Economic Conditions and Prospects

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Thank you for the invitation to join this conference here in Hong Kong.

Asia remains one of those parts of the world where prospects for growth are exciting, and where people expect – for good reason – the future to be better than the past. Yet for the past six months or more, global attention has been riveted on the 'old world' – continental Europe – where many have feared the best was in the past.

The Reserve Bank of Australia has taken a very close interest in the events in Europe. At the purely analytical level, the sheer magnitude and complexity of the problems that have arisen will be a fertile area of study for students of economics and other disciplines for decades to come.

Of course the adoption of the euro was not solely, maybe not even primarily, an economic decision, but it nonetheless had economic consequences. In several very important respects the euro area's first decade was a remarkable success. But there were important structural stresses underneath and some of these have suddenly become more visible in the past few years. Now the euro's future depends on whether the commitment of the Europeans extends to building more of the economic substructure consistent with the single currency, which will entail both fiscal and supply-side reforms. It is of course quite difficult to lay foundations when the house has already been erected on the site, but that is the job ahead in Europe.

I think the evidence is that European policymakers understand the importance of their response and are going to great lengths to implement it. Progress has been made. But there is a long way to go yet. During that long journey, there will surely be numerous episodes of heightened anxiety, any one of which could erupt into a more extreme crisis if one or more of the key actors makes a serious mistake.

In terms of the practical impact of these events, at present we can say that the euro area has been in recession for some months. Some individual countries have been in a deep downturn for much longer than that, but I am speaking here of the euro area in aggregate. The recession is expected by official forecasters in Europe, and bodies like the International Monetary Fund, to be a relatively mild one, though all would acknowledge that it is impossible to be sure, as is usually the case with such episodes.

We see three potential channels of effects from these events to Australia.

The first is a direct trade link. Australia's exports of goods and services to Europe are actually quite modest (Table 1). By far the biggest trade relationships these days are with Asia. Hence, a bigger impact of the euro crisis on Australia would come indirectly via trade with Asia.

It is pretty clear that growth across much of East Asia moderated in 2011 and that there has been some effect of the slower euro area economy on Asian exports.

There have been other forces at work too – the Japanese tsunami a year ago had significant effects on production chains around Asia. These effects had

Table 1: Australian Exports of Goods and Services by Destination
2010

	Value US$ billion	Share Per cent
East Asia (excl China and Japan)[(a)]	61	23
China	59	23
Japan	42	16
European Union[(b)]	25	10
India	18	7
United States	13	5
New Zealand	10	4
Other	32	12

(a) Includes ASEAN member nations, Hong Kong, Korea and Taiwan
(b) EU 27 including the United Kingdom
Sources: ABS; RBA

probably not completely disappeared when the floods in Thailand had another significant impact, which may still be affecting the data. So detecting the effects of weaker European growth against the backdrop of the supply disturbances to trade patterns following these natural disasters might be a little like trying to pick up one conversation in a crowded room: there's a lot of background noise.

But most of the high-frequency data on trade and production did not seem to show the slowing intensifying as we went into 2012. It is too early yet to say that a new strengthening is under way. But we do not seem to be seeing the signs of a rapid fall in trade that we saw in late 2008.

A reference to 2008 brings me to the third channel through which we think about the effects of the European crisis. And it is perhaps the most unpredictable and potentially most damaging kind: the financial link. It would not be the direct exposures of Australian institutions to the most troubled countries of Europe that would be of concern, because those are quite small. It would be the more general impact on global markets of a European problem. What we saw in late 2008 was effectively a closure of funding markets for financial institutions for a period, after the failure of Lehman Brothers. These sorts of events affect virtually all countries, because the impacts on credit conditions, trade finance, share prices, and household and business confidence – all of which lead to precautionary behaviour – occur almost instantaneously everywhere.

There was a period late in 2011 where there was a genuine fear that this could happen again. Funding markets tightened up and effectively closed for many European banks. Interbank activity more or less ceased in Europe. The cocktail of sovereign credit concerns, large bank exposures to those sovereigns, possible bank capital shortfalls and prospective large debt rollover needs of banks, not to mention the unpredictable dynamics of the Greek workout, had everyone very much on edge. The effects were felt globally. The actions of the European Central Bank have alleviated the immediate funding issues for banks. Tensions eased a good deal, and this has been reflected in reopened term markets, falls in sovereign spreads for countries like Italy and Spain, and a rise in equity prices. We have also heard reports that some European participants in trade finance in Asia that had been pulling back in the last quarter of 2011 have begun to seek some business again recently.

