

I J Macfarlane: The world economy and its implications for Australia

Inaugural Di Yerbury Economic and Financial Studies Lecture by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, Sydney, 14 April 2004.

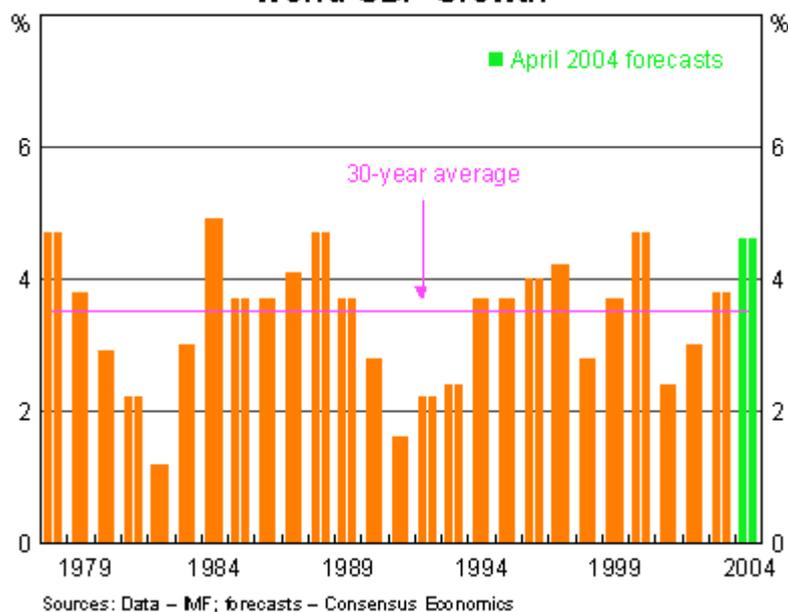
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It is a great honour to be invited by Macquarie University to deliver the Inaugural Di Yerbury Economic and Financial Studies Lecture tonight. I also note that this is the 40th anniversary of the establishment of Macquarie University. For fourteen of those years Professor Yerbury has been Vice-Chancellor - a remarkable achievement by any standard. Our paths first crossed in the late 1960s - although neither of us has much recollection of it - when Di was a lecturer and I was a tutor in the Economics Faculty at Monash University. Since then, of course, Professor Yerbury has gone on to an illustrious career in academia, government and university administration.

The world economy

I will speak tonight about recent developments in the world economy and their implications for Australia. It is about 18 months since I spoke about the world economy, and a number of things have changed in that time, mainly for the better. Despite various hesitations and temporary setbacks, the recovery from the world recession that beset G7 countries in 2001 has consolidated. For the world economy as a whole, GDP growth picked up in 2002, again in 2003, and is forecast to be higher again at a relatively robust 4.4 per cent in 2004 (Graph 1). Over the past four quarters, both the United States and Japan have reported growth in excess of 4 per cent, and in non-Japan Asia it has been a lot higher.

Graph 1
World GDP Growth



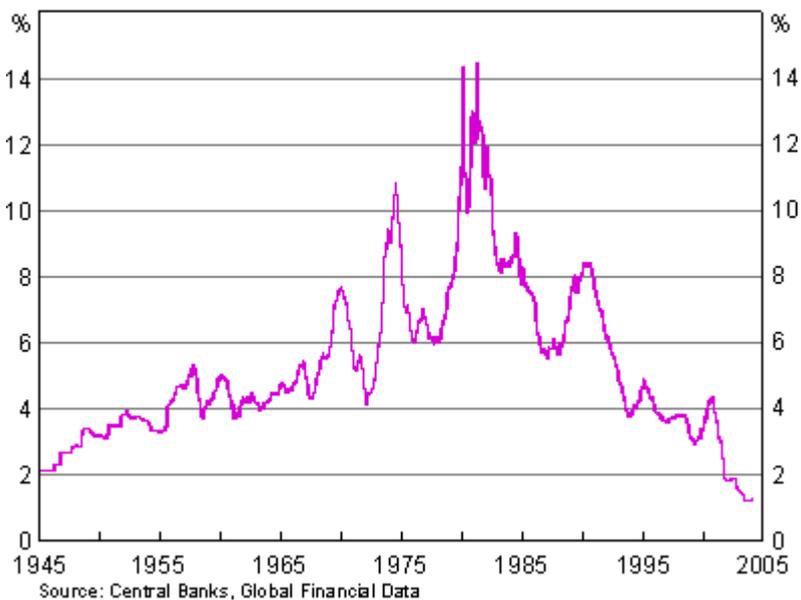
At the same time, inflation in almost all countries has remained low. At the level of final goods prices, as shown by consumer price indices, inflation is low almost everywhere, and few countries report upward pressure.

