Glenn Stevens: Economic prospects in 2008 – an Antipodean view

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to Australian Business, London, 18 January 2008.

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It is a pleasure to be here in London to speak with you today. As Australians recharge their batteries over the summer break, after a long year of coping with an economy operating at full stretch, people in this part of the world are hard at work trying to assess the outlook for the world economy.

The year 2007 as a whole was another one of pretty good growth in the world economy, with the PPP weighted IMF series for global GDP thought to have risen by 4¾ per cent, compared with an average of about 4 per cent per annum since the beginning of this decade.[1] For the G7 economies the outcome was a bit below average but the emerging world continued to grow strongly.

Yet as the year closed, and the fallout from the risky practices in the US housing market was becoming clearer, questions were arising over the outlook for 2008. There is no shortage of opinions on the outlook for the US economy. Hence I will be brief on that question. The question I would like to address at more length is what the implications of any change to the US outlook might be for the world economy, and for the Asian region in particular, which of course is important for Australia. I would like to conclude with some observations about inflation.

The US economy

In the face of the large downturn in housing construction and a fall in house prices, the US economy has in fact done remarkably well so far to keep growing. Reasonable growth in consumption, strong capital spending by businesses and a turnaround in the trade accounts have been key factors. The decline in the US dollar is presumably assisting the latter. In other words, the floating exchange rate is playing its proper role of responding to the differences in macroeconomic circumstances between the US and elsewhere.

Nonetheless, it is a reasonable presumption that the US now faces a period of below average performance as the problems in the housing market are digested. The excess stock of dwellings has to be worked off; the bad loans have to be recognised and written down; and to the extent that the recognition of all this damages the balance sheets of major financial institutions (not all of which are American), repair work is in order. It has already commenced, with a number of the most significant globally active banks seeking significant capital injections from cash rich investors.

Arguably, these banks are now putting in place belatedly the capital that should have been devoted to these activities all along. Even if we accept that there were some genuine advances towards more optimal risk sharing through the development of securitisation and its associated structures, it cannot be denied that there was a capital saving associated with the conduct of business through off balance sheet entities: banks had to put up less capital ex ante than the risks really warranted. That earlier business advantage is now being unwound as much of the credit risk comes back to the banks. It seems a reasonable bet that more capital will be required over the years ahead.

[1] These PPP weighted growth rates reflect the results from the recent International Comparison Program announcement on relative prices.

So the US economy is in a period of adjustment, as is the banking core of the international financial system. Even with the renowned flexibility of both, and good policies, this will take a bit of time. Just how long remains uncertain.

The global economy

The question then is how much impact a period of US weakness will have on the global economy. I think it makes sense to think about the answer along two dimensions.

The first is "spillovers" – essentially sequential causal connections whereby slower activity in a major country like the US affects its trading partners via reduced US demand for goods and services in international trade. This would, other things equal, slow economic activity in those trading partner countries, which in turn would slow their demand for goods and services, and so on. Of course, all else may not be equal – other shocks and adjustments might be occurring in the other direction in other countries. An obvious possibility is economic policy: it may be open to policy makers in those other countries to respond to weaker US demand by running more expansionary policies at home. Whether it is or not would depend on their overall macroeconomic situation and their policy regime.

The second dimension is the extent of commonality in the originating event that triggers the whole adjustment to begin with. So if, for example, it were the case that a "credit crunch" occurred simultaneously in many countries, there would be a contractionary impact around the world even before any spillover effects via trade got going. Obviously, that would be a much more serious situation, since policy makers in each country would be seeking to combat declining domestic demand as well as declining foreign demand. Combating credit crunches in particular can be very difficult.

I think we can take it as given that there will be trade spillovers from the weaker US economy to the developing world and to other developed countries in due course, even though there is not a lot of evidence of such an effect in the data we have as yet. The spillovers will not just be from the US either. The fact that the euro area appears to be slowing a bit, with the UK also expected to slow before long, means that the core industrial countries as a group may, over the period ahead, impart noticeably less impetus to global growth than they have in recent years. How big a difference that will ultimately make we cannot know for sure, given the apparent increased internal dynamism of much of the emerging world, and given that we do not know what policy responses those countries may make.

But the bigger question is the extent to which a range of countries also experience the same shock as the US. It is in answering this question that we need to consider the financial events of the past year or so. The essential elements are well known by an audience in this city. Over some years, the availability of credit increased in many countries. In the US in particular this phenomenon saw a large extension of credit into the sub prime space in the housing market. This was all aided by the securitisation process and the search for yield, which had its genesis in the high saving rates in other parts of the world.

