

THE GLOBAL OUTLOOK

Address by Dr Malcolm Edey, Assistant Governor (Economic), to Committee for Economic Development of Australia (CEDA) Economic and Political Overview 2009, Sydney, 18 February 2009.

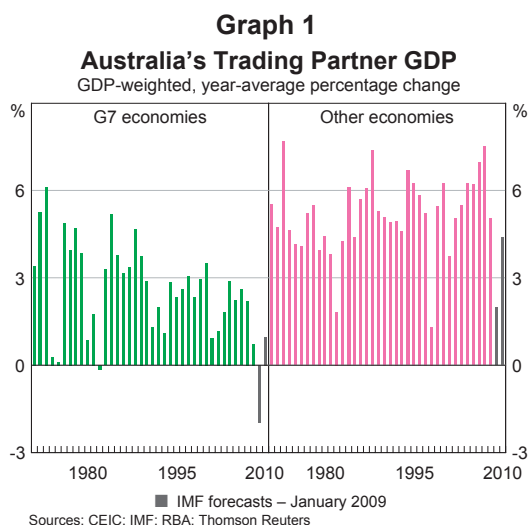
Once again, I thank CEDA for the invitation to speak here today. This is the fifth year that I've spoken at this event, and it's certainly the toughest year for the global economy that we've seen during that time.

Economic events around the world have moved very quickly over the past few months. We've known for some time that a significant downturn was occurring in the major industrial countries, as they felt the effects of the global financial crisis. But for much of last year, other parts of the world were looking quite resilient. China and the other developing economies in Asia (and elsewhere) mostly kept growing at a good pace up until the September quarter, and world commodity prices up to that point were still close to their peaks.

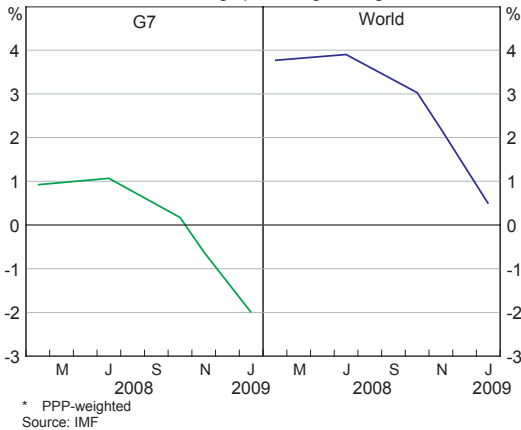
But the period since then has seen a sharp deterioration in conditions. The downturn in the G7 economies intensified in the December quarter, and at the same time it spread to other parts of the world, including Asia, Latin America and eastern Europe (Graph 1).

For the world economy as a whole, 2009 is shaping up as a very difficult year. IMF forecasts released in late January are for world growth of half of 1 per cent this year, with the G7 economies contracting by 2 per cent. If these forecasts are realised, it would amount to the weakest year for the global economy, and for the advanced industrial countries, in the post-war period.

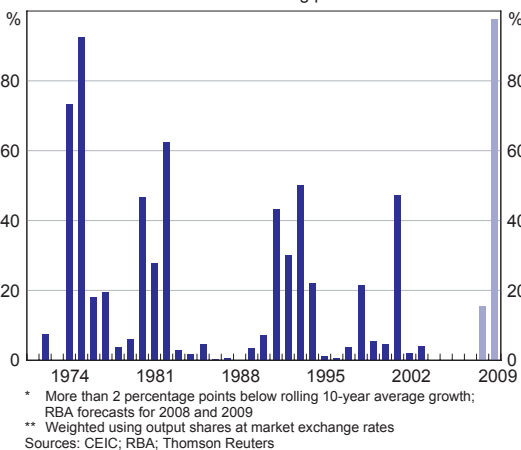
Two things stand out as being quite remarkable about the recent sequence of events. One is the abrupt nature of the deterioration. The graph we're looking at here shows the sequence of forecasts for the G7 economies, and for the world as a whole, that were made over the course of the past year (Graph 2). As recently as July last



Graph 2
2009 IMF GDP Forecasts*
 Year-average percentage change



Graph 3
Trading Partners with Well-below Trend Growth*
 Share of Australia's trading partner GDP**



year, the IMF's 2009 forecast was for world growth of 3.9 per cent, which would have been close to its long-run average. A downward revision to the world outlook by more than 3 percentage points over the six-month period since then is, to my knowledge, unprecedented. Much of that revision has taken place within the last three months. I make these observations not as a criticism of forecasters, but as an indication of how quickly the momentum of the world economy was changing during this period. For the G7 economies the shift was almost as pronounced, from a forecast of plus 1 to minus 2 over the same period.

