

***TALK TO AUSTRALIAN BUSINESS IN EUROPE - LONDON
4 JUNE 1998***

1. Introduction

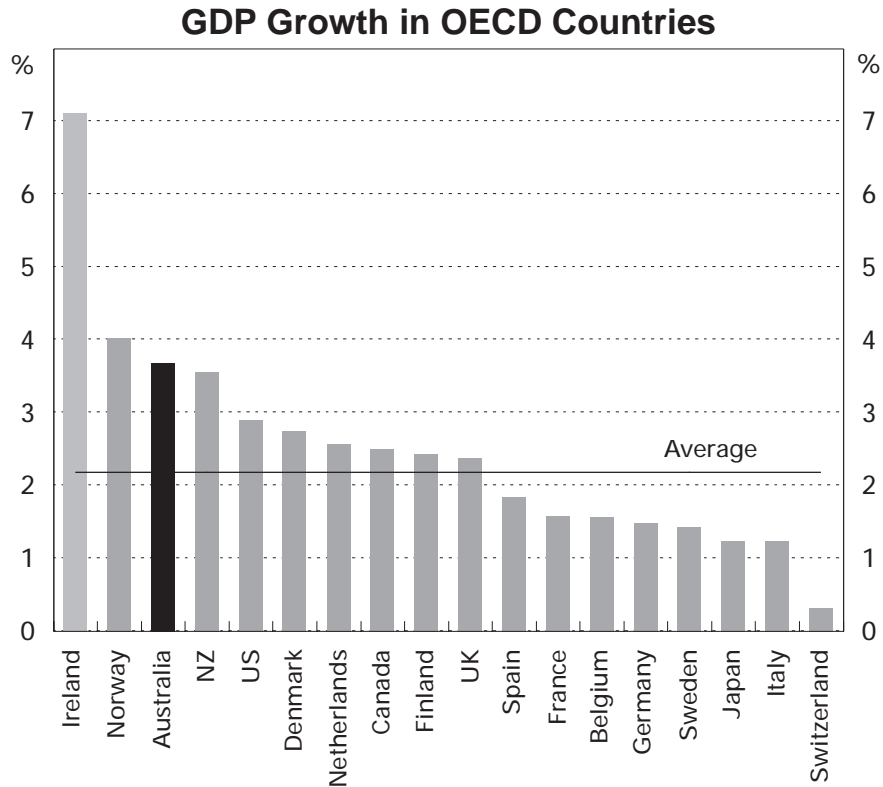
It is a pleasure to be here in London again, in front of such a distinguished audience. I was speaking to a similar group here last June, but the atmosphere was rather different. I was able to speak exclusively about Australia, but in today's climate I would be remiss if I was not also to spend some time talking about Asia.

For this reason, I will cover both the Australian economy and some of its neighbours. With your indulgence, I will use a number of graphs, mainly in the form of international comparisons, to illustrate my points.

