RESERVE BANK OF AUSTRALIA

The International Economic Outlook

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Thank you to CEDA for the invitation to speak in Melbourne today.

As is customary over many years, I want to confine my remarks mainly to the international context, with one or two comments on the implications for Australia.

It is useful to begin by recapping how things looked at this time last year, so as to review how 1999 turned out compared with the expectations held at that time.

The situation a year ago

At this time last year:

- It was reasonably clear that economic activity in the east Asian crisis economies had bottomed during 1998. The issue was what sort of recovery they would experience. The general expectation was that recovery would be slow.

- The US economy looked strong, but with low inflation. There was an expectation that growth in 1999 would come down. (In fact, there had been real worries about a possible recession, induced by a "credit crunch", although these had lessened by early 1999.) There was talk of new paradigms etc.

- The Euro had just been introduced. Despite some earlier talk of the possibility of great disruption, the process had gone very smoothly.

- Japan was in recession. Fiscal stimulus was beginning to work, but confidence in Japan's economic prospects probably reached its lowest point during the early months of 1999.

- There was a much more cautious attitude to risk by players in capital markets, in the wake of the LTCM episode. Credit spreads on various financial instruments had increased markedly (though for many good quality borrowers, the absolute cost of borrowing had not increased, and was still pretty low).

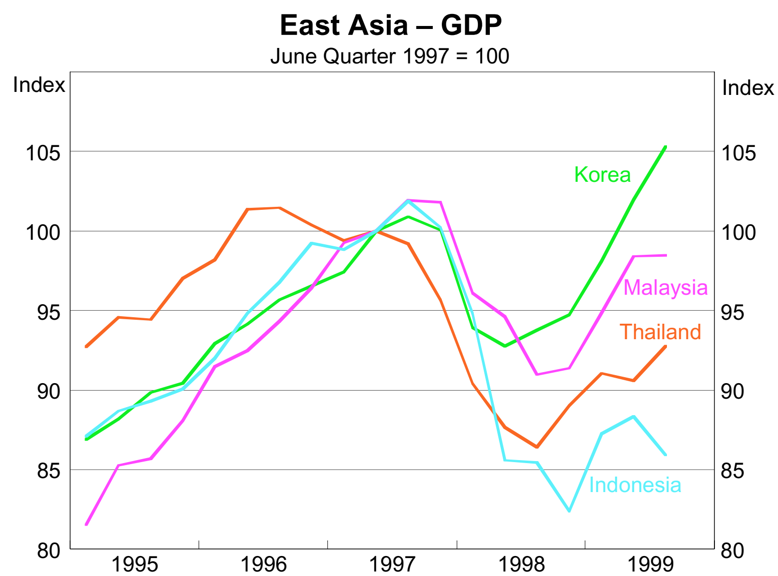
- Around the turn of the year, the Brazilian crisis had erupted, sending credit costs for many emerging market borrowers much higher, and leaving many of us wondering whether 1999 would be another year of global financial instability.

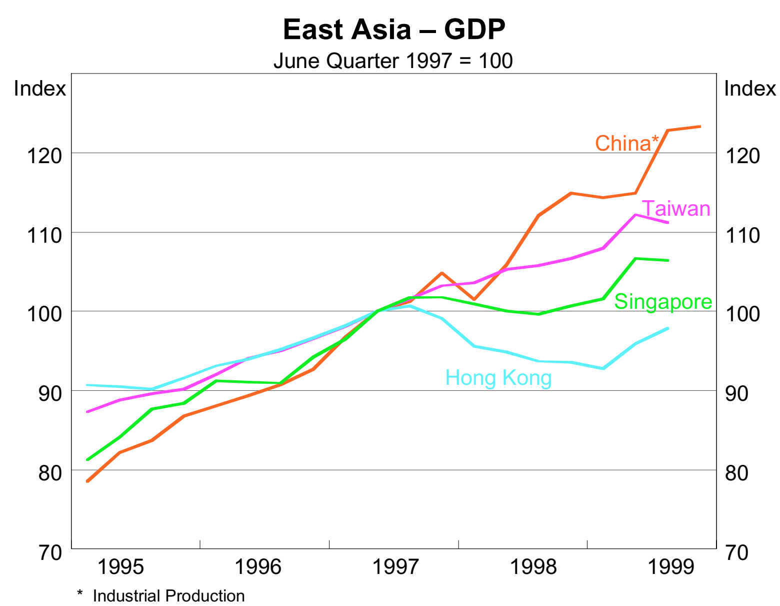
- Forecasts for global growth had been downgraded. Monetary policy had just been eased in many countries in response to lower growth outlook, very low inflation and financial market jitters. There was still some talk around about global deflation.