The other notable feature is the highly synchronised nature of the downturn. We can illustrate that by looking at the proportion of Australia's trading partners that are growing at a pace significantly below trend (Graph 3). It's worth noting here that the four-year period up to 2007 was itself highly unusual, in that none of Australia's major trading partners fell into that category during that time. In contrast, growth in virtually all of Australia's trading partners will be well-below-

trend this year, if official forecasts are realised. This would also mean that the current cycle is more highly synchronised than the three previous international recessions, in the early 80s, the early 90s and in 2001.

The trigger for this rapid downgrading of the international outlook has been the flow of very weak data coming from around the world in the past few months, pertaining mainly to the December quarter. Preliminary estimates are that the US economy contracted by 1 per cent in the quarter, having posted only a small fall in the previous quarter and moderate growth on average over the year prior to that (Graph 4). Consumer spending and business investment both weakened noticeably, and the housing sector has been an ongoing drag on activity for some time. Job losses accelerated during the quarter to more than half a million a month (Graph 5).

Similar patterns are being seen in a number of the other advanced economies. GDP in both the UK and the euro area fell by 1½ per cent in the quarter. We learned earlier this week that Japanese GDP fell by 3 per cent. Across the Asian region in particular, a number of countries experienced unusually sharp falls in measures of output and international trade during this period. In Japan, for example, industrial production fell by 20 per cent over the final three months of the year, as did the volume of exports (Graph 6). Similar movements occurred across the smaller economies in the region (Graph 7). China's GDP continued to grow in the quarter, but at a much reduced pace (Graph 8).

Clearly, then, the deterioration in global conditions in the December quarter was both abrupt and widespread.

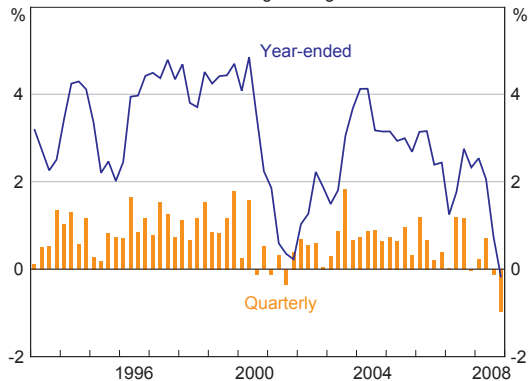
What caused it?

I suggest three main factors were at work.

The first was a widespread loss of confidence in the wake of the collapse of the US investment bank Lehman Brothers, which occurred on 15 September last year. You will recall that this was a period of exceptional turmoil in global financial markets. The Lehman collapse itself followed the effective nationalisation of the US federal mortgage agencies a

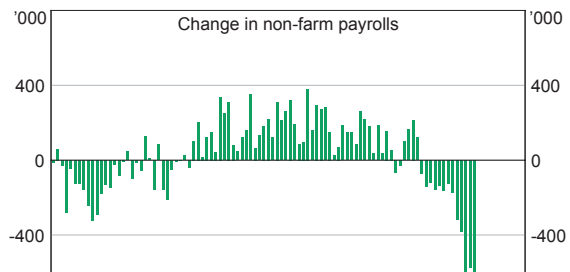
week earlier. These events were then followed in quick succession by the nationalisation of the US insurer AIG, along with a string of other announcements of the failure or near-failure of financial institutions in the United States and Europe. Uncertainty about the nature and scope

