

I J Macfarlane: Australia and the international cycle

Talk by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to Australian Business Economists/Economic Society of Australia (New South Wales Branch) Forecasting Conference Dinner, Sydney, 6 December 2001.

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I last spoke at this Conference Dinner two years ago, and a lot has happened to the Australian and world economies since that time. I am pleased to be invited back and given a platform from which to share a few thoughts with you tonight. In keeping with the theme of the Conference – which is about forecasting – I will address the issue of how well placed the Australian economy is to handle the challenges of the next year, particularly the international challenge. In a sense, the talk will also be a replacement for my regular half-yearly report to the Parliamentary Committee on Economics, Finance and Public Administration. Because of last month's election, there has not been time to re-form the Committee and schedule a hearing date in the current half-year.

I will start tonight by showing a graph which compares Australia's current economic expansion with its predecessors in the 1970s and 1980s. Some people may think I am tempting fate by showing this graph at this particular juncture, but I have been doing so, from time to time, over the past three years without ill effect. What the graph shows is that the current expansion is a good deal longer and smoother than its predecessors. One of the most important reasons for this is that inflation has been a lot lower on average and less variable than in the earlier expansions. Monetary policy, therefore, has been able to play a different role than formerly – one that involves earlier movements in interest rates, but with smaller amplitudes of movement. The inflation targeting framework has been a crucial element in bringing about this result.

Diagram 1: Expansions in GDP

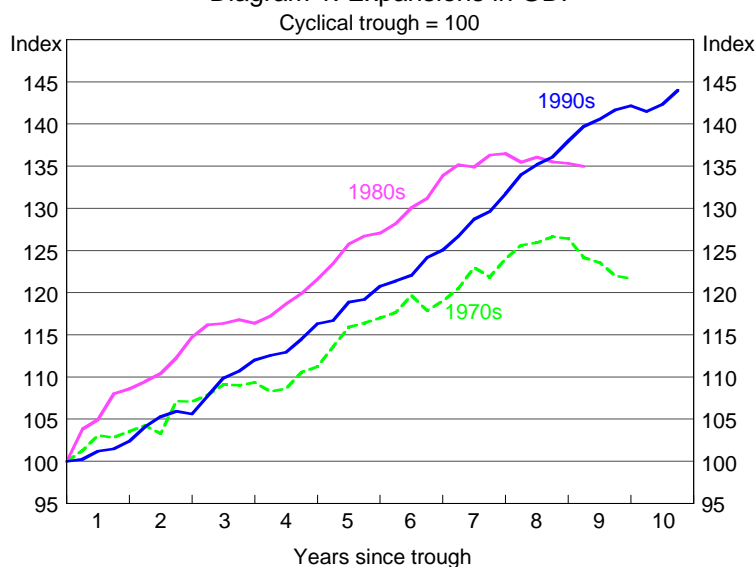


Table 1

Expansions in GDP

	1970s	1980s	1990s
Length of expansion in quarters	31	28	40 so far
Total increase ¹	26.6	36.5	45.6
Average growth rate	3.1	4.5	3.8
Number of quarterly declines	7	2	2
Standard deviation of quarterly growth rates ²	1.1	0.9	0.6
Average inflation rate	11.2	6.9	2.4
Standard deviation of quarterly inflation ²	1.2	0.7	0.3

¹ Percent. ² Percentage points.

For most of the period of the current expansion, the international background has been benign. The exception until recently was the period between mid 1997 and the beginning of 1999, when the Asian crisis confronted us with a pronounced fall in the demand for our exports and some pretty skittish international capital markets. We survived – indeed, prospered – in that period, much better than any of us thought likely at the time. Now we are confronted with another period of weak international demand, and this time the United States – the former powerhouse of the world economy – is the principal source of the weakness. This time we confront a problem that is global rather than specific to our region.

