Ric Battellino: Economic and financial developments

Address by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to Citi's 3rd Annual Australian & New Zealand Investment Conference, Sydney, 25 October 2011.

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Introduction

2011 has been a frustrating year for the world economy. The recovery in most of the large advanced economies lost momentum in the first half of the year and financial market volatility and concerns about sovereign debt posed renewed threats in the second half. This led the IMF in September to note that the world economy had "entered a dangerous new phase". In many ways, these difficulties can be seen as the continuing after-effects of the financial crisis that gripped the North Atlantic economies in 2008.

Australia, as with most of Asia, has to date been relatively shielded from the events in the North Atlantic countries. Nonetheless, the local economy has not been as buoyant as had been expected at the start of the year and downside risks stemming from further weakness in the major overseas economies or financial market volatility cannot be ruled out. The situation in Europe is particularly disturbing since the authorities need to agree on policies that deal simultaneously with excessive government debt, weak banking systems, soft economic activity and sharp differences in competitiveness among European countries.

The situation is not all gloom, however. Economic data in the United States over the past month or two have, more often than not, surprised on the upside, Asia is also generally continuing to do well, and some of the local economic news has also been more positive of late.

Let me run through some of these issues in more detail. I will start with the world economy.

The world economy

As you know, 2010 had been a very strong year for the world economy. Growth was a little over 5 per cent, which is about as fast as the world economy ever grows. The strong growth was not surprising, as most countries were applying unprecedented amounts of monetary and fiscal stimulus as they sought to recover from the 2008/09 recession.

It was always expected that economic growth in 2011 would not be as strong. Early in 2011, most forecasters were expecting growth for the year of about 4½ per cent; while this was less than 2010, it was still a very good figure.

By the second quarter, however, economic outcomes were beginning to disappoint. In the United States, consumer confidence and spending weakened, possibly due to the strong increases in oil prices that had taken place; US industrial production was affected by the disruptions to global supply chains caused by the Japanese earthquake in March; employment growth slowed; and jobless claims, which had been gradually declining, started to rise again.

Growth in Europe also faltered in the second quarter, with confidence being eroded by the escalating concerns about sovereign debt in several European countries. And, of course, Japanese economic activity was severely disrupted by the after-effects of the earthquake.

Elsewhere in the world, however, economic activity remained robust. In fact, through most of Asia and Latin America the concern was that the strength of economic activity was putting upward pressure on inflation, and the authorities in many countries in these regions were tightening monetary policy.

Overall, forecasts for global growth in 2011 were scaled back around mid year to around 4¼ per cent, due mainly to the softer outlook for the major developed economies.

Subsequent to this, the marked increase in financial market volatility that occurred in the third quarter caused analysts to expect further weakening in the global economy, due to the sharp falls in consumer and business sentiment that occurred in most countries and the significant reduction in wealth caused by the falls in share prices.

The reductions in growth forecasts were again most pronounced for the developed economies. IMF forecasts for growth in the United States and the euro area in 2011 were reduced to around 1½ per cent. Although growth forecasts for Asia and Latin America were also revised down somewhat, the forecast outcomes for these countries remained quite robust.

While the forecast for overall growth for the world economy in 2011 was reduced to 4 per cent, that figure is still a healthy outcome. It is broadly in line with trend. The disparate outcomes between the advanced economies and the emerging economies, however, mean that the growth is very unbalanced and there is a sense that the forecast is fragile because of possible severe downside risks.

While forecasts have been revised down since the recent period of financial volatility, the run of actual economic data that has become available over that period, at least for countries outside Europe, has generally been better than might have been expected. This is particularly the case in the United States. It seems that, before the onset of the financial volatility, the US economy was starting to recover from the first half slowdown and that, so far at least, despite the fall in confidence, real economic activity has held up. Recently, analysts have been revising up their estimates of annualised US GDP growth for the third quarter, and the consensus is now for a figure of around 2½–3 per cent.

Japan also seems to be continuing to recover gradually from the economic effects of the earthquake.

Elsewhere in Asia, recent data have been mixed, though broadly consistent with the modest slowdown that authorities in the region have been trying to achieve in order to contain inflationary pressures. India perhaps has been the country pursuing this approach most vigorously, and seems to be the country where growth has slowed most noticeably. Overall, however, growth in the region remains solid. Growth in Chinese GDP over the year to the September quarter was 9.1 per cent, and recent monthly data for retail sales and industrial production have been robust. The latest data available to the Bank on shipments of Australian coal and iron ore to China (these are up to September) suggest that shipments have held up, though the weakening in iron ore prices over the past couple of weeks may be pointing to some softening ahead.

The Australian economy

Here in Australia, 2011 got off to a shaky start, despite the bright prospects offered by the second phase of the resources boom. A lot of this was due to the weather, as cyclones and floods disrupted economic activity, and coal production in particular. As you know, GDP fell noticeably in the first quarter of the year.

GDP recovered in the second quarter but, overall, measured economic output in the first half of the year was pretty flat. As well as the weather-related disruptions, there remained a generally cautious mood among households and businesses.