Graph 4
United States – GDP
Percentage change



Source: Thomson Reuters

Graph 5
United States – Labour Market
Change in non-farm payrolls

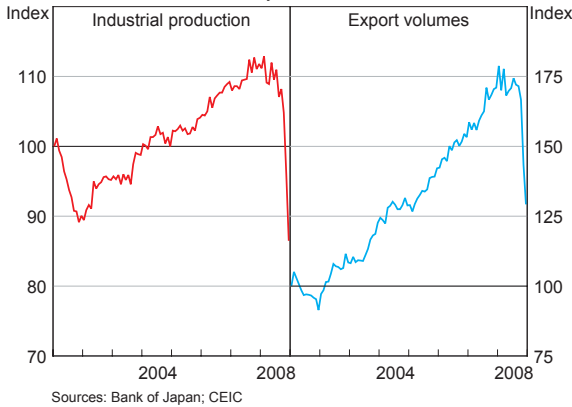


Unemployment rate

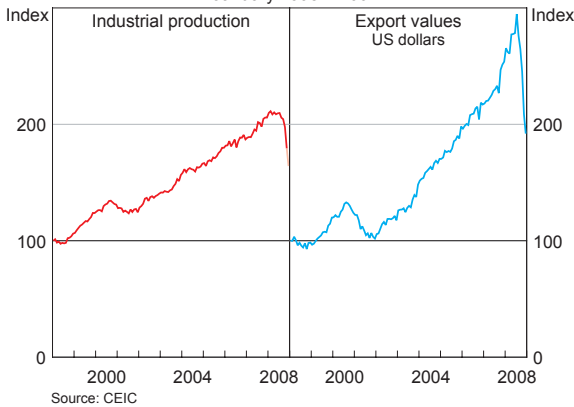


Source: Thomson Reuters

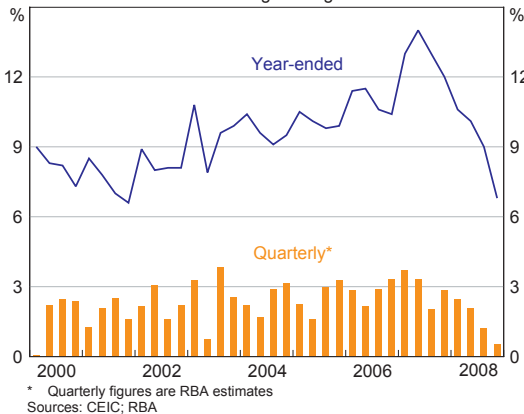
Graph 6
Japan – Industrial Production and Exports
 January 2001 = 100



Graph 7
Other East Asia – Production and Exports
 January 1998 = 100



Graph 8
China – GDP
 Percentage change



of various rescue packages proposed through this period added to the general turmoil. It was during this period that a number of governments moved to guarantee deposits in their banking systems.

One indicator of the way these events affected confidence is the reaction of equity markets. In the three months following the Lehman collapse, world equity prices recorded some of their largest daily movements (in both directions) in history. In net terms, equity prices in the major economies fell by around 30 per cent in that period. They have, however, fluctuated around a more stable average since then (Graph 9).

Survey-based measures of business and consumer confidence also fell sharply in the major economies (Graph 10). It seems plausible that improvements in communication, and the more rapid transmission of economic news, have contributed to making these swings in confidence more highly synchronised than they were in the past.

In any case, while it's clear that conditions were generally weakening already from around mid 2008, they took a sharp turn for the worse in the period immediately after the Lehman collapse. Households and businesses around the world seem to have made a rapid re-evaluation of their spending plans, and in particular they cut back on their discretionary spending. One very clear example of that was a sharp drop in the demand for cars in the final months of 2008. This resulted in car sales in the major economies falling from their

early 2008 levels by around 25 per cent (Graph 11).

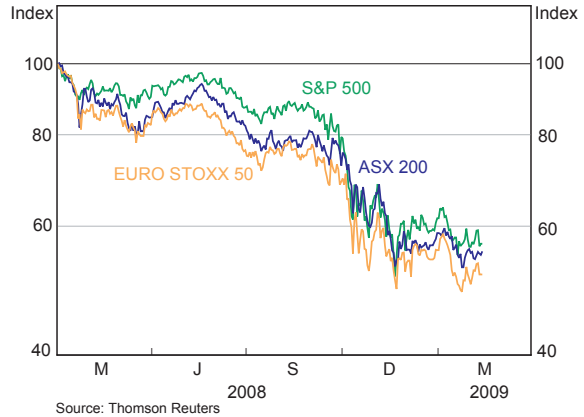
A second factor, also related to the Lehman collapse, is likely to have been a further tightening of credit standards in the major economies (Graph 12). This manifested itself, amongst other things, in disruptions to trade credit and insurance, and in a tightening of lending for consumer and business spending.

