ECONOMIC CONDITIONS AND PROSPECTS[1]

Address by Mr Glenn Stevens, Governor, to QUT Business Leaders' Forum, Brisbane, 14 June 2007.

The last time I gave a speech in Brisbane was three years ago, in June 2004. The key themes of that address were a world economy growing faster than average, rising oil prices, narrow pricing for risk in global financial markets, an Australian economy enjoying a long expansion, and a Queensland economy growing faster than the national average.

You might be forgiven for saying that not much has changed in the interim. The global economy has continued to grow faster than its long-run average, oil prices have risen a lot further, compensation for risk in financial markets remains remarkably skinny, Australia's economic expansion has continued and Queensland is still experiencing stronger economic conditions than the average for Australia.

But the fact that all those things *are* still occurring is quite remarkable. The Australian economy is on the cusp of the seventeenth year of the expansion which began in the second half of 1991. There is, at the moment, moreover, a high degree of confidence about the future, with share prices near record highs, property markets firming again and borrowing proceeding apace.

I shall begin with some remarks about the global economy, and then talk about Australia's recent performance. I will make some observations about how the Reserve Bank Board, responsible for monetary policy, is seeking to manage the risks which we judge the economy faces.

The Global Economy

The most recent outlook released by the IMF in April forecast global GDP growth in 2007, measured on a purchasing-power-parity basis, at just under 5 per cent. This is down a little from about 5½ per cent in 2006, but that was the fastest growth for over 30 years. The projected 2007 outcome is still well above the long-run average growth rate of around 3½ per cent.

Between regions, there are some important divergences under way. Europe has been enjoying an acceleration in economic activity, recording over the latest year its strongest outcomes since the beginning of this decade. This has been led by Germany, which after some years of rather indifferent performance has emerged more efficient, competitive and confident. Growth in Asia remains strong, led by the remarkable pace of China. The US economy, on the other hand, has slowed down over the past year or so. So one question for the period ahead is whether the

1 *Vanessa Rayner provided research assistance for this address.*

slower US growth portends a softening elsewhere, or whether other regions are big enough and internally vibrant enough to carry on growing reasonably well in the face of the US slowdown.

To a large extent this will hinge on how widely the slowing extends within the US economy itself, and how long it lasts. To date, it has been largely confined to a reduction, albeit a pretty large one, in construction of dwellings, after a period of unusually strong activity in that sector. People have been asking whether it will spread further, especially given the recent travails in the sub-prime mortgage market, which had at the peak accounted for about 15 per cent of mortgage loans made to US households. A decline in credit standards during 2006, as lenders sought to keep business growing in the face of the slowing demand for loans and a change in trend in house prices, has since resulted in a rise in loan arrears. In turn, this has resulted in a blow-out in spreads on the low-rated tranches of the securities issued by some of the US lenders active in this market, and a number of loan originators in the sub-prime space went out of business. There was understandably a concern that this sequence of events could prompt a pulling back by lenders for housing generally, which would deepen the downturn in construction. There was also a possibility that there would be a more widespread reassessment of risk and a tightening in credit across the US economy, so dampening growth more generally.

But so far, the US economy and financial system seem to be absorbing the sub-prime problems pretty well. There has been a significant tightening in credit standards in the sub-prime area, as there had to be, but no widespread withdrawal by lenders more generally. While the US housing sector has yet to show much convincing sign of a pick-up in construction, the softness in the US economy does not seem to have spread to consumer spending, as incomes have been supported by ongoing gains in employment. That does not necessarily mean we have seen the last of concerns about US weakness but, at the moment at least, adjustments to the growth outlook are at the margin, rather than amounting to a wholesale rethink of economic prospects.

It is also noteworthy, and very important from a global perspective, that underlying inflation appears to have come down in the US somewhat over the past six months, having drifted higher for the previous six months. Low and stable inflation has been a key underpinning of US and global economic expansion for the past decade and a half. Policy-makers around the world are rightly on alert for threats to that stability. If the US authorities *have* managed to turn inflation back down, then the foundations for future growth will have been strengthened. But US policy-makers themselves would still say, I think, that such remains to be seen, and we have recently seen some shift in market pricing in recognition of the fact that the risk of higher inflation has not yet disappeared.

Around Asia, Japan is growing again, but the big story is of course China. According to the official figures, China's GDP grew at about 11 per cent over the latest year, even faster than the preceding period. Just about every statistic on the Chinese economy paints a picture of dazzling growth, though there are also several areas where the Chinese authorities have expressed concern. There is more than a hint of froth in Chinese asset markets, especially the share market, which has increased by around 50 per cent this year. Rises in prices for soft commodities are also finding their way into food prices, which is a pretty big share of the cost of living in China and a number of other like countries.