A further factor which a year ago was just coming onto most people's radar screens was Y2K. We heard a lot more about this as the year went on.

How did things turn out in 1999?

One of the more noteworthy features was the speed of pick-up in economic activity in many countries in east Asia, particularly some of the crisis countries. Indonesia, sadly, remains the exception.



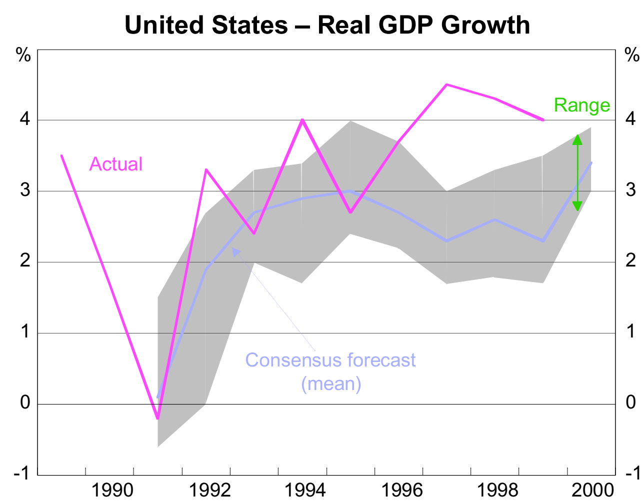


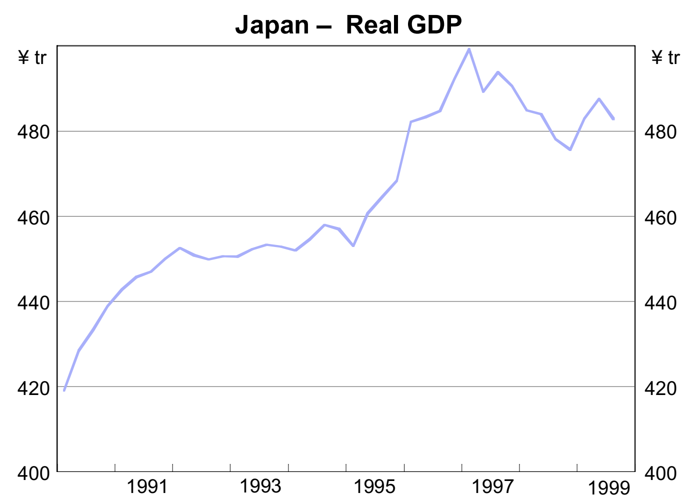
Asian GDP Growth in 1999		
	Late 1998 forecast[1]	Latest Estimate[2]
Korea	0.5	9.7
Malaysia	-0.3	5.0
Thailand	0.1	4.3
Philippines	1.1	2.9
Indonesia	-3.2	-0.1
Singapore	-0.5	5.5
Hong Kong	-0.8	1.9
Taiwan	4.6	5.4
China	7.4	7.1 (Actual)