The current problems did not, of course, start on 11 September, and I think there has been a tendency to exaggerate the economic consequences of that event, and under-estimate the underlying weakness that preceded it. If I had to give a date when it became clear that the international economy was in for a rough ride, I would nominate 3 January, when the Fed surprised everyone with the first reduction in interest rates in this phase only a fortnight after their previous meeting at which they had kept rates constant. After a flurry of interest rate reductions around the world in the next few months, the situation then settled down for a while. In Australia, after our three initial reductions, we paused for four months while we evaluated the incoming information. By mid August, we had concluded that the international situation was worsening again, and we began a second round of easings in early September, about a week before the fateful events in New York. Thus, taking these events together, we have been in a situation where we were conscious of a weakening world economy for virtually a full year. During that time – or for the three quarters covered by the national accounts – the Australian economy has grown at an annual rate of 4 per cent, while the US has been flat. We have also done better than other comparable economies. This is a very encouraging result for us, but success so far does not guarantee success in the future. Indeed, there is a large body of opinion that says we are destined to follow where others have led.

Table 2

Growth and Inflation in 2001
per cent, year-to-date annualised.

	GDP Growth	CPI Inflation
United States	0.2	2.1
Canada	0.5	1.8
Euro Area	0.9	2.5
United Kingdom	2.1	1.5
Australia	4.0	3.0

I suppose that is the question that has been on everyone’s lips for quite a few months – if the world economy goes into a recession, as the United States and Japan have done and much of the rest of the world seems to be doing, does that mean that Australia has to follow? People who would answer yes to this question would point out that we have done so in the past, for example, in the mid 1970s, the early 1980s and the early 1990s. Why should this time be any different?

This is a view of the world that I would call historical determinism, and it may or may not be a good guide. But before we accept such a prediction, it should be challenged by a close examination of the circumstances then and now. What such an examination reveals is that present domestic circumstances are very different to those prevailing in the earlier episodes. To put it bluntly, we brought a lot of the problems on ourselves in the previous episodes, whereas this time we have not done so. On the previous occasions, we could not in all honesty make the claim that it was mainly the fault of the rest of the world – much of the fault was clearly of our own making. In other words, Australia had a lot of serious domestic imbalances that contributed to the downturns.

Imbalances - then and now

For a start, each of the earlier downturns was preceded by an episode of high inflation. In the 1970s and 1980s, the CPI was rising in double digits; in the 1990s, although this measure peaked at a lower rate – about 8 per cent – it was accompanied by unsustainably high asset price inflation. Accordingly, monetary policy had to be tightened on all three occasions to combat these imbalances, and short-

term interest rates reached very high levels – either a little above or below 20 per cent on each occasion. Nothing remotely like that has happened this time to either inflation or to interest rates. Perhaps more importantly, monetary policy this time has been able to be eased much earlier than on previous occasions – interest rates have been successively lowered for nearly a year now, during which the economy has been growing at a good rate.

While I think the different behaviour of inflation and interest rates is the biggest change between then and now, there are a number of other factors that contributed to our difficulties in earlier times that are not present now. I have listed these before, but there is no harm in doing so again:

- There were large rises in real wages that squeezed the business sector in the 1970s and 1980s. This time wages have grown at a reasonably steady 3½ per cent per annum over the past year or two.
- There was an investment boom that led to over-capacity in the early 1980s. Investment has been quite subdued over the past two years, and, in more normal circumstances, we should be due for a pick-up. Even in current circumstances, a straightforward reading of last week's Capex Survey suggests a rise in the current financial year, though it is concentrated mostly in one sector (mining).
- In the early 1990s, the exchange rate appreciated sharply in the period ahead of the downturn. On this occasion, it goes without saying that the exchange rate is exerting an expansionary influence.
- On each earlier occasion, the deficit on current account of the balance of payments widened by an amount that alarmed many people. On this occasion, it has fallen to a level not seen in more than 20 years.

I will return to some of these subjects later, but before I do so, I would like to address another form of historical determinism.

Imbalances - United States and Australia

The macro-economic performances of Australia and the United States in terms of output growth and inflation were very similar over the 1990s. It would therefore not be unreasonable to ask the question of why they should not also be similar in the first few years of the new century. Again, I think there is a reasonably straightforward answer to that question which stresses some very big differences between the two economies.

- The US economy exhibited in the late stages of its expansion two or three developments which arguably warranted the use of the term "bubble":
- The US stock market, particularly the technology sector as measured by the NASDAQ, rose to exceptional heights and has since fallen. The broad indices such as the S&P 500 or the Wilshire are down by about 25 per cent from their peak, whereas in Australia the ASX 200 is only down about 4 per cent.
- In the United States, there was a burst of physical investment towards the end of the expansion, mainly in high technology equipment. We are now seeing the reaction to this and the consequent excess capacity, in the form of sharp falls in investment. As explained earlier, this pattern of action and reaction is absent in Australia.
- The trade-weighted value of the US dollar has risen appreciably over recent years and, despite lowering interest rates faster than any other country this year, the currency remains at a very high level.

