Introduction

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This is the fourth time the Reserve Bank has held a conference to review the Australian economy over the preceding decade. These decadal reviews provide an opportunity to place the events that have shaped the economy in perspective, consider patterns of structural change, and reflect on the persistent themes through the decade and across successive decades. The 2000s were particularly eventful for both the international and Australian economies. There were: two recessions in many countries; the largest international financial crisis since the Great Depression; the ongoing rapid development of Asia; asset booms and busts; and Australia experienced the longest sustained increase in commodity prices and the terms of trade in the nation's history.

The Australian economy entered the 2000s in a healthy state. While the 1990s had its ups and downs, the papers at the Bank's Conference in 2000 provided a generally positive report on the economy. The strong economic growth, decline in unemployment, increase in productivity, and the resilience to the Asian financial crisis were generally attributed to the process of economic reform. Financial market reform was also seen to be having a positive effect on the economy after earlier concerns that it had produced little benefit, and the introduction of inflation targeting in the early 1990s meant that inflation was lower and more stable. The size of the current account deficit also continued to receive attention at the 2000 Conference, although most commentators had generally become more sanguine about the deficit over time.

A decade on, some themes are familiar from previous reviews, but others have changed. The Australian economy once again performed well over the past decade. There was strong employment growth, with the unemployment rate declining further, strong income growth, low inflation and general macroeconomic stability. Many themes in this volume continue those of previous reviews, such as the important role of international shocks, changes in the labour market and the key role of the finance sector. However, one marked difference to the volume reviewing the 1990s is the emphasis now given to the role of China in shaping developments in Australia. Another is the discussion of productivity, with productivity growth in the 2000s significantly below the strong growth in the 1990s that was attributed to economic reforms. The focus on the current account deficit has also lessened with greater recognition that it largely reflects a high investment rate rather than major distortions in the economy.

As noted, international factors have remained important to the Australian economy, but the key drivers have changed. The most significant external influence in the 2000s was the ongoing economic development of Asia. Over the decade, the average growth rate in Asia was faster than expected, but was, in fact, not that different than in the 1990s; average annual growth in China increased only marginally to just over 10 per cent, while growth in India and the rest of Asia increased slightly to be around 7 per cent. Yet this strong and sustained growth, particularly in China and India, which contrasted with the episodes of contraction in many of the advanced countries, saw the share of global output from non-Japan Asia increase from around 10 per cent at the start of the decade to around 17 per cent by the end. Beyond their larger share of global output, China and other Asian nations became more connected and influential in the global economy, as Yiping Huang and Bijun Wang outline in their conference paper. Asian economies became an integral part of supply chains, and in doing so contributed to subdued increases in the prices of manufactured goods around the world. In addition, they became large exporters of capital when the share of their income devoted to domestic investment declined.

Without doubt Asia's largest influence on the Australian economy was the region's growing demand for commodities. Over the century up to the early 2000s, Australia faced a trend decline in the terms of trade as commodity prices fell relative to the price of manufactured goods. From the middle of the 2000s that changed markedly, with the relative price of most commodities increasing, with particularly sharp increases in the prices of iron ore and coal, resulting from Chinese demand for steel. By the end of the decade, China was producing close to half the global output of steel, and coal and iron ore constituted around one-third of the value of Australia's exports, up from one-tenth earlier in the decade.

Ellis Connolly and David Orsmond, in their paper summarising the mining sector's turnaround, highlight the magnitude of the changes that have taken place. Their paper, and the one by Jonathan Kearns and Phil Lowe, draw out some of the broader implications for the Australian economy, including the significant flow-on effects for employment in related industries. The mining boom has also brought about a big increase in investment given the sector is highly capital intensive, with a further substantial increase in investment planned. Another consequence of the rising terms of trade has been that the Australian dollar has appreciated substantially, to 30-year highs. In doing so, it has prompted the reallocation of resources within the economy.

In contrast to the positive external influence from Asia during the 2000s, Australia was subject to significant negative shocks from developed economies, with many of these countries experiencing a recession at each end of the decade. The first of these came with the collapse of the tech bubble. This turned out to be a relatively mild recession, both in depth and breadth, with fewer OECD countries experiencing a decline in economic activity than in the recessions in each of the three preceding decades. Globally, economic growth quickly rebounded with the so-called 'great moderation' continuing to see low macroeconomic volatility.