1. Consensus forecast at December 1998.
2. Consensus estimates in January 2000.

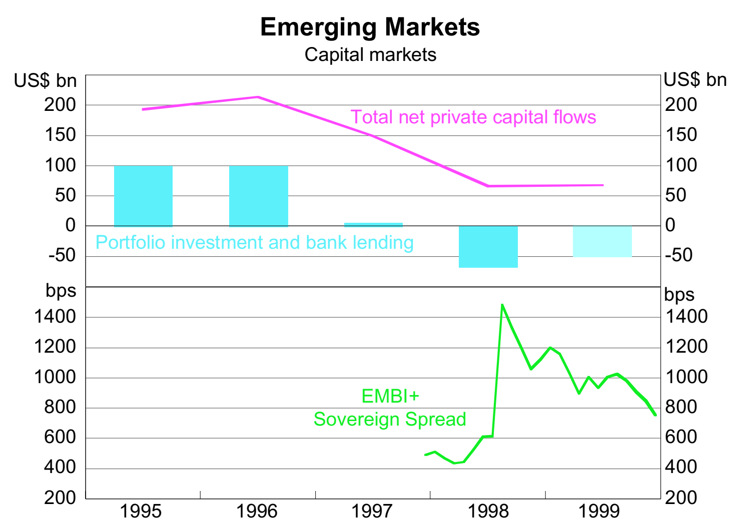
Freed from the pressure of very tight macroeconomic policies and severe financial distress, domestic spending rebounded in several instances. In tandem with the domestic growth, trade between the Asian countries has begun to expand quickly again, and the region's demand for imports has surged, reversing a good deal of the import compression observed during the depths of the crisis in 1997 and early 1998.

The second feature was the ongoing strength of the US economy, which recorded growth of 4 per cent again in 1999. There has been a persistent tendency for economists to expect a slowing over several years that has not, so far, occurred. In fact, growth has exceeded the expectations of even the most optimistic forecaster in each of the past three years. There is still ongoing debate about "new paradigms".





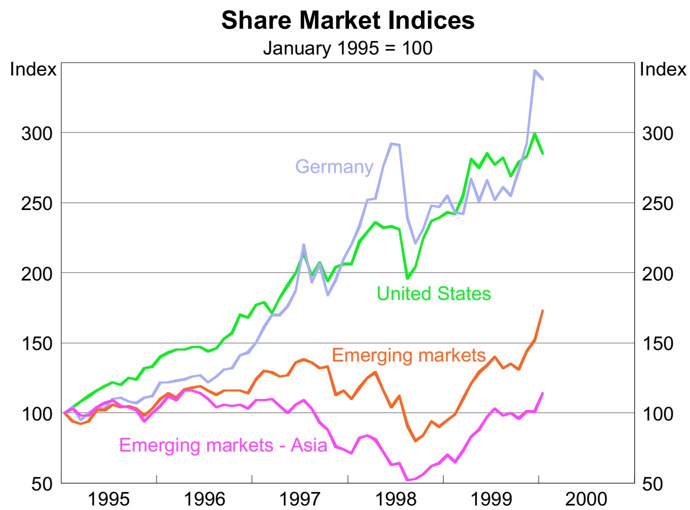
A third feature was that Japan began to grow. This surprised many observers, not least Japanese ones, who have tended to become more pessimistic than others about their own economy. The initial upturn owed a lot to fiscal expansion, but private spending, as measured in the Japanese accounts, also began to grow. There was also an expansion in Japanese exports, principally to the United States and the countries of east Asia. The latest national accounts data leave it unclear to what extent growth continued in the second half of the year, and there have been concerns in some quarters over the possible effects of the higher yen. However, other data suggest rising industrial output, falling inventories and an upward trend in business and household confidence (from exceptionally low levels). Overall, the performance of Japan in 1999 surprised just about everyone by its strength.



Sources: IMF and J.P. Morgan

Fourth, financial markets globally were not as unstable as in 1998. Markets did treat emerging market countries very carefully – according to IMF and BIS data, private capital flows to emerging market countries in total were probably similar in 1999 to 1998, at about one third of the size seen in 1995 and 1996. Credit spreads remained wide for Latin American and East European borrowers, though for Asian borrowers they tended to fall. Credit spreads also remained a little larger in developed countries than they had been prior to the LTCM episode.

But while debt markets were more cautious on the whole, equity markets boomed. US share prices rose by about 25 per cent through 1999; there were similarly strong rises in Europe and Japan. Hong Kong saw a 60 per cent increase. Nor was this confined to developed markets. Emerging market share prices also rose strongly. In the developed countries, prices for "high-tech" stocks saw very large increases.