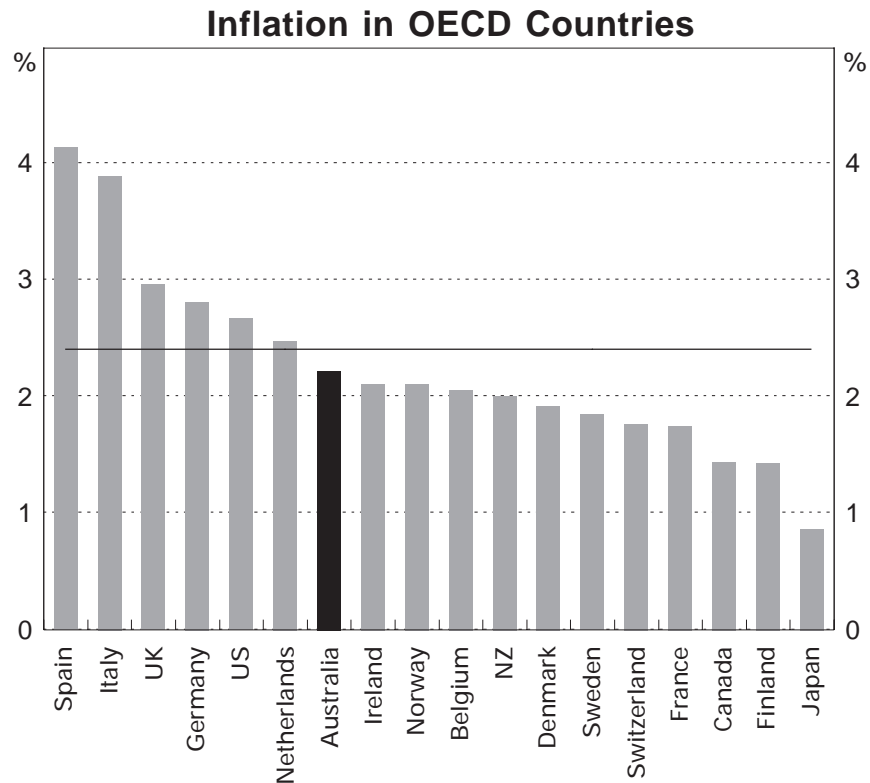
2. Positive Factors

As usual, I would like to start this presentation by emphasising the positive. The main positive factor is that Australia is completing the seventh year of an expansion that started in mid 1991. Over that period, our economy has grown at a rate which is very good by the standards of OECD countries. Diagram 1 shows the growth rate of OECD countries over this seven year period. The average growth rate for Australia of 3.7 per cent put us near the top of this comparison. Only Ireland and Norway have grown faster but they are very small economies compared with Australia - adding their GDPs together, they are still about half the size of Australia.

Of large economies, the United States has obviously done well, and the Netherlands, which is about the same GDP and population as Australia, has attracted widespread praise for its economic performance.

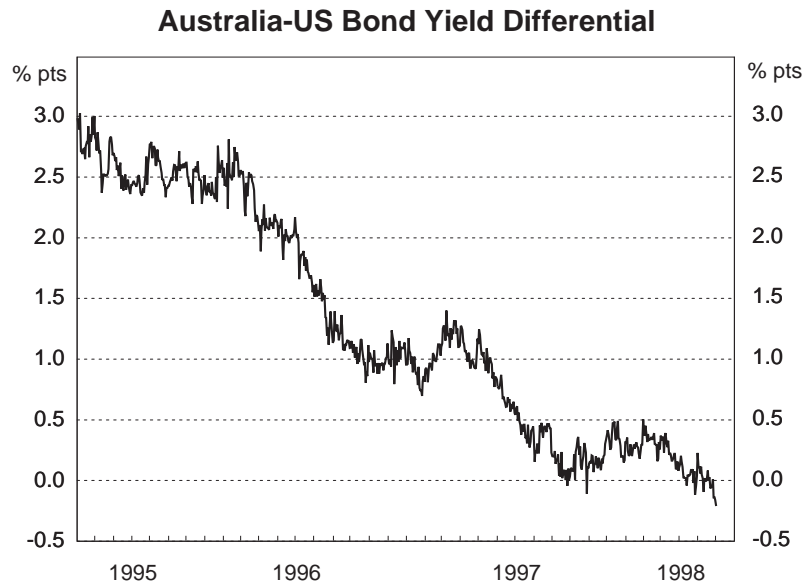


At the same time, as we have put in this good growth performance, we have also maintained low inflation. This has helped us to live down the reputation we gained in the 70s and 80s as an inflation-prone country - over the 90s this has definitely not been the case as you can see by my second diagram. Australian inflation has averaged 2.2 per cent per annum, which is a shade below the average for OECD countries over this period. More importantly for us, it has meant that we have achieved our inflation target, which is to average somewhere between 2-3 per cent in the medium run. Our current rate of inflation, i.e. over the last 12 months, has been 1½ per cent, which is actually below the bottom of the range that we expect to be in in the medium run.