Financial markets generally also displayed low volatility during these middle years of the decade, and so risk premia on many assets declined. Along with ongoing financial innovation, this set up an environment in which the risks that precipitated the global financial crisis could grow. In the end, it was excesses in the US housing market that triggered the first stages of the financial crisis in money and debt markets in mid 2007. The intricate connections through the financial system, both across countries and within countries, saw those shocks amplified and transmitted to banking systems and equity markets. The intensification of the crisis in September 2008 led to a sharp contraction in economic activity. In contrast to the experience in the early 2000s, the late 2000s recession was widespread and deep and has consequently been termed the 'great recession'.[1] In their paper at the Conference, Tamim Bayoumi and Trung Bui consider how the shocks were

1 For example, only two OECD countries, Australia and Poland, avoided a sustained contraction in GDP with year-ended GDP growth turning negative in all others. Further, G7 GDP fell by almost 6 per cent and global GDP fell whereas it had not in previous recessions.

transmitted across countries during the late 2000s and conclude that financial links played a much larger role than trade links. In her discussion, however, Kathryn Dominguez highlights the collapse in trade of durable goods as an important propagation mechanism during the crisis.

The global financial crisis had a direct effect on the real Australian economy through the downturn in international economic activity, although the impact was smaller than in most other countries. A number of factors contributed to this, including the substantial fiscal and monetary stimulus, the strength of the Chinese economy and the rebound in commodity prices, the flexibility of the Australian economy and in particular the exchange rate, and the strong financial system.

There were a number of possible explanations for the good performance of the financial sector canvassed during the Conference. The quality and attentiveness of financial regulation and supervision in Australia was seen to have been important, along with the lessons learned from earlier financial shocks (notably the failure of insurer HIH in 2001 and the banking difficulties in the early 1990s). This contributed to the Australian banks' healthy balance sheets heading into the crisis. The very limited holdings of risky securities was also influenced by the profitable lending opportunities in the domestic market, and banks' marginal source of funding being wholesale markets, so providing a disincentive to invest in newly developed, highly structured securities. Notwithstanding the solid position of the sector, and in particular the core financial institutions, some small financial firms failed, while some markets were particularly affected, such as the virtual cessation of the issuance of securitised assets, as Kevin Davis describes in his paper. The supporting role that policy played was also no doubt important. The government guarantee arrangements for deposits and banks' wholesale funding, which were introduced after other countries offered guarantees, and the Reserve Bank's enhanced provision of liquidity were both important to the good outcome for the financial sector.

The boom in the housing sector in the early part of the 2000s was another important development in the decade. During the first four years of the 2000s dwelling prices increased by around 70 per cent while housing credit increased by over 90 per cent. Through this period policy-makers, including the Reserve Bank, expressed concern about elements of excess in the housing market. From 2004, house price growth abated, with little net change in prices relative to income over the remainder of the decade, while credit growth gradually slowed.

The rapid growth in house prices brought housing affordability to the fore as a substantial social and policy issue, as Judith Yates emphasises in her paper. The increase in the availability of credit, and the reduction in nominal interest rates which eased initial payment burdens, were recognised as significant factors in increasing housing demand and prices in the late 1990s and early 2000s. However, there were concerns expressed during the Conference that housing supply in the latter part of the 2000s was not sufficiently responsive given prices remained high by many metrics and, if anything, the growth of supply had slowed relative to estimates of underlying demand.

As in the two previous review conferences, the labour market remained a central theme. The labour market paper at the 1990 Conference described a centralised labour market under the 'Accord'. This contrasted starkly with the paper a decade later that reviewed the move to a more flexible labour market. Further changes in labour market regulation in the past decade are discussed by Jeff Borland at this Conference. Overall, the performance of the labour market was very positive in the 2000s. The unemployment rate averaged 5½ per cent and fell as low as 4 per cent, both outcomes not experienced since the 1970s.

