RESERVE BANK OF AUSTRALIA

Speech

Joining the Dots: Exploring Australia's Economic Links With the World Economy

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Introduction

I'd like to begin by acknowledging the Traditional Owners of the land on which we meet today, the Yuggera and Turrbal people of Meanjin and pay my respects to Elders past and present.

And thank you to the Economic Society of Australia [Queensland Branch] for giving me this opportunity to talk to all of you.

I'm sure many are familiar with the Lenin quote 'There are decades where nothing happens; and there are weeks where decades happen'. It certainly feels like the last few months fit into the latter category. The broad-based nature of the proposed US tariffs, retaliation from major partners and other policy shifts all have the potential to structurally alter the world economy. As recently discussed by our Deputy Governor Andrew Hauser, what happens overseas matters for the Australian economy and is therefore a key factor in monetary policy settings.[1]

In the recently released *Statement on Monetary Policy* (SMP) we outlined our thinking on how recent developments will influence the Australian economy. To help us understand the implications for Australia, we have developed a framework that captures the key transmission channels and combined this with a set of alternative scenarios that flex key assumptions and judgements. Together they underpin our

thinking about how this environment will flow through the global economy and how Australia is exposed. The key transmission channels we have identified are:

- Trade flows between countries are likely to realign, and over time multinational businesses could start moving production to different countries.
- Households and businesses in the countries that apply tariffs are likely to change what they consume, as some products become relatively more expensive, and as prices change more generally.
- Until it's clearer where policy will settle, businesses and households are likely to become (understandably) more cautious, and potentially delay major decisions such as capital investment.
- Fiscal and monetary policy can respond, potentially helping to offset adverse impacts.
- Financial markets will respond by repricing all assets including equities, bonds, commodity prices and exchange rates. These moves impact financial conditions, which further impact firms' and households' decisions.

I will now discuss these channels in more detail, including how they are embodied in the scenarios in the May SMP.

Tariff policy and global trade flows

Economic theory and evidence suggest that higher global tariffs will put a drag on the global economy. This is true in both the short and long run, though here I'll focus on the short run as that is what is most relevant for monetary policy.[2]

For the country imposing them, tariffs are a tax on imports. In the short term, this makes imported goods more expensive and pushes up domestic prices, to the extent the tariff is not offset by lower profit margins in overseas producers and exchange rate adjustments. Higher import prices will mean less imports and shifts in demand towards locally produced products.[3] But it takes time for domestic businesses to invest and expand, and for some products (such as raw materials) it may not be possible for domestic production to fill the gap. This means prices are likely to remain higher in the near term, which will reduce households' purchasing power and therefore drag on business incentives to invest.

Collectively, domestic demand in the tariff-imposing country falls, all else equal. If households expect the tariffs to have a sustained effect on economic growth, and so their future incomes, they may also cut

back further on spending today.[4] For the countries that are subject to higher tariffs, they will weigh on export demand and in turn their broader economic conditions. Domestic stimulus may offset some of these effects; in the May SMP our baseline scenario assumes that China will support its economy through expansionary fiscal policy. But for both sets of countries, any net weakening in demand growth will spill over to their trading partners.

Overall weaker global growth would put near-term downward pressure on the prices of globally traded goods. For countries that are not imposing higher tariffs, such as Australia, this could flow into import prices, making products cheaper and lowering inflation. In the current episode, this 'trade diversion' channel could be amplified by the nature of the changes, in particular the US authorities' focus on China. As a lynchpin of the global manufacturing supply chain, Chinese goods represent a large share of imports for many countries (including Australia). With the US market harder to access, Chinese producers could lower their prices and try to redirect their products to other markets.

But working in the other direction, the broad-based nature of the increase in tariffs and increased use of non-tariff barriers such as export bans could create a new bout of supply chain disruptions. By increasing the cost of intermediate inputs that cross borders, such as commodities, machinery and equipment and components, tariffs could potentially lift the cost of production globally. This could push up consumer prices in all countries, particularly for more complex products, such as cars, whose components are sourced from a wide range of countries.