In response, China has tightened its macroeconomic management policies, and taken taxation measures aimed at dampening speculative excesses in the share market.

We can expect, however, that China will seek to remain on a pretty rapid growth path for some time to come. To do so will require continuing efforts to find domestic sources for growth, with not quite so much emphasis on export-led growth, if only because China will be too big for the rest of the world to accommodate an export-led strategy either comfortably or willingly. It will also involve increasing attention to environmental issues, especially as Chinese living standards continue to rise towards those elsewhere.[2] But the Chinese authorities are aware of all that, and have shown an impressive capacity for economic adjustment over the years.

Hence, I remain reasonably optimistic about China's long-run growth potential, and by extension the growth potential of those parts of Australia's economy that are complementary to China's growth needs. That said, it would be imprudent to assume that the recent consistency of exceptionally strong Chinese growth is normal. It is more likely that there will be occasional bumps along the road, and some of them could be pretty big.

In the near term, were the US slowdown to become deeper and more protracted, Asia would probably be affected. It is true that direct trade linkages with the US have become relatively smaller as a share of total Asian trade in recent years. But while a larger share of Asian exports is now going to China, most of this trade is just part of the regional chain producing final goods for sale outside of the region in the major countries, a big part of which is still accounted for by the US. So higher intra-Asian trade does not of itself mean that Asia is more independent of the US. The power of linkages via financial market prices and attitudes of risk-takers should not be underestimated either. Hence a bigger US slowdown would still be a big deal, if it occurred, and keeping good global growth going would increasingly depend on policy responses in other parts of the world.

But provided the weakness in the US economy remains largely confined to its housing sector, as seems to have been the case to date, the spillover effects to the rest of the world through trade and financial channels are likely to remain small. There is some historical evidence in support of this point of view,[3] with other moderate US growth slowdowns in the past having had a relatively modest effect on world growth. This seems to be the most likely outcome as we look forward over the next year or two.

The Australian Economy

The trends in the global economy have imparted a very large expansionary impetus to the Australian economy. The rise in resource prices (and to a lesser extent a decline in global prices for manufactures) have increased Australia's terms of trade by about 40 per cent over the past four years, to their highest level since the 1950s.

2 *One recent study suggests that, based on the experience of most other countries which have made that transition, the number of motor vehicles owned in China would be expected to rise from 20 million in 2002 to almost 400 million by 2030. That would be equivalent to nearly 50 per cent of the vehicles in the world today. Other startling statistics can be quoted. No-one knows whether such projections will turn out to be accurate, but even a start down such a track by China surely will carry significant implications for energy and resource prices, climate change, technology and a host of other issues. Available at <http://www.econ.nyu.edu/dept/courses/gately/DGS_Vehicle%20Ownership_2007.pdf>.*

3 *In its April 2007* World Economic Outlook, *the IMF examines the global repercussions of past US recessions and mid-cycle growth slowdowns. The IMF finds that the US growth slowdowns in 1986 and 1995 had a negligible effect on growth elsewhere in the world. Specifically, the median growth decline in industrial countries was 0.1 per cent during US growth slowdowns, compared with a decline of 2 per cent during US recessions. In most emerging-market economies, median growth increased slightly during US growth slowdowns, but declined during US recessions.*

Despite the various other factors that are affecting the economy – like the drought – this is a boost of first-order importance, with real national income nearly 8 per cent higher than it would otherwise have been. Some of that additional income accrues to the foreign shareholders of companies but a good deal of it stays in Australia in the form of profits and dividends, taxes, wages and so on. There are then indirect effects as that income is partly spent on domestically produced goods and services. Assuming the change to the terms of trade is not just temporary, there are further effects as firms respond to the prospect of higher profits in future by investing in greater capacity in the relevant sectors, though investment could well decline in other sectors of the economy where relative prices look less attractive.

Typically, in such episodes the exchange rate rises because capital tends to be attracted to Australia by the same prospects of profitable investment, and also because markets anticipate that the expansionary forces at work will require higher interest rates. This tends to dampen activity in some parts of the traded sector, distributes the benefits of the higher terms of trade more widely across the economy, and gives a price signal for labour and capital resources to shift, over time, to the parts of the economy with the strongest prospects. It also assists to keep inflation under control by lowering prices for tradable goods and services.