The strong growth in employment was widespread with participation rates for most segments of the labour force, and the employment-to-population ratio, increasing. One notable change in the economy, as Judith Sloan notes in her comments, was that the adjustment in the two downturns in the decade largely came through a reduction in average hours per worker, rather than a decline in the number of employed persons as in previous decades. This meant that the costs of the downturns were more evenly spread across the workforce, which is a beneficial form of risk sharing.

While average employment growth was stronger in the 2000s than in the 1990s, growth in output slowed, with the implication being that measured labour productivity growth also slowed from the strong growth in the 1990s. Once the capital deepening from strong investment during the 2000s is taken into account, the level of multifactor productivity is estimated to have been broadly unchanged over the decade. Several papers and discussions touch on this weak performance of productivity, and in his paper providing a thorough review of the topic, Saul Eslake discusses several possible explanations. Sharp declines in productivity were recorded in the mining and utilities sectors, at least in part reflecting special factors. In mining, the increase in investment – much of which is yet to be fully operational – and the extraction of lower-quality deposits which are profitable at high prices, contributed to the decline. In utilities, the increase in investment to enhance the reliability of provision (such as desalination plants for supplying water during droughts and greater peak-load capacity in electricity distribution) was thought to have contributed to weak productivity. Generally benign economic conditions were also conjectured to have reduced the incentive for firms to innovate and improve their efficiency. The strong growth in employment also brought into the workforce people who, at least initially, had relatively low productivity. However, in his comments, John Quiggin argues that the decline in productivity was illusory, reflecting lower work intensity, just as he had argued that the increase in productivity in the 1990s reflected increased work intensity. Overall, the magnitude of the decline in productivity growth remained a puzzle, and there was a general sense that it added to the impetus for further reforms to promote competition and innovation.

Many of the central themes in the assessment of the Australian economy over the past decade will likely be relevant in the 2010s, but new themes are also likely to arise. No doubt international economic conditions will continue to be an important driver of the domestic economy. Indeed, at the Conference it was international shocks that were seen to pose the major risks for the Australian economy. The need for fiscal consolidation in the North Atlantic economies presents a significant challenge for these countries and the global economy. Further, Australia's trading relationships have become more concentrated, both in terms of trading partners (with Asia) and exports (key commodities). While this connection to a region with high potential growth and a need for natural resources brings many opportunities, it also poses challenges. Over the next decade, Asia will undergo structural change as it adjusts to being a larger share of the global economy, individuals become more affluent, and its financial sector and other markets become more developed. Past experience in other countries suggests such structural change does not always occur smoothly.

Commodity prices will again be a key factor in shaping the Australian economy over the next decade, and at the Conference there were a range of opinions about the prospects for commodity prices. Most participants agreed that Asia would continue to grow strongly, even if this growth may temporarily be disrupted by an external crisis or even one generated in the region. However, there was more uncertainty as to what Asian growth would mean for commodity prices. One view had it that with large numbers of people in Asia yet to experience substantial economic development, the demand for commodities could continue to record strong growth. Alternatively, there was conjecture that the large resource investments would result in a significant increase in supply, just as the growth in commodity demand slows with more moderate – and less resource-intensive – growth in Asia. A sharp decline in relative commodity prices would be a significant shock for the Australian economy, reducing incomes and budget revenue as Chris Richardson notes. The larger share of mining in the economy may also contribute to greater volatility in economic growth, and the Government's fiscal position, due to the greater cyclicality of demand for resources and the slower response of supply than in other industries. One response to the uncertainty over future commodity prices is to have higher saving to smooth the economic impact of possible future price declines.

Productivity growth was once again an important focus at the Conference. In 2000 the focus was the significant increase in productivity growth, while at this Conference it was an attempt to explain the slowdown. One thing is clear, if the standard of living is to continue to increase as it has in previous decades, a pick-up in the rate of productivity growth will be required over the years ahead.

An enduring theme at these decadal review conferences has been the benefits of flexibility in the Australian economy. Flexibility, including the floating exchange rate and adjustment of average hours worked, has made the economy more resilient to shocks over the past two decades. Given the uncertainty facing the global economy, this flexibility will again be an important aspect of the Australian economy's ability to prosper over the decade. In introducing the volume for the Conference in 2000, David Gruen noted that the economic landscape had changed considerably over the previous decade. That would seem no less true over the past decade. The only constant, it would seem, is change.