THE ROAD TO RECOVERY

Address by Mr Glenn Stevens, Governor, to the Australian Institute of Company Directors' Luncheon, Adelaide, 21 April 2009.

The global economy is in recession. Virtually all of Australia's trading partners are contracting. In fact almost every country with which we would normally make comparisons is in recession, and for many of them it is a bad one.

It is very rare for Australia to escape an international downturn and there is no precedent for avoiding one of this size. We, like most countries, have trade and financial linkages to the rest of the world. We are all aware of what happens abroad, and our own expectations and economic behaviour cannot but be affected by those events. Whether or not the next GDP statistic, due in early June, shows another decline, I think the reasonable person, looking at all the information available now, would come to the conclusion that the Australian economy, too, is in recession.[1]

These are periods of hardship for significant parts of the community. People lose jobs, businesses fail, loans go bad, and plans are unfulfilled. As such, they are to be avoided if possible and at least ameliorated when they occur. It is for the latter reason that most countries today have extensive social safety nets, so that when recessions do occur, we can avoid the extent of outright misery seen in episodes like the 1930s.

Policy-makers also seek to cushion such downturns with macroeconomic policy. They are usually more successful if they have managed to restrain the preceding boom. But no country's policy-makers have been able to eliminate the business cycle, much as they have all tried. Cyclical behaviour has always been a feature of market economies. It always will be. Should you see, at some future time, a claim to the contrary, it would be advisable to treat it with great scepticism and, indeed, as a possible indication that a cyclical turning point is in the offing.

Most of the time, economic activity expands, as population growth, increasing wealth and aspirations to higher living standards lead to more demand, while a growing workforce, higher productivity and technological innovation push up supply capacity. That is the normal situation for an economy.

But every so often – on average about once every seven or eight years, but not regularly enough to predict with accuracy – a set of conditions arise that see demand weaken for a while, output decline and unemployment rise. That is a recession. Usually, though not always, inflation tends to fall as a result of such episodes.

1 *Perhaps it is useful to be clear what we mean by the term 'recession'. The original definition is 'a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators'. This is the working definition of the National Bureau of Economic Research (NBER), and is based on Burns AF and WC Mitchell (1946), Measuring Business Cycles, NBER, New York.*

Modern Australia has experienced a number of recessions – in the early 1950s, the early 1960s, the mid 1970s, the early 1980s, the early 1990s, and now in 2008/09. There were also events that could reasonably be labelled brief recessions in 1957 and 1977. On that count, the current episode will be the eighth recession since World War II. Most of these events have been associated with international business cycles.

There were significant mid-cycle slowdowns, which did not develop into recessions, in the mid 1960s and very early 1970s[2], the mid 1980s, the mid 1990s and 2000/01. In each of these periods, output slowed or even fell very briefly, the rate of unemployment stopped falling and/or rose, and inflation moderated.

The 2000/01 episode was notable in that it coincided with a downturn in the major countries. It was very unusual for Australia not to have a recession in such circumstances, though as it was, the rate of unemployment rose by about a percentage point in the space of a year. One aspect that helped us on that occasion was that the downturn in many of the major countries was not an especially deep one. Another was the continuing strength in some other key trading partners, not least China. This time, the state of the global economy is much worse.

The extent of that weakness was unexpected. Until the financial crisis escalated so dramatically last September, it appeared that some of the major countries would have downturns, but that the emerging world, including Asia, would not slow as much as on some other occasions. Although affected by weaker demand from the industrialised world, many of these countries appeared largely to be free both of the financial problems in the major countries and of the sorts of problems they themselves had experienced in past episodes. The growth of China seemed to be on a strong medium-term path, albeit with a cycle like every other economy. This was not 'de-coupling', simply the assessment that the net of competing forces would produce a significant slowdown, but not a slump. Hence, global growth was generally expected to slow to below average, after several years in which it had been unsustainably high.

