Glenn Stevens: After the boom

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to an Australia-Israel Chamber of Commerce (WA) Corporate Breakfast, Perth, 2 December 2015.

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It is very good to be back in Perth. As you know, the Reserve Bank Board held its meeting here yesterday.

We decided to leave the cash rate at 2 per cent. The reasoning was given with the decision, and so I don't propose to discuss that. Instead I want to reflect on the nature of the adjustments going on in the economy, and in which Western Australia is very important.

It is four years since the Board last met here. The previous occasion was in September 2011. I don't need to tell you that quite a lot has changed in the intervening period.

At that time, the price of a tonne of iron ore was about US$170. A tonne of hard coking coal was bringing in about US$300. These were among the prices that saw Australia's terms of trade soar to a level some 75 per cent above their average for the preceding century. Few countries have seen such a windfall.

These extraordinary prices had already, by that time, triggered a massive investment program, which was lifting capacity. Four years ago, Australia was shipping about a million tonnes of iron ore each day, which was already double the rate of 2004. A bit under a million tonnes of coal left our shores daily.

By 2011, capital spending by the resources sector had already roughly trebled since 2005. It would peak the following year after rising by a further 50 per cent.

The results of that investment have come on stream, or soon will. Today, Australia ships around 2 million tonnes of iron ore and 1 million tonnes of coal per day. The investment was not just in iron ore and coal. On forecasts of strong demand from Asia – not just China but Korea and Japan as well – massive investments are under way in gas. LNG exports have begun from some of the Queensland projects and are expected to increase strongly over the coming years. As the WA projects come on line in the next few years, Australia's total LNG production capacity will reach over 80 million tonnes per year. This compares with a production capacity of around 10 million tonnes a decade ago.

I should note in passing here that I have felt that we have been given a pretty good steer on the magnitude of the investment build-up and the early stages of the reversal, on the back of the very good work done by our regional liaison people, especially here in Perth. As a result, we've been much better at forecasting investment in the resources sector than in the other industries. That's because of the help we were given by the large players in the resources industry. I know that many of you have participated in these discussions, which have been extremely helpful in understanding the nature of the episode. So I want to thank you for helping in that way.

As it happens, about the time the Board was meeting here in 2011, resource prices and Australia's terms of trade were about at their peak. And what a peak it was. On a ten-year average basis, the terms of trade exceeded anything seen for at least a century. This was not just a very brief spike like some commodity price events have been (such as the early 1950s rise in the price of wool). It was quite persistent. Not permanent, but quite persistent.

Nonetheless, the peak was four years ago. Since then, as you know, prices have fallen considerably. Today the price of iron ore is about US$40 per tonne, and coking coal around US$75. At a national level, Australia's terms of trade, having been through an extraordinary surge, have fallen by a third and are still declining.

But even at those reduced prices, iron ore is still bringing a price 60 per cent higher than it did in 2000. Natural gas prices are 50 per cent or more above their 2000 level. The terms of trade, though down a long way from the peak, are still nearly 30 per cent higher than their 20th century average. Of course they may yet fall further. Time will tell. In the meantime, many resource companies are making significant strides in reducing their production costs so as to remain viable, and in some cases still very profitable, at these reduced prices. That's consistent with most experience in the long history of the resources business. Australia's presence in these markets is greater now. It would be true to say that, though weaker demand is part of the story, a significant part of the fall in prices is a result of increased supply from this continent.

The ‘super-cycle’ in commodity prices, and the associated surge in capital spending, have been of national and international significance. At times, the price of iron ore has even, on occasion, displaced from page one of newspapers the price on which Australians typically focus most intensely – that of a house. The spill-overs of these activities have been felt around the country. For the fifty years up to 2005, resources sector investment had averaged just over 1½ per cent of national GDP. Periodically, in a boom it tended to reach a peak of perhaps 3 per cent of GDP.

This peak was about 8 per cent – nearly three times the size of the ‘normal’ peak, and easily the biggest such surge for over a century. The resources sector was doing 40 per cent of the nation's total business capital spending. And, as you know, a big share of that was occurring here in WA.

On other occasions, these types of events have ended up being very disruptive for the national economy. Terms of trade surges in the 1950s and the 1970s produced significant inflation on the way up and were followed by very major slowdowns or recessions in economic activity as the terms of trade fell back. That hasn't happened at a national level on this occasion. Inflationary pressure was relatively contained on the way up, and while aggregate growth has been a little disappointing for the past couple of years, in the circumstances we face – including very difficult global conditions in the aftermath of the financial crisis – the outcomes are, I think, quite respectable.

In fact, in a number of respects the economy has adjusted to the shocks in the way you would hope. Productive resources were re-deployed to sectors where returns looked like they would be higher. This was true for capital but also for labour – relative wages shifted upwards in WA, for example. Population shifted in response, we had fly-in-fly-out and an immigration response, facilitated by visa arrangements and so on. These were helpful parts of the adjustment process.

Likewise, the exchange rate adjusted, as would be expected in a flexible system. When we were here in early September 2011, the Australian dollar was trading around US$1.07 and had been as high as about US$1.10. Today it is about 35 per cent lower than that against the US dollar, and about 20 per cent lower against a relevant basket of currencies. This movement – both up and down – was part of what helped the economy through the commodity super-cycle without seriously inflating or crashing.