1999 was a better year for global output growth than expected, by a sizeable margin. In late 1998, the IMF had forecast that global growth, which was 2 1/2 per cent in 1998 (a lot lower than earlier expected), would fall to 2 1/4 per cent in 1999. In the event, it looks as though world growth, far from declining further, increased. As of October, the Fund had increased its estimate to about 3 per cent. Even that is looking a bit on the low side, and more recent estimates produced in the private sector suggest world output expansion may have been about 3 1/4 per cent in 1999, almost up to the average rate of growth for the past thirty years.

Part of the reason for the better-than-expected outcome is obviously the ongoing dynamism of the United States economy. But that isn't the only reason, because the unexpected strength of global growth in 1999 was not just the result of stronger-than expected US growth. Most other regions also grew more strongly than expected. Europe is probably the only region where 1999 growth looks like it has turned out more or less as expected (in aggregate – though with differences in individual countries).

In many instances, domestic factors have been at work in producing this outcome. A global factor that should not be forgotten is that the cost of funds has been quite low in recent years. Major central banks have run on average reasonably accommodating monetary policies, long-term interest rates have been low as well because inflation was low, and the boom in equity markets has pushed down the cost of raising equity. This has been an expansionary force, and helps to explain why the Asian crisis, despite being very serious indeed, did not bring down the global economy. The fact that fears of a credit crunch in major countries were relatively short-lived kept this expansionary impetus in place.

So my summary of how things look in early 2000 compared with a year ago is as follows.

Early 1999	Early 2000
East Asia had reached bottom. Some sort of gradual recovery in prospect.	East Asia has recovered much faster than expected. "V-shaped" in several instances.
US economy looked strong, but expected to slow. Talk of "New Paradigm".	US economy (still) looks strong, but (still) expected to slow. (Still) talk of "New Paradigm".
Euro introduced, without problem.	Euro has been weak. Euro area growth now picking up.
Japan in recession. Fiscal policy expansionary, but growth prospects thought to be poor, due to weak private demand.	Japan grew unexpectedly in 1999. Private spending expanded. Increasing signs that a cyclical upturn is occurring, though still fragile.
Cautious attitude to risk in capital markets. Markets prone to instability and fears of crisis. But cost of capital still very low.	1999 a boom year for global stock markets. No current crisis.
Forecasts for global growth being marked down. Markets concerned over deflation.	Forecasts of global growth being marked up. Markets concerned over inflation.
Concern in some quarters over Y2K; this grew as year progressed.	Y2K came and went without significant problem.

Prospects for 2000

What then of the year ahead?

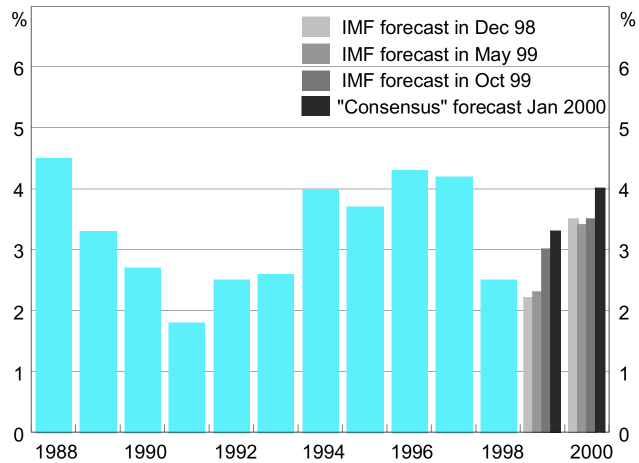
First, one is bound to observe that a notable feature of early 2000 is that for the first time in a few years, there does not appear to be a major crisis affecting global financial markets or the global economy around the turn of the year. At this time last year, the Brazilian crisis was at its height. The year before, the Asian crisis was dealing a savage blow to Indonesia, having taken down Thailand and Korea.

Some were expecting a Y2K crisis this January. Some of the more extreme predictions of global economic recession caused by wide spread computer malfunction were well wide of the mark. Developed countries were very well prepared, and sensible precautions had been taken. Even if there were to be some failures of non-compliant systems in the months ahead, it now seems unlikely that such an eventuality would prove very damaging to economic activity.

The absence of either a financial or technological crisis perhaps means that prognostications about the year ahead ought to be able to be made with more confidence than was possible last year. There is indeed less dispersion in economists' forecasts for economic activity at present than there was a year ago. Whether this translates to greater accuracy ex post remains to be seen.