Then, things took a serious turn for the worse. The financial turmoil following the Lehman collapse was the most intense in generations. It was contained within about six weeks, and indeed over the past few months conditions have been gradually improving in financial markets, in several respects. But we are now seeing the fallout in the rest of the economy from that financial turmoil. The weakened ability of the financial institutions to provide credit to industry is one of the factors at work, but in my judgment a bigger one is the decline in confidence, and the sudden and widespread aversion to risk, among firms and households all over the world. It seems that everyone, everywhere, having seen the instability in financial systems in September and October 2008, and consequently feeling poorer and fearing bad times ahead, simultaneously decided to pull back their own spending, curtail their expansion plans and reduce their debt.

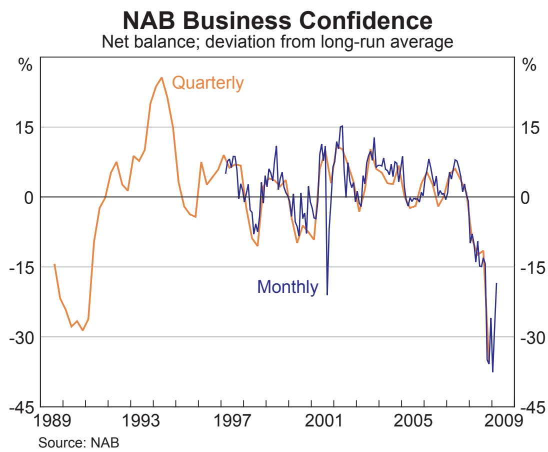
It was, of course, entirely rational, at the individual level, for firms and households to behave in a more precautionary way. But the collective sum of those decisions created, over the ensuing six months, an international slump in demand for consumer durables and investment goods that was sharper, and more synchronised, than any seen for decades. The result is that the world's

2 *In both those cases, by the way, if we applied the 'two negative growth quarters' definition, they would be labelled recessions. No-one remembers them as recessions, though, which perhaps illustrates why that definition is not very useful.*

gross product is now thought likely to decline in 2009, the first time that has happened for many decades.

Australians shared in this more cautious behaviour, particularly in the business world. A range of business surveys indicate that a trend moderation in business confidence that had been occurring for some months turned abruptly much weaker in October, and remained weak thereafter (Graph 1). There was some recovery in March. (The behaviour of Australian household confidence surveys has not been as weak, as I shall come to later.) While official data are yet to show it, it is likely that business investment spending is in the process of declining sharply. Hiring intentions have been scaled back quickly. Residential investment and exports have fallen.

Graph 1



The net result is that the Australian economy has been contracting, though on the best information we have, not at the pace seen in a number of other countries, where quarterly declines in real GDP of 3, 4 or even 5 per cent have been observed in the last quarter of 2008 and are likely to have occurred in the first quarter of 2009.

A key dimension through which Australia experiences the global business cycle is the terms of trade, a gauge of the income gains or losses that international relative price changes impart to Australia. Over the five years to 2008, a period of exceptional strength in the global economy, the terms of trade rose by about 60 per cent, equivalent to about 12 per cent of a year's GDP – about $140 billion – in additional annual income. It was the biggest such gain in half a century. Now, the terms of trade are falling, reversing part, though so far only part, of that earlier gain.

I would like to make two points, however, about those terms of trade swings. The first is that, in earlier episodes such as in the early 1950s, and the mid and late 1970s, very large terms of trade movements seriously destabilised the economy. On this occasion, there have been plenty of adjustment challenges – generally coming under the heading of the so-called 'two-speed economy', where the resource-intensive regions and industries grew quickly and others slowed. But for all that, a floating exchange rate, a much more flexible labour market and better macroeconomic policy frameworks have helped the economy adapt to the terms of trade swings without the degree of instability seen in the past. That is a testament to the arrangements that are now in place.

