Ric Battellino: Twenty years of economic growth

Address by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to Moreton Bay Regional Council, Redcliffe, Queensland, 20 August 2010.

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I would like to thank my colleagues in the Bank's Economic Group for their assistance with this talk, particularly Susan Black and Cathie Close.

1. Introduction

The Australian economy has started what will be its twentieth year of economic growth. This has been a remarkable performance – one that is unprecedented both in Australia's economic history and among other developed economies over this period. It raises a number of interesting questions:

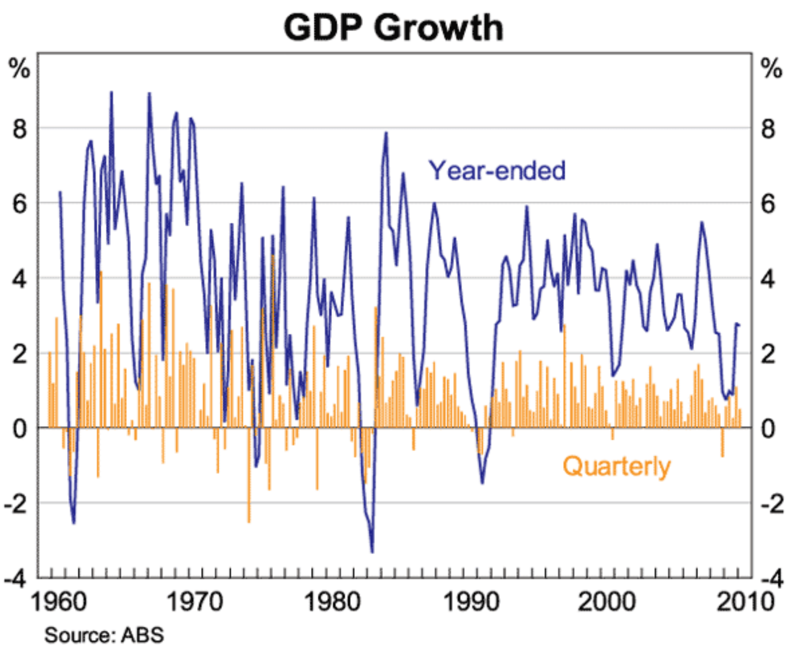
- why was Australia able to record such a good performance; were we just lucky, or were there economic policy decisions that contributed to it?
- how has this growth been distributed across the nation? and
- what is the likelihood of it continuing?

I would like to focus on these issues in my talk today, but, before I do, it might be useful if I set out some facts and figures.

2. Historical and international comparisons

Following the recession in the early 1990s, the Australian economy began to grow again in the September quarter 1991 (Graph 1). In the period since, the economy has grown in every quarter except three.

Graph 1



There were a couple of periods when economic growth slowed noticeably, but at no time did year-ended growth turn negative. The lowest rate that year-ended growth fell to was 0.7 per cent. That was in the year to the March quarter 2009. The other slowdown was in 2000–2001, when growth slowed to 1.4 per cent.

I should note that, while growth remained positive, both these slowdowns in economic activity did cause a noticeable rise in unemployment.

The period since 1991 is the longest period of growth that Australia has recorded for at least the past century. The next longest period during which year-ended growth remained positive was the 13 years between 1961 and 1974.[1] In the 1970s and 1980s, growth phases typically lasted only seven or eight years before another recession hit.

As I mentioned, no other developed economy has experienced uninterrupted growth over the past 20 years. In fact, many developed economies have experienced two episodes of negative growth during that period: one in 2001 following the collapse of the dot-com bubble; and one in 2008 following the collapse of the US sub-prime housing bubble. Even among the fast-growing emerging economies, such an extended period of growth is rare, as most of these countries were affected at some point by the various crises that occurred over that period.

Australia's performance, therefore, is quite unusual and I think it is worth spending some time thinking about how it was achieved.