Our current baseline scenario assumes that, overall, the weaker global growth environment will moderately dampen prices for tradable goods, all other things equal. That is, we expect weaker demand to outweigh the inflationary impact of any supply chain disruptions. We will be monitoring global trade flows and inflation data closely in the coming months to assess whether this judgement is correct.

Uncertainty's drag on economic activity

Aside from the effects of changes to global trade that I've talked about so far, the unpredictability of where tariffs will settle and changes to other policy settings has the potential to create significant uncertainty, both around the nature of the policies themselves as well as their impact. And there is ample research showing that higher uncertainty can lead to declines in investment, output and employment.[5]

Typically, higher uncertainty leads firms to delay decisions that are costly to reverse, like investment and hiring. This makes sense intuitively, because there is value in waiting to see how things are playing out before making a decision that is (at least partially) non-reversable – something often referred to as 'real options' value. These ideas are borne out in the historical data. Research suggests that the negative impacts of higher policy uncertainty – including trade policy – are largest for businesses, as they typically pull back on investment. Some studies find higher uncertainty also has a measurable impact on household consumption, but this is typically more modest.

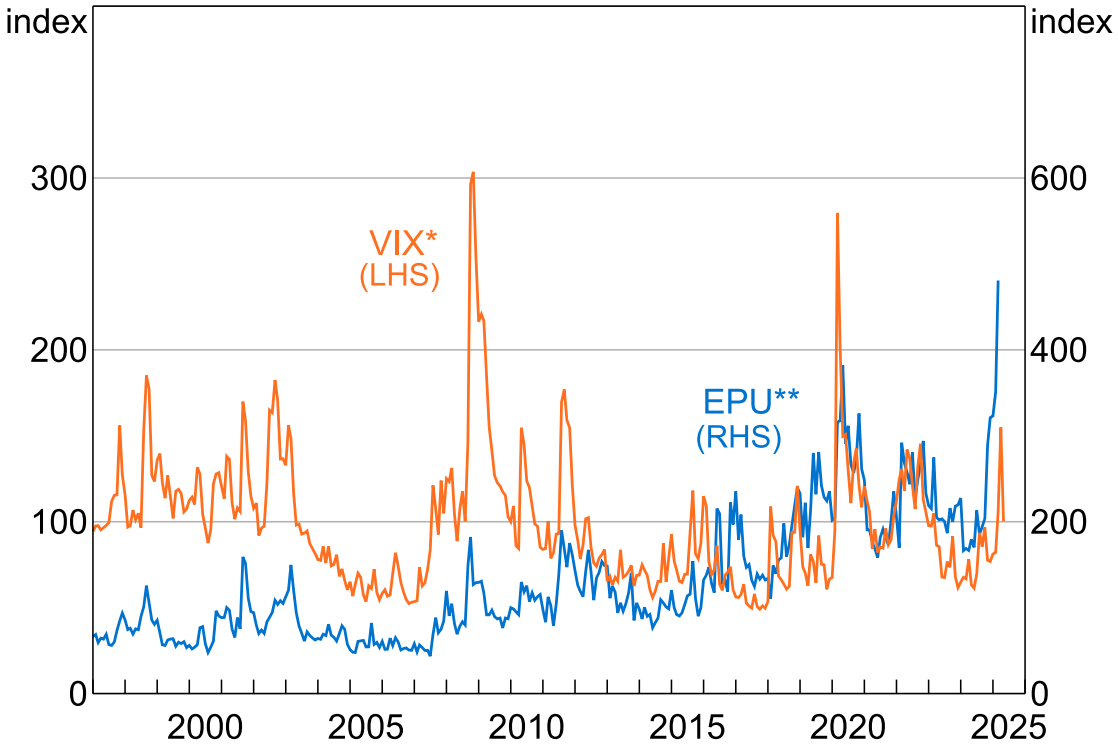
Uncertainty is a bit of a slippery concept and there are lots of different ways of trying to measure it, but the graph below shows two (Graph 1).[6] One – the global economic policy uncertainty index – is based on the number of news articles that talk about policy uncertainty. The other – the VIX – is a measure capturing how uncertain markets are about near-term equity prices. Both show a sharp rise in uncertainty recently, though the VIX index has declined in recent weeks.

