ECONOMIC CONDITIONS

Address by Mr Glenn Stevens, Governor, to the American Chamber of Commerce in Australia Business Luncheon, Melbourne, 13 June 2008.

Thank you for the invitation to address you in Melbourne today. I read that AmCham is the largest international chamber of commerce operating in Australia, and has been working to promote trade, investment and general business links between the United States and Australia since 1961. Over that period of nearly five decades, the US and Australia have enjoyed a mutually beneficial trade relationship, enshrined most recently in the Free Trade Agreement.

During that time, a lot of other shifts have occurred, of significance to us both. In 1961, nearly a quarter of Australian exports went to the United Kingdom, our number one trading partner. Trade with China was of inconsequential size. Japan had become a prominent destination for exports by then, but would go on to become by far our largest trading partner by the end of that decade, due to the expansion in the mining sector. In 2007, the UK was number six as a destination. The US was number three (little changed from 40 years earlier). China equalled Japan in first place for two-way trade, and will easily outstrip Japan this year.

Of course, the United States is still far and away the largest economy in the world, and will remain so for quite a while. Nonetheless, the change in the trade experience of Australia – and we are hardly alone in that – is an indicator of the way the weight in the world economy is gradually shifting to the Asian region.

On the financial front, in contrast, Asia remains in many respects underdeveloped, especially in terms of the prominence of its local-currency capital markets. US capital markets remain the largest, deepest and most influential, driving developments in stock, bond and money markets, and their various derivative offshoots, around the world.

That contrast – the increasing economic weight of Asia and the continuing dominance of American behaviour in financial markets – is in many ways at the centre of the set of challenges facing Australia, and I suspect other countries, right now. Before coming to that, however, it is fitting to begin with some remarks about the US economy. I will then talk about the global economy more broadly, and particularly the effects of the US slowdown on the rest of the world before focusing particularly on Australia and the current challenges of economic management that we face.

The United States Economy

As you well know, the US economy is struggling with a period of weakness at present. Growth has slowed to a very subdued pace, and confidence is well down. There continues to be debate as to whether or not what we are witnessing can be called a recession. In some respects, this is a

rather silly preoccupation because there is no doubt that conditions are weak, and it is not worth spilling much ink over whether the growth rate is just above or just below zero. That said, the US economy has, thus far, done a little better than many people had feared.

Of course the episode is not yet over; a period of adjustment still lies ahead. The epicentre of this adjustment is the housing sector, where deteriorating lending standards and a speculative boom in parts of the country a few years ago led to a build-up of excess physical stock and over-stretched borrowers. Subsequently, the need to work off this overhang has seen construction rates for new homes fall by half, and prices for established homes in many major cities decline for the first time in many years. Rising defaults and foreclosures are likely to dampen prices further. The non-recourse nature of mortgages in some US states is potentially a destabilising factor as well, since even people who can service a loan have an incentive to walk away once their equity falls to zero. Tighter credit conditions are a dampening factor for the US economy more generally, as lenders work to limit risk in order to repair their own balance sheets.

So the real question is when the preconditions for a renewed expansion will come into place. It is perhaps a bit soon to conclude that we have reached that point. There are certainly some helpful dynamics at work: the worst fears of a serious financial collapse have abated somewhat over the past couple of months, the process of balance sheet repair for key institutions is well under way, macroeconomic policies have been put into expansionary mode and initiatives to offer some modest support to the housing market are in train. Considerable uncertainty, nonetheless, surrounds the outlook for the United States over the next year or so.

The Global Economy

What is the effect of this on the rest of the world? In a previous response to this question,[1] I suggested that there are two key channels to consider. The first is trade spillovers, as the fall in US income means that the US demands less in the way of products from other countries. The decline in the US dollar also works in this direction. The second potential channel is financial contagion, with the possibility that other countries may experience the same financial dynamics as those which have been at work in the United States.

My view was that this second channel was likely to be the more important one in this episode. The trade channel certainly is working – lower US demand is being felt in weaker exports to the United States from most parts of the world. But other forces are also at work, and the strength of some other regions has meant that many export-driven economies, certainly those in Asia, have continued to record quite solid growth into the early months of 2008. Some of these countries have also developed a good deal of momentum in domestic demand. So to date, trade *per se* has not been the major issue.

But financial exposures to the problem assets were spread around the global system. Credit-related losses that have been disclosed by financial institutions around the world to date amount to something approaching US$400 billion, of which about half is in institutions domiciled outside the United States. More losses reside in entities outside the core financial system. So the pressure on balance sheets arising from the decline in credit standards in the middle of the current decade

1 *'Economic Prospects in 2008: An Antipodean View', 18 January 2008 (available at <http://www.rba.gov.au/Speeches/2008/sp_gov_190108.html>).*

has extended beyond the US itself, at least to Europe and the UK. Given the integrated nature of financial markets in the developed world, moreover, pressure on term borrowing costs for banks has been seen in many places over the past nine months, even if in a less acute way than observed in the countries at the centre of the crisis.