3. Factors contributing to this performance

Part of the growth came, of course, from the fact that the population grew strongly over the period, particularly in recent years. Some people might also say that Australia was just lucky: that it was well-placed to take advantage of the emergence of China, both in terms of its location and the composition of its exports. I think these factors have played a role, but they are only a small part of the explanation. The China story has been significant only over the past five years; most of its significance still lies ahead. Remember, too, that the country that was our main export market, Japan, has experienced very subdued economic growth over the past 20 years, and that several other of our Asian trading partners experienced a very severe economic crisis in the 1990s. I would therefore conclude that our luck has been somewhat mixed, and we need to look to other factors to explain Australia's good growth performance.

I won't pretend to be able to provide a detailed analysis of these factors in the short time available today, but I do want to highlight a couple of factors I think have been important. These are the increased flexibility of the Australian economy and the pursuit of prudent and disciplined financial policies.

The Australian economy over the past 20 years has shown a greater degree of flexibility than was the case in the 1970s and 1980s. This has made it more resilient to the various external shocks that have been experienced over the period: the Asian crisis; the collapse of the dot-com bubble; and the recent collapse of the US sub-prime credit bubble, to name some of the more severe.

One of the key elements in that flexibility has been the floating exchange rate. The Australian dollar has played an important countercyclical role by rising and falling in response to various external events that otherwise might have had the potential to destabilise the domestic economy. This was evident both during the Asian crisis and the dot-com bubble, when the Australian dollar fell sharply in response to deteriorating economic conditions abroad, helping to insulate the domestic economy.

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[1] That period, however, was broken by consecutive quarters of negative growth in December 1971 and March 1972.

Evidence of the role played by the exchange rate in stabilising the economy can also be seen in recent years. The Australian dollar rose strongly between 2006 and 2008 as commodity prices rose, which helped to dissipate pressures that would otherwise have caused the economy to overheat. Conversely, the temporary, but sharp, fall in the exchange rate during the recent financial crisis helped cushion the economy on the downside.

Given the consistent way in which the exchange rate has moved to insulate the economy from various external shocks, I would have to conclude that the decision to float the exchange rate in 1983 ranks among the most important economic reforms, if not the most important reform, of the past 30 years.

But other reforms have also clearly played a role:

- a wide range of reforms to competition and industry policy, implemented over many years, have seen the business sector become more outward-looking and competitive;
- labour market reforms, some extending back to the late 1980s, gave the labour market increased flexibility to respond to changing economic conditions without producing large swings in unemployment or unsustainable pressures on wages; and
- various reforms of the financial system gave it greater capacity to meet the financing needs of the economy and made Australia more attractive to foreign investors.

In total, these reforms contributed to a substantial pick-up in productivity in the 1990s. The Bank estimates that, during that decade, Australia was able to produce an extra 1½ per cent of output per year simply by using capital and labour more efficiently (Table 1).

Table 1

Output growth

All industries

	GDP growth	**Contributions to GDP growth (percentage points)***		
	Average annual percentage change	**Labour**	**Capital**	**Multifactor productivity**
1990/91 to 2000/01	**3.6**	0.8	1.3	1.5
2000/01 to 2008/09	**3.2**	1.0	1.8	0.4
1990/91 to 2008/09	**3.4**	0.9	1.5	1.0

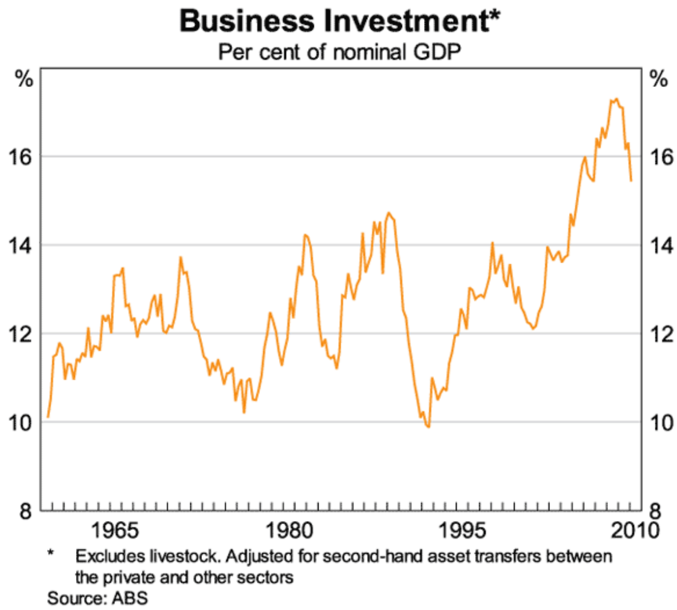
* Estimates based on a Cobb-Douglas production function.