Through all that, tested macroeconomic policy frameworks have aimed at overall stability, and the financial sector has been kept in good shape by sensible regulation and generally competent management.

While the episode is not yet over, at this point the economy overall has been recording growth. We will very shortly get a reading on GDP and the various expenditure and income accounts for the September quarter.

Looking ahead, nationally, the outlook appears to be for a continuation of moderate growth. The Reserve Bank issued its latest forecasts a few weeks ago. I won't go into detail here, but, in brief, year-ended GDP growth is forecast to be in the range of 2 to 3 per cent in June 2016 and to pick up a bit during the following year. Domestic inflationary pressures are expected to remain subdued. Inflation is forecast to be in the range of 1½ to 2½ per cent over the year to

June 2016, and 2 to 3 per cent over the year to June 2017. The unemployment rate is projected to remain around 6 per cent or a little above over the next year, before gradually declining.

We do not make detailed forecasts at state level, but obviously the picture for WA relative to the rest of the country looks different from the way it did a couple of years ago. Previously, economic activity was very strong in the west and the north-east, driven by the investment boom, while in the south-east of the country it was somewhat subdued. Now, as the mining investment boom in the west is in the reversal phase, economic activity here in WA is more subdued, while in the south-east it is picking up.

These differences are plain in most of the economic data. Whereas business investment in NSW and Victoria is growing (albeit modestly), in WA it is, of course, contracting very sharply (as it is in Queensland). I think most people have understood for some time that this was on the cards. Consumer spending and employment growth in WA, which had outpaced the national average by a wide margin, have come back to be a bit below the national average. The rate of WA's population growth has slowed. Housing prices have declined a little, while those in Sydney and Melbourne have, at least until recently, risen at quite a clip. Measures of business conditions in WA are at about their long-run average, having been a long way above that for some years.

So WA has ‘come back to the pack’, though the pack has actually picked up some speed in the meantime.

Yet even with all that, employment in WA is still increasing. The unemployment rate has increased, though only to the national average so far. Going back a few years, WA had, at times, the lowest unemployment rate recorded of any state at any time over the past 40 years; on occasions there was a ‘2’ before the decimal place. That was obviously not going to be sustained indefinitely. And while labour market performance not is as strong as it was, it is still a good deal stronger than it was in episodes like 1983 or 1991–92. Interestingly, those periods of serious weakness in the labour market in WA were part of a national event. In the early 1990s, that event had little to do with mining and a lot to do with an asset price boom and bust, coupled with high corporate leverage.

Of course, further adjustment in the resources sector is still ahead. Although most of the construction employment losses in the iron ore sector have probably occurred, the large LNG projects in WA are still in the investment phase. Over the next few years some labour presumably will be released from these projects. So it will be a while yet before we will be able to say that the difficult phase is completed.

That aside, the point I want to offer is that it's worth remembering the positive legacy of the events of the past decade.

The sheer scale of the investment that has been undertaken makes WA production, already a powerful force in some key commodities, more powerful. To be sure, prices are lower, but the quality of the resources, the attention to cost reduction and of course a lower Australian dollar are likely to leave many producers well placed.

Of perhaps more direct relevance to the ordinary person has been the trend in income per head. In 2000, WA's per capita income was about the same as in Queensland or South Australia but lower than in either NSW or Victoria. But WA has seen easily the largest increase over the intervening period. Today WA enjoys the highest per capita income of any state, at around $50 000 per person per year. It is true that the ACT and NT boast higher figures, but they are very unusual cases, being heavily influenced by the effects of government employment and/or subsidies, not to mention being quite small. It would take quite a few years at the current pace of growth for the other states to catch up to WA.

Household net worth in WA in 2013/14 (the latest available data), at about $950 000 per household, was a good deal higher than in any other state. Since then, housing prices in WA have declined while those in some other places have risen, so this gap may have diminished. Nonetheless, my guess is that, among the Australian states, the citizens of Western Australia are on average, probably still among the richest. Even if the others gradually close the gap over time, as they well might, you are better off for having had the boom.

WA has unique endowments of resources. Mining has always been a cyclical business, which has long been understood. On this occasion, given the size of the boom, you've done a pretty good job of managing it. As a result, there will be permanently more income and wealth than there was before.

Conclusion

I expect that, in a few years' time, the Reserve Bank Board will once again meet in Perth. I imagine that, by then, the current contraction in capital spending will probably have reached an end. New opportunities for growth will have emerged, resulting from things like the growth in the middle class of Asia, with all what that means for demand for services as well as for energy and agricultural production. The growth of India is surely also a potential opportunity for WA – facing as you do the Indian Ocean, and with the advantage of relative lesser distance. A mere eight hour flight time! No doubt Western Australians will be looking to seize those opportunities.

At the same time, this vast part of the Australian continent, endowed by nature with so many resources, will still be a major player in key commodities. Even if the extraordinary boom in investment was hard to digest, and even if some of the investments don't pay off quite as handsomely as hoped, it still seems that Western Australians will be richer for the experience.