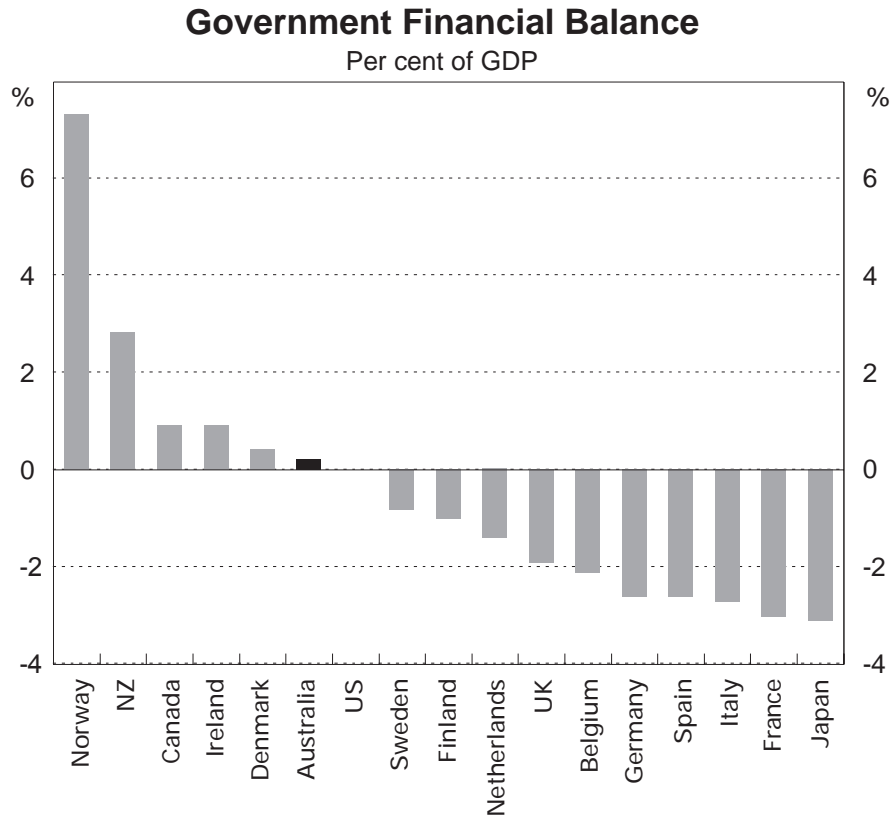
As I said, I think our monetary policy is now getting the recognition it deserves. One good indicator of this is our bond yields. For as long as most people can remember, these were a lot higher than US yields, even 400 or 500 basis points higher. As you can see from Diagram 3, this margin has been gradually whittled away, and over the last three months it has disappeared. In fact, the yield on Australian bonds today is 13 basis points below US bonds and 25 basis points below gilts.

Note that I am talking here about long-term interest rates. These are set by the markets and reflect the world's assessment of our future stability, particularly of our future price stability. I have not been talking about our short rates such as the overnight, or interbank interest rates, which are set by the Reserve Bank. At this point, I should say, however, that I am somewhat surprised by the tendency of the money market to price into these rates a possible easing in monetary policy. Well, I suppose anything is possible, but I would have thought this to be very unlikely.