The second point is that, at this stage, the fall in the terms of trade that is occurring does not seem to be reversing *all* of the previous rise. Even with the large falls in prospect for contract prices for bulk commodities, Australia's terms of trade look like they could, at the end of this year, still be about 40 per cent higher than the average for the period from 1980 to 2000. Perhaps that will not persist. Alternatively, perhaps what commodities markets are telling us is that some factors beneficial to Australia – foremost the continued likely emergence of China – remain in place. It is probably not entirely coincidental that the clearest signs of a turning point in economic activity appear to be accumulating in China, though not exclusively there.

That is a quick description of where we are, and some of the background of how we got here. I will not speak here of the broader background of the financial excesses that helped to create the situation, because that has been covered in detail before.

Instead, I want to devote some attention to the question: how do we get on the road to recovery? History shows that recessions come, but also that they end. Can we speed that process? And to the extent that we have some capacity to shape the next expansion, how might we use it?

Since this is essentially an international episode, and not really an Australia-specific one, much depends on what happens abroad. This neither means we are helpless to affect our own future, nor absolves us of the responsibility to pursue sensible policies to promote recovery here. I shall come to that, but first, a few words about the conditions for a durable global recovery. I take it as given that we all agree that a better financial regulatory architecture is needed and there is a lot of work under way on that. But that is about avoiding a repeat crisis. What about steps to get out of this one?

There are several necessary elements.

The first, as many have said, is to sort out the mess in the financial system, especially in the United States, the United Kingdom and Europe. It is not an easy problem to solve. But quite a lot is known from previous episodes, including in the United States itself, of the main principles that must be observed in this process.

The first step is an honest accounting of the situation. Then, the 'legacy' assets have to be quarantined so that the potential for further erosion of their quality, and uncertainty over their value, does not lead to further loss of bank capital and associated confidence problems. The relevant institutions must then be recapitalised if need be, so that, freed of the problem loans, they can resume normal commercial activity – lending for sound proposals. It may be that, appropriately cleaned up, banks can attract new private capital. If not, then public funds have to be made available to recapitalise them where needed.

Everyone understands these principles. The question is how to implement them. There are a few ways to go about it, all of which are on the table at present. One is to hive off the problem assets into a 'bad bank' or some other like vehicle, which is then managed and gradually wound down. The assets have to be transferred at some price, and the process of striking that price has to protect the interests of taxpayers, who should not over-pay for the bad assets and thereby give a windfall to shareholders. At the same time, there has to be pressure on the institutions concerned actually to get on with the clean-up, as opposed to just waiting for something to *turn* up. The plan being implemented in the United States is designed to induce private capital to take part in the asset management vehicles, which helps to sort out the pricing question.

Another approach is to leave the assets on the banks' balance sheets, but have the government insure them, for a price, to limit further downside. This is the essence of the UK approach. Yet another approach is to nationalise the relevant institutions, which obviates any pricing issues for the assets *per se* and automatically provides enough capital, but introduces new questions in dealing with shareholders. This approach is the traditional one, though it has mostly been used in smaller countries or, where used in major countries, for smaller institutions.

The economics of all these approaches is essentially the same: recognising losses that have occurred, reducing the riskiness of bank balance sheets and finding new capital to restart the credit process. Which technique to choose is a matter of judgment.

The politics may be harder than the economics. Ordinary people resent, not surprisingly, taxpayer funds being used to fix problems that arose, in part at least, because of seriously misaligned incentives that rewarded financiers for taking too much risk. But it has to be done, otherwise economies will suffer for longer. The political leaderships of the United States, the United Kingdom and some other countries have the unenviable task of persuading their citizens to accept the need for these initiatives.

A second near-term condition for recovery is macroeconomic support for aggregate demand, in an environment in which private spending has weakened sharply, owing to loss of confidence and strained credit markets. That is coming into place as a result of easier monetary policy, and easier fiscal policy also in many countries. Internationally, the role of fiscal policy is more prominent on this occasion than has been the case for many years, since the impaired credit system makes monetary policy less effective than it would normally be in many countries. The reason official interest rates are approaching zero in a growing list of countries is not because central banks think it is a good idea to make credit available for free. It is because the flow-through from official rates to the rates that matter most in these economies – those paid by businesses and households – has not been working very well.

