Will Australia Catch a US Cold?

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It is a great pleasure to be taking part in this conference, and in particular to be here in New York again.

I have been visiting New York regularly for a large part of my career at the Reserve Bank. I have always very much enjoyed these visits, but that, of course, was not their purpose. The point of my visits was to find out what was going on in the US economy because, for a long time, this had a major bearing on the Australian economy.

Through the 1980s and into the 1990s, developments in the Australian economy showed a close correlation with those in the US economy. It was particularly striking that the recessions of the early 1970s, early 1980s and early 1990s were highly synchronised between the two countries and had many similarities in their nature and origins. As a result, it was common in the 1980s and 1990s to hear the phrase 'when the US sneezes, Australia catches a cold'.

Australian economists, including those in the Reserve Bank, spent a lot of time researching the question of why growth in the Australian economy was so highly correlated with that in the US. We were intrigued by the closeness of the relationship because the trade flows between the two economies were not particularly large. The United States has always been only a moderately important export destination for Australia.

The research unearthed various channels that contributed to the close relationship, but two factors seemed particularly important:

First, the economic shocks faced by the two countries in the lead up to the recessions of the 1980s and 1990s were similar, as were the policy responses. It was understandable, therefore, that the economies would follow similar paths.

Second, the financial and cultural links between the two countries have always been very strong. The United States is a large investor in Australia and many Australian companies have operations in the US. US economic news receives very wide coverage in the Australian media. This, in turn, has often promoted very similar movements in financial prices, business sentiment, and even household behaviour.

Scrutiny of this close relation between the two economies reached its peak around the mid 1990s. Ironically, this was around the time when the relationship began to change.

Certainly, by the first decade of this century, the paths of the economies had clearly diverged. Whereas the United States experienced recessions in 2001 and 2008/09, the economic downturns in Australia around those times were relatively mild. It has been 20 years since the Australian economy experienced a year of negative growth. This represents the longest period of uninterrupted growth in Australia's economic history, and one for which there are few precedents among the developed economies.

Why have the paths of the two economies diverged? I don't think I can provide an exhaustive or conclusive answer to this question, but there are a couple of factors that have clearly played significant roles.

First, both the 2001 and 2008/09 recessions in the United States were to a large degree the consequence of financial misadventure. The former was heavily influenced by the collapse of the 'tech' bubble, and the latter by the collapse of the sub-prime housing bubble.

Australia was not affected nearly as seriously by either of these events. The tech bubble largely missed Australia. In fact, in the late 1990s Australia was constantly being berated for being an old-world economy in that it did not have a homegrown information technology industry. As it turns out, being a heavy user of technology, but not a manufacturer of it, was an advantage. The Australian economy was not distorted by the tech bubble that built in the late 1990s, and it did not weaken as much as the US economy when the price of tech stocks collapsed in 2001.

The mildness of the 2001 economic slowdown in Australia meant that the Reserve Bank was able to normalise interest rates relatively quickly thereafter. In the event, this helped Australia avoid the worst of the excesses in housing markets that subsequently built up in many other countries. The housing market was most 'frothy' for Australia as a whole around 2002–2003, and it cooled noticeably in 2004 as interest rates rose. While there were subsequent price increases in particular cities, the speculative element in the market had subsided considerably in most states by the time the global financial crisis hit in 2008.

Aside from increasing interest rates, the Reserve Bank also warned repeatedly around that time about the danger of excessive increases in house prices and borrowing, which may have, at the margin, curtailed some speculative activity. It was also helpful that the Australian Prudential Regulation Authority (APRA), the prudential supervisor, pressed the banks to maintain relatively high lending standards. While there was some sub-prime lending activity in Australia, it was on a small scale, and mainly by non-bank lenders. As such, arrears rates on housing loans have remained at low levels, and Australian banks have remained profitable. Australia, therefore, did not have a homegrown financial crisis in 2008/09, and its financial institutions also had little direct exposure to the US housing market. As a consequence, just as had been the case in 2001, Australia experienced only a mild economic slowdown in 2008/09.

