Australian Industry Group Forum Growing Your Business in 2008, Sydney, 5 March 2008.

Thank you to AI Group for the opportunity to speak here today. This is now the fifth time that I've spoken at this event, and it's always a pleasure to do so.

I'm pleased to say that the RBA has enjoyed a very good cooperative relationship with AI Group over a number of years. The information we get from talking to businesses is very important to our work, and we can't do that without the cooperation we receive from groups like yours.

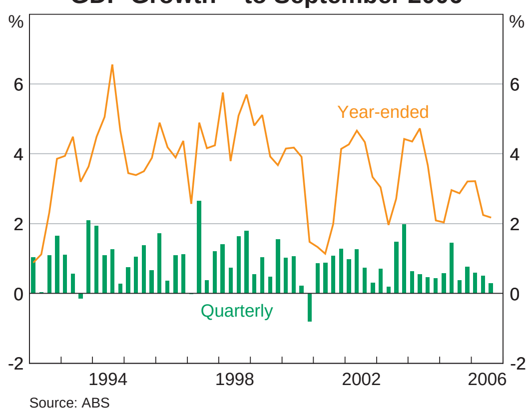
Since I spoke here last year, the economic situation in Australia and abroad has changed quite markedly. The outlook and risks for the global economy have clearly shifted, and so have the prospects for domestic inflation. I want to use my time today to review how these things have evolved over the past year. The main themes are that the past year was a period of higher-than-expected growth, both here and abroad; that domestic inflation picked up; but there are some forces at work that can be expected to put downward pressure on inflation over time.

Let me start with a snapshot of how things looked a year ago.

- The first thing to note is that economic growth in Australia, as estimated by the latest national accounts, looked relatively weak[1] (Graph 1). The latest figures that we had, which were for the September quarter of 2006, showed annual growth of 2.2 per cent. Part of the weakness at that time was the result of drought, but non-farm growth was also below average.
- Growth of domestic demand was estimated at 3.4 per cent, which was broadly in line with trend growth in the economy's productive capacity.
- Labour market conditions were strong. The unemployment rate, which was then at 4½ per cent,

Graph 1

GDP Growth – to September 2006



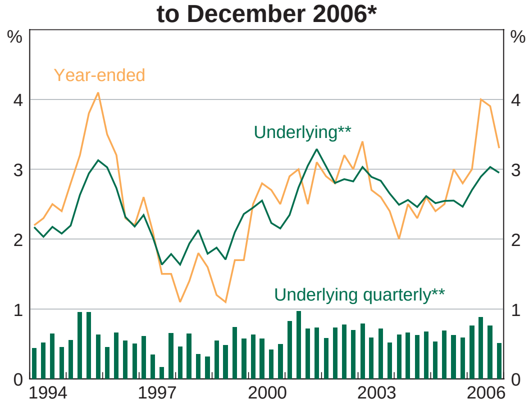
1 *In Graphs 1–4, Table 1 and the first column of Table 2, the data presented are the estimates that were available at the time of publication of the February 2007* Statement on Monetary Policy. *The purpose is to compare the current conjuncture with the position as it was estimated to be a year ago.*

was already well below its previous cyclical low-point. Employment was growing at an annual rate of 2.8 per cent.

- Inflation in Australia was relatively high, though there were some tentative signs that it might be easing (Graph 2). The annual rate of CPI inflation over 2006 was 3.3 per cent, which was down from the banana-related spike earlier in the year. Looking through the volatile price items, estimates of underlying inflation were around 3 per cent. This was still higher than ideal, but as the RBA noted at the time, the quarterly figures had moderated a little. With the economy apparently growing at quite a slow pace, and supply capacity expanding, the RBA forecast was that inflation would ease slightly in annual terms over the next couple of years. But it was still expected to stay in the upper part of the 2–3 per cent target.