The national income accounts show the broad contours of the effects. It is usually hazardous to base a story heavily on any one quarter's statistics, as these data can display considerable volatility over short periods. But taking the trend over the past year, growth in real GDP was around 3¾ per cent, half a percentage point higher than in the preceding twelve-month period. Business investment spending is high, suggesting a substantial increase in the nation's capital stock is occurring. Consumer spending gathered pace, on the back of large gains in employment and disposable incomes. Final spending by governments (that is, spending that directly affects demand, as opposed to transfer payments and taxation measures) has also risen at an above-average pace over the past year. Together these pushed domestic final demand up by about 4½ per cent over the four quarters to March. Some of the growth in demand was satisfied by imports. Exports picked up on the preceding period, but were held back somewhat by the drought, and in the case of some bulk resources, continuing capacity constraints.

This is a strong result considering that the effects of the drought and rising interest rates were also at work. But these data seem at present to align reasonably well with other information. Business surveys have consistently pointed to buoyant conditions. The labour market survey shows strong growth in employment, and measures of surplus labour, whether the standard unemployment rate or various measures of underemployment, have all declined further. Tax revenues, a rough cross-check on the growth of the nominal economy, have continued to be very strong.

Looking ahead, there does not seem to be a high likelihood of the world economy slowing abruptly in the near term. Hence, the external forces at work will in all likelihood continue to be pretty positive. Australian households overall appear to have plenty of disposable income and the confidence to spend it. Business profits are in good shape, and firms will be well placed to continue their high levels of investment as needed. They are also displaying a strong propensity to borrow, with business credit growth at its highest for nearly two decades.

Meanwhile, the number of dwellings being built looks to be below what is normally thought to be underlying demand arising from population growth and household formation. At some stage, therefore, it will probably need to pick up, adding to demand for labour in the construction sector and to demand for raw materials. There are nearly a million people working in construction, broadly defined as by the ABS, a rise of about 50 per cent from six years ago. Perhaps there is some further supply of labour available, but realistically there could well be a need for other types of private construction activity to tail off, so as to release some productive resources to accommodate (no pun intended) higher rates of dwelling construction. The intended further step-up in public infrastructure projects at the state level could also put some pressure on the engineering sector, unless private infrastructure projects also tail off.

That is just one manifestation of the point that we need to pay attention to the economy's supply side, as well as to the demand side. Observers conventionally assess the outlook for growth by looking at the prospects for demand components, adding them up, and then assuming that supply will respond. Anything that stimulates demand is thought to be 'good for the economy'.

But over recent years, we have increasingly been reminded that it is the economy's *supply*-side performance – the quantity and quality of the capital stock, the availability of labour and the productivity with which both those factors are used – that ultimately determines its rate of growth over the long term. Demand management policies – monetary policy and government spending and taxation measures designed to have a broad economic impact – can usually ensure that there is adequate expenditure to use the economy's productive resources. But while we can, in most circumstances, create additional demand, it is much harder to create additional supply. Unless additional supply is somehow forthcoming, however, expanding demand just produces overheating and inflation.

Inflation did pick up in Australia during the middle years of the current decade, from 2.4 per cent in 2003, to 2.6 per cent in 2004, 2.8 per cent in 2005, and 4 per cent by mid 2006. That peak in the CPI inflation rate was affected by some temporary factors, which have now reversed. But measures of inflation designed to extract the underlying trend showed a pick-up too, from about 2½ per cent to 3 per cent during the first half of last year.

The most recent data for inflation, however, showed a more welcome trend, with underlying measures of inflation running at a reduced pace and the CPI rate on its way down as well. In our *Statement on Monetary Policy* released about six weeks ago, our judgment was that underlying inflation would probably run at about 2½ per cent for the year 2007, which was a slight downward revision to earlier expectations. Data on labour costs received since then add credence to that forecast.

Compared with what we expected a year ago, then, growth has turned out to be stronger, employment higher, but underlying inflation a little lower, and wages growth has been steady in the face of unanticipated labour market strength. This is quite a favourable set of outcomes, and should prompt us to ask how it all fits together.

One possibility is that all we are observing is lags at work. Earlier national accounts showed a weakening in growth from mid 2005 through to mid 2006. Perhaps this led, with a lag, to the slowing in prices recorded in recent quarters. If this is the story, the recent apparent acceleration in growth will presumably before long lead to a noticeable renewed pick-up in inflation. While we should not completely discount this possibility, one shortcoming of this story is that the earlier slowing recorded in the GDP data was by and large not so apparent in other pieces of information, especially labour market information. The recent acceleration in GDP likewise is not so marked in other indicators, though neither is it entirely absent.