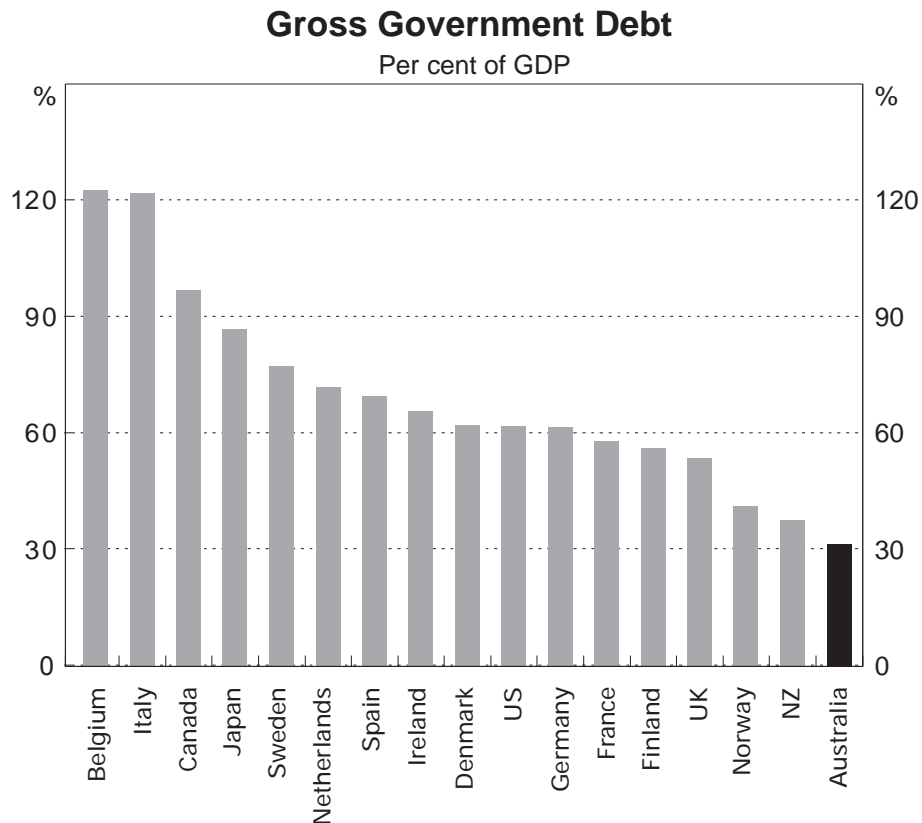


So much for monetary policy, what about fiscal policy? Australia has not had the difficulties that many European countries have had in getting fiscal policy back under control. For example, as you have probably heard from Australian policy-makers on previous occasions, we would have had no difficulty in meeting the Maastricht criteria at any stage over the last four years. Our budget deficit is low as a proportion of GDP and the stock of outstanding government debt is also very low by world standards. Let me illustrate this with another set of international comparisons:

- Diagram 4 shows the Australian budget position as a proportion of GDP compared with other countries in the last year. Our surplus of 0.2 per cent of GDP is again one of the better performances amongst OECD countries. The budget which has just been passed for 1998/99 will show a surplus of about 0.7 per cent of GDP. Note that the measure of the budgetary position we are using is an underlying one; if we had used a headline measure, which includes the proceeds of privatisation, the budget would have been in massive surplus in recent years.



- I mentioned the stock of government debt to GDP. This really measures the accumulated effects of all the past budget deficits. The Maastricht requirements here is for countries to be below 60 per cent, although it is regarded as such a difficult task that the umpire is turning a blind eye to those countries that cannot meet it. In Australia's case, our figure is 31 per cent and going down quite sharply because we are retiring debt.