Graph 2

Consumer Price Inflation – to December 2006*

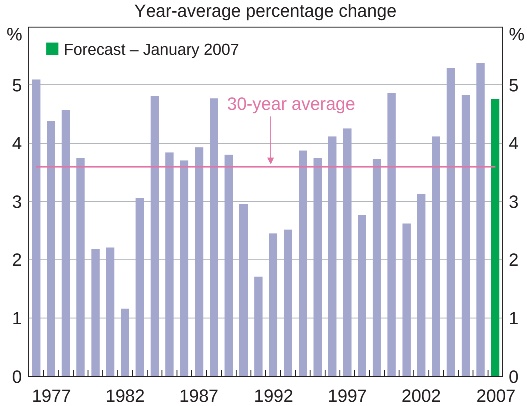


* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
** Average of the trimmed mean and weighted median
Sources: ABS; RBA

Graph 3

World GDP

Year-average percentage change



Sources: Consensus Economics; IMF; RBA

- And finally, global economic conditions were strong (Graph 3). The world economy was estimated to have expanded by 5.4 per cent in the previous year. Expectations for 2007 were that growth would moderate somewhat, but would remain above average. There were some early signs at that stage that strains were emerging in the US sub-prime mortgage market, but the full significance of these events was not yet apparent.

Domestically, the combination of weak GDP and strong employment represented what was referred to as a 'productivity puzzle' (Graph 4). Broadly speaking, with GDP growing at rates not much above 2 per cent, and employment at a similar rate, the estimated growth in GDP per employee was close to zero.[2] Non-farm productivity was actually showing a small negative rate of growth over the two latest years, compared with an average of around 1½ per cent per annum over the decade before that.

In its economic commentaries during this period, the RBA considered a number of possible explanations for the apparent productivity slowdown. One hypothesis was that it was, in part,

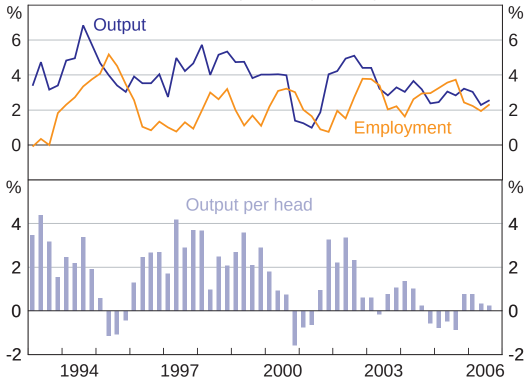
2 *Employment growth over the year to the September quarter 2006 was 2.3 per cent.*

a statistical anomaly. The slow pace of estimated GDP growth seemed at odds with other pieces of information, including strong business surveys and buoyant government revenues. Hence the Bank gave some credence to the view that the economy was actually growing faster than the official estimates recorded. To some extent, that view has been borne out by subsequent upward revisions. Nonetheless, even the revised figures still record that growth was below average through most of 2005 and 2006.

Graph 4

Non-farm Labour Productivity – to September 2006

Year-ended percentage change



Source: ABS

From that starting point a year ago, let me highlight four main developments that have taken place in the period since then.

The first is that economic conditions, both globally and in Australia, proved to be stronger than generally expected.

The observation that 2007 was a stronger-than-expected year for the world economy might seem surprising, given the current focus on the downturn in the United States (which I'll come to in a moment). Nonetheless, in understanding Australia's recent macroeconomic performance, it's important to recognise that international conditions in the past year have, by and large, been favourable to growth in Australia.