These forces are contractionary in nature, and so global growth is widely expected to be lower in 2008 than the very strong result in 2007. According to the IMF, global GDP growth will moderate to about 3¾ per cent in 2008 and 2009, with slowing concentrated among the developed economies of North America, Europe and Japan. This forecast embodies a mild US recession during 2008.

But while this outcome for global growth would be well below the exceptional pace of about 5 per cent seen in 2006 and 2007, it is actually in line with the average rate of growth for the world economy over the past 15 years. And although the IMF suggested in April that the short-term risks surrounding this forecast were concentrated on the downside, with a 25 per cent chance of global recession (which it defines to be global growth at or below 3 per cent), recent developments do not suggest that those risks are any more likely to be realised than was the case a couple of months ago.

To date, in fact, the financial developments that have so occupied the minds of developed world policy-makers have not been as big an issue for many countries in the emerging world, at least not those most important to Australia. Banks in those cases have not had serious funding problems, perhaps in part because their own exposures to the bad assets were minimal. Capital markets, which are less important as avenues of funding than in many developed economies, have not been a source of significant disruption. Admittedly, share markets in the emerging economies have declined noticeably, but credit expansion has continued unimpeded and, as I indicated a moment ago, economic growth appears to have remained pretty solid.

In fact, around much of the emerging world at the moment, the bigger problem seems to be neither the near or actual recession of the United States, nor the credit crunch about which we hear so much in the discussion of the major countries, but inflation. From Asia to Latin America to Africa, as well as in many of the industrial countries, we are hearing a lot more about inflation now.

Food price rises loom large in developing countries' consumer basket, so the big rises in grain prices over the past year have been very prominent. Several potential drivers of these increases have been nominated. One is the change towards a more protein-intensive diet as developing countries' incomes rise, which increases demand for grain to feed animals kept for meat. This is no doubt a factor, but it is a long-run trend and there is no evidence that meat consumption has exploded just in the past year.[2] Another is the diversion of some grains towards production of bio fuels, with up to half the increase in the consumption of some crops in 2006/07 going to this source, thus constraining supply available for additional food production.[3] But while this has played a role at the margins, supply disruptions have arguably been the most important cause

2 *Indeed, food demand in emerging economies began to increase strongly in the 1990s, long before the current run-up in prices, see IMF* World Economic Outlook: Globalization and Inequality, *October 2007 (available at <http://www.imf.org/external/pubs/ft/weo/2007/02/pdf/text.pdf>).*

3 *See IMF* World Economic Outlook: Housing and the Business Cycle, *April 2008 (available at <http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/text.pdf>).*

of big price rises in the past year. In particular, supply has been disrupted by adverse weather conditions in key production areas, for example, the drought in Australia. To the extent that those effects are temporary, it could be expected that food prices will not continue to rise at the same pace.

Temporary supply factors may, at the margin, also have been at work in pushing up oil prices of late. In addition, the inflow of financial capital into energy derivatives markets, as funds have expanded their asset universes to include commodities, has been another source of demand. This seems to be what people have in mind when they suggest that oil prices have been subject to speculative pressure.

But it is surely impossible to avoid the conclusion that most of the trend rise in oil prices over a number of years now has been due to rising demand by end users. Supply has risen too, in contrast to what occurred in the OPEC shocks of the 1970s, but it has struggled to keep pace and the cost of supplying the marginal unit has risen.

The same can be said, moreover, about other resource commodities, including thermal and metallurgical coal and iron ore – commodities that are very important to Australia as a producer. Chinese demand for these resources to construct first-world standard cities has been extremely strong, and has accounted for a large share of the increase in demand over the past several years. Anyone who visits a Chinese city can see the results. Such visitors also tend, more often than not, to get a sense that this demand could continue, as a structural phenomenon, for quite a long time.

At present, there is a strong sense of overheating in the Chinese economy. It would be even clearer in the statistics were it not for the administrative controls over many prices. As it is, China's official CPI is rising at close to 8 per cent per annum.

The effect of China on the rest of Asia, moreover, is expansionary. Coupled with fairly easy monetary policy settings in much of the region, which tends to occur in many emerging economies when US policy rates are very low because of the importance of exchange rate considerations to Asian policy-makers, this is likely to limit downside risks to growth in the short term. It does pose the risk, though, that inflation will continue to pick up. This is not confined to Asia, either: inflation pressures are evident in much of Latin America and South Africa, both regions where higher resource prices have delivered a terms of trade gain of substantial proportions. I would venture a guess, in fact, that the number of countries where inflation is the major problem greatly exceeds, at present, the number where the predominant concern is inadequate growth.