If we see businesses and households respond as they have in the past, then the current level of uncertainty will weigh materially on global activity. But the unpredictability and unprecedented nature of the current situation makes it hard to be precise on the size of the impact. In the SMP we have tackled this by using alternative scenarios that capture smaller and larger responses to uncertainty. The baseline scenario assumes a relatively modest drag, the trade peace scenario no significant drag, and the trade war scenario a substantial pull back in activity. Going forward we will be monitoring carefully which assumption is closest to how things unfold.

Graph 1

Measures of Uncertainty

January 2010 = 100



* S&P 500; data up to May 2025; monthly average of daily data.

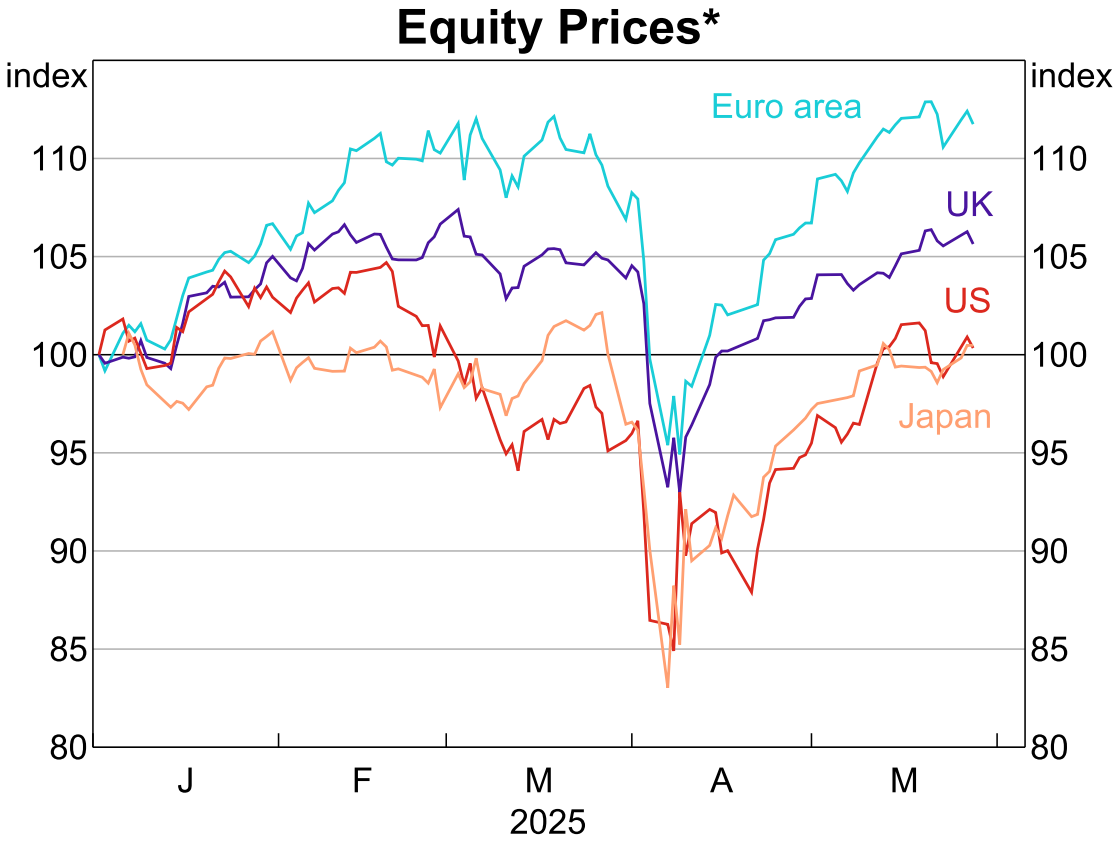
** Global economic policy uncertainty index from Davis (2016); data to March 2025.