Sources: ABS; RBA.

Unfortunately, this growth in productivity appears to have slowed substantially more recently. Perhaps this is partly a measurement problem, since the large shifts we have seen in the composition and pricing of output in recent years may have complicated the measurement task. Some of the slowdown in productivity is also a reflection of the economy being relatively fully employed in recent years. It is also possible, however, that the slowing in productivity growth is due to the fading effects of the earlier economic reforms.

Output growth has not slowed as much as productivity in recent years, because businesses have been applying increased amounts of labour, and particularly capital, to production. Business investment in recent years has risen to a very high level relative to GDP, one of the highest among the developed economies (Graph 2). Employment growth has also been strong. Nonetheless, the slowdown in productivity growth has meant that GDP growth in the latest decade was not as fast as in the previous decade.

Graph 2

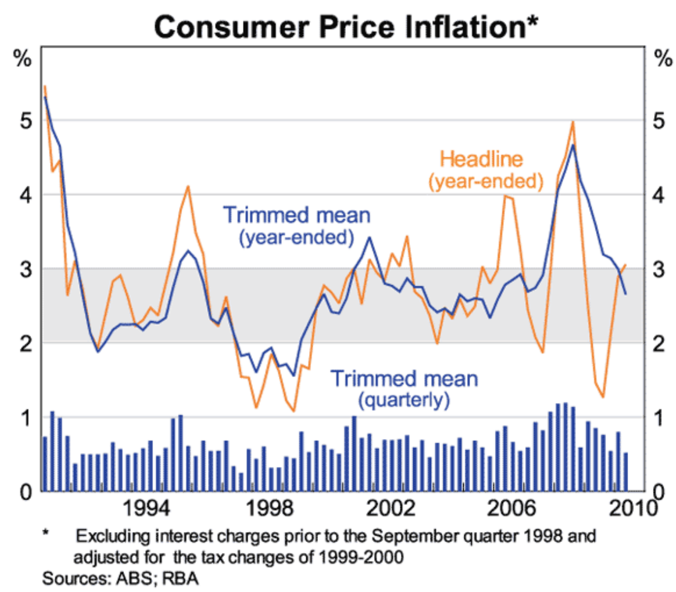


Disciplined economic policies also contributed to the good economic performance of the past 20 years. They have prevented the build-up of imbalances that might otherwise have threatened the economy, as occurred frequently in the 1970s and 1980s.

Government budget finances were greatly improved during the period. Budget surpluses were recorded in 10 of the 19 years since 1991. Government debt was reduced sharply, leaving Australia as one of the best positioned developed economies in terms of government finances.

Monetary policy helped keep inflation low, providing a stable environment in which businesses and households could plan and undertake their economic activities. Since inflation targeting began in 1993, inflation has averaged 2.7 per cent, a little above the mid-point of the target range (Graph 3).