Growth of Australia's major trading partners last year was 5.2 per cent, making it the fourth successive year of above-average growth. Whether we use official or private sector forecasts as a benchmark, this outcome was quite a bit stronger than was expected at the start of the year (Table 1). The only significant exception to that was a weakening in the United States, but this

Table 1: GDP Growth in 2007[(a)]

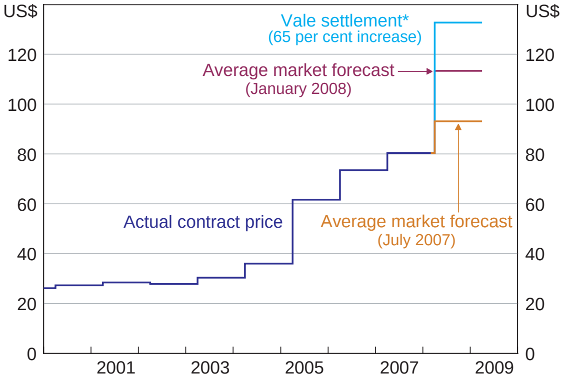
	Forecasts[(b)]		Actual
	IMF	Consensus	
United States	2.9	2.4	2.2
Japan	2.1	1.8	2.1
Euro area	2.0	2.0	2.6
China	10.0	9.6	11.4
Other east Asia	5.0	4.8	5.6
Latin America	4.3	4.5	5.5
Emerging Europe	5.7	5.9	6.8
Australia's major trading partners	**4.2**	**4.1**	**5.2**

(a) Weighted using merchandise export shares
(b) September 2006 *World Economic Outlook* and January 2007 *Consensus Forecasts*
Sources: Consensus Economics; IMF

Graph 5

Iron Ore Contract Prices

US$ per tonne

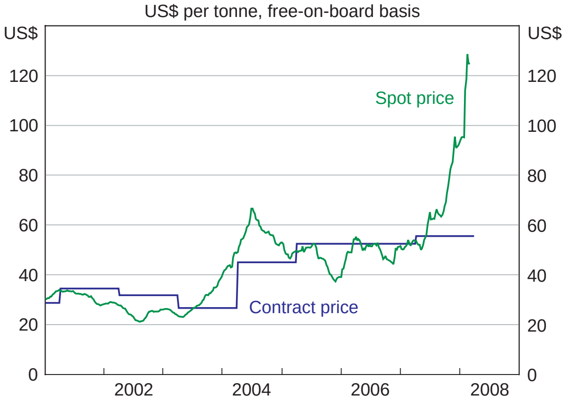


* Iron ore contract price settlement between Vale and Nippon Steel
Sources: Consensus Economics; RBA

Graph 6

Thermal Coal Prices

US$ per tonne, free-on-board basis



Sources: Bloomberg; globalCOAL; RBA

Table 2: Economic Indicators

Year-ended percentage change

	February 2007	February 2008
GDP	2.2	4.3
Domestic final demand	3.4	5.5
Consumption	2.8	4.5
Business investment[(a)]	4.3	10.0
Employment	2.8	2.7

(a) Excluding the effects of transfers between private and other sectors; adjusted for the privatisation of Telstra
Source: ABS

was more than offset by stronger-than-expected growth in China, India and the smaller east Asian economies.

Another aspect to the favourable environment was a further improvement in Australia's terms of trade. Over the year to the September quarter 2007, they rose by 3 per cent, to be up by a cumulative 40 per cent over a four-year period. As I've remarked on other occasions, this has been a major source of stimulus to domestic incomes and spending. Perhaps equally important, prospects for further rises in Australia's export prices have been strengthening. Analysts' forecasts for coal and iron ore prices in the 2008 contract round have been revised up almost continuously over the past year (Graph 5). Spot prices for coal have now risen well above last year's contract prices (Graph 6). Based on these developments, we forecast in our most recent *Statement* that Australia's terms of trade would rise by roughly a further 5 per cent this year. The latest market developments now suggest that this may turn out to be conservative.

Against that background, the Australian economy strengthened quite markedly over the past year. A summary of some key indicators is presented in Table 2.