The broad international consensus about growth seems to be that world growth will improve further in 2000, even though the US economy may slow (that forecast, which has been around seemingly forever, will eventually be correct).[1] With ongoing recovery in Asia, positive growth in Japan, a turnaround of modest proportions in Latin America, and some improvement in European growth, these should be reasonable growth. In fact, if we update the IMF's forecast from last October with the more recent forecasts in the private sector, we find that world GDP growth of something like 4 per cent is envisaged. If it occurred, this would be performance like those of the mid 1990s.

World GDP Growth



Source: IMF *World Economic Outlook.*

Reflecting this, financial markets have had one of their periodic shifts in sentiment. In early 1999 they were worried about global recession and falling inflation or deflation. Now they are focussed on synchronised global economic strength and the possibility of inflationary pressure. Long-term interest rates have risen from the unusually low levels seen during 1999, as markets perceive that monetary policies in many countries have changed direction. Central banks, sensing the changed international circumstances, have moved to gradually unwind the reductions in interest rates made in late 1998 or early 1999 – not because anything is going wrong at present, but simply to have policy settings better aligned with the new circumstances. Financial markets have absorbed this change, and anticipate further changes. That is reasonably normal behaviour. At this stage, I would characterise this modest tightening in international financial conditions as reflecting the pick-up in world growth which has already occurred, and lessening any further pick-up, rather than as likely to result in the current rate of growth declining.

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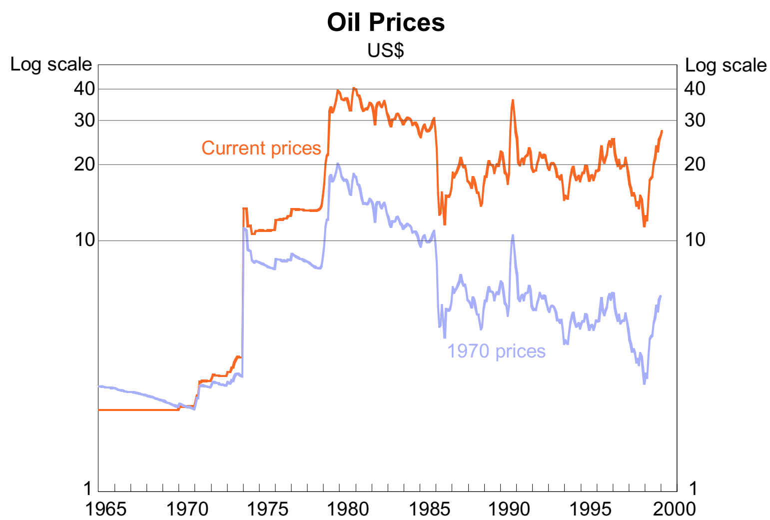
[1] Note that with recent historical data revisions, US trend growth is almost half a percentage point higher in the 1990s than earlier estimated. Forecasters are now presumably factoring this into their ideas about the degree

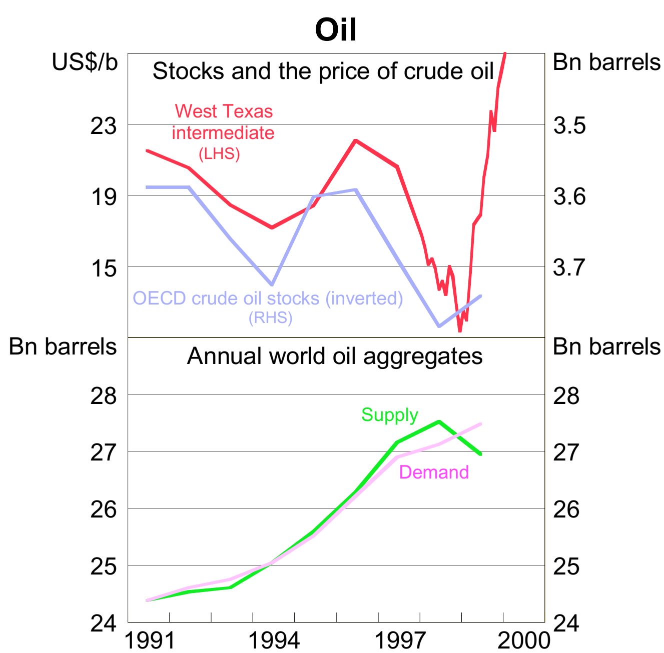
What are the risks to this outlook?