It may be that the slowing in growth in train in the major countries will lead to energy prices and some other commodity prices moderating. On the other hand, the forecast moderation in global growth is taking it back only to about average pace. With the bulk of new demand for energy and resources coming from countries which are yet to show much sign of cyclical slowdown, and whose energy intensity of demand is continuing to increase secularly, any near-term softening in these prices might only be modest.

Hence the fact that the low level of interest rates in the major countries results, *de facto*, in the setting of monetary conditions being pretty easy in many developing countries as well, is starting to raise warning flags among observers who can see inflation pressures already building.

This could pose some quite difficult choices for policy-makers, particularly in the emerging world, over the next year. Longer term, of course, the likely ongoing growth in demand for energy by developing countries will surely pose major adjustment challenges for the rest of us.

The Australian Economy

The external environment certainly poses some big, and very immediate, challenges for an Australian economy which has experienced a long expansion and largely used up its reserves of spare capacity. The forces at work from abroad pull in different directions, to an extent seen on few occasions in the past.

On the one hand, the seriousness of the sub-prime credit crisis, and the associated weak outcomes being experienced in the US, and thought to be in prospect in the UK and some parts of Europe, are well understood by Australian households and businesses. The financial turmoil of the past nine months has also seen a market-driven tightening of financial conditions in addition to that which resulted from the tightening of monetary policy.

Combined, these developments are having a dampening effect on demand. Households have, over recent months, adopted a more cautious attitude to borrowing and spending, the evidence for which is a string of flat results for retail sales, and a significant decline in the flow of new loan approvals for housing. Credit approvals to businesses have also declined significantly. While this partly reflects the winding down of a process of rapid reintermediation that had been occurring as businesses turned to their banks and away from capital markets around the turn of the year, total business funding has slowed. In short, things are happening that suggest a moderation in growth in domestic demand is occurring, signs of which were beginning to appear in the national accounts data released last week. At this stage, inevitably, the extent and likely duration of the moderation remains uncertain.

There is not much uncertainty, though, about the need for a moderation. Inflation increased over 2007, and in underlying terms reached the highest rate for 15 years or more. It is true that it was boosted by the international rise in oil and other commodity prices, but Australia's inflation rate has risen more than most of those in our usual peer group when measured on a comparable basis. It is also pretty clear that strong domestic factors were at work, with growth in local demand at a pace exceeding, by a large margin, any plausible estimate of the economy's long-run potential growth rate for output, at a time when capacity was already tight. Had not the rise in the exchange rate occurred over the past couple of years, moreover, the Australian dollar prices of energy and other raw materials (as well as other tradable goods and services) would be even higher.

So inflation has picked up, and needs, over time, to be reduced. Reductions of inflation usually require a period of slower demand growth, and this episode is no different.

At the same time as we are seeking this moderation in domestic spending, the rise in resource prices that is occurring courtesy of strong demand abroad has complex effects on the Australian economy. Since Australians pay world prices for their petroleum products, the rising global oil price adds to costs for businesses and consumers. This is inflationary in its immediate impact, though it also acts as a brake on spending on other goods and services, unless people are prepared to reduce saving or borrow to sustain that other spending at previous levels. Other things

Table 1: Terms of Trade – Selected Countries
Percentage change, 2002–2007

Country	%
Chile	78
Russia[(a)]	64
Australia	42
Forecast for 2008:Q3	67
Norway	38
Argentina	21
Canada	19
South Africa	13
Mexico	4
Turkey	4
Indonesia	1
United Kingdom	0
France	–2
Germany	–2
Italy	–2
United States	–6
South Korea	–13
Japan	–22

(a) 2003–2007
Sources: ABS; Badan Pusat Statistik (BPS-Statistics Indonesia); Banco Central de Chile; Federal State Statistics Service (Russia); Instituto Nacional de Estadística y Censos (National Institute of Statistics and Censuses, Argentina), INDEC; OECD; RBA; South African Reserve Bank

equal, this brake dampens inflation impulses in those other areas.

But other things are not equal. Australians also receive higher incomes as a result of higher resource prices. As shareholders they experience higher profits. Employees in the resource sector, as well as in the construction sector or the various areas that supply goods and services to mining, are receiving larger pay packets. Governments are receiving higher revenue flows, which in some cases they will spend, at least in part. So in net terms, this terms of trade effect is expansionary. In the normal course of events, it would add more to demand than the higher commodity prices would take out.