Thirdly, these effects seem to have been transmitted very quickly around the world through the trade channel, as businesses cut back on production in response to reduced orders. Falls in exports and production were particularly pronounced for cars, steel and electronics.

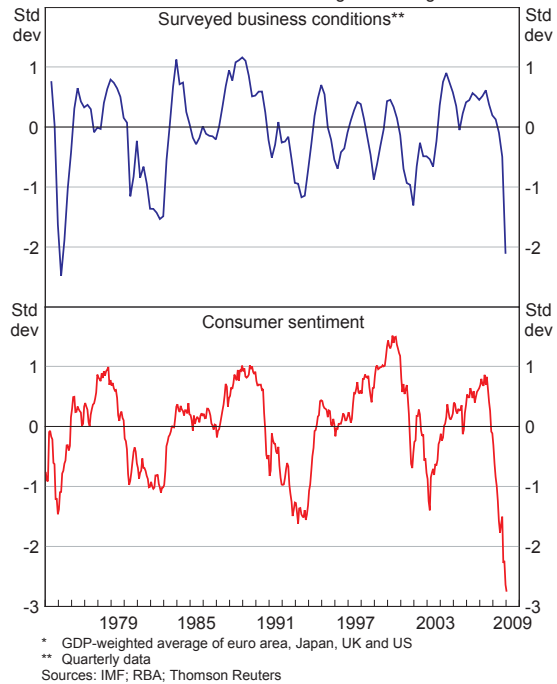
There were probably some internal cyclical dynamics in some countries that amplified these effects. In China, for example, the economy had for some time been growing at a faster-than-trend pace, and the authorities had taken steps to rein in growth during 2007 and the first half of 2008. With external demand falling away, there seems to have been a build-up of inventories that prompted a sharp adjustment to production volumes late last year (Graph 13). More generally, firms around the world probably sought to economise on their inventories in response both to weaker expected demand and reduced availability of working capital.

It seems likely that the contraction in activity seen in the December quarter contained a significant one-off element. Businesses and consumers made a big adjustment to their spending levels in response to the shock to confidence, and businesses cut production and inventories in response to the fall in demand and tighter credit. It's too early to tell, though, what the trends in demand and activity will look like as we emerge from this period. We don't yet have sufficient data to get a good reading on that.

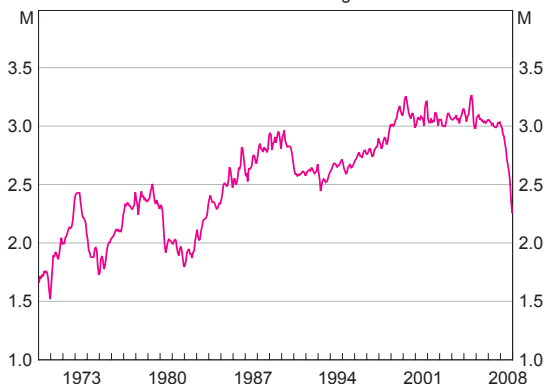
Graph 9
Global Equity Markets
1 January 2008 = 100, log scale



Graph 10
Selected Major Economies – Activity and Sentiment Indicators*
Standard deviation from long-run average

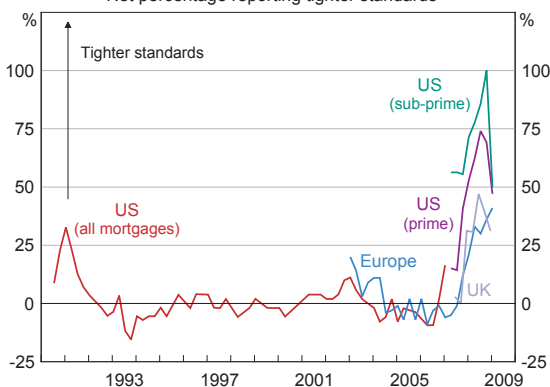


Graph 11
Car Sales in Major Developed Economies*
 Three-month average



* Canada, euro area, Japan, UK and US; passenger cars only except for US and Canada
 Sources: RBA; Thomson Reuters