These three factors were really a manifestation of the excessive euphoria associated with the widely held view that the secret of economic success was to pour resources into the "high tech" sector. In the event, the countries that were most exposed to that sector are the ones that are showing the largest falls in output.

The transmission from the world to Australia

So far, I have emphasised the strong points about the Australian economy, and the differences between us and other more vulnerable economies. But it would be foolish to deny that a fall, or even a pronounced slowdown, in the world economy and world trade would have a significant contractionary effect on the Australian economy. Clearly, such an effect will occur, some of which is already showing up. The two classical channels are through a fall in the volume of exports and through a lower terms of trade, but there may also be other channels. The remainder of my presentation will look at the probable size of these channels.

Table 3

Export Contribution to GDP

Downturns	Period (year-ended)	Contribution to GDP
Mid 1970s	Mar 1974	-1.4
Early 1980s	Jun 1983	-0.9
Early 1990s	Dec 1989	0.3

It is true that during world recessions, the volume of Australian exports usually falls. Table 3 shows that at the time of previous world recessions, Australia has experienced periods of falling or weak exports roughly coincident with these recessions. But the negative contributions to GDP in any one year are not large; the biggest we can identify is the 1.4 percentage points in the year to March 1974. Clearly, if the rest of the economy was growing at a reasonable rate, this would not be enough to induce a recession.

Traditionally, the Australian economy has had a reputation for doing better than most other economies in the good times and suffering more in the bad times. One reflection of this was that the Australian dollar was seen as a "commodity currency" because it was heavily influenced by our terms of trade. Again, it is true that during previous world recessions, Australia experienced periods of falling terms of trade that coincided roughly with the recessions. The biggest negative contribution of 1.7 percentage points of GDI was in the year to March 1975 (following a massive positive contribution the previous two years). The magnitude of these effects is such that, although they have made a noticeable contribution to slowing the economy, they would not be enough to cause a recession.

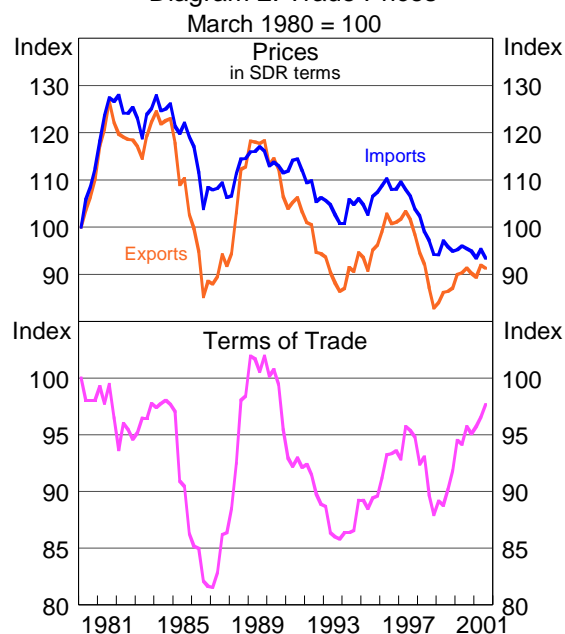
Table 4

Terms of Trade Contribution to National Income (GDI)

Downturns	Period	Contribution to GDI
Mid 1970s	Year to Mar 1975	-1.7
Early 1980s	Year to Mar 1982	-0.6
Early 1990s	Year to Jun 1991	-1.2

Even if we add the export volume effects and the terms of trade effects together (noting that they usually cover different, but roughly adjacent, periods), the combined effect in any one year would not be enough to turn a reasonable positive growth rate into a negative one. The other conclusion that can be drawn from this table is that the contributions tend to be getting smaller, particularly for the most recent recession in the early 1990s.