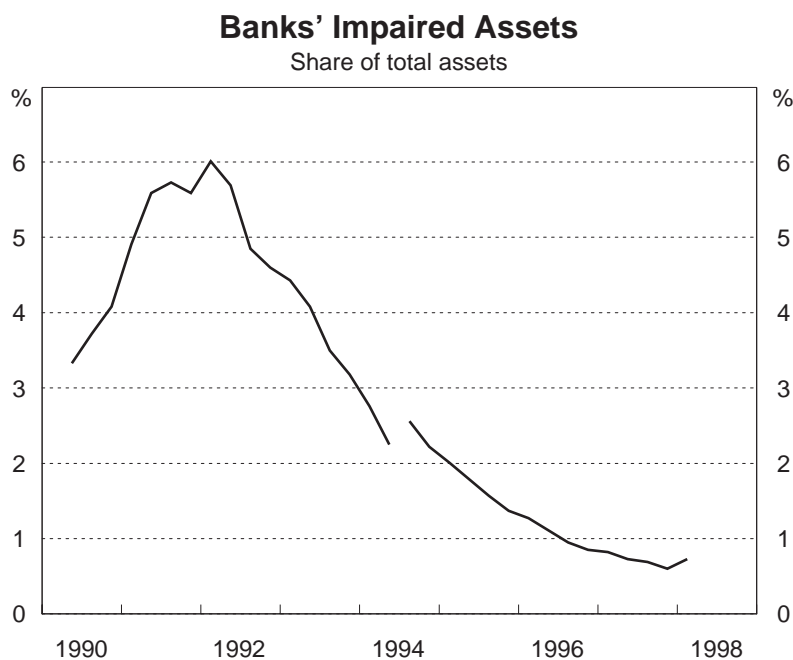


3. *The Risks*

Some of you will be thinking that this all sounds too good to be true, and are asking yourselves - “what about the downside?” Yes there is a downside, and in Australia’s case it is called Asia. Whilst we have benefited in the past by our trade connection with Asia, and I believe we will benefit again in the long run, it is definitely hurting us at the moment. Australia will be affected more than Europe or North America by the sharp reduction in Asian imports. In fact, it is already happening on quite a big scale and showing up in some of our figures at the end of 1997 and particularly in the first quarter of 1998. I will spend the rest of this talk bringing out for you what I think the main effects are and will be.

Again, I intend to start by emphasising the positive. As you will have realised from my introduction, the first thing that we have going for us is that we have entered this difficult period in very good shape. GDP has been growing at 4 per cent, which is enough to have lowered our unemployment rate by $\frac{1}{2}$ per cent or so over the past nine months, and as I said before:

- Inflation is below our medium-term target.
- Our financial institutions are also very sound. Our banking sector has overcome all its problems of the late 1980s and for the past several years has been in very good shape. Bad debt as a proportion of total loans outstanding are about as low as it is possible for them to be (Diagram 6).



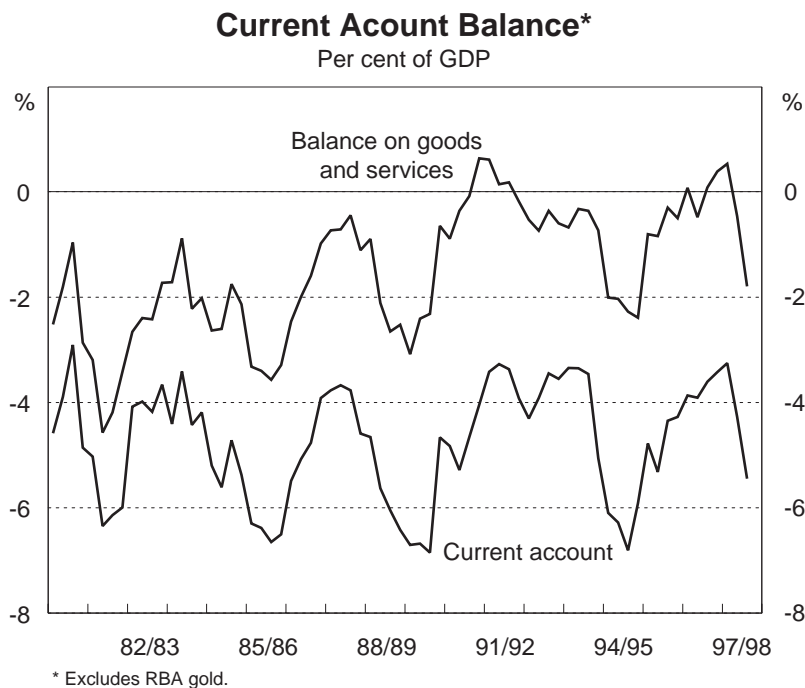
- Our corporate sector balance sheets are in good shape and gearing ratios are a lot lower than they were at the beginning of the decade.
- Our asset prices certainly do not show any sign of over-valuation. Although the share market has risen over the last couple of years, it has not risen to anywhere near as much as North American or European markets, and our commercial property prices have been quite restrained during the 1990s.

