East Asia and Australian monetary policy

Adam Cagliarini[1]

Over the past few decades, Australia's economy has increasingly been transformed by the effects of economic developments in East Asia. Australia's economic relationships with economies in the region have been deepening over a number of decades. The most profound effects on the Australian economy have been experienced over the past 10 years or so with the emergence of China as a major economy and trading partner.

My comments today will focus on the effect of emerging Asia on inflation in Australia, and I will then briefly discuss how external developments are affecting the conduct of monetary policy in Australia.

The Effect of Emerging Asia on Australian Inflation

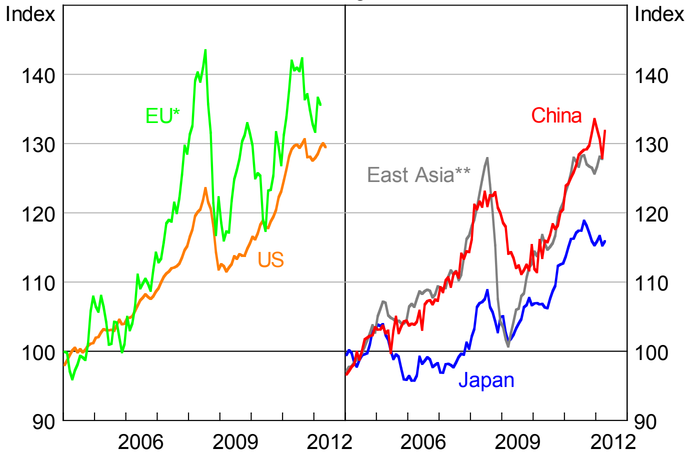
Given the limited time I have, I will focus on the main direct channels by which developments in East Asia have affected Australian inflation.

There has been a great deal of discussion about the effect that East Asia, and especially China, has had on inflation in developed economies. Prior to the global financial crisis, there was much talk about East Asia "exporting deflation" to the rest of the world. However, export prices for these economies were not deflating; the rate of increase in export prices (in US dollar terms) has been consistent with the rate of increase in export prices in more developed economies (with the exception of Japan) since 2004 (Graph 1).

Graph 1

Export Price Index

2004 average = 100

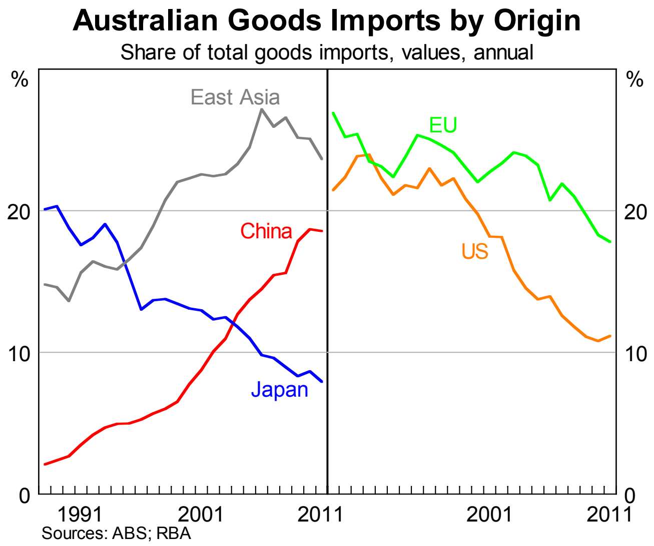


* Export unit value index
** Aggregated using GDP at market exchange rate weights
Sources: CEIC; Eurostat; RBA; Thomson Reuters

[1] Head of Asian Economies Research Unit, Reserve Bank of Australia.

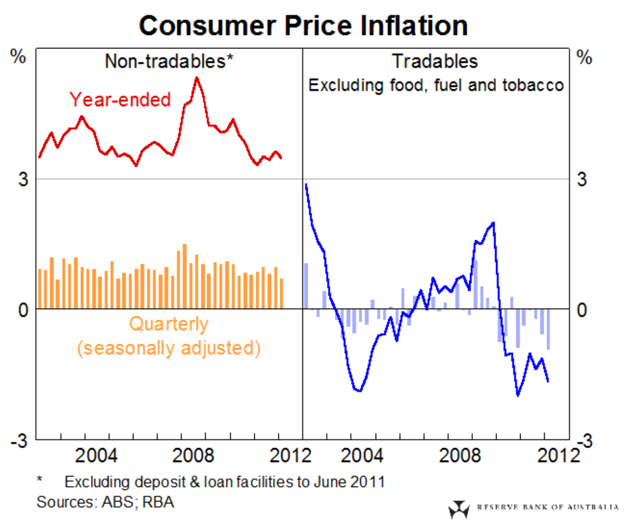
What has been happening is that East Asia has accounted for an increasing share of global manufacturing production, and the level of prices at which it sells these goods is generally lower. In Australia, an increasing share of merchandise imports has been sourced from East Asia and China (Graph 2). This switch to lower-priced goods has helped exert some downward pressure on the general level of prices faced by consumers and businesses.

Graph 2



As the development of East Asian economies accelerated through the 2000s, commodity prices rose strongly and the terms of trade for commodity exporters, including Australia, increased to around historic highs. Australia's currency appreciated significantly over that period, which helped to offset some of the inflationary effects of the increase in commodity prices. However, in the period prior to the global financial crisis, the appreciation of the exchange rate was not enough to offset the inflation in landed import prices in Australia; tradables inflation in Australia had been rising even as the exchange rate appreciated from 2006 to 2008 (Graph 3).

Graph 3



This has not been the case more recently. During the crisis, the Australian dollar depreciated significantly but briefly. With stimulatory policies put in place in response to the crisis, particularly in China, commodity prices began to rise again, and Australia's currency began to appreciate. However, this time around, notwithstanding the increase in commodity prices, the appreciation of the Australian dollar has been rapid enough to exert some downward pressure on tradables prices, and consequently the CPI.

Monetary Policy in Australia and External Developments

Given Australia's status as a small and open economy, it is not surprising that developments in the global economy have an important bearing on the decisions made by the RBA Board. The RBA Board has repeatedly referred to developments overseas in its minutes as being important considerations for policy in Australia. In the period leading up to this conference, the Board recognized the headwinds that the Australian economy was confronting. Conditions in Europe were playing a particularly important part in the discussions of global economic conditions, and in its minutes the Board noted that conditions in Europe, and to some extent those in China, had the potential to slow the Australian economy. The Board has noted at a number of meetings that "The financial problems in Europe continued to be a potential source of adverse shocks to the world economy…" and that "sentiment remained somewhat fragile".

The deepening economic relationship with a large and growing Chinese economy has meant that the RBA Board has increasingly turned more of its attention to developments in China (as well as the rest of East Asia). In recent months, the Board has been considering the effect of a slowing Chinese economy and its implications for Australia. Not only would a slowing in China have a direct real effect through a slowing in exports, but lower growth in the Chinese economy would precipitate a fall in commodity prices, thereby lowering Australia's terms of trade and potentially the value of the Australian dollar. The nature of the slowing in the Chinese economy would also matter, for example the extent to which it might affect steel consumption, and so the degree to which lower growth in China will affect the Australian economy remains uncertain.