As the Bank has pointed out before, in recent years there has been a structural change in household spending and financing in Australia.[1] After a 10–15 year period during which households increased their gearing and reduced their rate of saving, they have returned to a more conservative, and traditional, pattern of financial behaviour. Household credit growth has slowed to a rate in keeping with, or slightly below, the growth in household incomes; the saving rate has increased to a level that is more normal based on history; and household spending growth has slowed from a rate that substantially exceeded household income growth, to one that, over the past year, has been broadly in line with income growth. Within total consumer spending, there appears to have been a shift away from spending on goods in stores to spending on services, particularly services such as overseas travel, eating out and entertainment. As a result, retail sales have been particularly weak.

This adjustment in consumer behaviour has created a difficult trading environment for some businesses, coming as it has after a prolonged boom. But the adjustment in Australia has been benign compared with the adjustments in household finances and housing markets elsewhere in the world, and it has put household spending and financing on a more sustainable path. This will ultimately benefit the health of the economy.

In the case of business investment, there is a clear dichotomy between the resource and non-resource sectors of the economy. Investment by the former is very high at present, and much more lies ahead. Outside the resources sector, however, business investment is relatively flat. In some cases this is due to the dampening influence of the high exchange rate, with the manufacturing and tourism industries particularly affected. In the case of tourism, the problem is not so much that foreign tourists have stopped coming to Australia but that many more Australians are going overseas. Overseas trips by Australians are running about 60 per cent higher than five years ago. Given the increase in overseas travel, it is not surprising that the traditional holiday destinations in Australia, such as the Gold Coast and North Queensland, are currently among the weaker parts of the Australian economy. In other sectors, such as commercial property, the weakness is mainly the result of investors and lenders having to deal with the consequences of over-gearing in the pre-2008 period. When too much borrowing and lending occurs, as it did in this sector, it can take many years for the excesses to be unwound. Some large adjustments have already taken place in the commercial property sector but the process probably still has further to run.

While the sectoral composition of business investment is uneven, the overall growth of investment has been very solid, with a rise of 6 per cent in the first half of 2011. Overall, private demand is rising solidly, and taking the place of public spending, which is now growing more slowly as earlier fiscal stimulus is unwound.

Total final demand grew by 3.4 per cent over the year to June, which is about in line with past trends. That, however, has not translated to trend growth in GDP, as the high exchange rate and the high import content of some mining investment have seen an increased proportion of demand being met from imports, rather than domestic production. The weather-related disruptions to coal exports added to the shortfall in production. In this environment, employment growth slowed noticeably in the first half of the year, and around the middle of the year there was some rise in unemployment.

At the same time, inflationary pressures, which had declined through 2010, appeared to pick up noticeably in the first half of 2011 and the prospects were that inflation would rise to above the target range of 2–3 per cent over the next couple of years. That created a difficult environment for monetary policy. As the Bank noted after the October Board meeting, however, the downward revisions to recent estimates of underlying inflation and the softer global economic outlook have made the outlook for inflation less concerning, providing scope

[1] See Stevens G (2011), "The Cautious Consumer", Address to The Anika Foundation Luncheon, Sydney, 26 July.

for monetary policy to be supportive of economic activity, if needed. Tomorrow's CPI data will provide further information in this regard.

It remains to be seen how the Australian economy will respond to the recent financial volatility and the consequent fall in confidence and the loss of wealth. To date, however, as in the United States, the flow of monthly data in Australia has been a little better than might have been expected given the volatile financial environment. Retail sales have picked up a little, housing loan approvals also seem to be picking up somewhat, most measures of business conditions remain around average levels and the most recent employment data have been more positive after a number of weak months. Nonetheless, job vacancies and advertisements are lower than their peak around the start of the year, overall credit growth remains subdued and the housing market remains soft.

Recently, there has been some easing in financial conditions following the fall in market interest rates that has accompanied the financial volatility. Banks have passed through to borrowers notable declines in interest rates on term housing loans and some business loans, as their cost of funds has declined. Increased competition among banks in response to the increased availability of deposits and relatively subdued demand for loans, has also resulted in some shaving of interest rates on standard variable mortgage loans for new borrowers. As a result, the interest rates on new loans are now around 10–15 basis points lower than they were early in the year. The modest net fall in the exchange rate in recent months has also, to some extent, reduced pressures on some sectors of the economy.

Looking ahead

As I have noted, as yet there have not been signs outside Europe that the rate of growth of economic activity has taken another step down since the recent bout of financial volatility. It is, however, still too soon to conclude that this will not happen. As we have seen from last weekend's events in Europe, much still needs to be done to deal with the challenges these countries are facing, and further market volatility is therefore to be expected. The United States also has challenges to deal with in the areas of fiscal policy and housing, so it would be optimistic to assume that the US economy will resume robust growth any time soon. Economic activity in large parts of the developed world is therefore likely to remain subdued in the period ahead.

The question is whether this will flow through in due course to the large emerging economies that have been the main force driving global GDP growth in recent years. Some flow-on is, of course, to be expected, even if the situation in the advanced economies does not deteriorate further. However, so far at least, there has not been the debilitating freezing up of trade finance that damaged Asian economies in 2008.

More generally, domestic demand in these economies has considerable momentum and, should it slow more than the authorities desire, they have considerable scope to provide support via monetary and fiscal policy, unlike in many advanced economies. The fact that inflationary pressures in many of these economies seem to be peaking may provide room to do so.

Overall, while it is possible that the global economic situation might take a sharp turn for the worse, at this stage the Bank's central scenario is that global GDP growth will be broadly in line with its long-run average over the period ahead. That would create a reasonably benign environment for the Australian economy. The global situation remains fragile, however, and will require careful monitoring.