The fact that Australia avoided the direct impact of both the tech crash and the sub-prime crisis obviously helps to explain why the Australian economy has done better than the US in the past decade. But another factor that has contributed to its outperformance has been the growing role of China in the global economy. The expansion of China has had an overwhelmingly positive impact on the Australian economy over the past 10 to 15 years, whereas the implications of the Chinese expansion for the United States have been more mixed. The integration of China into the global economy has been an important factor shaping the performance of many economies over the past 10 to 15 years. Generally, economies that complement the Chinese economy have done relatively well. Obvious examples are commodity exporters such as Australia and some Latin American countries, exporters of capital equipment and luxury cars, such as Germany, and countries that are part of the China supply chain, such as many in Asia.

Arguably, Australia is one of the economies that most complements the Chinese economy. It is a large producer of food, energy, basic materials and education and tourism services – products and services for which China has a very strong demand – while the limited size and specialised nature of Australia's manufacturing sector mean that the economy as a whole is not facing widescale competitive pressures from China. As evidence of this, over the past decade Australia has experienced a much larger rise in its terms of trade than all other major commodity exporters, apart from Chile.

While it is clear that China now has a large influence on the Australian economy, that is not to say that US developments no longer matter. Clearly, they do. They continue to play an important role in shaping financial market behaviour, and household and business sentiment. The point, however, is that over the past 10 to 15 years these channels have not been powerful enough to dominate overall economic outcomes, being outweighed by the other influences I have mentioned.

At this juncture, the US and Australian economies find themselves in very different cyclical positions. The United States is still struggling to recover from the deep recession caused by the sub-prime crisis, while Australia, having grown for 20 years, is operating with relatively little spare capacity and is investing heavily to meet rapidly growing demand for resources from China, and elsewhere in Asia.

A topical question at present is whether the recent turmoil in global markets will eventually overwhelm the positive effects on the Australian economy from China.

That could occur either because the financial uncertainty undermines household and business confidence, and therefore consumer and investment spending, or because the turmoil also weakens the Chinese economy, leading to reduced demand for resources.

It is simply too early to be able to answer this question. For one thing, nobody yet knows when, or how, the issues that are causing the financial turmoil will be resolved. In some cases they go to the heart of institutional arrangements in Europe, and cannot be resolved quickly. It is impossible to know, therefore, how long the turmoil will last, or even if it will escalate further.

As yet there is little in the way of hard economic data available for the period since financial market volatility escalated, but let me briefly run through what we do know.

I will begin with some observations about China. A few years ago, a common question was whether the Chinese economy could continue to grow if the US economy slowed. The experience of the past three or four years has, I think, answered that question, and the answer is in the affirmative. China has maintained strong growth in the face of the US recession and the sluggish recovery. The latest batch of Chinese data, which relates to August, suggests that any slowing in the economy has, to date, been modest. This is confirmed by recent data on Australia's shipments of coal and iron ore to China, which have also held firm. So too have the prices of iron ore and coal.

In relation to Australia, the most comprehensive data on the economy – the national accounts – are only available up to the June quarter, and so pre-date the recent financial volatility. They confirmed, at that point, a picture of very strong business investment; declining government investment, as earlier fiscal stimulus is unwound; relatively flat dwelling investment; and weak commercial construction. All this was broadly in line with expectations.

The one area of the national accounts that surprised was the strength of household consumption. Retail sales had been subdued through much of this year, and this had generally been taken as a sign of weak consumption overall. But the national accounts showed that household spending on services has been strong. Households are spending more on entertainment, eating out and travel, particularly overseas travel.

At one level, this was surprising given the clear signs of caution among households, but it is less surprising when account is taken of the ongoing fast pace of increase in household income. For a time, this increased income was used to rebuild saving, but with the household saving ratio having stabilised in recent quarters, income growth is now providing the wherewithal to fund consumption.