Sources: Davis (2016); FRED; RBA.

Financial markets' response

This brings us neatly to financial markets. Movements in global asset prices after the United States announced its tariffs on April 2 capture how financial market participants initially evaluated their likely impact, and these movements broadly aligned with the channels I've already discussed. Equity prices declined sharply – particularly in the United States – at least in part reflecting expectations for the direct impact of the tariffs and the indirect impact via slower economic growth on company earnings. Expectations of lower future growth also meant that expectations for future central bank policy rates declined, which flowed through to bond yields (Graph 2).

Graph 2



* 6 January 2025 = 100 for Japan; 2 January 2025 = 100 for US, euro area and UK.

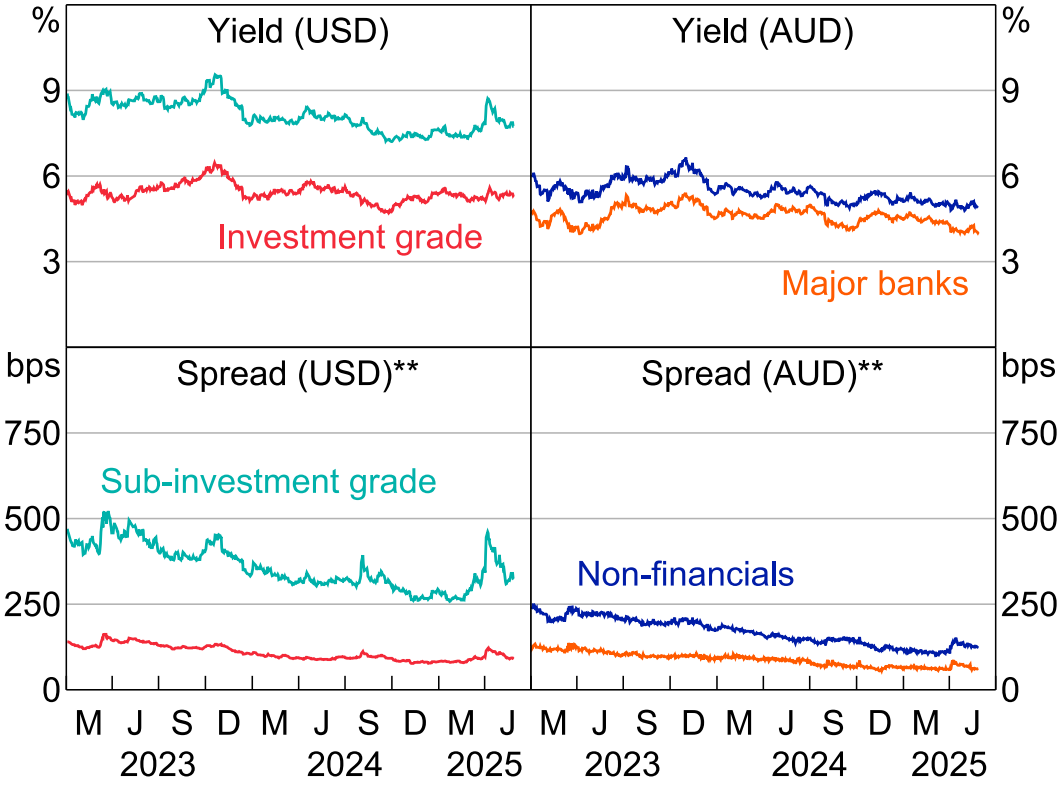
Source: Bloomberg.

At the same time, increased uncertainty and risk led investors to require larger risk premia to hold risky assets. This was reflected in increased spreads on corporate bonds, and some increases in equity risk premia that put further downward pressure on equity prices (Graph 3).[7] In other words, investors wanted more compensation for holding riskier assets.

Some of these movements unwound in the following weeks after pauses in implementation of some tariffs. As of 30 May, financial market participants appear to be pricing in some downside risk to global growth, but they are no longer pricing in a material economic downturn. Consistent with this, expectations for central bank rate cuts have also been pared back.

