

Glenn Stevens: Cross-currents in the global economy

Speech by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, at the Australian Industry Group's Annual National Forum, Canberra, 25 October 2010.

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Introduction

The topic the AIG had proposed for this session was “The Australian Economy to 2020”. That would of course involve forecasting up to 10 years ahead. That’s a rather risky proposition because forecasts are very hard to make. It might be safer, especially for a central banker, not to look forward at all!

The way I want to start is by looking back 10 years. This may serve as something of an admonition to be circumspect in making forecasts. But identifying some big trends in the Australian economy over the intervening period – one or two of which were quite unexpected a decade ago – may contain some indications of issues for us to be aware of in the next decade. A couple of the trends that are readily observable also point to some current challenges in global economics and finance, and it is these to which I shall turn in the second part of these remarks.

2000 – the year that was ...

A decade ago, Sydney had just hosted the 2000 Olympic Games. The city of Melbourne had hosted a meeting of the World Economic Forum. There were some wonderful sporting moments for Australians in the Games, though the Games are perhaps remembered for their logistical success as much as for the medal tally. The WEF meeting is perhaps most remembered for the protests, which turned ugly.¹

But these events should also be remembered as occurring at the height of the dot-com mania and its obsession with the “new economy”. Australians were told by more than one prominent visitor that year that we lived in an “old economy”, with the implication that we needed to shift towards the production of IT goods. Blue-sky valuations were being applied to companies that had not, at that point, earned a single dollar of profit (and many never would). The Australian dollar was slumping.

The Economist magazine remarked that:

“... As Sydney was presenting the new face of modern Australia to the world, the currency markets were giving a different verdict. At the end of the games’ first week, the Australian dollar fell to a record low of 53.63 cents against its American namesake. ... The Australian dollar’s fall is partly explained by the greenback’s remarkable strength ... But it also reflects a continuing belief among financiers and potential investors that Australia has yet to complete the transition from being an old economy, based on natural resources, to a new economy fired by information and other technology.”²

Other examples could be given.

¹ A Google search seems to turn up numerous references to the various protests and protest groups, but not all that much in the way of what was actually said at the Forum. Whether that reflects an ephemeral discussion or the nature of news reporting is difficult to gauge.

² “Australia’s game still to win”, 28 September 2000.

As we now know, the dot-com bubble had actually started to deflate by the time those words were printed. The NASDAQ share index had already fallen by about 25 per cent from its early 2000 peak. By early in 2001 the US Federal Reserve would be cutting interest rates as the US economy went into recession. The new economy – the latest (but not the last) in a long line of new paradigms – still had a business cycle after all. The Australian dollar would fall further in 2001, reaching a low point of about US48 cents in early April. Some felt that it might fall as far as US30 cents. More than any other single economic indicator, this particular price was often taken as a summary statistic for economic health.

In 2000, some people were making the point that, in the old versus new economy stakes, it was probably in the *use* of information technology, rather than in the production of IT goods, that the gains would be greatest. On that score Australia ranked highly.³ Or they made the point that Australia would probably do best, in its production structure, to stick to its comparative advantages in minerals or agriculture or various services.⁴ But it was hard going trying to make sensible points against the barrage of market and media commentary.

Ten years on, though, it does not seem to have been to Australia's disadvantage not to have built a massive IT production sector. On the contrary, the terms of trade are at a 60-year high, the currency just about equals its American counterpart in value and we face an investment build-up in the resources sector that is already larger than that seen in the late 1960s and that will very likely get larger yet. In the area of information technology, meanwhile, the pace of change continues to be rapid: prices continue to fall, profits have proved very hard to come by and a number of prominent names from 2000 have disappeared. It is still better, it seems, to be a user than a producer of IT.

The point of saying all this is not to poke fun at those whose prognostications a decade ago turned out to be wide of the mark. Anyone who *has* to forecast for a living has, from me, a degree of sympathy. The point is simply that forecasting is very hard and that the latest conventional wisdom often turns out to be just a passing fashion. We might add that market pricing, at some points in time, may not be much better than that, even though markets tend to get it roughly right on average.

Long-term trends

Having given that caution, it is worth recounting just a few of the trends we can observe over the past decade or longer. The increased borrowing of the household sector was one such notable trend. It had already been under way for nearly a decade by 2000, but kept going for the best part of another decade after then. I have said before that this probably won't be a feature of the next decade. We are seeing more caution in borrowing, and the rate of household saving from current income, while still low, has risen over recent years. It follows that some personal and business strategies that did well in the earlier period of households gearing up probably won't do as well in the future.