- The economy over the latest year has grown at a significantly faster pace than a year ago – about 2 percentage points higher.
- Domestic demand similarly grew at a rate that was about 2 percentage points higher than

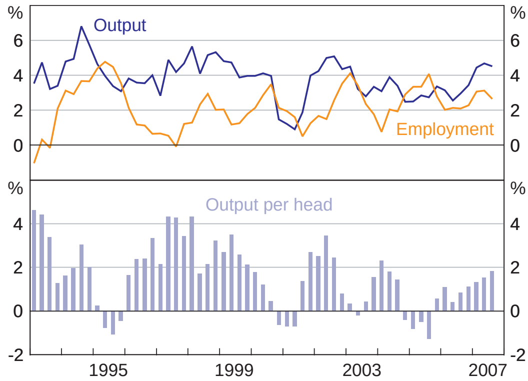
a year earlier, at around 5½ per cent. Both consumer spending and business investment made big contributions to the pick-up in growth.

- With employment still growing at around the same rate as before, this means that productivity growth has now picked up to a more normal pace (Graph 7). Combined with the upward revisions to history, the result is that the productivity slowdown of the past few years looks less severe than it did based on the initially-published estimates. As an aside, given the volatility of these numbers, I wouldn't want to read too much significance into this for the medium-term productivity trend. It's still the case that average productivity growth so far this decade is noticeably below what it was in the second half of the 1990s. The possible reasons for that are a subject for another day. The point I'm making here is that, with the latest set of data, we're now getting a more consistent reading of the overall pace of the economy than we did a year ago.

Graph 7

Non-farm Labour Productivity – Latest

Year-ended percentage change



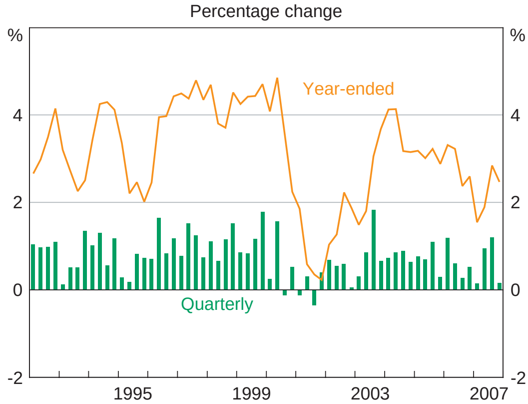
Source: ABS

My second observation is that, although 2007 as a whole was an above-average year for world growth, conditions in the US and the other major industrial economies started to weaken markedly towards the end of the year. In the US, fourth quarter national accounts indicated a sharp slowdown, and most expectations now are for a period of further weakness in the first half of this year (Graph 8). Some observers are saying the US is about to enter a recession, or is already in one.

Graph 8

United States – GDP

Percentage change



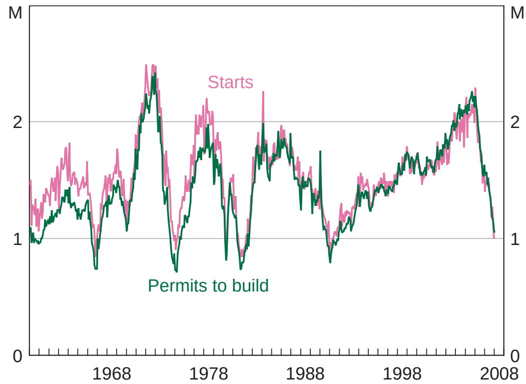
Source: Thomson Financial

The main driver of the US weakness has been a slump in the housing market. Housing starts are down by more than 50 per cent from their peak two years ago (Graph 9). Even though housing is typically only about 5 per cent of the economy, falls of this magnitude are a significant drag on growth because they feed back into employment, incomes and other forms of spending. Adding to the contractionary impact is a downturn in established house prices. According to one major index, these are down about 10 per cent from their peak, and still falling (Graph 10). These forces, and the ongoing fall-out from the sub-prime