With the rises in bulk commodity prices taking effect now, Australia's terms of trade will rise by about 20 per cent, on top of the very substantial lift that has occurred over the past several years. Since 2002, the total rise in the terms of trade will, by the end of this year, be of the order of 65–70 per cent. Some other countries are also experiencing significant terms of trade rises (Table 1). But few will have seen anything bigger than Australia's over a five-year period.

There is an obvious contrast with the United States, whose terms of trade have fallen by about 6 per cent over the same period, owing to the importance of energy imports to that country. The strongest contrast, though, is with countries such as Japan or South Korea, which, unlike the US, have no significant resource endowments of their own.

Turning back to Australia, the effect of the 65–70 per cent increase in the terms of trade has been to lift the purchasing power of our GDP by around 13 per cent. In the terminology of the national accounts, this is the boost to real gross domestic income or real GDI. Of course, our resources sector has significant foreign ownership, so a significant part of the gains accrue to foreigners and the boost to the real income of Australian residents is not as large. Over 2008, the boost to real GDI is estimated at around 4 per cent, with the boost to national income somewhat less than this, but still substantial.

The expansionary terms of trade shock occurring now obviously would have the potential, absent some other adjustment, to be seriously destabilising.

By design, certain features of our macroeconomic policy framework help to handle the shock. A higher exchange rate plays a very valuable role in dampening the expansionary impact, lowering prices for traded goods and services and spilling some demand abroad. In the year ahead, the Government has said that the so-called 'automatic stabilisers' in the Federal Budget, which refers to the feature that the tax system withdraws more income from the economy the faster it grows, will be allowed to operate, which is also helpful.

It falls to monetary policy to play its proper restraining role as well, dampening private demand not only because inflation has already picked up, but seeking to head off further problems that could easily emerge given the expansionary effects of the terms of trade. This is why a tight monetary policy setting is essential. It is why the Reserve Bank has lifted interest rates, even as the Federal Reserve was reducing them.

Not only does the overall pace of demand growth need to slow, but we are having to accept a change in its composition. There is a major process of investment going on, by businesses as well as by governments. Business investment is at very high levels relative to GDP, and businesses in aggregate say they intend to increase investment further next year. Governments at the State level intend a substantial infrastructure spend as well, though the experience of the current year is that they are having trouble implementing their plans because of the demands already being made on the engineering construction sector.

In most economies, it is usually not possible, and certainly not prudent, to try to have a consumption boom at the same time as an investment boom. Of course, Australia can and does access the savings of foreigners to fund additional investment – a process of running a current account deficit – so we do not have to finance the totality of the additional investment ourselves. This is something not unknown to the US economy either (in fact, it has been a common feature of most of the Anglophone market economies over the past decade).

But even so, there are probably sensible limits here. Practically speaking, domestic consumption, together with housing demand, and some areas of business investment not linked to the resource sector, is being asked to make some room, for some period of time, for the rise in other forms of investment that will sustain higher incomes and living standards in the future. Given that the economy is pretty fully employed, total investment levels are already high, the nation's call on net capital inflow from abroad is over 6 per cent of our GDP and inflation is already 4 per cent, it is difficult to see any serious alternative to an adjustment of this nature.

To try to absorb the expansionary terms of trade impact without any macroeconomic policy restraint is not really an alternative at all. In such an inflationary scenario, I expect that we would still find that the resources sector and the parts and regions of the economy that benefit most directly from its flow-on effects would attract additional labour and capital, and become proportionately larger in the national economy over time. Other sectors and regions would, proportionately, still diminish in size. The process would simply be less efficient: the price signals for resource allocation that are pretty clear at present would be more difficult to detect under conditions of higher inflation. Indeed, that is one of the problems high inflation brings. This course would also leave the rest of the economy with the legacy of embedded high inflation, commensurately higher nominal interest rates and so on. That would be harmful for living standards over time. As such, allowing it to occur would be a policy mistake.

Conclusion

Both the United States and Australia face significant economic challenges. For the US, dealing with the fall-out of the financial excesses of the earlier years looms large at present. This is not made any easier by the simultaneous lift in global commodity prices, which raises consumer prices but, in the US, also dampens economic activity. For Australia, the financial fall-out has been less severe, mainly because participation in the earlier excesses was so much smaller, while the very large change in prices for mineral and energy resources is the most expansionary external shock to affect the economy for 50 years or more. It has occurred at a time when the productive capacity of the economy has already been stretched by the long expansion. Hence, the prospect of inflation has presented a larger and more immediate danger to us than it has, thus far, to the US.

One way or another, the near term continues to present challenges on both sides of the Pacific, as the two respective economies adjust to the shocks hitting us. But both of these economies are pretty adaptable. There is no reason why, with sensible policy frameworks, competitive and innovative firms, and capable and industrious workforces, they should not continue to prosper over the long term.