Graph 3

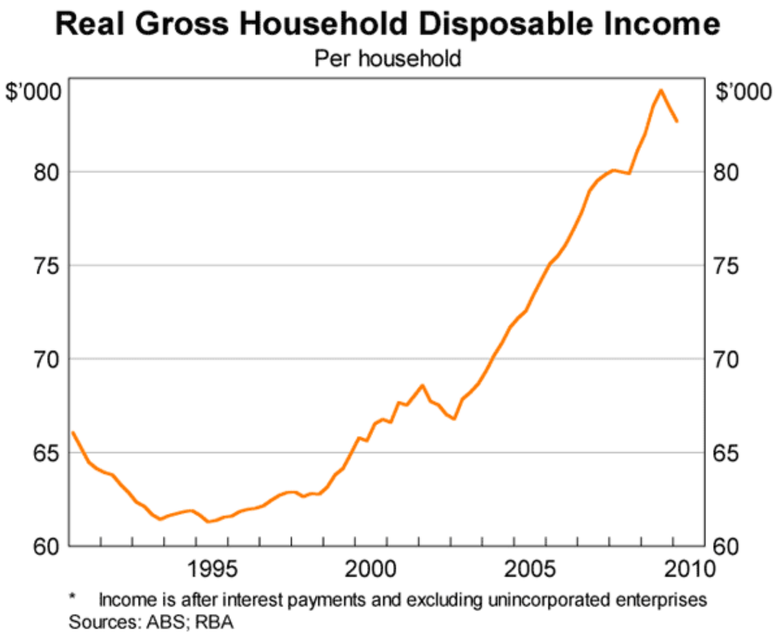


4. How has this growth been distributed through the economy?

Economic growth is important because it allows living standards to rise and more people to find work. The benefits that have flowed to Australians in this respect over the past couple of decades have been impressive. Since June 1991, 3.5 million new jobs have been created and income per household has risen by a cumulative 30 per cent in real terms (Graphs 4 and 5).

Graph 4

Graph 5



The increase in jobs, which represented a rise of 2 per cent per year on average, was faster than the growth in the population, and was met partly by an increase in the proportion of the working-age population that is in the workforce, and partly by a decline in unemployment. Over the period, the unemployment rate fell from 9 per cent to a little over 5 per cent.

One question of interest is how the benefits of this growth were distributed through the community. There are various ways to look at this: one is across the states; another is across the income distribution; and a third is across industries.

Let me start with a comparison of the states. The key point that stands out is that all the states shared in the growth over the period, though Queensland and Western Australia grew faster than the others. As can be seen in Table 2, growth in gross state product in Queensland averaged 4.8 per cent per year, and that in Western Australia, 4.5 per cent. The other states averaged between 2.8 per cent and 3.7 per cent. Population shifts explain most of this gap, however, and on a per-capita basis growth in gross state product was more uniform.

Table 2

State economic indicators

1991/92 to 2008/09; annual average growth, per cent

	NSW	**VIC**	**QLD**	**WA**	**SA**	**TAS**
Gross state product	2.8	3.7	4.8	4.5	2.9	2.9
Population	1.0	1.2	2.2	1.8	0.6	0.4
Gross state product per capita	1.8	2.5	2.6	2.7	2.3	2.5

Source: ABS.

All the states also experienced large falls in unemployment over the past couple of decades (Table 3). In fact, the states with the highest unemployment rates in 1991 generally experienced larger falls. At present, the rate of unemployment is fairly uniform across the states, with the exceptions of Western Australia, where it is below average, and Tasmania, where it is above average.

Table 3

Unemployment rates by state

Seasonally adjusted, per cent

	NSW	**VIC**	**QLD**	**WA**	**SA**	**TAS**
September 1991	9.4	10.3	9.4	10.6	10.4	10.6
Current (July 2010)	5.6	5.5	5.6	4.4	5.1	6.5

Source: ABS.

The benefits of growth were also spread fairly widely across households at different points of the income distribution. Income relativities across the bulk of the population did not change much over the period, though the relative position of households in the top 10 per cent of the income distribution improved somewhat, and that of households in the lowest 10 per cent deteriorated (Graph 6).