Yet much more needs to be done to put sovereigns and banks onto a sound footing longer term. Interbank activity remains constrained and

unsecured funding remains expensive for banks. It is noteworthy that large corporates can borrow more cheaply than can banks with higher credit ratings, such is the odium investors attach to banks (though this is not confined to Europe). Much also has to be done on the supply side to generate growth in Europe, for without growth the fiscal arithmetic will always be challenging, if not impossible. The road to sustainability on these multiple fronts is a long one, which is why, as I say, there will be more periods of anxiety in the months (and years) ahead.

While everyone has been fixated on Europe, the United States economy has avoided a 'double dip' recession, and continues grinding out a modest expansion. In recent times, the pace of jobs growth in the United States has picked up and other labour market indicators are showing signs of improvement.

The United States has its own challenges of course, not least that it must sooner or later have some fiscal consolidation and that may slow growth. America's inherent dynamism and capacity to innovate, however, which is matched by few other societies, has to be seen as a positive over the longer term.

Then there is China. The slowdown in Chinese growth – from 10 per cent to a mere 8 per cent! – is a major talking point, and some see it as portending a major crash. But some slowing was required to reduce inflation and, therefore, put growth on a more sustainable path. One can certainly think of ways in which China could have a 'hard landing' at some point. It is very difficult for anyone to know (doubly difficult, I think, if trying to know while sitting in a trading room in New York or London). But if the Chinese economy does slow 'too much', one could expect that the Chinese authorities will have both the will and the capacity to respond, the more so now that inflation has moderated.

China will have cycles like other economies, but it seems likely that the Chinese economy will grow pretty strongly *on average* for a while yet. It will be a very large economy. Even at the new growth target of 7½ per cent, a lower target than in the past five years (all of which were, of course, exceeded), Chinese GDP will equal that of the United States, in purchasing power parity terms, in about a decade. It will exceed that of the euro area within the next few years.

There are issues of rebalancing the sources of growth in Asia, to which I shall return shortly. But the main point for now is that the global economy is faced at present with a year of sub-trend growth in 2012, according to international forecasters. This is a subdued but not disastrous outcome. And Asia in particular is well-placed to do fairly well, given sensible policies. Downside risks certainly do remain, and are easier at this point to imagine than upside ones. At this point though they remain risks, rather than outcomes.

What then about Australia? At the moment, the viewpoints of those inside Australia differ somewhat from those of people outside Australia.

Viewed from abroad, judging by what people say, observers see an economy that experienced only a relatively mild downturn in 2008–2009, that made up the decline in output within a few months, and that has continued to expand, albeit at only moderate pace, since then. They see an economy that has not experienced a significant recession for 20 years, that has strong banks and little government debt – and that debt remains AAA rated. Some observers worry about high levels of housing prices and household debt. This is understandable given the problems that have occurred in some other countries. But then others point out that the arrears rate on mortgages, at 60 basis points, is quite low, and that the rate of new construction of dwellings in recent years has been low relative to population needs.

Foreign investors see a country that remains quite open to them, and that, reflecting its economic circumstances, offers rates of return that are high by international standards, even though they are low by Australian historical standards. They understand the potential returns on the mineral and energy wealth stored in or around the Australian continent, and

that our terms of trade have over the past year been higher than at any time for more than a century. There has been increased appetite for Australian dollar-denominated assets, particularly sovereign debt, and the Australian dollar has risen strongly, to be at its highest level in three decades.

Those at home see this as well. As consumers, they have responded to the higher exchange rate with record levels of international travel. As producers, however, they also see, with increasing clarity, that the rise in the relative price of natural resources amounts to a global and epochal shift, which carries important implications for economic structure in Australia, as it does everywhere else. Some sectors of the economy will grow in importance as they invest and employ to take advantage of higher prices. Other sectors will get relatively smaller, particularly in the traded sector, as they face relatively lower prices for their products and competition for inputs from the stronger sectors. The exchange rate response to this shift in fundamentals is sending very clearly the signal to shift the industry mix, though this would occur at any exchange rate. The shift in relative prices is a shift in global prices that is more or less invariant to the level of the Australian dollar.

In other words, while the global shift in relative prices is income-enhancing for Australians overall, it is also structural change-inducing. A former leader once quipped that 'microeconomic reform' was such a common topic in Australian discussion that even the parrots in pet shops were talking about it. I think the same is increasingly true of structural change: it is a term that will be on everyone's lips over the next few years.

Structural adaptation is hard work. Few volunteer for it. But we have little choice but to do it, not just to make the most of the new opportunities that have been presented, but to respond to the changed circumstances that some industries face as a result. In this sense, Australia, though blessed with many natural endowments, is in the same position as most other nations. We have to adapt to changing times. This perhaps helps to explain the sense of concern in some parts of the Australian community and the tendency to focus on the difficulties, rather than the opportunities, which come with our situation.

This difference in perceptions between foreigners and locals is quite unusual. For most of my career, the difference has tended to be in the opposite direction. We always seemed to struggle to get foreign observers and investors to give us credit for performance we thought was pretty reasonable. And it is only little more than a decade ago that Australia was being described as an 'old economy'. Now perceptions have changed, at least in a relative sense.