Third, with these near-term policy requirements – repairing the financial system and macroeconomic stimulus – come associated medium-term requirements, which fall under the heading of 'exit strategies'.

For those countries where governments end up owning part or all of banks, there will need to be a plan to divest that holding when conditions improve. The same can be said of the various guarantees under which banks globally are raising money at present. This was an important step to help the system through a period of severe dislocation, but it is surely not desirable as a permanent state of affairs. At some point, it will be prudent to start weaning banks, or more to the point investors, off those guarantees. Perhaps co-ordinating such a departure across countries would be a useful role for the Financial Stability Board.

The other international exit strategy needed will be on macroeconomic policies. The size of the downturn, the extent of fiscal stimulus and the cost of the financial restructuring packages have placed a very large burden on government finances in a number of countries. I am not arguing against the measures. But they will need to be accompanied by a credible story about how governments will keep their own finances on a sustainable footing over time. Taxpayers, markets and creditors will lose, rather than gain, confidence if they cannot see that path back to sustainability. And, at this point, confidence is what it is all about. The same issues will arise for the exceptional monetary policy measures.

The fourth condition for a durable new international expansion is to avoid perpetuating the so-called 'global imbalances'. The excess of saving over investment in the emerging world, especially Asia, was one part of the story of how the search for yield led to excessive risk-taking. This is not to blame Asia for the crisis, but simply to state the obvious: that for people to misuse abundant capital as they did, there has to be a fair bit of it around to begin with. As it has turned out, there was more of it than the United States and some other developed countries were able to use wisely.

So to the extent that strong global growth relied on advanced country consumers lowering their saving rates, absorbing the export surpluses of the emerging world, and accepting higher debt burdens, the model is broken. Of course, the most important matter in the immediate term is for the US economy to resume growth. But even when it does, the reality is that for some time ahead, advanced country households will be looking to lower their debt burdens and save more of their income. They will not be the same spur to consumption growth as they were.

This will mean that global growth will be, for a while at least, lower on average than we saw for most of the past decade. How much lower will depend in part on the extent to which the economies in the emerging world are able to foster more demand at home. For them to feel safe in doing that, and perhaps to return to their traditional position as capital importers, there will be other conditions – not least confidence on their part that the rules of international engagement are not just skewed to the advantage of the advanced countries. In the end, though, durable growth will have to be more balanced than the growth we had over the past decade.

To the above, I should add that maintaining openness to trade and capital flows is critical – lest the mistakes of the 1930s be repeated. This should hardly need saying, yet times of serious recession are often times when protectionist sentiments grow stronger.

That is all I have to say today on the global conditions for recovery.

Turning closer to home, Australians cannot do a great deal to make these improved international conditions come to pass. But we can maximise our chances of benefiting from a new international expansion.

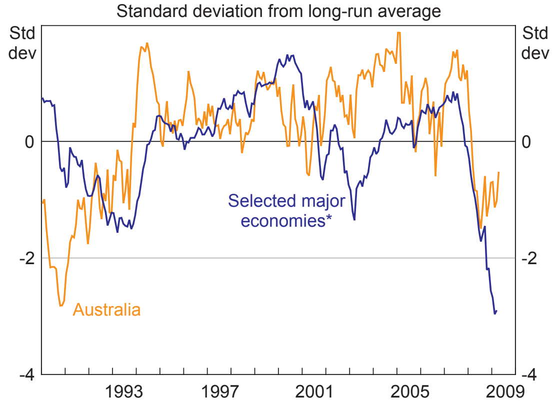
The first thing is to maintain some confidence in ourselves and the prospects for our country over time. We cannot achieve effortless prosperity either on the back of ever-escalating mineral prices or simply by bidding up the prices of our houses. It is as well to realise that. But as I have said on previous occasions, Australia's genuine long-term economic prospects remain good, and there remain good grounds to think that we will continue to weather the storm better than most.