Graph 9

United States – Housing Indicators

Annualised rate, monthly

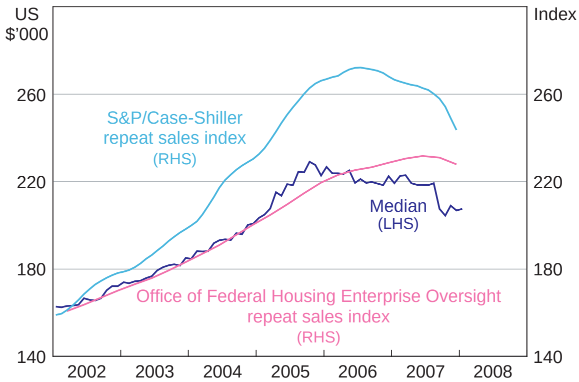


Source: Thomson Financial

Graph 10

United States – House Prices

Levels

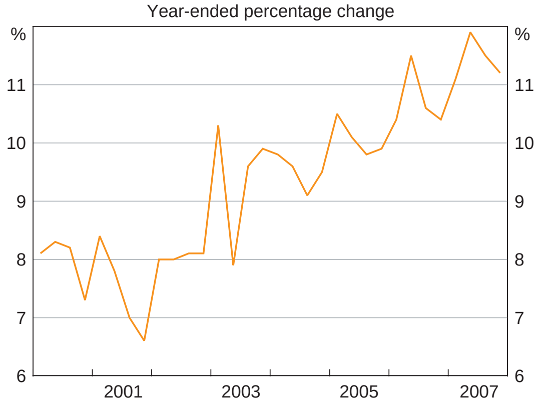


Sources: MacroMarkets LLC; Thomson Financial

Graph 11

China – GDP

Year-ended percentage change



Source: CEIC

crisis, could continue to dampen the US economy for a while yet.

At the same time, it's important to note that there are still forces supporting growth. The US export sector is getting the benefit of a lower dollar; there's a significant fiscal package in the pipeline, which will add more than 1 per cent of GDP to private spending power; and sharp cuts have been made in US official interest rates, with financial markets expecting more to come. The overall course of the US economy will depend on the net impact of all these forces, and this is still hard to predict.

In varying degrees, the other major industrial economies are also experiencing a period of weakness. But up to now, the economies of the Asian region have kept growing strongly. China grew by 11 per cent last year (Graph 11). Elsewhere in east Asia, conditions seem to have remained firm through to the end of the year. Growth in industrial production picked up, as did export growth, probably a result of rising Chinese demand. Overall, the east Asian economies expanded by 6 per cent through to the end of 2007, which was a faster-than-average rate, with no sign that the pace was easing off towards the end of the year (Graph 12).

The extent to which the current weakness in the G7 economies will spread to the Asian region in 2008 is still uncertain. But some dampening impact has to be expected, and this is likely to mean a below-trend rate of expansion in Australia's trading partners in aggregate this year.

The third development I want to highlight is that world financial markets have become much more unsettled in the period since the middle of 2007.

From around that time, the strains that originated in the sub-prime debt market in the US began to spill over to credit markets more widely. Conditions have fluctuated in the period since then, but the general results have been a widening of credit spreads and greater difficulties being faced by private borrowers in accessing capital markets. Money markets have come under strain, and banks have faced higher funding costs.

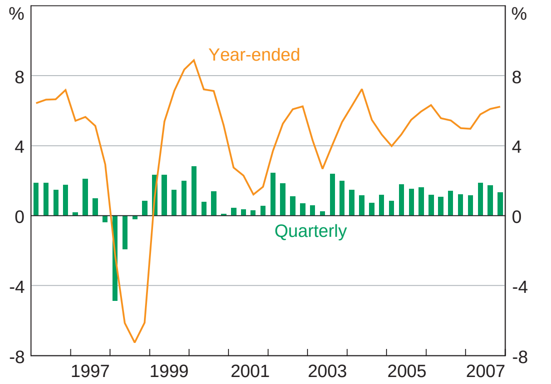
These events, in conjunction with rises in the policy interest rate, have contributed to an appreciable tightening in domestic financial conditions. One gauge of that is the increase in the 90-day bank bill rate. Taking into account yesterday's decision, the cash rate has increased over the past year by 1 percentage point, while the bill rate is up by about 1½ percentage points (Graph 13). Banks have been responding to the higher funding costs by increasing their lending rates. They've also tightened their lending standards to risky borrowers, and that process may have further to go.