Graph 12
Credit Standards for Residential Mortgages*
 Net percentage reporting tighter standards**



* US and Europe ask whether *lending standards* have changed. UK asks whether the *supply of credit* has changed.
 ** UK applies twice the weight to a 'considerably' answer relative to a 'somewhat' answer. US and Europe apply an equal weight.
 Sources: Bank of England; Board of Governors of the Federal Reserve System; European Central Bank

Graph 13
China – Purchasing Managers Index
Stocks Components
 Diffusion indices, monthly



Source: CEIC

What we do know is that economic downturns don't last forever. So despite the gloomy circumstances, it's important to ask the question: what are the factors that can contribute to an upturn in due course? I've given you three factors that contributed to the recent deterioration, so let me counterbalance that with three factors that, over time, can be expected to contribute to an upturn.

The first factor is the substantial set of expansionary measures that have been taken through conventional monetary and fiscal policies. Interest rates have been cut to very low levels in most countries, and there are some very large fiscal policy initiatives in the pipeline around the world (Table 1). In a number of countries, including the United States and China, discretionary fiscal expansions of the order of 2 per cent of GDP look like being implemented in 2009, on top of the working of the automatic stabilisers.

Secondly, the major economies have taken a range of steps to provide direct assistance to their financial sectors. These have taken several forms – including central bank facilities to improve access to liquidity, direct injections of capital into financial institutions and the provision of government guarantees. Probably more needs to be done in the major economies on this front, but there are some tentative signs at least that these steps are contributing to some improvement in the functioning of financial markets. The extreme volatility that followed

the Lehman collapse has eased off in the last couple of months. And the availability of government guarantees has seen a recovery in bond issuance by banks around the world. This is helping to put banks in a position where they can be more confident of their long-term funding.

My third point is that the normal cyclical dynamics of the global economy can eventually be expected to run their course. By this I mean several things. The de-stocking that typically occurs in the early stages of an economic downturn is essentially a limited phenomenon. It only needs to occur once. Similarly, where over-building has occurred, it will take some time to work off the accumulated over-supply, but eventually the growth of underlying demand will reassert itself. We are seeing that mechanism gradually playing out in the US housing sector, where the fall in housing starts has meant that excess stocks of new homes are being wound back, which is an essential precondition for eventual recovery (Graph 14).

Other cyclical forces will work through asset and credit markets. During a generalised loss of confidence, a range of markets including those for equities, for housing and for commodities can often overshoot fundamentals on the downside. But at some point, they will reach a level that is sufficiently cheap to encourage investors back into the market. I can't say whether they might be close to that point yet, but it is encouraging that both equities and commodity prices have been more stable in the last couple of months after the sharp falls that we saw in the December quarter (Graph 15).

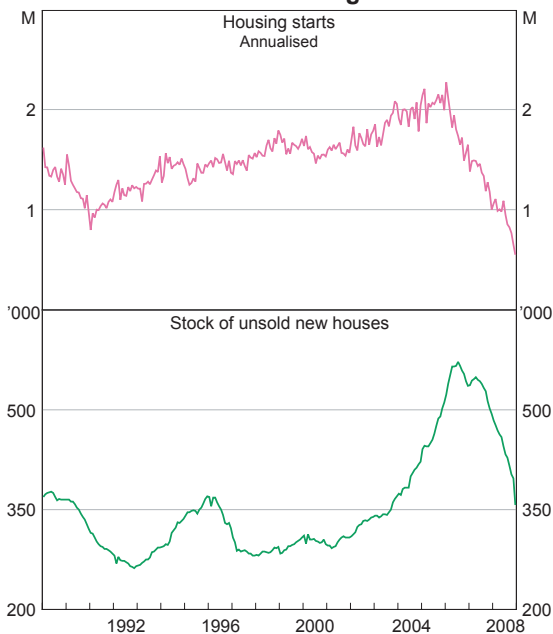
These various mechanisms work on different time frames. A conventional inventory cycle might be quite short. At the other end of the scale, experience suggests that balance sheet repair can take considerable time. Nonetheless, governments around the world are taking significant