Graph 3

Corporate Bonds*



* The USD series are the ICE BofA high yield and investment grade indices; the AUD series are three-year bonds for the major banks and five-year BBB-rated bonds for non-financials.

** Spread to equivalent maturity government bond yield.

Sources: Bloomberg; ICE Data used with permission; RBA.

Still, there remains a risk that further changes to tariffs or other policy settings, or actual economic outcomes prompt financial markets to downgrade the outlook, which leads risky asset prices to fall sharply. If this were to occur, it would lead to a more sustained tightening in financial conditions, which would make it more expensive for businesses in particular to borrow or raise funds for investment. This outcome is embodied in the trade war downside scenario we presented in the May SMP and is a significant amplifier of the initial shock generated by the sharp hike in tariffs.

Exchange rates

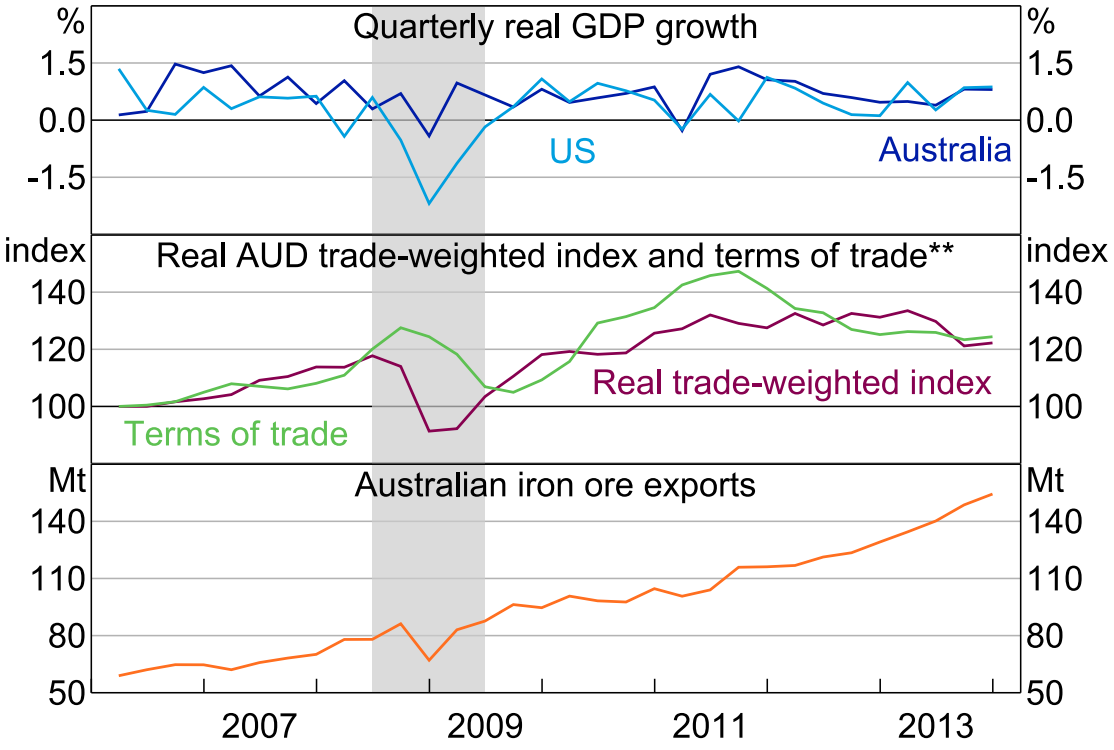
One financial market that deserves some deeper discussion is the exchange rate. When the outlook for global growth weakens, the Australian dollar typically depreciates (falls in value) as investors expect our economy to be buffeted by the global headwinds and the RBA to respond with cuts to the cash rate.

