Box B: Direct Effects of a Weakening World Economy on Australia

The world economy has a significant influence on developments in the Australian economy through its effects on Australia's exports, both in terms of the amount sold and the price received for them, relative to the cost of imports. The scope of this channel has increased through time as the Australian economy has become more open.

The current slowdown in world growth is forecast by the IMF to be of a similar magnitude to the early-1990s slowdown for the industrial countries, but not as large as that in the mid 1970s or early 1980s. Reflecting the global slowdown, Australian export volumes declined in the September and December quarters. The terms of trade have remained relatively resilient. Despite falling in the December quarter, they are still higher than a year earlier, as import prices have fallen further than export prices (in foreign-currency terms).

To provide some context for the current situation, Table B1 documents episodes over the past 40 years where declines in export volumes or the terms of trade have subtracted at least 1 percentage point from domestic incomes. The table shows that some of these episodes occurred when the world economy was in recession, but a number of episodes were associated with only a relatively mild slowdown in world growth. Some of these differences reflect the extent to which Australia's trading partners were affected relative to the rest of the world. The table also shows that significant declines in export volumes and the fall in the terms of trade have rarely occurred simultaneously, with the Asian crisis being a notable exception. In that episode, the combined effects of a decline in export volumes and lower prices reduced Australian national income by around $2^1/2$ per cent – considerably more than in any of the three world recessions of the 1970s, 1980s and early 1990s.

These three world recessions had contrasting effects on the external sector. The decline in export prices in foreign-currency terms was considerably larger in the early 1990s than in the other two episodes, although the terms of trade decline was greatest following the 1970s recession reflecting rapid growth of import prices. However, whereas export volumes declined in both the 1970s and 1980s episodes, in the early 1990s, export volumes grew at a relatively rapid pace, increasing by 13 per cent in 1991 and by $5^1/2$ per cent in 1992.

Table B1: External Slowdowns and Domestic Income

Contribution to year-ended gross domestic income growth, percentage points

Episode (year-ended)	Export volumes	Episode (year-ended)	Terms of trade
December 1960	–1.7	March 1965	–1.0
March 1974	–1.4	March 1971	–1.7
December 1980	–1.1	March 1975	–1.7
June 1998	–1.0	September 1977	–1.4
		March 1986	–1.6
		June 1991	–1.2
		June 1993	–1.0
		December 1998	–1.5

In each of these three episodes, the effect of lost foreign earnings on national income was not large enough, in itself, to cause a recession – even allowing for the operation of a multiplier as demand and production responded to the initial loss of income. While international forces contributed to the severity of the recessions in the 1970s and 1980s, it was a contraction in domestic demand that was the more powerful force. This was even more the case in the early 1990s, where international factors did not have a significant negative effect on the economy through the external sector, yet Australia experienced a recession because domestic demand fell sharply during the process of unwinding the imbalances of the late 1980s. During the Asian crisis, in contrast, the strength of domestic demand kept the economy growing quite strongly, despite the pronounced contractionary influence from abroad.

This simple analysis suggests that while a pronounced weakening in global growth does affect Australia, whether or not this leads to a recession depends critically on the extent to which the Australian economy is already suffering from domestic problems. If the economy is relatively free of imbalances, there is a good chance that, even though the pace of GDP growth will moderate, an outright contraction in economic activity can be avoided. ✣