Another development in financial markets has been a fall in world equity prices in the past few months (Graph 14). The main drivers of that have been credit write-downs by some major global financial institutions, along with increased concerns about the US and the world

Graph 12

Other East Asia – Real GDP

Percentage change

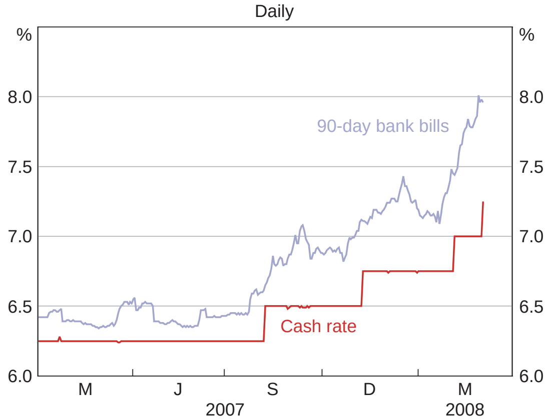


Source: CEIC

Graph 13

Short-term Interest Rates

Daily

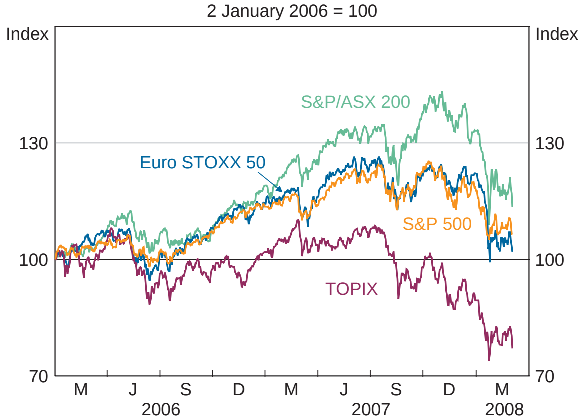


Sources: AFMA; RBA

Graph 14

Share Price Indices

2 January 2006 = 100



Source: Thomson Financial

economic outlook. The major equity markets peaked around October and since then they are mostly down by around 15–20 per cent. This brings them back to around their levels of late 2006. The Australian market, similarly, is back to around its late 2006 level.

Returning to the domestic economy, the fourth development I'll highlight is the rise in inflation pressures.

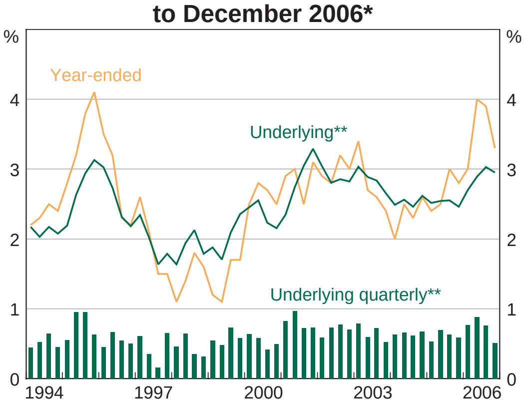
Over the past year, the incoming information on inflation has evolved in two distinct phases. I said earlier that, although inflation was relatively high a year ago, there were some tentative signs that it might be easing off (Graph 15). That made some sense if demand and GDP growth were as soft as reported, although it seemed at odds with other indicators of economic strength. On balance, while there were a range of conflicting signals to take into account, it appeared plausible this time last year that the supply-demand balance in the economy might be improving, and that this was taking some pressure off underlying inflation.