Graph 6

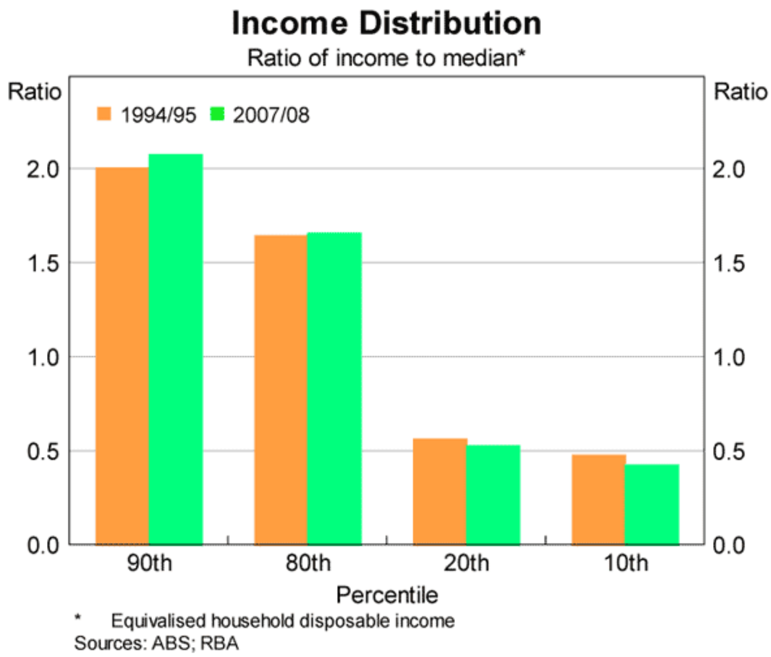


Table 4

GDP by industry*

Per cent of total

Industry	2008/09	1991/92	Difference
Financial & insurance services	10.8	7.0	3.8
Education, health & social assistance	10.4	10.8	–0.4
Retail & wholesale trade	9.6	10.2	–0.6
Manufacturing	9.4	14.0	–4.6
Ownership of dwellings	8.0	8.9	–0.9
Administrative (including public administration & safety)	8.0	7.9	0.1
Mining	7.7	5.0	2.7
Construction	7.4	6.3	1.1
Professional, scientific & technical services	6.1	4.3	1.8
Transport, postal & warehousing	5.8	5.6	0.2
Utilities, accommodation & food services	5.0	6.4	–1.4
Information media & telecommunications	3.4	4.1	–0.7
Rental, hiring & real estate services	3.0	3.1	–0.1
Arts, recreation and other services	2.8	3.1	–0.3
Agriculture, forestry & fishing	2.6	3.3	–0.7
Total	**100.0**	**100.0**	

* GDP excludes taxes, subsidies, and the statistical discrepancy.

Sources: ABS, RBA.

One area where there have been sizeable differences in growth performance has been across industries. The output of the mining, financial services and professional services industries grew at a much faster rate than average, while the output of the manufacturing sector increased by less than average (Table 4). Around three-quarters of the economy now involves the production of services rather than goods, and the financial sector has replaced manufacturing as the largest single industry in the economy.

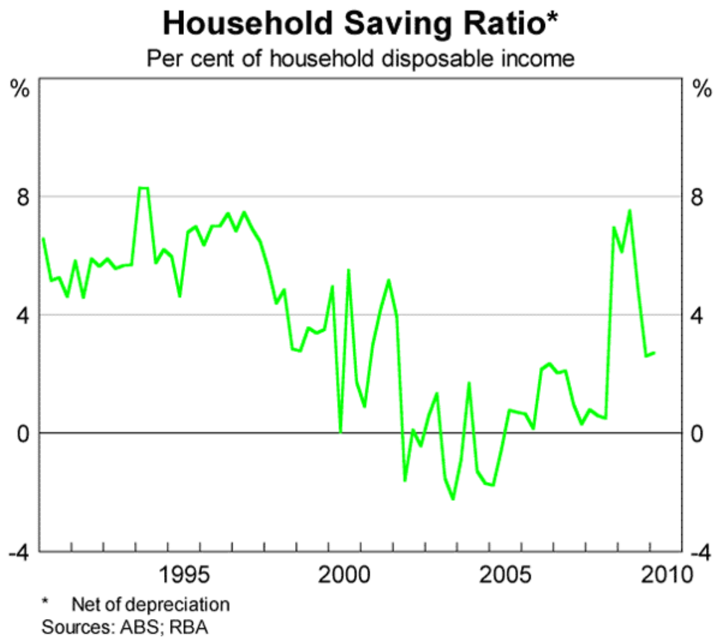
While many people lament the small share of manufacturing sector in the Australian economy, the low exposure to manufacturing may have been one reason why the economy has fared relatively well over the past couple of decades. It meant that Australia was less affected than many other countries by the global shift of manufacturing to emerging markets, particularly Asia, that took place over that period.

5. Current conditions

Let me turn now to the current state of the economy, and the prospects for the next few years.