Other trends have been a continuation of developments that had already been under way for a long time. For example, as a share of the economy, services have continued to rise, while manufacturing and agriculture have declined. Those sorts of trends, in broad terms, are pretty common to advanced economies.

Mining's share of output had changed little since the mid 1980s, but has picked up noticeably over recent years. This seems likely to continue in the near term at least, so we are seeing a

³ See Macfarlane I, "Talk to World Economic Forum Asia Pacific Summit Melbourne", 11 September 2000 and *The Australian Financial Review*, "Whither the new economy?", 6 March 2000.

⁴ See Harcourt T, "Should we worry about the IT deficit?" <<http://www.austrade.gov.au/Should-we-worry-about-the-IT-deficit/default.aspx>>, 16 October 2000.

faster pace of change in the relative sizes of industries than we had seen for a number of years. Formal metrics of the extent of structural change in the industry composition of GDP have increased but do not, at this point, show it to be outside the range of previous experience.⁵ That could well change, though, given the size of the resources sector build-up that appears to be under way.

Looking at the trade accounts, we can see that the share of resources in exports has risen very significantly over the past decade while those of the manufacturing, agricultural and services components have declined. This is not to say that the absolute values of exports for the latter sectors have fallen since 2000 – indeed services exports have grown quite strongly – but the rise in resource exports has well and truly outpaced everything else, as a result of both volume and price rises.

It is in the destinations of exports, however, that we see perhaps the most striking changes over the space of a decade. As it happens, the weights in the Reserve Bank’s trade-weighted measure of the value of the Australian dollar were updated just a few weeks ago. In the most recent year, the overall weight on the Chinese currency rose by 4 percentage points. That was quite a large movement in a single year but it is just the latest manifestation of a profound trend. Stepping back, it is apparent that there has been a striking further orientation in trade towards the Asian region since 2000.⁶ The table below tells the story.

Australia’s merchandise exports by destination

Per cent share of total, financial years

Destination	1999/2000	2009/2010
China	5.1	23.2
Japan	19.3	18.5
South Korea	7.8	8.2
India	1.6	8.1
United States	9.9	4.8
New Zealand	6.9	4.0
Euro area	7.7	4.0
United Kingdom	4.3	3.6
Taiwan	4.8	3.4
Singapore	5.0	2.5
Thailand	1.8	2.3
Indonesia	2.5	2.2
Malaysia	2.2	1.6
Hong Kong	3.3	1.4
United Arab Emirates	0.9	1.0
Papua New Guinea	1.0	1.0
South Africa	1.1	0.9
Saudi Arabia	1.4	0.8

⁵ Connolly E and C Lewis (2010), “Structural Change in the Australian Economy”, RBA *Bulletin*, September, pp 1–9.

⁶ The data show shares based on exports of goods. The text also refers to trade in goods unless otherwise stated.

A decade ago, Japan was far and away the largest export destination for Australian goods. The United States was second, South Korea and Europe tied for third and China came sixth after New Zealand. Today, Australia's top goods export destinations are, in order, China, Japan, Korea and India – accounting for some 58 per cent – followed at some distance by the United States, New Zealand and the euro area, all closely bunched, accounting for a further 13 per cent or so between them.

Given the ongoing shift in the world economy's centre of gravity towards Asia, the direction of this change is not at all surprising. Many countries would be seeing the weight of their trade shifting in the same direction as ours. One of the reasons for the strong performance of the German economy this year, for example, has been the strength of demand for high-end manufactured products in Asia. For Australia, though, it is a powerful phenomenon.

Now this is just the exports side. When we consider both imports and exports – and indeed when we include trade in services – the United States and Europe remain important for Australia (though less so than China these days).

The United States and Europe – along with New Zealand – also continue to account for a large proportion of Australian investment abroad and are the source of the vast bulk of foreign investment into Australia. In fact, the share of outward Australian investment going to Asia has actually fallen slightly since 2000. Moreover, financial developments in the major economies, and especially the United States, are still very important drivers of capital flows, and of shifts in financial and business sentiment.

So there are still important links to the major economies. I am not arguing for “de-coupling”, if by that idea is meant that somehow the north Atlantic countries have ceased to have a significant impact on the global economy, or no longer matter to us. Everything is connected, and economic events in the north Atlantic countries still matter greatly.

