

Glenn Stevens: The state of things

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Quite a lot has happened since I last had the opportunity to address a London audience in January 2008. Later that year, a sequence of financial events saw the global financial system teeter on the brink, followed very quickly by a very sharp global economic slowdown in the closing months of 2008 and the early part of 2009.

For the global economy, a recovery in activity commenced shortly thereafter. It has turned out, contrary to widely held expectations two years ago, to be quite a robust one overall. Real GDP for the world is estimated by the IMF to have grown by 5 per cent in 2010, well above the medium-term trend of a touch under 4 per cent. As of the most recent published forecasts, the IMF expects the world economy to grow by almost 4½ per cent this year – still above trend.

But the pattern of the growth has been rather uneven. Here in this part of the world, recovery is proving to be difficult and protracted. Yet in the Asian region, the recovery has been quite rapid and concerns have been expressed about excesses.

There is more than just cyclical dynamics at work in these trends. Important structural forces are in operation, and they have significant implications. These are worthy of careful consideration, even though we cannot do them full justice today.

The North Atlantic region

The group of countries that could be labelled as being in the North Atlantic region (North America, the United Kingdom and continental Europe) are in the early phase of recovery from a deep downturn. For several of them, the downturn was the worst for decades. In other cases the downturns were serious, though not more so than those of the mid 1970s or the early 1980s. But what has been unusual is less the depth of the downturn than the slowness of the recovery.

For most major countries, in most cycles in the second half of the 20th century, the pace of a recovery tended to be related to the depth of the preceding recession: generally, the deeper the recession, the sharper the upturn that followed. This episode has been different, in that a serious recession has been followed by a fairly shallow upswing so far. In the case of the United States, the level of real GDP has reached its pre-crisis peak, but it took three years to do so. In the United Kingdom and the major continental economies, levels of real GDP remain well below their peaks of three or so years ago. In some other cases in Europe the declines are larger and, in fact, are continuing. In all these cases the level of output remains well below what policy-makers would regard as their respective economies' "potential" level. A corollary of that is the rate of unemployment in most cases remains unusually high after a year or more of recovery.

This slowness of initial recovery is of course related to the nature of the downturn, which differed from most of the post-war business cycles in that it was characterised by serious and widespread financial distress. History shows that recoveries from downturns associated with banking crises and collapsed asset booms are, more often than not, drawn-out affairs. Really we need look no further than Japan's experience over the past two decades to see this, but in fact it is well established by a great deal of research. Moreover, while banking systems are in the process of regaining health, that process is not yet complete. Nor is it clear that households are yet finished the process of reducing their leverage.

Output and Unemployment

	Real GDP Percentage change from pre-crisis peak	Unemployment rate Percentage point change from pre-crisis trough
North Atlantic		
Canada	1.2	1.9
United States	0.0	4.5
Euro area	-2.9	2.7
<i>Germany</i>	-1.4	-0.6
<i>France</i>	-1.6	2.0
<i>Spain</i>	-4.3	12.5
<i>Ireland</i>	-12.8	9.3
United Kingdom	-4.6	2.7
Asia Pacific		
China*	23.2	–
India*	20.9	–
East Asia**	8.0	0.5
<i>South Korea</i>	6.2	0.6
Australia	4.4	1.1
New Zealand	-1.8	3.4
Japan	-4.1	1.3

* Quarterly GDP did not contract during the global downturn; percentage change in GDP is from the quarter preceding a marked slowing in output growth ** Excluding China and Japan; GDP aggregated at market exchange rates; unemployment rate also excludes Indonesia, Malaysia, the Philippines and Thailand

Sources: ABS; CEIC; RBA; Thomson Reuters

There are now some other factors that may impede the recovery. One of them is the delicate state of government budgets, which leaves many of these countries feeling they have little choice but to pursue policies of fiscal contraction. In a proximate sense, this problem is due to the financial crisis. The direct costs of assisting banking systems were the smaller part of the effect – the main impact on budgets has simply been the cumulative loss of revenue and the general impost on spending that comes with a protracted period of economic weakness.

Ideally, government budgets *should* move temporarily into a position of deficit when the private economy suffers an adverse shock. The budget should play the role of a “shock absorber”.

But that ideal assumes that the government’s own accounts are in a strong enough position to play such a role without raising questions of the state’s own solvency. The problem is that

in a number of countries, large burdens of spending, significant debt burdens, underfunded pension systems and unfavourable demographics have been on a collision course for a long time. What the crisis has done is to bring on the adjustment sooner.