That view seemed to gain support from the March quarter CPI result, which was released in April last year. It showed, as expected, a further sharp fall in the annual headline CPI figure, as the earlier banana-price effects unwound (Graph 16). Underlying measures were also quite low for the second successive quarter. Taking this information into account, the RBA lowered its inflation forecast at the time of its May *Statement*.

But, in contrast to the more favourable indicators that came in during the early part of last year, later information has pointed to stronger inflation pressures (Graph 17). The June, September and December quarter CPI figures were all relatively high in both headline and underlying terms, and these outcomes were taking place against the background of stronger estimates of demand and activity. The December quarter CPI showed a year-ended rate of 3 per cent, with underlying measures on average around 3½ per cent. When

Graph 15

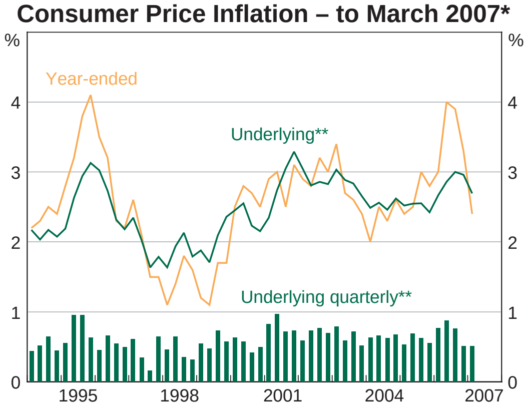
Consumer Price Inflation – to December 2006*



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
** Average of the trimmed mean and weighted median
Sources: ABS; RBA

Graph 16

Consumer Price Inflation – to March 2007*



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
** Average of the trimmed mean and weighted median
Sources: ABS; RBA

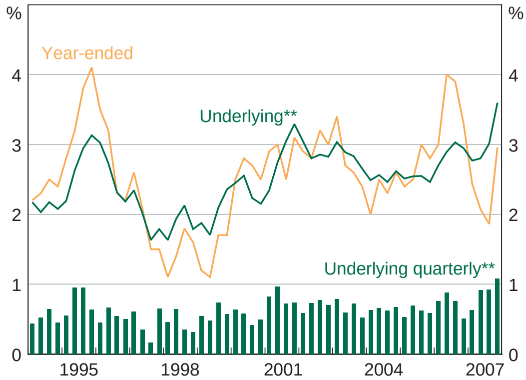
the calculation rolls forward another quarter, these annual figures can be expected to rise further. So inflation in early 2008 is appreciably higher than appeared likely a year ago.

Let me conclude by making a few remarks about the outlook.

In its recent statements, the Bank has made clear that there will need to be a significant slowing in domestic spending if inflation is to be brought back within the 2–3 per cent target over time.

Graph 17

Consumer Price Inflation – Latest*



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

** Average of the trimmed mean and weighted median

Sources: ABS; RBA

The four developments that I've summarised today embody a range of contrasting influences on Australia's economic prospects. Domestic demand last year developed a good deal of momentum, and one of the major drivers of Australia's recent growth – the rising terms of trade – looks set to strengthen further. On the other hand, there are significant dampening forces also at work. These include higher interest rates and tighter lending standards in the domestic economy, as well as the slowdown now underway globally. The recent appreciation of the exchange rate will work in the same direction. Weighing up these factors, the RBA's recently published assessment was that growth of the Australian economy would slow to a below-trend pace this year and next, and that this would contribute to some easing in underlying inflation pressures. Obviously this assessment will need to be further updated to take into account yesterday's policy decision as well as other important pieces of information, including the national accounts due out today.

Given the nature of the forces at work, it's important to note that there are significant uncertainties in both directions. The global economic situation is one important source of uncertainty, as is the situation in world and domestic financial markets. Another is the risk that the recent rise in inflation feeds back into wage and price expectations. All of these will be important areas to watch in the period ahead.

Thank you.