But trends in those countries are leavened to no small degree by developments in the Asia-Pacific region, which is progressively becoming both larger and more capable of exerting a degree of independent influence over its own economic performance. It used to be said that when the United States sneezed, Asia caught a cold. Recently it seems that the United States has contracted pneumonia, while Asia sneezed and caught a bad cold, but then recovered pretty quickly. Even in the financial field, the size of offshore investments by Asian official holders has become quite important, including for the Australian dollar. And while the stock of cross border investment between Asia and Australia remains small compared with that between Australia and the United States or Europe, that is surely in the process of changing.

The point of all this is not to say that somehow Australia has been, or will be, “saved” by China or Asia. The emergence of Asia is to our advantage, if we respond to it correctly. But there is no free ride from the global or regional economy and there never will be. Nor is it to deny that a country's own policies, for better or worse, and followed over a long period, also make a significant difference to its economic outcomes. There is no escaping responsibility to keep our own house in order.

The point, rather, is that we ought to take more than a passing interest in events in our region, and in the conduct of economic policies in our region, and not just those in the countries that once completely dominated the global economy, but no longer do.

This brings me to the issue foreshadowed in my title.

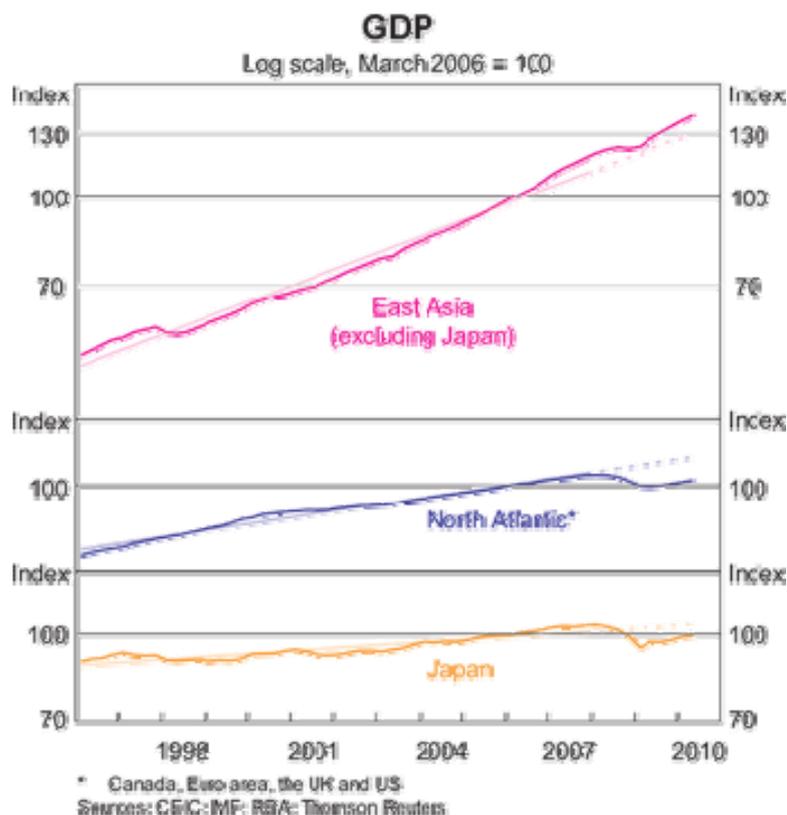
Cross-currents in the global economy

At the risk of over-using a clichéd term, the global recovery has been very much a two-speed one. The United States, the United Kingdom, Japan and some continental European economies saw deep downturns in output, and have to date experienced only weak recoveries that have left the level of output well below its previous trend and unemployment

much higher than normal (Graph 1). In the United States in particular there is a very troubling increase in the duration of unemployment, which, with its likely atrophy of skills, does not bode well for future growth.

In Asia outside of Japan and in Latin America, economies have traced out the more classic “v-shaped” path. In east Asia excluding Japan, the level of real GDP is well above its previous peak. It follows that most of these economies are likely to experience some moderation in the pace of growth, from something well above trend, to something more like trend. This is normal after a rapid recovery.

Graph 1



This difference in performance between large parts of the emerging world and the core of what we could call the “established” world of industrialised economies leaves the global economy poised at a critical juncture. In Asia, capacity utilisation has more or less recovered and growth will moderate. Many of the old industrial countries, in contrast, still have large volumes of idle capacity and are searching, with increasing urgency, for ways to *increase* their growth. But they are having trouble increasing their own demand. So we face a slowdown of some degree in global growth at a time when substantial spare capacity remains in the global economy. The “global imbalances”, so called, have persisted, and have a new dimension: there is an imbalance in the location of spare capacity in the world.

What could be done to foster a better outcome for everyone?