In the euro area the intersection of banking and fiscal issues – including through the exposures of banks to sovereign debt – heightens the difficulty. Although the single monetary policy framework is highly developed, single frameworks for other areas of financial policy have been less highly developed. This is gradually being addressed, though of course it is a complex issue. At its heart, the debate is essentially over the incidence across the taxpayers of Europe of the various costs of fixing banking problems.

The Asia-Pacific region

The contrast between the story for the North Atlantic countries and that for Asia could, in all frankness, hardly be more pronounced. Most of the countries in the Asian region have had a “v-shaped” recovery. Of course this has been led by China and India, where levels of GDP actually did not fall at all and where very robust growth rates have been maintained since the second quarter of 2009. Real GDP in both cases is now 20 per cent or more above pre-crisis levels. A range of other countries have also had a pretty strong rebound.

Japan is an exception. The long aftermath of the “bubble economy” period, together with a declining population and generally low rates of return on capital, have made Japan a much less significant source of dynamism for the region and the world than it was for the couple of decades up to 1990. In truth, though, the global economy has become used to this.

How is it that the Asian story has been so different to that of the North Atlantic?

The first important factor was that Asia did not have a banking crisis. In fact, most countries in the world didn't have one. The extraordinary events of September and October 2008 put immense pressure on markets, and banks everywhere inevitably felt the effect of that. But most banks in Asia and Latin America over the past few years have generally not seen unusually bad losses on loans, nor had they been very much involved in the holdings of securities that did such damage to some of the world's largest banks. Similarly, the majority of governments have not ended up needing to re-capitalise banks in these regions.

The second factor was that various countries in the Asian region had ample scope for fiscal stimulus, and were prepared to use it. The Chinese stimulus measures were just about the largest anywhere. The manner in which these were implemented may have led, in the view of some people, to other problems. But there is little doubt such measures were effective in boosting demand at the critical moment.

The fact that there was scope to use fiscal policy this way reflects a long period of impressive fiscal discipline among most countries in the region. This is reinforced by Asian habits of thrift among the population and the generally better growth dynamics for these countries, which of course makes fiscal management inherently easier.

There is another factor at work too, whose implications have been powerful but increasingly are being seen as not quite so benign. That is that monetary policy in Asia has been quite accommodative. Compared with the North Atlantic countries, this monetary accommodation has been much more effective as a stimulus, again because of the better state of banks through which much of its effect is transmitted. The issue more recently has been that accommodative conditions have started to look out of place given the robust growth in output, rising asset values and increasing goods and services price inflation. A number of countries, including key ones such as India and China, have been responding to this with tightening. Some of the Latin American countries have done likewise.

The matter is complicated for those countries by the very low interest rates in the major countries – implemented, understandably, for their own domestic reasons – and concerns

over the extent of capital inflow and potential exchange rate appreciation. This is one of the key issues for the year ahead.

Shifts in the global economy

These are all important manifestations of the fact that different regions are at different points in their recoveries from the crisis. It isn't, however, only a cyclical matter. This contrast between the economic performances of the key emerging countries and those of the older industrial economies in the past few years is seeing a marked acceleration in the shift in the world economy's centre of gravity towards the east (or west, if viewing from North America). Since the beginning of 2008, Asia (excluding Japan) has accounted for about 70 per cent of the growth in global GDP (measured on a purchasing power parity basis). It has also accounted for about 70 per cent of the growth in global demand over that period. This compares with a figure of about 30 per cent over the period 2000–2007.

It has often been said that more domestic demand is needed in Asia to help “rebalance” the global economy. There may have been a structural sense in which Asian saving rates were “too high” and saving in some other countries too low. But it is not at all clear that more demand growth in Asia is desirable at present. After all, global GDP growth has been strong, and prices for most commodities have been rising. Just at the moment, from a global perspective, what we need is not so much faster domestic demand growth in Asia, but a way of supplying more of Asia's demand for goods and services from the parts of the world where excess supply remains – mainly the North Atlantic countries. Of course exchange rates are relevant here.

Moreover, there is a secular increase in living standards occurring in Asia and changes in consumption patterns are accompanying that. Energy intensity is rising quickly with income. The steel intensity of production is already high in China but, with China seeking strong overall growth for many years yet, steel consumption could well continue to increase at a rapid pace. In India, steel intensity has a long way to rise yet. In many developing countries, higher living standards are also prompting changes to diets. The already clear trend towards higher protein consumption in emerging countries such as China potentially has major implications for demand (and prices) for livestock and grain feed globally.

So it is not really surprising that rapid economic growth in Asia is placing upward pressure on prices for foodstuffs, energy and minerals. There may be speculative demand adding to these pressures at the margin. But speculators can't hold up prices over the long run. These big changes, which appear to be rather long-running, surely are mainly a result of powerful, and rather durable, fundamental forces.