As you know, the Australian economy recovered relatively quickly from the slowdown that followed the global financial crisis. It is currently growing at around its trend rate, in part due to a large increase in government spending. Consumer spending remains relatively restrained, even though consumer confidence is high. It seems that households have become more cautious in their financial habits, borrowing less and saving more. The household saving rate has risen back to around 4 per cent over the past year, after being close to zero in the early part of the decade (Graph 7). Investment in new housing is also growing at only a modest pace, despite fast growth in the population. This is because of the relatively high cost of housing, rigidities in the housing supply process and difficulties for developers in obtaining finance.

Graph 7

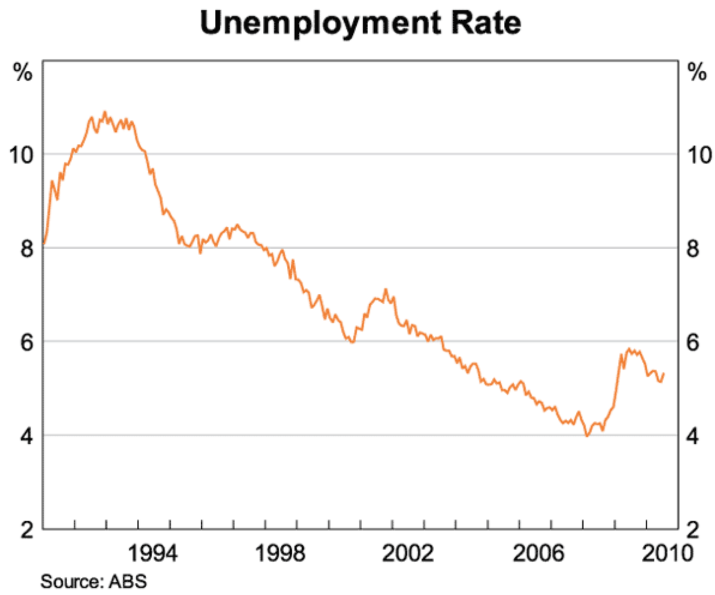


Business investment, however, is at very high levels. It did decline somewhat during the financial crisis, but it is expected to increase strongly again over the period ahead, driven importantly by the mining sector.

Exports are also increasing at a solid pace at present, as earlier increases in mining capacity are coming on stream. Together with much higher export prices, this has meant that the trade account of the balance of payments has moved strongly back into surplus, an unusual situation for Australia.

Employment has been growing strongly, in fact more strongly than would normally be associated with recent rates of increase in GDP, and the unemployment rate has fallen significantly since mid 2009, to around 5¼ per cent (Graph 8).

Graph 8



As I mentioned earlier, over the past couple of decades the typical pattern had been for growth in the resource-rich states of Queensland and Western Australia to be faster than the average of the other states. Currently, however, that is not the case. Queensland is lagging the other states, with relatively weak growth in retail sales and consumption, and particularly business investment (Table 5). Over the past year, Queensland has experienced little growth in final demand, whereas in the rest of Australia demand grew by close to its highs of the past decade (Graph 9). Part of the problem is that Queensland seems to be suffering from an overhang in the property market after a period of exuberance in the lead-up to the financial crisis. Apartment building outside Brisbane is especially weak, as is commercial building. The high exchange rate is, of course, also affecting the tourism industry in Queensland, as Australians are taking advantage of cheaper foreign holidays.