It is noteworthy that in measures of confidence taken from surveys, household confidence has fallen in Australia relative to the ebullient levels of a year ago, but it remains much more resilient to date than comparable results in major countries (Graph 2). While households expect unemployment to be much higher in a year's time, their stated expectations about economic conditions five years from now have barely diminished at all from what we have seen consistently over a number of years (Graph 3). So notwithstanding their evident caution at present, people remain essentially optimistic about the long term.

Graph 2

Consumer Sentiment

Standard deviation from long-run average

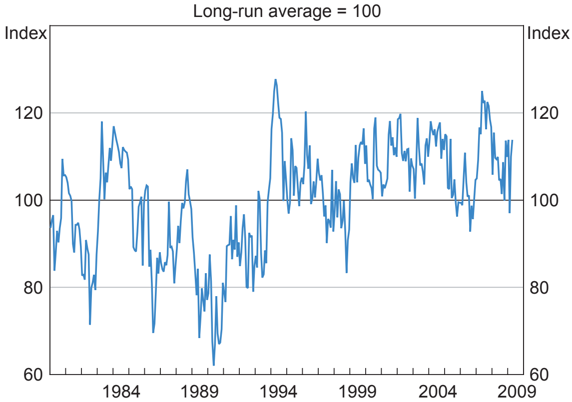


* GDP-weighted average of euro area, Japan, UK and US
Sources: Melbourne Institute and Westpac; Roy Morgan Research; Thomson Reuters

Graph 3

Households' Anticipated Economic Conditions over the Next Five Years

Long-run average = 100



Source: Melbourne Institute and Westpac

Consumer demand in Australia, while weak compared with recent years, is actually at the stronger end of international comparisons among advanced countries. This presumably owes something to the stimulatory effects of fiscal measures and lower interest rates for borrowers (though savers are feeling the pinch). But perhaps it also shows the inherently optimistic view Australians take in the future. Optimism, combined with an awareness of risk, is a fundamental strength. It is to be hoped that this will be matched by a recovery in business confidence over the months ahead. That remains to be seen, though there have been some encouraging signs recently.

What can policy-makers do to help? Unfortunately, there is no lever marked 'confidence' that policy-makers can take hold of. Our task is very much one of seeking to behave, across the board, in ways that will foster, rather than erode, confidence. Over the past six months, that has, of course, involved the rapid deployment of both fiscal and monetary measures, to support demand. The effects of those measures will still be coming through for some time yet. Measures to sustain confidence in the financial sector and to keep key markets functioning were also important.

Perhaps there is also some value in articulating a view of where we want to get to when the cyclical downturn ends, as it will, and recovery takes hold. What sort of country does Australia want to be, economically, during the next expansion? How do we want to be positioned in the global marketplace for capital, in an environment in which markets will have absorbed a lot of government debt and will be evaluating opportunities for other uses of capital?

I suggest that Australia has a very good chance of offering an economic setting in which the following conditions hold.

First, political stability remains assured – something becoming a bit less common.

Second, the Government does not own, and has not had to give direct financial support to, the banking system. Australia will be free of the difficult governance and exit strategy issues that such support is raising in a number of countries.

Third, public finances remain in very sound shape, with modest debt levels and a medium-term path for the budget back towards balance. Without the massive obligations arising from bank rescues that will inevitably narrow the options available to governments in other countries, Australia should be able to articulate such a path more effectively than most.

Fourth, sensible policy frameworks – both macroeconomic and microeconomic – remain in place; the financial regulatory system is strong and tested.

Fifth, we remain open for trade and investment, and have a capacity to deploy both our own and other people's capital carefully and profitably.

Finally, there is an exposure to, and an engagement with, an Asian region that still has the most dynamic growth potential in the world, where hundreds of millions of people will for decades to come be seeking rising living standards.

There are rather few countries that have the potential to offer so attractive a proposition to international capital, and to their own citizens, over the years ahead. It is a proposition that, if pursued sensibly and consistently, offers the most secure basis for confidence in Australia's future. It is such confidence that, more than anything else, will help to drive us along the road to recovery.