Diagram 2: Trade Prices



I would like to say a little more about the terms of trade before I leave that subject. As I said earlier, there has been a tendency to see Australia as being some sort of “loser” in the international economic competition because of our vulnerability to terms of trade movements. There is an assumption that our terms of trade are subject to a long-term downward trend, that they are also cyclically sensitive, and that both of these characteristics stem from an unfortunate export mix, with its over-representation of “commodities”. I think this is a somewhat dated view for the following reasons:

- On the question of long-run trends, it should be noted that the low point in our terms of trade was as far back as 1986/87. The two troughs since then have been at successively higher levels.
- On the question of cyclical sensitivity, we have had conflicting signals over recent years. Our terms of trade fell between mid 1997 and mid 1998 as a result of the Asian crisis, but since that time, i.e. over the past three years, they have risen, even though the last of those three years has been a very weak one for the world economy. They are now above the peak they reached immediately before the Asian crisis.
- The focus on our export prices is misplaced because the really interesting action seems to be taking place on import prices. They are not as cyclical as export prices, but they have shown a more pronounced downward trend over the 1990s, particularly over the past five years. We know that a lot of this is due to the sharp falls in the prices of telecommunications and computing equipment, but it is more widespread than this. Of the 29 categories of goods for which the ABS publishes import prices, 26 fell in SDR terms between 1996 and the present. Nearly all of them are categories of manufactured goods.

Whether the trend in the price of a particular category of internationally-traded goods is up or down depends to a large extent on long-run supply elasticities. It now seems likely that the highest supply elasticities are to be found in large-scale manufacturing rather than resource-based goods. Semi-conductors are an obvious example, as are less sophisticated products such as clothing, textiles and footwear, but it also seems to be true for electrical equipment, automobiles, and for many types of industrial equipment. In some senses, these are now the “commodities” of international trade. I am not suggesting that all manufactured goods have this characteristic, but it seems that most of them do.

My conclusion from this discussion of movements in exports, imports and the terms of trade is that they are not big enough by themselves to transmit a world recession into a domestic recession. A fall in domestic spending would be required to bring about that result. Why should domestic spending fall if the domestic economy was in reasonably good shape? One possible explanation is multiplier effects from the export sector, but most econometric estimates suggest that these would not be large enough to tip the balance. Another channel is through confidence effects – perhaps business and consumer confidence are influenced, not only by domestic developments, but also by international ones. Given

the massive amount of information about the US economy that is routinely transmitted to Australians, it would not be surprising if this were the case.

It is clear that some international events show up in measures of confidence among Australian consumers and business, September 11 being an obvious example. But, on the other hand, consumer confidence is still above its long-term average, and like most measures of business confidence, its recent trough was in the March/April period of 2001 – about nine months ago. At that time, we were getting bad news on the domestic front, particularly the temporary decline in GDP in the December quarter of 2000. The level of confidence recovered from this temporary trough, and on average over the past six months, has been a good deal higher than earlier in the year, and has held up reasonably well through the recent international turmoil.

There is one thing about recent business behaviour that has worried me a little, but so far it seems to be mainly confined to the United States. I am referring to the practice by companies of announcing large lay-offs of employment whenever a downward earnings revision occurs. This practice is no doubt designed to please investors and therefore to prop up the company's share price. If these lay-offs are occurring as announced, it suggests a more rapid employment response than in previous downturns. While the practice may help one company when viewed in isolation, it is a serious error to think that companies in general can protect their earnings in this way. Earnings are meant to decline cyclically in circumstances such as the present because it is impossible to cut costs as fast as revenue is declining. The more the cyclical fall in earnings is resisted in this way, the more it is transferred to employment, and the more pronounced the cycle becomes.

Conclusion

Calendar year 2001 has been a difficult one for the world economy, and the first half of 2002 looks like remaining weak before a recovery gets underway. This would mean 18 months of economic weakness for the world economy, and be classified as a recession like those of the mid 1970s, early 1980s and early 1990s. The Australian economy has got through the first half of it in reasonably good shape considering the circumstances.

Can we keep up our present performance until we are again in an environment of reasonable world growth? Can we span the valley? I have given a number of reasons why I think we can, even though we will experience falling exports, falling earnings and the usual inventory adjustments. These are examples of externally-induced contractionary effects that cannot be avoided, but which are not big enough by themselves to cause a recession. For that to occur, we would have to see an over-reaction by domestic consumers and businesses. The evidence to date from surveys of confidence, from household spending and from business investment intentions is that they are holding up reasonably well. Far from over-reacting, they are exerting a generally stabilising influence. If this changes for the worse, or if it appears that the outlook for the world economy is weaker than currently assumed, we will be prepared to adjust monetary policy accordingly.