Graph 9

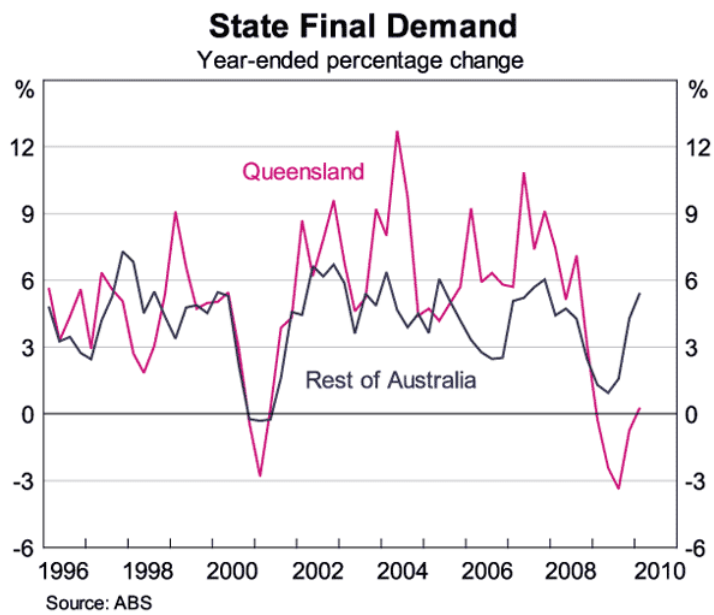


Table 5

State economic indicators

Percentage change over past 12 months*

	NSW	VIC	QLD	WA	SA	TAS
State final demand (sa, per cent)	4.7	6.4	0.3	6.1	5.2	3.1
Consumption	2.8	3.3	1.8	5.9	3.3	3.0
Dwelling investment	0.1	0.6	1.3	5.0	–8.1	6.8
Business investment	1.9	10.4	–17.8	0.6	–0.7	–24.3
Government	13.4	12.8	10.6	14.5	17.7	15.8
Employment (sa)						
Per cent	1.4	3.6	2.9	5.2	2.2	–0.1
Number ('000)	48	98	66	60	18	0

* State final demand data are over the year to the March quarter 2010; employment data are over the year to July 2010.

Source: ABS.

6. Outlook

Our expectation is that economic growth in Australia will continue for at least the next couple of years, the period for which the Bank typically prepares forecasts. Our latest forecasts, which were published earlier this month, show growth in the Australian economy continuing at a solid pace over this period.

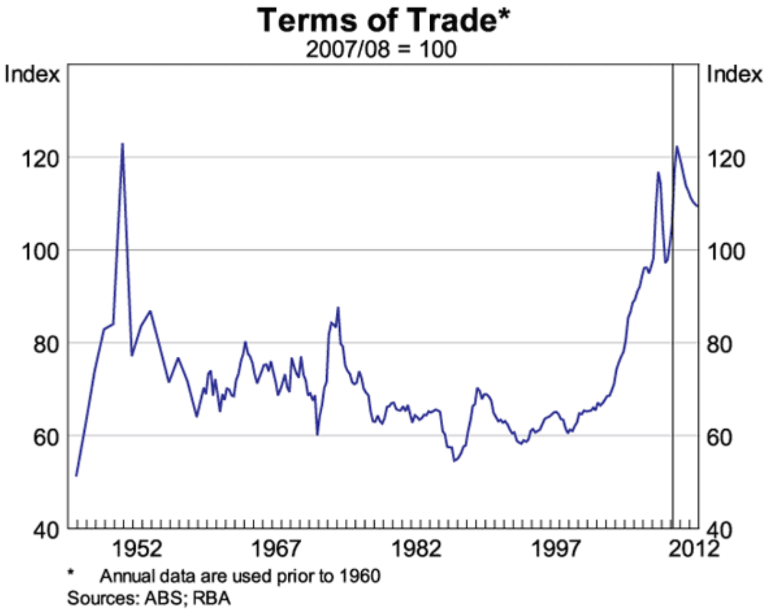
This view is partly based on the expectation that the world economy will continue the expansion that began in 2009. World economic growth is estimated at about 4½ per cent for this year, which is above average – in other words, quite a healthy outcome.

Growth in our major trading partners, a group that is more heavily weighted to the fast-growing economies of Asia, is expected to be even stronger this year.

Despite the good performance of the past year, there has been considerable discussion in recent months about whether the global economy can continue to grow solidly in the face of the financial problems it has been experiencing, particularly the overhang of government debt in many countries. However, while official forecasters around the world all acknowledge that this is a potential risk to growth, they are nonetheless forecasting that the global economy will grow at a reasonable pace over the next couple of years. This is the Reserve Bank's view as well.

The strong growth of the global economy over the past year or so has again pushed up the prices of commodities that Australia produces. They have returned to the high peaks reached before the onset of the global financial crisis in 2008. Relative to prices of our imports, export prices are at their highest level in 60 years (Graph 10). This is generating a large increase in income for the country: we are forecasting that Australia's gross income (in nominal terms) will rise by about 10 per cent this year.