Another factor that we have going for us is that we do not have the brittleness built into our system that the fixed-exchange rate countries of Asia had in theirs. Our exchange rate has already depreciated substantially - against G7 countries it has gone down by about 14 per cent over the past year as the market has factored in the problems of Asia and the resulting widening of our current account deficit. It has also depreciated against

sterling by a similar amount. In the main, this depreciation was accomplished in an orderly fashion but on a few occasions, once in January, once in May, and again today, we judged that the market was over-reacting and we intervened. We are watching the situation closely. A significant fall in the exchange rate as we have had was always going to be part of the adjustment to this external shock, but an overshooting would be in no-one's interest.

4. *The Current Account*

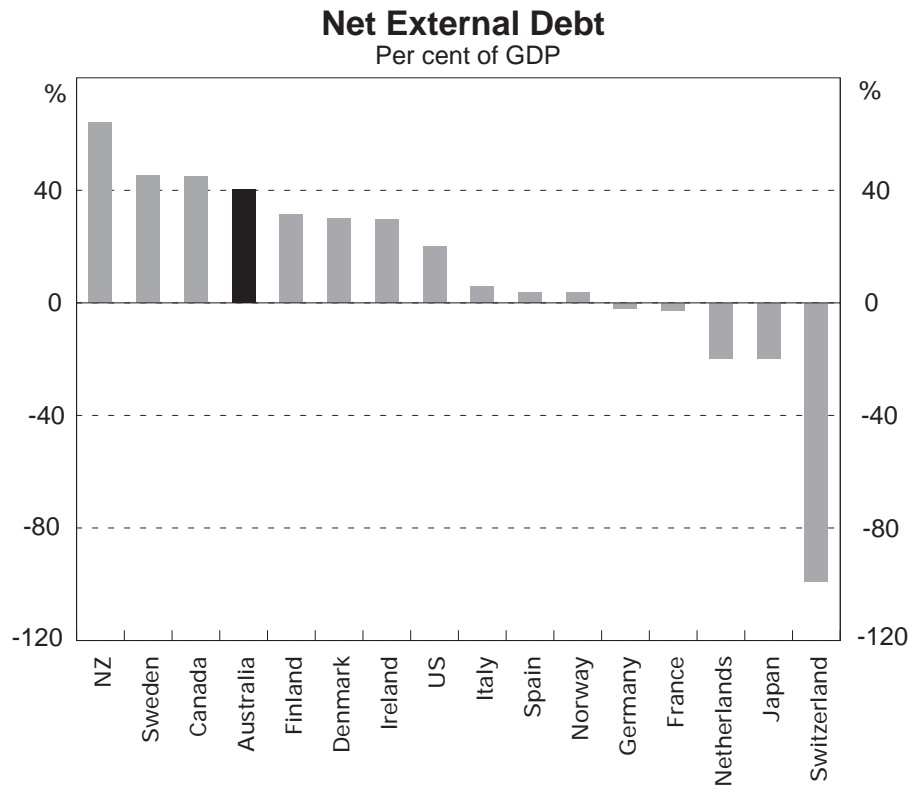
There is no doubt that the current account deficit is widening and that this will attract a lot of attention. This is, of course, not new for Australia. As Diagram 7 shows, this will be the fifth time in the last two decades that the current account deficit has pushed into the region of 6 per cent of GDP. My feeling is that the market is now beginning to realise this is the normal cyclical behaviour of the Australian economy. I also think that they recognise that on this occasion it is almost entirely due to the contraction in our trading partners. In the past, it has been possible to point to domestic imbalances and policy deficiencies in the Australian economy as important causes, but not on this occasion:



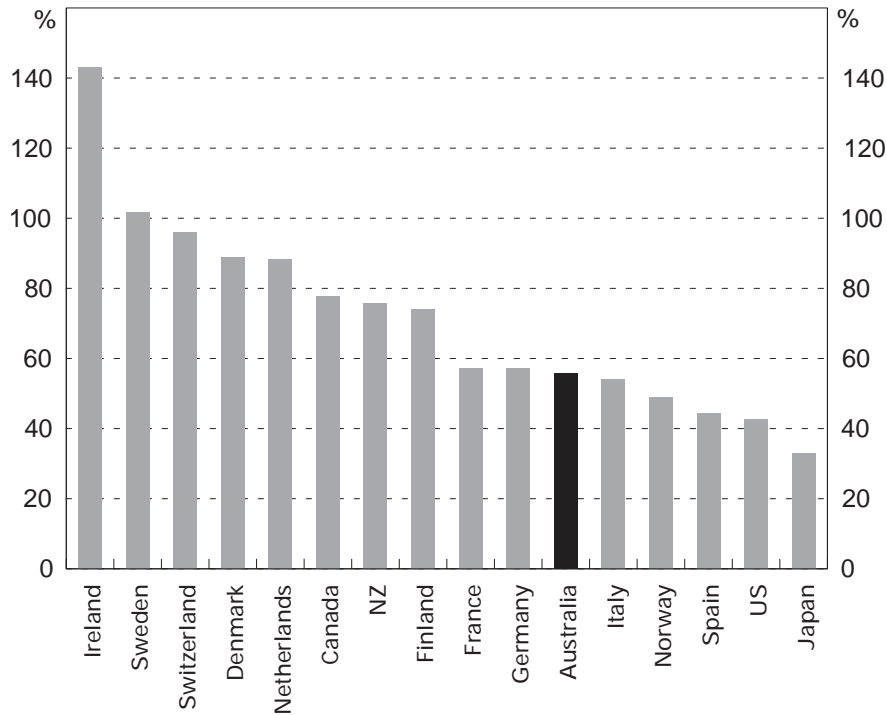
the domestic economy is not overheating as it was on past occasions when the current account widened greatly;

- the fiscal position is not contributing to the widening of the current account as the Government is running a small surplus; and
- Australia is not losing competitiveness through having a higher inflation rate than its partners. To the contrary, we are gaining competitiveness because our inflation rate is slightly lower than our trading partners and our currency has depreciated substantially against our major competitors.

The other thing that makes the situation different this time is that we have a lot more information on that favourite topic of the 1980s - foreign debt. It is clear from IMF data on the subject that Australia is not uniquely tarred with this particular brush. While our net debt to GDP level puts us in the most heavily indebted quartile of OECD countries, we are not at the top, as many people believed. New Zealand, Canada and Sweden all have a higher net foreign debt to GDP ratio than Australia. If we look at gross debt to GDP, which I think is a better measure of foreign exchange vulnerability, Australia is in the middle of the field.



Gross External Debt Per cent of GDP



5. *The Speed of Asian Adjustment*

When I last spoke about this subject about three months ago, I talked about the effects of Asia as being something that was still going to happen. Now, it is clear that these effects have already shown up in a very big way.

Since trade statistics are produced in the most timely way, the evidence has shown up there first, particularly in the imports figures for Asian countries. If you compare the average so far in 1998 with the quarterly average immediately before the crisis broke - the June quarter of 1997, the figures are as follows.

Country	Change in Imports %
Korea	-34.4
Indonesia	-25.7
Malaysia	-24.8
Thailand	-33.6

Even Singapore, which is not part of the problem but is affected by it, has seen its imports fall by 18.5 per cent over the same period.

The figures on current account positions are not as timely, but if we make use of the IMF forecasts for 1998 we can see clearly how rapid the turnaround in these countries' positions has been. For example, Thailand had a current account deficit of about 8 per cent of GDP before it entered the crisis; the latest IMF forecast for 1998 is that it will have a surplus of 7 per cent of GDP. This is a truly astonishing turnaround, but Korea has had a similar turnaround, and Indonesia has also returned to surplus. How have they done it so quickly? Basically, by savage contractions in domestic demand and GDP.