Not surprisingly, this reassuring macro-economic picture has led to a return of confidence to financial markets. Share markets around the world have risen appreciably from their troughs in early 2003, and in many markets price earnings ratios are well above medium-term averages. A similar return of confidence has occurred in debt markets, where spreads have narrowed to historic lows. Borrowers in emerging market economies can obtain finance on very advantageous terms as investors chase yields. A similar process is at work for sub-prime and even sub-investment grade borrowers in

developed economies. Such a compression of spreads means that providers of capital perceive risks to have been greatly reduced and therefore do not need to be enticed with high premia to compensate for those risks.

While the performance of the world economy has improved and the downward risks abated, this has not been reflected to any great extent in economic policies. With few exceptions, the stances of monetary and fiscal policies are still at the expansionary settings to which they were moved in order to offset the fall in asset prices and associated recessions in 2001. In fact, for the three major economies - the United States, the Euro area and Japan - monetary policy, as indicated by interest rates, is, if anything, more expansionary now than it was in 2001. If we construct a measure of the average short-term interest rates for the world, the present level is the lowest since the Second World War (Graph 2). Of course, nominal interest rates are not necessarily the best indicator of the stance of monetary policy¹, but when they are as low as they are at present, they must be telling us something.

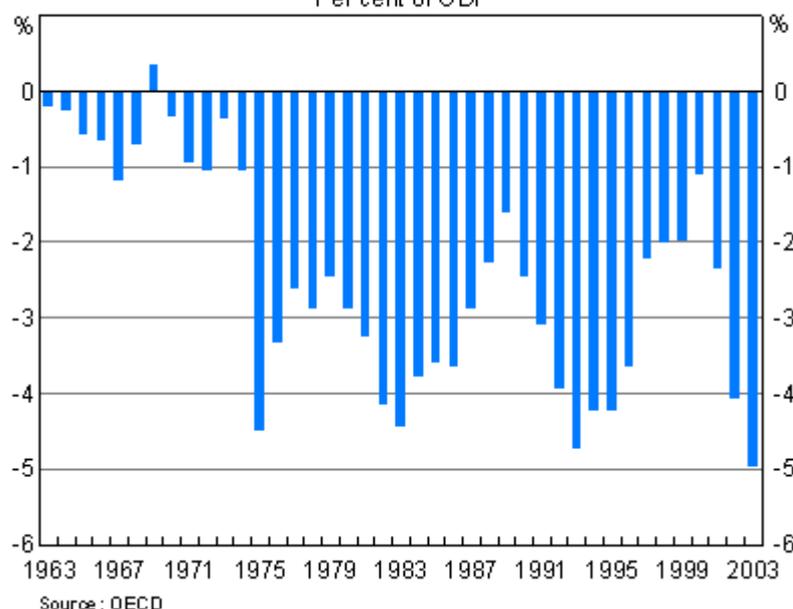
Graph 2
G7 Policy Interest Rate



A similar picture applies to fiscal policy. The fiscal deficit among G7 countries has increased noticeably in the past three years and is now at least as large as any experienced since the early 1960s (Graph 3).

¹ Other measures, such as the yield curve, also suggest very expansionary monetary policy settings. The evidence from quantitative data is harder to read because of its volatility but, in both the United States and Europe, credit growth has picked up from the lows reached a couple of years ago. Over the past year, credit has grown by 8 per cent in the United States and 6 per cent in Europe. In China, credit has grown by around 20 per cent, but in Japan it is still declining.

Graph 3
G7 Fiscal Balance
 Per cent of GDP



I have not spent a great deal of time on outlining these developments, but I think we can agree that there does appear to be a contrast between, on the one hand, a reasonably buoyant world economy and confident financial markets, and on the other hand, an exceptionally expansionary setting of macro-economic policies. I would now like to spend some time on the questions of why is it so, and how will it be resolved?

The main reason that the average level of world interest rates is so low at present is that interest rates in key countries - particularly the United States - are at historical lows. And in the case of the United States, it is the absence of domestic inflationary pressure that explains why there has been no inclination on the part of the Fed to move to a less expansionary stance of monetary policy.