While most of these sub prime borrowers have in fact been servicing their loans quite adequately, flaws in the process saw standards slip towards the end of this cycle. As the problems came to light, pressure came to bear on various entities. Institutions with exposure to sub prime mortgage assets, holders and intending issuers of structured products in general, SIVs, conduits and other intermediaries that relied on wholesale funding were all tested. Core banking institutions that sponsored off balance sheet entities very quickly found funding pressures transferred back to them. Doubts over asset quality, uncertainty over funding and generally reduced appetite for risk suddenly erupted last August into a scramble for liquidity. These pressures have been seen in most of the developed economies, though they have been most acute in the US, the UK, the euro area and Canada.

For at least some of the G7 economies, then, these events would appear to have the characteristic of a common shock, in the form of a rise in the market cost of finance and, in some cases, perhaps, the possibility of a wider withdrawal of credit. Even though it was American borrowers who could not repay, lenders much further afield were affected. It is against this backdrop that forecasters are bringing down their growth estimates for 2008 in some of the major countries, and policy makers there are growing more concerned about downside risks to growth.

Suppose then that the G7 group faces the prospect of softer growth in 2008 due at least in part to these financial factors. There will be spillovers from this via trade. But is the financial shock also common to the emerging world, and to Asia in particular – a region that has been a spur to global growth in recent years?

To date, at least, it would appear not. Asian investors appear to have relatively small exposures to the sub prime loans per se. Banks in the region typically rely less than their developed country counterparts on wholesale funding, so the liquidity squeeze has been less of a problem for them. The cost of debt to Asian borrowers, as measured by sovereign bond yields, has not risen much at all. Nor has the cost of equity capital, if the levels of Asian share price indices are anything to go by. The economic growth of most of east Asia has to date remained pretty solid as well.

None of that is any guarantee of plain sailing in the future. Nonetheless, it is a good start to weathering whatever the effects of slower growth in the developed world might be. If the financial shock that some of the G7 economies have experienced, and which they fear could intensify, has not been replicated in Asia, then the effects on Asia should be limited mainly to those coming through the trade channel, and perhaps via general business confidence linkages.

The trade channel remains important, of course, for some key Asian countries. There has been a big rise in intra Asian trade over the past decade, but much of that trade is basically a production chain whose output is still destined for the major country markets. So developments outside the region are still very important. But some moderation in the externally generated part of growth is a manageable issue for Asian policy makers. In countries where inflation has been a little on the high side, they can allow it to reduce pressure on prices. In other cases, they would be in a position to allow more expansionary settings for domestic demand.

Much hinges on events in China, an economy that now has a very prominent effect on conditions in the Asian region. Over the past couple of years the Chinese economy has continued to boom, asset prices have surged and the authorities have struggled to contain the ebullience. Some of China's growth has been courtesy of a rise in exports but, even if that contribution to growth diminished, China would still be growing very strongly as domestic spending has been rising rapidly. With very high saving rates at present, there would appear to be plenty of scope for further rises in consumption spending over time, as the Chinese people become accustomed to higher incomes.

A slower pace of growth in the G7 will presumably trim this growth to some extent. But my guess is that China can cope with that. The Chinese authorities may even welcome some moderation in growth. If China does suffer a serious interruption to growth at some point – and all economies do from time to time – it is more likely, in my judgement, to be caused by some domestic problem than by the sort of events we are witnessing in the developed world at present. For Australians, it will be just as important over the years ahead to keep an eye out for imbalances in the Chinese economy as to watch the problems of the US economy.

All told, it seems likely that, after several strong years, global growth will be noticeably slower in 2008. Much of this slowing will be driven by weaker outcomes in the developed world, particularly in countries facing tighter credit conditions. Some of the G7 economies are likely to experience a period of growth well below trend. It seems likely that this will affect emerging market and other economies mainly via trade linkages. At this stage, it is not clear how significant this effect will be, but it seems prudent to assume that we will be moving from a position where growth in the global economy has been well above trend to one where it will be no more than trend. Some moderation in the pace of global expansion is welcome, given the pressure on prices for energy and raw materials we have seen in recent years. But the full picture for this phase of the international cycle will become clearer only over time.

Australia

What then of the outlook for Australia?

The continuing rise of Chinese and other incomes through those levels at which resource usage intensifies significantly has meant strong and persistent demand over recent years for the mineral resources with which Australia is abundantly blessed. At this point, there appears to be a widespread expectation that contract prices for some key resources will rise in 2008. If they do, Australia's terms of trade, which have already risen by about 40 per cent over the past five years, would move higher still. Perhaps this general set of forces at work is behind the striking difference in confidence one encounters when travelling from the Pacific time zone to the European one.

It is not as though Australian investors and borrowers have escaped completely unscathed from the turmoil abroad. While their direct exposure to the US sub prime market has been limited, we have seen additional demand for liquidity put upward pressure on term funding rates for financial institutions, though to a smaller extent than in Europe or the US and the pressures are now easing somewhat. Firms whose business models relied on short term debt funding have been tested; a couple have, for practical purposes, left the scene.