Graph 10

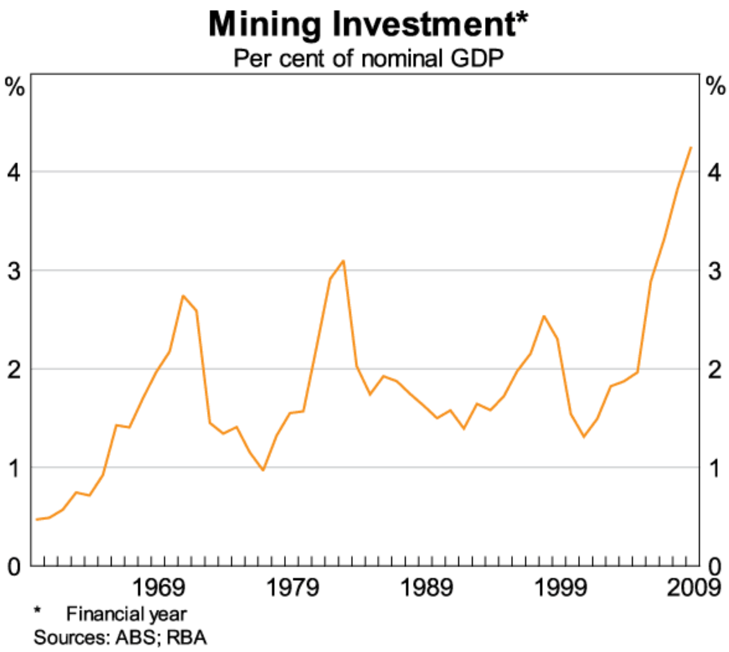


We expect that export prices will ease back somewhat over the next couple of years, as more supply comes on stream and as economic growth in our trading partners slows to a more sustainable rate. Nevertheless, by historical standards, prices will still be very high.

This creates a very favourable environment for the Australian economy. Household income will most likely rise quite solidly, which should underpin consumption even if households maintain their recent higher rate of savings.

Most importantly, however, we think that economic growth will be driven by strong business investment. This will be concentrated in the mining and gas industries, including some large projects that are planned here in Queensland. Mining investment typically runs at about 1¾ per cent of GDP, and in past mining booms it has reached up to 3 per cent of GDP (Graph 11). In the current boom, it has already risen to 4¼ per cent and, even on conservative assumptions, is expected to rise significantly in the years ahead. That will provide a major impetus to growth.

Graph 11



Even outside mining, investment is likely to rise, given that capacity constraints exist in many parts of the economy. This expansion in business investment is expected to outweigh the planned scaling back of government spending.

In this environment, we see further growth in employment, probably continuing to run ahead of growth in the labour force, so that unemployment will continue on a downward trend.

One issue is whether the strength of the economy will have implications for inflation. At present, underlying inflation has fallen back into the top half of the target range after rising noticeably over the second half of 2007 and 2008. We expect that it will stay around its current rate for the next year or so but, after that, upward pressure on inflation is again likely to emerge with a strongly growing economy. History tells us that inflation can be a problem during resources booms, and while there are grounds for thinking it will be less of a problem this time than in the past, we need to remain alert to the risks.

While Australia will, most likely, continue to do well over the next few years, it would be a mistake to assume that the economic cycle has been eliminated. We also need to recognise that it is difficult to foresee what will happen in the future, and that there are risks regarding the future path of the economy. It is possible, for example, that growth in the world economy will lose momentum, creating a significantly less favourable environment for Australia than is currently assumed. Both the volume and price of our exports would be weaker and external financing might also be more difficult. On the other hand, it could also turn out that inflationary pressures build more quickly than assumed.

7. Conclusion

Let me conclude.

Australia has delivered a very good growth performance over the past couple of decades. That was the benefit that flowed from a long process of economic reform and the adoption of prudent and disciplined economic policies. Even though there was significant variation in growth across industries, the benefits of growth were spread relatively widely across the states and across the income distribution of the population.

It is reasonable to expect that further growth lies ahead. However, with the economy now operating close to its capacity, it will take further improvement in productivity and disciplined policies for this growth to be sustained.