The national accounts also showed that Australia's GDP continues to be affected by the severe effects on mining activity of the floods over the Australian summer. Taken literally, the weakest sector of the Australian economy over the past year has been the mining sector, where output has fallen by 9 per cent.

We know this is in the process of being reversed, so we need to look through it to judge the underlying strength of the economy. Our estimate of the underlying trend in mining-related activity over the next couple of years is for increases in the order of 10 to 15 per cent. The rest of the economy on the other hand, is growing at an annual rate of only about 2 per cent. This is below what would have been regarded as normal in the past.

This slow pace of growth in the non-mining sector is not simply a matter of a shortfall in demand. There are signs that the capacity of this part of the economy to supply goods and services has also slowed. For one thing, growth in the working-age population has slowed markedly over the past couple of years, due largely to a slowdown in immigration. Also, productivity growth continues to be low. For growth in the non-mining economy to pick up, it is likely that these trends will need to reverse.

Labour market data are available up to August. They continue to point to soft outcomes for employment, after the surprisingly fast increase last year. The unemployment rate has also risen by 0.4 percentage points over the past few months, after having been steady at around 5 per cent for much of the year. These trends could be an indication of the economy having slowed recently to a pace that is below its potential.

On the other hand, there are some aspects of labour market numbers that have a stronger feel. Contrary to the slowing in the number of people employed, there has been solid growth in total hours worked recently. Also, the very recent rise in unemployment has been most pronounced in the resource-rich states, while an independent indicator – the number of people on unemployment benefits – does not point to any rise in unemployment. All this suggests more information is needed before we can draw any firm conclusions about whether or not the labour market is weakening.

Measures of consumer and business confidence declined sharply in August, following the increase in financial market volatility. This is not surprising. Consumer confidence has subsequently recovered somewhat in September. We will need to wait to see how these swings in confidence affect spending. So far, recent liaison information from retailers does not point to any further significant weakening.

Let me end with a few words on how the Reserve Bank has been seeing monetary policy.

The context for monetary policy over the past year or so has been that the overall economy is operating with relatively little spare capacity, and is facing a very large boom in investment and a large rise in national income. The Bank's view has been that, if this is to be accommodated without generating undue inflationary pressures, other components of spending would need to grow less than might otherwise be the case. The implication of this is that monetary policy would need to provide an element of restraint. Accordingly, the Bank late last year lifted the cash rate to the point that resulted in most lending rates in the economy being a little above average.

From time to time over the past year, the Bank has considered whether further restraint was required, but on balance concluded that existing policy settings remained appropriate, particularly given the restraint also being applied by the high exchange rate. At its most recent monetary policy meeting, the Board judged that the recent financial volatility could weaken the outlook for demand, and hence may, in due course, act to dampen pressure on inflation. On this basis, the Board judged that it was prudent to maintain the current stance of monetary policy.

In the meantime, financial markets seem to have concluded that the risks are weighted towards the Australian economy weakening sharply and, taken literally, seem to be pricing in a reduction in official interest rates towards the unusually low levels reached after the global financial crisis. There are technical reasons why current market pricing may not be giving an accurate picture of interest rate expectations. Nonetheless, markets do seem to have reached a pessimistic assessment and this appears to be based mainly on the assumption that weakness in the US and Europe will flow through to Australia.

The present situation has some similarities to that in 2003. From late 2002 to the third quarter of 2003, financial markets were pricing in cuts in interest rates in Australia, largely on the back of concerns about the sluggishness of the US recovery at that time. In the event, however, that sluggishness in the United States did not flow through to the Australian economy and Australian interest rates did not fall.

Conclusion

Let me conclude.

It is too early at this stage to judge with any degree of certainty whether Australia will catch cold from the US. However, given that over the past 10 to 15 years the Australian economy has been less vulnerable to severe US symptoms, there are reasonable grounds for optimism.

Until a clearer picture emerges, the Bank's approach will be to keep an open mind, and base its assessments about appropriate policy on a careful analysis of the data that become available.