What is new is that this pressure on prices is not coming from the advanced world (except perhaps in the case of demand for grain to be converted into ethanol). It is not the story that would have been told, until only a few years ago, of the industrial cycle of the OECD countries picking up and adding to demand for resources and energy. The action is, for the most part, occurring outside that group. Prices are under upward pressure because of rising demand,¹ but it is the demand coming from a couple of billion people in Asia seeking, and in many cases rapidly converging on, the way of life that the advanced countries have enjoyed for decades.

These price rises, not to mention those occurring most recently as a result of pressure on oil supplies, are quite unhelpful for the advanced countries, particularly those whose recoveries have been hesitant to date. They will also be unwelcome for very poor countries whose populations spend much of their meagre incomes on food. For practical purposes they

¹ Food prices, as well as oil, are also being affected by supply disturbances at present.

amount to a supply shock for the advanced countries – someone else’s demand has pushed up the price at which markets are prepared to supply energy, agricultural and resource commodities. That will make it harder to engender a strong recovery in the advanced countries. Moreover, were demand in the advanced countries to grow faster, as is presumably the intent of current economic policies in those countries, the price pressures will grow more intense, unless substantial new capacity comes on stream and/or growth in the emerging world moderates somewhat.

As it happens, new capacity is being planned in many resource commodities. In Australia, where iron ore shipments are running a little over a million tonnes a day, projected capacity expansion will likely take that to about 2 million tonnes within four or five years. Significant capacity expansion is also planned in other areas. These and similar expansions in other countries will presumably help to contain pressure on prices for many resources over time.

In the case of foodstuffs, much of the growth in supply over the medium term will need to come from productivity gains or greater farming intensity. The experts seem to think that such productivity gains are possible but not given. In fact the rates of productivity growth will need to be higher than those actually observed in recent years to generate sufficient output.²

One thing is for certain: the rise of Asia is changing the shape of the world economy and the set of relative prices that goes with it. It seems to be doing so more quickly than was generally assumed.

Australia

Australia sits in an interesting position here. Like our Asian neighbours we were affected by the events of late 2008. But the downturn was fairly brief. We were in a position to apply a liberal dose of stimulus to the economy, which was done in a timely fashion. The banks remained in good shape. Hence recovery began in the first half of 2009. A strong Asian recovery has also helped Australia.

As in other developed countries, our consumers feel the effects of higher commodity prices as a reduction in real income. But since Australia is also a producer, the big rise in demand for energy, resources and food is expansionary for the economy. In fact, with our terms of trade at by far their highest level, on a five-year average basis, in more than a century, these events are very expansionary indeed. A very large increase in investment in the resources sector is under way and has a good deal further to run yet.

Just recently, we have been experiencing growth close to trend, relatively low unemployment – about 5 per cent – and moderate inflation, about 2¼ per cent in underlying terms. In comparison with the experience of the past generation, that is a pretty good combination.

Looking ahead, our job is to try to manage the terms of trade and investment booms. Historically, Australia has often not managed periods of prosperity conferred on us by global trends terribly well. On this occasion, we have to do better. We have to take the opportunity to capitalise effectively on some very powerful trends in the global economy to which we are, almost uniquely, positively exposed.

A few things are working in our favour. One is that the exchange rate is playing a role of helping the economy to adjust to the change in the terms of trade in a way that it was prevented from doing on numerous previous occasions. Another is that, at least so far, households are behaving with a degree of caution, insofar as spending and borrowing are

² See, for example, the UN Food and Agriculture Organization (FAO) discussion paper “How to Feed the World in 2050”, which was prepared for a high-level expert forum of the same name held in Rome on 12–13 October 2009. The document, and other background information, is available at: <<http://www.fao.org/wsfs/forum2050/wsfs-background-documents/issues-briefs/en/>>.

concerned, that we have not seen for a long time. Having taken on quite a degree of debt over the preceding 15 years or so, households have thought better of taking on too much more. They are saving more than at any time for 20 years or more. So are households in many other countries, of course, but our good fortune is to be making that adjustment against a backdrop of rising income.

We are now engaged in a national discussion about how to stretch the benefits of the resources boom over a long period, and how to manage the risks that it will bring. These are complex matters that involve a wide range of policy areas – macroeconomic, microeconomic, taxation, industrial and so on. But if that discussion can be conducted in a mature fashion, and followed up with sensible policies, then we have a good chance of leaving to the next generation a wealthier, more secure and more stable Australian economy.