The United States makes its monetary policy for its own domestic needs: no-one could expect it (or any other country) to do otherwise. The problem is that a number of other countries, which fix their exchange rates to the US dollar, effectively also match US monetary policy. Another group of countries, even though they have no desire to match US monetary policy, are nevertheless limited in the extent to which they can depart from it by exchange rate considerations. The net effect of all this is that, to some extent, the United States sets the world's monetary policy - a partial return to the situation that prevailed under the Bretton Woods system.

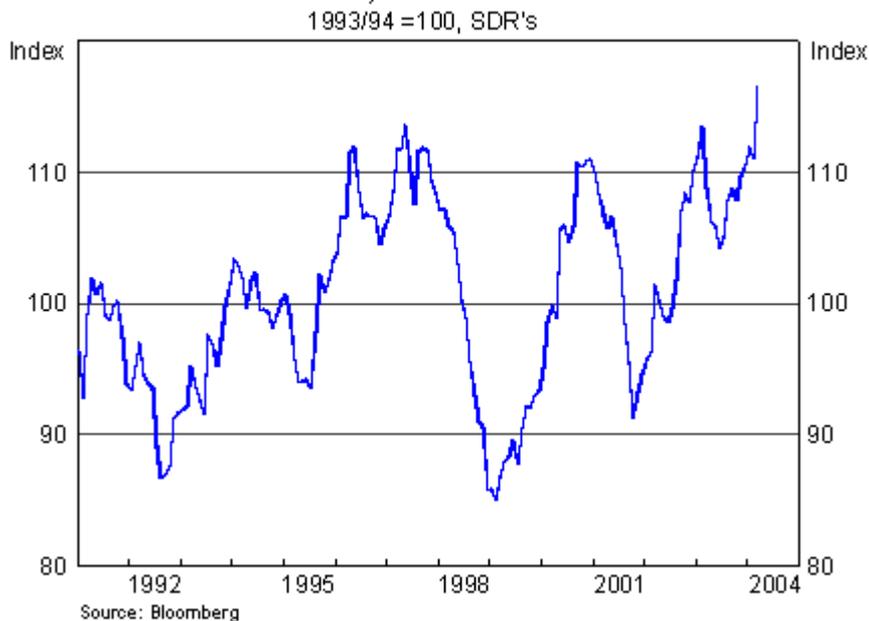
This may or may not be a bad thing, depending on where you view it from. For some parts of the world, where economic activity is subdued and domestic inflationary pressures non-existent, an extremely low interest rate structure like that in the United States may be suitable. But for other parts of the world, it could lead to the build-up of imbalances. For the world as a whole, we do not yet know whether the maintenance of an extremely low average interest rate is helpful or harmful to its longer-term interests.

On the one hand, the after-effects of the bursting of asset price bubbles are still exerting downward pressure on goods and services prices in the United States and Europe, and in Japan (where it has been going on for a decade or more). More importantly, the downward pressure on goods prices - particularly *internationally traded manufactured goods prices* - caused by the massive expansion in Chinese capacity continues apace. This is a structural phenomenon which has been with us for some time now and can be expected to remain important for the foreseeable future, particularly with India joining in. It is what economists call a positive supply shock, and among many of its effects, the one most relevant to the current discussion is that it has made the maintenance of low CPI inflation easier than it formerly was.

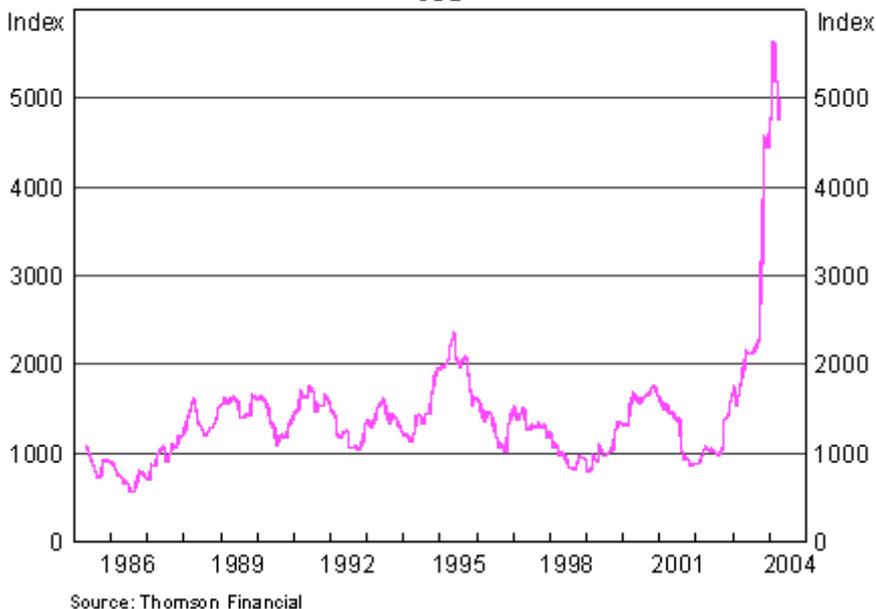
While these influences are important, we should not forget that the international business cycle is also alive and well, and can be expected to have an influence as we go forward. Good economic growth and expansionary policies are now starting to make their presence felt in a range of international