Here the figures are not as timely or reliable as the trade statistics, but we can get some guidance by looking at Korea which does produce quarterly GDP statistics. When we seasonally adjust these, they show that GDP fell by around 6.5 per cent in the March quarter (after falling by $\frac{1}{2}$ per cent in the previous quarter) - that is an actual rate, not an annual rate. I cannot remember any of the countries I am familiar with having an annual fall as big as this, let alone a quarterly fall. If that is not big enough to surprise you, gross domestic demand fell by 22 per cent in the March quarter of 1998. Indonesian GDP in the March quarter appears to have fallen by a similar amount to Korea's, and judging by the fall in Thai imports, I would not be surprised to hear that the Thai economy had contracted by a similar amount. I think it is probably true to say that we are already in the period of maximum contractionary impact in Asia.

As you would expect, these events have already made their presence felt in Australia, where export volumes have already fallen by 3 per cent in the last quarter of 1997 and by 2.2 per cent in the first quarter of 1998. While we cannot get volume figures for Australian exports by country, our estimates suggest that:

- for a number of destinations - such as Thailand, Indonesia and Malaysia - our exports have fallen in line with their imports;
- for Korea and Japan, our exports have declined by less than their imports;
- for non-Asian destinations, particularly Europe and North America, our exports have grown faster than their imports.

When we aggregate these effects, it is clear that our export volumes have fallen, but by a smaller amount than our export markets. An important reason for this is that most of our exports are sold into a worldwide market, rather than to country-specific markets. For example, if we cannot sell zinc to Thailand, we sell it somewhere else, rather than keeping it at home. Another factor, which we think will become increasingly important, is that many Australian exports are inputs into other countries' exports. In time, when Asian exports pick up in line with their improved competitiveness, we should expect to benefit from this.

Having said this, I do not wish to put too much of a gloss on it. We clearly are suffering a fall in exports, which combined with above-trend growth in imports has led to a significant widening in our current account deficit. Imports now appear to be slowing, but they will not (or should not) slow to anywhere near the extent of our exports. We have to accept this widening of the current account deficit, analyse its causes and explain these developments to the wider public. If there is a bright side, it is that the Asian adjustment is occurring so quickly and therefore the downward phase should finish earlier. As these countries have cut imports by a third in the past six months, it is hard to believe that they can do so again in the next six months. It is more likely that they are approaching the point where they will level out and start to rise, even if only modestly. That does not mean that we are out of the woods yet because we are still being affected by the slowdown in other parts of Asia, but the first wave may be close to having worked its way out.

6. Conclusion

Although Australia is geographically an island, we recognise that we are not economically one. I should say two islands for fear of offending the Tasmanians. We cannot set ourselves economic aspirations that are independent of our international trading environment. What we can aim to do is to get through this difficult period with minimum disruption to the economy, but we cannot avoid the effects altogether.

With good policies in place, there is no reason why we should suffer a sharp contraction in economic activity like some of our Asian neighbours, although some slowdown compared with 1997 is inevitable.

Similarly, there is no reason why a relatively normal cyclical widening of the current account of the balance of payments should lead to an excessive depreciation of the Australian dollar, and a surge in inflation, as is

happening in some of our Asian neighbours. But again some pick-up in inflation compared to our current very low results will undoubtedly occur.

Some widening of the current account, some reduction in growth below last year's rate and some rise in inflation will all happen. No economic policy response, no matter how far-sighted or finely tuned, can prevent these changes. But there is no logical reason for these changes to be "life threatening"; we should be able to adapt to the changed circumstances better than at any stage in the past quarter of a century.

In the end, the result will depend very much on confidence, both domestically and internationally. That in turn will depend not only on the quality of our fiscal and monetary policy, but on a host of other attributes. It will depend on the soundness of our financial institutions, the depth of our markets, the basic fairness and transparency of the accounting and legal underpinning to our corporate sector, and the capacity to carry out business at arm's length and not to fear that vital information is being withheld. In short, it will depend on the world's judgment of the soundness of our institutional and political framework, and its assessment of whether Australia is a stable and safe place to do business. I am sure that we will pass that test.