The shift in global portfolio allocation that seems to be associated with this is potentially very important. In a more risk-averse world, the supply of genuinely low-risk assets seems smaller. Countries that have offered a reasonably stable economic environment and relatively sound public finances – of which Australia is one – are attracting greater flows of official capital now than they did a decade ago. This has recently been adding to the upward pressure on the exchange rate, independently of the rise in the terms of trade.

As is so often the case in economics, there are two sides to this. On the one hand, the additional rise in the exchange rate pushes our cost structure in the tradable sectors of the economy up relative to other countries. This is a contractionary force and adds further to the already considerable pressure for structural change.

On the other hand, it amounts to a reduction in the cost of international capital for Australian borrowers, particularly government borrowers. At the margin, this has to make the task of ensuring fiscal soundness a little easier. Even for private borrowers the unusually low level of long-term rates for the official sector offsets a good deal of the widening in spreads due to perceptions of higher private credit risk (that being, of course, a global phenomenon).

A greater flow of cheaper capital to a country is an advantage. It is important, of course, that it is

used wisely. When risk appetite is strong, and risk assessment by lenders too loose, such conditions can result in problems. For example, it has been argued that the flow of capital to the United States looking for low-risk assets was channelled by the US financial system into structured products that had the illusion of high quality, but which ultimately resulted in the subprime mortgage crisis.

At this point, however, we do not seem to have that problem in Australia. If anything, households, businesses and governments are looking, to varying degrees, to reduce their debt. The financial sector is quite risk averse in its lending practices, particularly towards some of the business sectors that might be willing to take on additional debt. In such circumstances, the competitiveness-dampening effect of the higher exchange rate on the traded sector that results from the portfolio shifts may, for some period of time, outweigh the expansionary effect of a lower cost of capital.

The economic background to this shift is an economy where a range of indicators had been tending to suggest that growth was running close to average. Key business surveys, for example, have suggested average performance compared with the past 20 years; the rate of unemployment has been little changed at what remains, by the standards of the past three decades at least, a reasonably low level. On the other hand, recent national accounts data suggest growth in the non-farm economy somewhat below trend over 2011.

Overall, recent economic performance in Australia is not too bad, particularly when compared, over a run of years, with a number of other advanced economies.

But neither is it so good that it cannot be improved. The full range of policies – macroeconomic and structural – need to play their part in seeking that improvement.

Monetary policy can play a role in supporting demand, to the extent that inflation performance provides scope to do so. But monetary policy cannot raise the economy's trend rate of growth. That lies in the realm of productivity-increasing behaviour at the enterprise, governmental and inter-governmental levels. Improving productivity growth is just about the sole source of improving living standards, once the terms of trade gain has been absorbed. This is increasingly being recognised in public discussion, but it is important we do more than just debate it.

Nor can monetary policy obviate the pressure for the production side of the economy to change in response to altered relative prices. These changes in relative prices are essentially given to us by the world economy; they are not driven by any policy in Australia.

So in Australia, reorienting our economy, adapting to structural changes and improving productivity performance are challenges we face. But we are hardly alone in facing adjustment challenges. More generally, reorienting economies in the Asian region, and around the world, remains a major challenge.

Changes in the right direction have been occurring. Countries in this region have been prepared increasingly to develop and follow domestic policy frameworks that guide their behaviour in sensible ways (for example, inflation targeting). They have been prepared to accept some more movement in exchange rates, and to seek more domestic-led growth in demand. China in particular has seen the ratio of domestic demand to GDP rise over the past few years, reversing much of an earlier decline.

More of this will be required, however, over time, for at least three reasons.

First, it is not a sustainable model to expect developed world households to consume ever higher volumes of the output of Asian factories with borrowed money. That model cannot return, which means that the imperative to find domestic sources of growth is not just a cyclical one.

Second, the eventual sheer size of the Asian economy is such that it will have to absorb more of its own output as it continues to grow. Continental-size economies such as the United States and the euro

area have long done so. Here it is important to note that for East Asia outside of China and Japan, the decline in domestic demand relative to GDP that understandably occurred during the crisis of 1997–1998 largely remains in place, more than a decade later.

Third, and most important, it will surely be the most enriching strategy for the people of this region to turn more of their own savings to developing their own physical and human capital. Yet at present trillions of dollars are lent by taxpayers in Asia to some highly indebted advanced world governments at yields that seem extraordinarily low. It seems very unlikely that there are not better risk-adjusted returns in Asia than that.

So for all of us, the challenges are those of adaptation to changing circumstances and new opportunities. A fascinating journey lies ahead. We in Australia will be facing our own adjustment imperative. We will also be taking more than a casual interest in developments in the region in this 'Asian century'.