markets. Commodity prices (as shown in the CRB Index, Graph 4) have risen over the past two years and are now at their highest level since 1989. The biggest rises so far have been among base metals, where the prices of nickel, lead and copper have more than doubled over the past year. Others such as zinc and aluminium have also risen sharply. The prices of bulk commodities such as iron ore and steaming and coking coal have also shown large increases in the recent contract re-negotiations. This demand has spilled down into the supply chain so we see increasing prices for such things as transporting goods (as shown by the Baltic Dry Index, Graph 5), and for wrapping them, as shown by the cost of new and recycled cardboard.

Graph 4
CRB Index, All Commodities



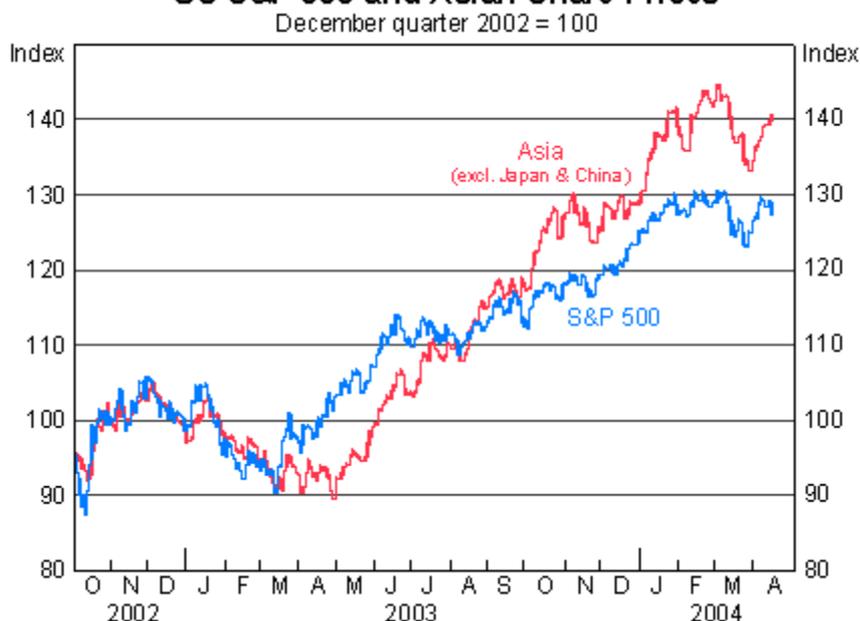
Graph 5
Baltic Dry Index
USD



As yet, this price pressure at the raw material and wholesale level has not fed into consumer prices, except in Asia where there is some evidence of this occurring, particularly in China.

On asset prices, however, there has been a lot of action as investors have pushed up prices of equities, again particularly in Asia (Graph 6) Lenders have also been prepared to lend at relatively small spreads to borrowers who until recently were regarded as not credit-worthy. This offers some support for the view that assets are being over-priced and risk under-priced. The so-called 'carry trade', where intermediaries borrow very cheaply in the United States, Japan or the Euro area and on-lend to other countries, particularly emerging markets, has regained much of the attractiveness it had immediately prior to the Asian crisis. This is, by definition, a highly-leveraged and hence risky activity.