Table 1: Discretionary Fiscal Easing in Selected Economies

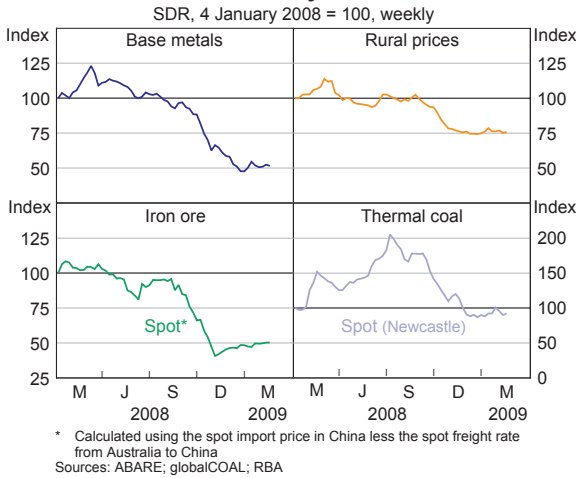
Per cent of GDP	
Estimated easing in 2009 ^(a)	
United States	over 2
United Kingdom	over 1
Germany	1½
Japan	1¼
China	over 2
South Korea	over 2
Taiwan	over 2
Australia	2½

(a) Based on policy announcements and media reports

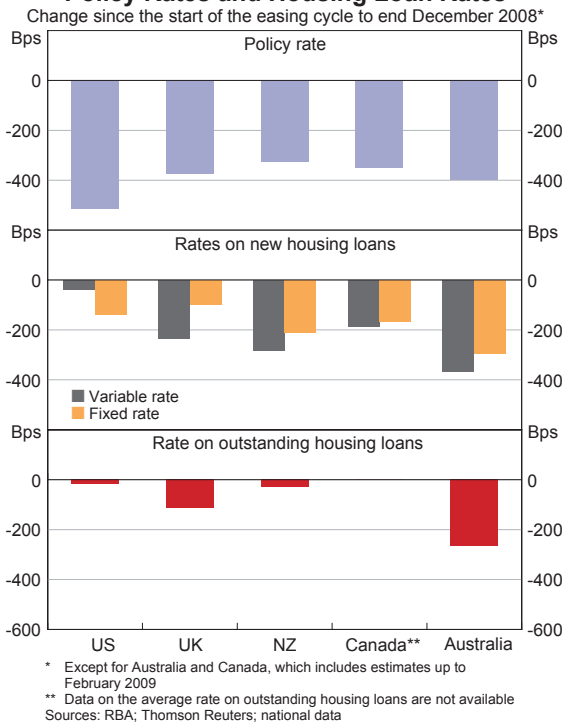
Graph 14
United States – Housing Indicators



Graph 15
Commodity Prices



Graph 16
Policy Rates and Housing Loan Rates



environment this year. Official forecasts, including those of the IMF, imply that output in the major industrial economies will contract further in the first half of this year, but start to pick up later in the year and into 2010. The situation is still very uncertain but, for the reasons I've been outlining, that seems like a reasonable expectation.

Thank you. ✂

steps to speed up the process, and various further proposals to take bad assets off the balance sheets of troubled institutions are still being considered.

There are reasons to expect that the Australian economy can continue to perform better than its international counterparts in the difficult period that lies ahead. Australia had more momentum than most comparable economies in the period leading into the crisis. As in other countries, substantial monetary and fiscal measures have been taken to support growth. But an important difference is that the Australian financial system remains in much better shape than its international counterparts. As a result of that, we have been able to gain much more traction from cuts in official interest rates. In the period since the RBA started cutting the cash rate in September, substantial rate cuts have been passed through to end borrowers, particularly for housing loans (Graph 16). This is in marked contrast to other countries, where banks have been more heavily affected by financial strains and the degree of pass-through has been much more limited. Another factor helping to insulate the domestic economy from events abroad is the depreciation of the exchange rate.

Having said all that, there's no doubt that Australia will be operating in a difficult international