It is customary for people to point to downside risks to US growth, stemming from the possibility that inflation will increase, prompting the Fed to tighten more quickly, or that the sharemarket (highly valued on conventional criteria) will fall, bringing down with it the wealth-enhanced boom in consumer demand. These remain possibilities. But for several years these fears have been present but not, as yet, realised. We should also take note of the fact that for four years now, the consensus forecast at the end of the calendar year was that the US economy would grow by a good deal less in the year ahead than in the year just finishing, and for four years, that consensus has been incorrect. Even economists learn eventually, so we have to allow the idea that US growth could, once again, surprise on the upside.

A second risk to the global outlook could conceivably come from rising oil prices. This has been quite steep in the past year, as global consumption began to recover and as OPEC took steps to control output. Prices are now a little above their average of the past decade. This does not qualify as an oil "shock" a la 1974 or 1979. If past supply responsiveness by producers is any guide, prices may well not rise further. Even so, it may be more difficult for the major countries, and especially the US with already stretched labour markets, to combine strong growth with very low inflation in the way they have in recent years. If oil prices did keep rising, economic performance along both these dimensions would surely deteriorate. So this is an area to keep a weather eye on.

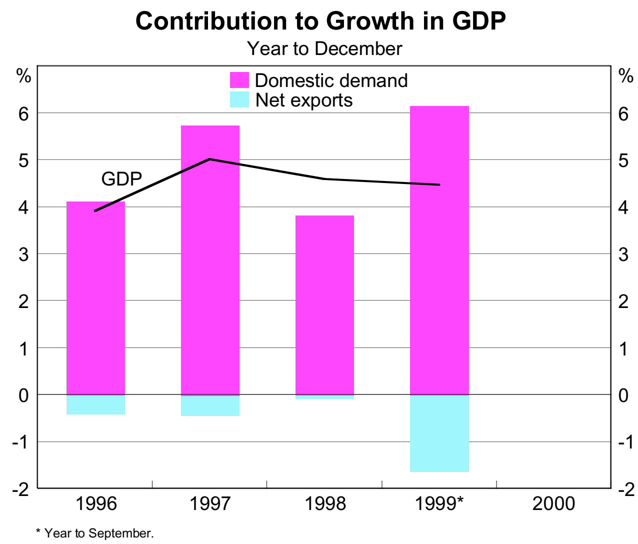
There is clearly a possibility of things going wrong on these fronts. But there is also a pretty reasonable probability that the global economy will have a very good year.





Sources: *International Energy Agency;* United States *Energy Information Agency*

What are the implications of all this for Australia?



Overall, the above scenario means a better external environment for Australian producers. It means that the trade sector of the economy, which was a drag on output growth for a while, won't be in the period ahead. Over the year to the September quarter of 1999, real net exports fell by the equivalent of 1 1/2 per cent of GDP. To be sure, a bit of this was because import volumes grew strongly driven by robust domestic demand growth in Australia. But export volumes were quite weak from late 1998 until mid 1999, despite a good deal of success by exporters in diverting products to alternative markets. Over the next year, it is a fair bet that the export contribution to growth will be much more positive, and we have seen signs of that in the most recent data. In due course, this may also be accompanied by some recovery on Australia's terms of trade through higher commodity prices, though that has not been widespread across the commodities most important for Australian producers as yet.

Generally speaking then, the world economy is more likely to be helping the Australian economy along in the coming year or two, rather than holding it back as it has done for the past year or two. At the margin, it may also mean that the degree of disinflationary pressure on prices for traded goods and services may lessen.

If things turn out that way, then the nature of economic discussion will be quite different this year to the past couple of years. Having spent two or three years focussed heavily on external events and trying to assess their impact on Australia's economic performance, 2000 is likely to be a year in which there is a much closer focus on events closer to home, and on how we manage the next phase of this long-running economic expansion.