Graph 6
US S&P 500 and Asian Share Prices



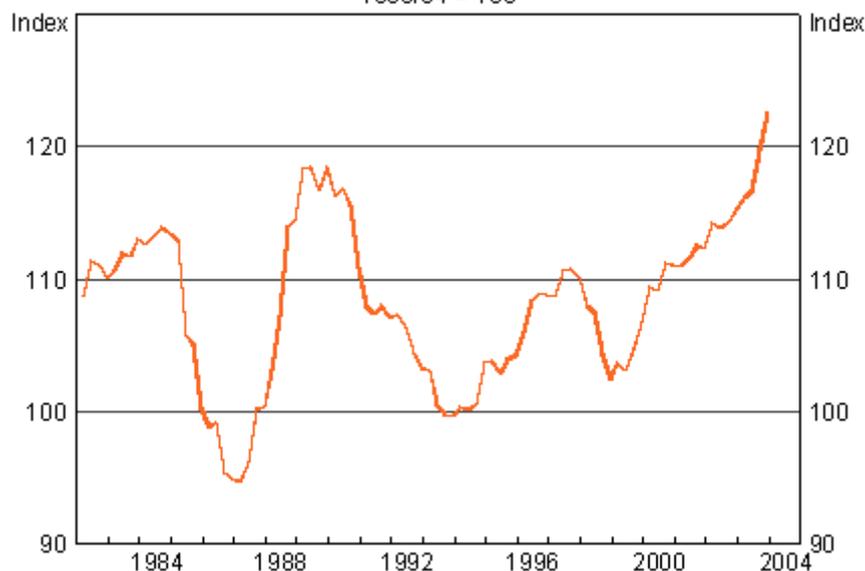
I do not want to give you the impression that the present easy stance of global monetary policy is already causing the world economy to overheat and financial markets to disregard risk. We have not reached that stage yet, but the longer monetary policy remains at this setting, the greater is the likelihood of these results. I have no doubt that this is understood by central banks around the world and in time the degree of monetary expansion will be reduced. In the meantime, it has made things more difficult in some ways for those countries where domestic demand has remained buoyant and domestic costs and prices have not been under downward pressure.

The Australian economy

Where does this leave Australia? My previous sentence may have given you the impression that it made life difficult for us. In one respect (which I will come to in a moment), this has been the case, but overall, developments in the world economy have worked to our advantage.

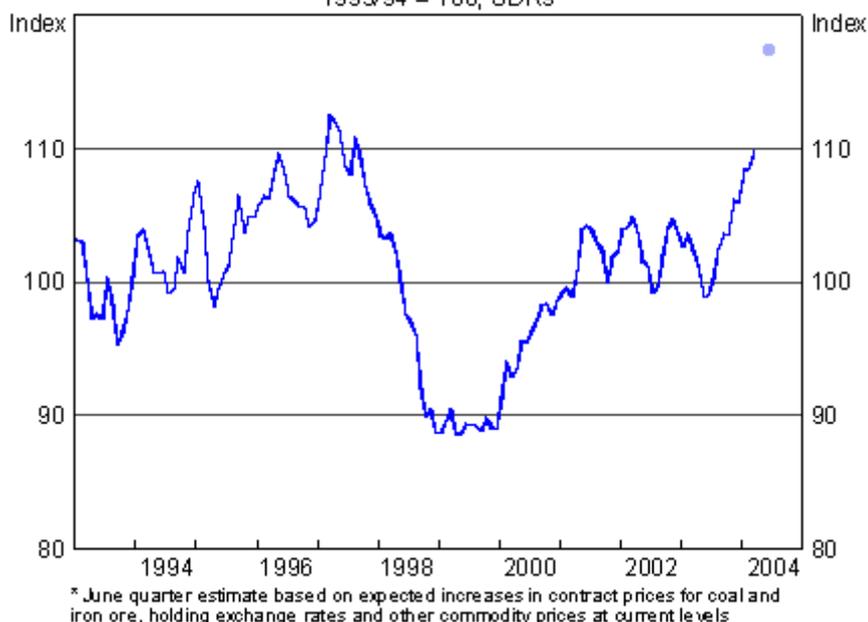
Certainly, a recovery in world economic activity is good for all countries, including Australia. The fact that the area of strongest growth is again in Asia means we benefit more than most other countries because we do so much of our trade with this region. The fact that commodity prices are rising is also of great benefit to us in that it contributes to a rise in our terms of trade (Graph 7). We are simultaneously gaining from stronger export prices for a wide range of our exports, and also receiving the benefit of falling import prices for the many manufactured goods that we import. This amounts to a rise in Australia's real income.