But my guess at present is that at least some of the explanation for these better-than-expected outcomes probably has to do with changed behaviour in the labour market. Despite, on most counts, the tightest labour market conditions for a generation, growth in most measures of labour costs has remained well disciplined for the past two years or more, after a mild acceleration earlier. Wages are rising quickly in some areas, but quite slowly in others. That is, *relative* wages are changing, adjusting to the forces at work on the economy, but without, so far at least, a serious inflation of the whole economy-wide cost structure. This looks like a textbook case of adjustment. We could note as well that, even though firms have been saying for some years now that labour is hard to find, they seem in many cases to have found it nonetheless. A rise in immigration has helped to accommodate the strong demand for labour (though immigration, of course, itself also adds to demand to some extent). Rising labour force participation across a number of groups, especially among those aged over 55, has also been quite important.

In economist-speak, the supply side of the labour market has recently been more 'elastic' than it used to be. It is a very different environment from the one that was in place last time we had a terms of trade event of this magnitude, testimony to the host of changes to the way the labour market functions that have occurred over the past two decades or so.

To this we can add globalisation, where for some products at least, the 'elasticity' of the global market is available in response to short-term demand fluctuations in Australia (or any other country). Australia is open to trade, which means not only that we have recourse to imports to meet demand if domestic supply is short, but since we are small in the world economy our demand *per se* has relatively little effect on the world price of those goods. The rise in the exchange rate would also be acting to dampen, at the margin, the rate of inflation for tradables. All these factors presumably help to explain the recent pattern of moderate price increases in the face of stronger demand and output growth.

But it would be a mistake to rely too heavily on these influences over a long period. While domestic supply has been reasonably elastic of late, it is surely not infinitely so. And while global sources of supply are steadily becoming more important for many products, large parts of demand are still overwhelmingly supplied from domestic sources. It follows that persistent rapid growth in demand for non-tradables would eventually start to be accompanied by more pressure on prices and wages than we have seen lately. We must, furthermore, be closer to the point where that will occur today than we were a year ago. If strong demand growth persists, risks will increase.

Nor can we assume that a rising exchange rate will exert a consistent dampening force on inflation of traded goods and services over the longer term, since exchange rates do not keep rising indefinitely. The ability to supply an increasing proportion of additional demand from imports probably also has some limit, though it is hard to tell where that might be.

Hence, as things currently look, inflation is more likely to rise during 2008 than to recede. This probability is something which was embodied in the medium-term part of the outlook we released six weeks ago. Data becoming available since then have given more credence to that part of the forecast.

These are the considerations the Reserve Bank Board is seeking to balance as it meets month by month. On the one hand, the medium-term concerns about inflation remain, for the reasons I outlined a moment ago. That is cause enough to err on the cautious side in setting policy, and to ask whether current settings are restrictive enough. On the other hand, the somewhat lower short-term inflation outlook means that the starting point for a future pick-up in inflation is likely to be a bit lower than earlier thought. This has afforded some additional time in which to assess trends in demand and the economy's capacity to meet them, while still leaving scope to implement a further response by monetary policy as and when needed. Weighing all this up, the Board has decided at each of its recent meetings to maintain, for the time being, the settings which have been in place since November last year.

The fact that a number of timely adjustments to monetary policy had already been made gave us some confidence in adopting that approach. In fact, a lot of the work needed to keep inflation on a reasonable track was done in the period from 2002 to 2005, when unusually low interest rates, which had been appropriate for the earlier part of the decade, were gradually lifted towards normal. They were raised a bit further, to be slightly higher than normal, during 2006. Without that sequence, we would today have been in a much less comfortable position.

Whether or not further instalments in that sequence will be needed is a question the Board will continue to address over the months ahead. The Board's judgment will, as usual, be informed by all the relevant data and an assessment of the risks we face over the coming couple of years.

Conclusion

We are living through a period of profound change in the world economy, which is offering a rare chance to improve further the economic success Australians have enjoyed over the past decade and a half. Historically, Australia often did not manage periods of prosperity very well, as our institutional and policy structures were not sufficiently flexible and long-term in their orientation. The chances of success are much higher on this occasion, and the evidence so far is that we are doing much better, but the situation is not without risks.

I trust that on some future visit to Queensland we will be able to look back and find that the risks had been effectively managed. If so, then monetary policy will have played its part in furthering the prosperity and welfare of the Australian people.