There has been an increasing focus on exchange rates of late, with talk of “currency wars” and so on. My view is that more flexibility of exchange rates in key emerging countries in Asia – including China, but not only China – would be part of a more balanced outcome.

But exchange rate flexibility alone isn’t enough. Changes in exchange rates don’t themselves create global growth, they only re-distribute it. Unless the exchange rate changes were

accompanied by more expansion in demand globally, we would not have solved the problem of excess capacity, we would only have relocated it. The additional step needed is stronger domestic demand, compared with what would otherwise have occurred, in the countries whose currencies would appreciate in such circumstances.

Of course there should be room for this given that the higher exchange rate would, other things equal, help to dampen inflation. In principle, at least, this looks like a potential “win-win” outcome. The appreciating countries could enjoy faster growth in living standards than otherwise, while the weaker countries whose currencies were moving lower would get some stimulus to aid their recovery.

There are, however, some complications. A number of Asian countries have been experiencing worrying increases in property prices. Low interest rates and easy financial conditions have contributed to this. Arguably domestic financial conditions in these cases need to be tighter, not looser. So it is not clear that monetary policy would be the best option to boost domestic demand. That said, allowing exchange rates to appreciate more quickly would probably help to dampen increases in asset prices.

What about more expansionary fiscal policies as the way of increasing domestic demand? Many, though not all, Asian countries would have some scope for that, given the long record of fiscal prudence and low public debt levels. But these countries are very unlikely to do things that would seriously impair their fiscal position in the long run. Hence my suspicion is that fiscal action, if it came, would be only modest.

Some argue that structural changes are needed to lower national saving rates in countries like China. Such changes could involve a shift in the distribution of national income away from state enterprises to households, who are thought more likely to spend it, a better developed social safety net, and so on. In all likelihood these sorts of changes will occur over time. But structural change is rarely a rapid process.

So I think we should be realistic about how much difference exchange rate flexibility would make to the unbalanced nature of growth in the global economy, at least over a time horizon of just a few years. It is definitely part of the answer (and it is surely in the interests of the countries with closely managed rates to accept more flexibility), but it is no panacea.

A full resolution of the imbalances will take time. It will involve more far-reaching changes to very deep-seated attitudes to saving, which remain very different across the regions of the world. As incomes in Asia continue to rise, saving rates will probably decline over time, but only gradually. Meanwhile, aggregate saving rates in America and Europe will have to rise over time, given the extent to which financial obligations have grown relative to likely future income, particularly on the public side. The key question is whether these two trends, in opposite directions, will occur at the same pace, or not.

Good policies can certainly help the world get to a better solution than might otherwise occur. But even with good policies, it is likely to be a slow grind out of the current difficulties for some countries. We probably have to accept that global growth was unsustainably fast in the few years prior to the crisis, that too much capacity of certain types was built up in the wrong places, that spending in some countries ran too far ahead of permanent income and that a period of adjustment and structural change cannot be avoided, even under ideal policy settings. If that is so, then, in all countries, an emphasis on accepting the need for adjustment generally – not just in exchange rates but in economic policies and structures across the board – is key.

Conclusion

Economies are not static machines. They are a complex and dynamic combination of actors, all continually seeking to adapt to changing conditions. That is one reason that economic

outcomes are very hard to predict, and why I am circumspect about predicting “Australia to 2020”.

Looking to the long run, we probably can make a few very general observations, but not much more. Real income per head has generally been on an upward trend in industrial economies for the past 250 years, with occasional setbacks. Most likely that will continue (albeit that some major countries will take some time to recover their income levels of three years ago). As a broad observation, and definitely not as a precise forecast, we might expect that a decade from now Australia’s per capita GDP will probably be roughly 15 per cent higher in real terms than it is now, give or take a few percentage points. The economic policy arguments, by the way, will all be about what policies might gain or lose those few percentage points.

In 2020, there will probably be, at a rough guess, an extra couple of million people working, compared with today’s 11.3 million. But exactly how all those people working will earn their living and go about their work is considerably less predictable. A good proportion of those 13 million-plus jobs will be in firms that don’t yet exist. Some will be in industries or occupations that barely exist as yet. And no one can give you a blueprint for which areas will succeed and which will not, any more than the pundits a decade ago, at the height of the “new economy” fad, could foresee the shape of Australia’s economy today.

Succeeding in the future won’t ultimately be a result of forecasting. It will be a result of adapting to the way the world is changing and giving constant attention to the fundamentals of improving productivity. That adaptability is as important as ever, in the uncertain times that we face.