Yet these events have been absorbed thus far with little disruption in the broader economy. The availability of credit to sound borrowers has not been impaired. It costs a bit more, but that is in the context of a fully employed economy struggling to meet demand. The key banking institutions are strongly capitalised, have adequate liquidity and relatively little exposure to the problems in the US housing market. Business and consumer confidence both remain high. In the local housing market over the past year, we have seen prices accelerate in several cities in the eastern states. The economy grew significantly faster than trend over the same period. As a central bank, while we have been careful to ensure ample liquidity in the money market at a time of international uncertainty and re pricing of risk, we have remained concerned about the outlook for inflation, which is likely to be uncomfortably high in the near term.

Based on what we can see at present, my judgement is that the direct financial effects of the global turmoil on Australia are likely to be confined mainly to the impact on borrowing costs of the liquidity squeeze of recent months, which has pushed up the cost of wholesale finance a bit in addition to the effects of monetary policy changes. Taking into account the strength of demand, this increase in borrowing costs does not seem likely to pose a particular problem for the economy as a whole. There is no evidence, moreover, of a "credit crunch" in the domestic financial sector. On the contrary, thus far the core elements of the domestic system have stepped into the potential gap left by the capital markets.

All this could change if the credit tightening abroad takes a serious turn further for the worse. But failing that, over the horizon of the next year or so, the main further impact of international events is likely to be through two channels. The first is the effects on global economic growth, and particularly the growth of China. The second channel is the potential intangible effect on business confidence, which could operate to the extent that Australian business leaders take a cue from their counterparts in the US and Europe. In both cases there is, thus far, no evidence of any significant impact, but it may be too soon to see it yet.

Inflation

As we consider the potential risks for economic activity over the year ahead, it is important to keep inflation in the picture too. The rapid pace of global growth in recent years has seen a pick up in some key prices. Prices for foodstuffs, energy and raw materials for industrial processes are quite high. The synchronised nature of the increases has been quite marked as well, in a fashion eerily reminiscent of the early 1970s.

What is different on this occasion is the way that labour costs have behaved. In the early 1970s, labour costs exploded in many countries as inflation expectations began to rise, economic policies were too ambitious on growth, and labour unions reached the peak of their power. By and large, labour costs have been quite contained in the present episode, even in cases of tight labour markets like Australia's.

This owes something to the openness of the global trading system and also to the way labour market institutions have evolved. The fact that inflation expectations have been low and pretty stable has also helped. Central banks have played a key role in anchoring expectations.

One risk is that the effect on CPIs of rises in commodity prices could disturb the balance. It is customary in many parts of the developed world to strip out the effects of food and energy prices on CPIs, on the assumption that such movements are usually due to temporary supply disturbances and hence will reverse. But the predominant reason for many of the commodity price rises is demand – not just developed country demand, but that in the developing world. The demand has proved to be persistent, rather than temporary. In the event that labour costs begin to respond to the headline inflation price rises that have already occurred, it would prove more difficult to contain underlying price inflation in the industrial countries. In developing countries, moreover, where food is a big share of the basic consumption basket, the rise in food prices may present a particular challenge. While slower growth in global demand, led by the major countries, and possible supply responses may ease pressure on some commodity prices, most of them remain very high at this stage.

It is conceivable, therefore, that a somewhat less favourable short term relationship between economic growth and inflation than the world enjoyed over the past decade might be experienced for a time. This outcome, were it to occur, would make for a more challenging environment for macroeconomic policy makers. It would limit the extent to which monetary policies could respond to the downside risks to economic growth in the short term without risking a rise in the trend rate of inflation and a pick up in inflation expectations.

I believe that central banks everywhere are acutely conscious of this. I would venture, however, that the tolerance among some parts of the investment community for a cautious approach by policy is not high, if some of the commentary we read is any guide. This, too, adds to the delicacy of the tasks facing policy makers. But it is important to stress that, were trend inflation to rise as a result of too ambitious an approach to supporting short term growth, financial prices would actually be among those most vulnerable to adjustment as long term interest rates rose.

Conclusion

2008 opens with the financial turmoil of the second half of last year fresh in our minds. Those events, and the deeper issues that triggered them, have mainly affected some of the G7 economies and have cast a shadow over their growth outlook in the near term. Emerging market economies have been less affected; in fact, in parts of Asia the main policy challenge has been to deal with the threat of overheating.

Will growth performance for these different parts of the world continue to diverge? Or will they converge again – and if so, how? And how successful will we – all of us – be in containing the inflationary tendencies which have been evident up to now? These will be among the key economic questions for 2008. At the moment, we do not know the answers. One way or another, 2008 could turn out to be an interesting year.

On that note, I wish all of you a happy new year and good judgement in the period ahead.