Graph 7
Terms of Trade
 1993/94 = 100



I have made the point on several occasions in the past that the long period when Australia suffered a trend decline in its terms of trade (approximately from the beginning of the 20th century) probably came to an end in the mid 1980s. Since, then the terms of trade have fluctuated, but around a generally rising trend. We should expect this upward trend will continue in the foreseeable future. The Reserve Bank Index of Commodity Prices shows that commodity prices have already risen appreciably over the past couple of years (when measured in a neutral numeraire). When the increases in the prices of steaming and coking coal and iron ore flow through into the index, we will soon see a further substantial rise (the blue dot in Graph 8).

Graph 8
RBA Index of Commodity Prices*
 1993/94 = 100, SDRs



To put these things in perspective, the current upswing in the global economy comes after a couple of years of significant under-performance, which had a serious impact on Australia's exports. It will take some time to recover the lost ground on that front, but the present combination of buoyant world growth, rising commodity prices and falling manufacturing prices is a favourable one for Australia. It

increases the chance of more balanced growth outcomes for the Australian economy in the period ahead, and therefore of further prolonging the economic expansion. What could go wrong?

There were two big risks to this generally favourable outlook. The first was the excessive growth of overall credit, especially to the household sector for housing purchases, and the consequent rapid increase in housing prices. The second was that the exchange rate could be pushed quickly to an unrealistically high level. Both of these risks now look to be less menacing than they did a few months ago, but we cannot be confident that they have gone away completely.

I will start with the second of these risks because it is the one that directly results from our interaction with the rest of the world. We should not have been surprised that the Australian dollar rose over the past three years given its extraordinarily low starting point, the rising terms of trade, the fact that the US dollar was finally weakening and the associated fact that US interest rates were so low. I think this was well understood by the public, including by exporters and manufacturers, even though they saw their margins shrinking and competition increasing.

Apprehension started to increase, however, when in the relatively short period between early November and mid February, the rate against the US dollar rose from US70 cents to US80 cents (14 per cent) and against the TWI from 61 to 66 (9 per cent). This was an uncomfortably fast rate of increase and the prospect of it continuing was clearly a consideration to be taken into account in formulating monetary policy. If there had been a domestic need to tighten earlier this year, as there well could have been, there would have been an extremely difficult decision to make. This is the type of conflict that can arise when the world has such an exceptionally low level of interest rates, but some countries do not need, or would be positively harmed by sharing, the same low interest rate structure.

The other risk we faced was that the excessive growth of credit to the household sector would continue, so fuelling further asset price rises, particularly in housing. This risk is diminishing. It now seems likely that the peak in credit demand was reached around October 2003 when monthly loan approvals for housing (owner-occupation plus investment) reached over \$15 billion per month, an increase of 40 per cent over the year earlier. Since then, we have had four monthly declines in loan approvals and they are now running at about \$12 billion per month.

Some may be inclined to think that a decline of this magnitude - 20 per cent - represents a sharp fall in the provision of housing finance. But \$12 billion per month is still a rapid rate of lending and, if continued, would be consistent with the stock of housing credit growing at a twelve-month-ended rate of about 18 per cent by end 2004. Admittedly, this would be well down on its peak of 23.6 per cent, but would still be unsustainably high. What we are talking about here is the difference between a flow (loan approvals) and a stock (household credit). The flow would have to fall quite a lot in order to bring the growth of the stock back to a sustainable rate.²

The jury is still out on what is going to happen here. There is no doubt that there are some areas of housing - Melbourne and Sydney apartments - where over-supply is pushing down prices, and off-the-plan purchasers and some developers are feeling the pinch. But elsewhere the slowdown, if any, has been more muted. We will naturally be keeping a close eye on these developments to see that the return to a more sustainable rate of credit growth continues.

Last year was a difficult period for monetary policy where, for much of the time, excessive domestic credit growth co-existed with a rapidly rising exchange rate. As we have proceeded through 2004, the situation has been made easier in that both have eased back a little. These are both welcome developments, but we cannot be sure whether they signal a new trend or are only pauses. Similarly, we are still waiting for the durability of the world economic recovery to be sufficiently recognised so that the major central banks around the world can start the process of returning interest rates to more normal levels. When that happens, the combination of a more stable exchange rate and a more restrained pace of credit expansion will become a lot easier to achieve.

² This estimate is based on the average historical relationship between loan approvals and the change in the outstanding stock of credit. For a further discussion of this relationship, see Box C from the February 2004 *Statement on Monetary Policy*.