This makes our exports cheaper in foreign currency terms, which offsets some of the effect of weaker global demand.[8]

An additional driver of the Australian dollar in times of uncertainty is its status as a 'risk-sensitive' currency. When global investors are worried, they tend to focus on reducing risk exposure, moving their capital to low-risk assets in countries like the United States, Switzerland and Japan. This means the Australian dollar tends to lose value against these currencies, over and above the depreciation linked to weaker growth and expected cuts in the cash rate. This dynamic partly explains the movements during the global financial crisis (GFC) when the Australian dollar declined very sharply, even though the Australian economy was much less exposed to the global downturn (Graph 4).

Graph 4

Global Financial Crisis and Mining Boom*



* Shading corresponds to the four quarters of consecutive negative real GDP growth in the US from the September quarter of 2008 to the June quarter of 2009.

** March quarter 2006 = 100.

Sources: ABS; LSEG; OECD; RBA.

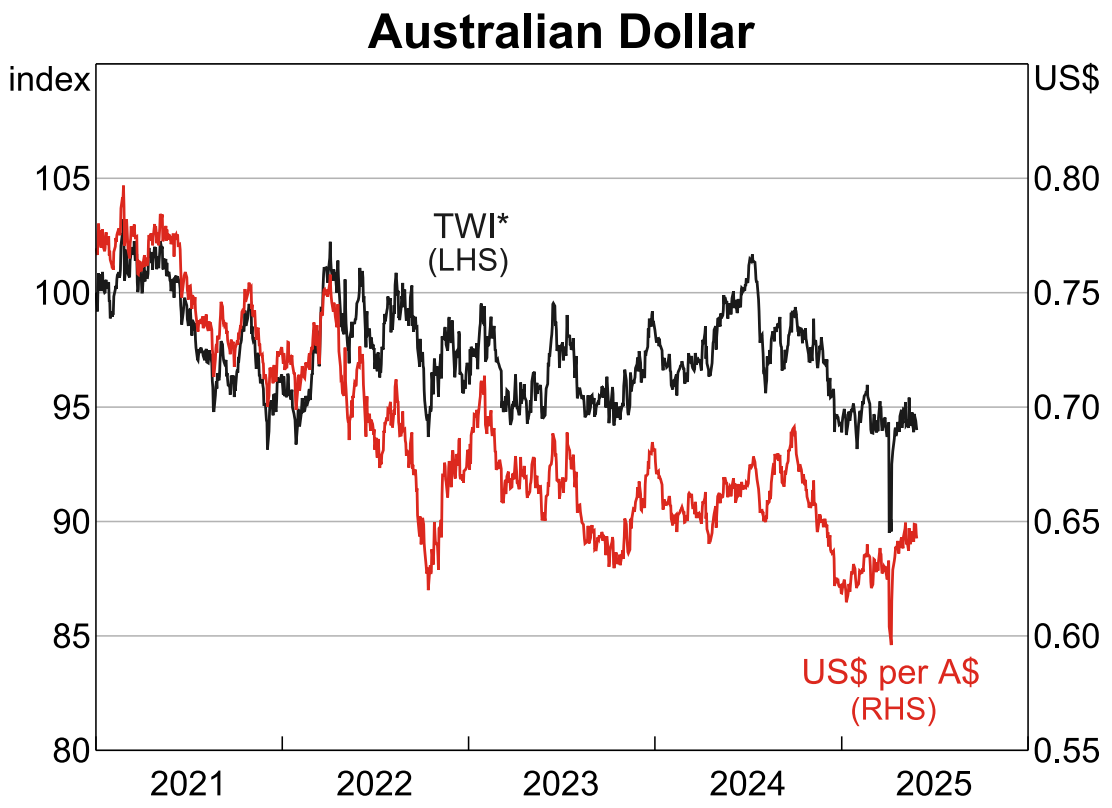
While the initial response of the Australian dollar during the current episode was in line with historical experience, the recent recovery against the US dollar in particular has been more unusual (Graph 5). The exchange rate has been volatile over recent months, but on a trade weighted basis is overall little

changed in response to global events. It has appreciated against the US dollar (and therefore also the Chinese renminbi and other currencies pegged to the US dollar) but depreciated against most other major currencies.

This appears to reflect some offsetting factors. Concerns about the growth outlook and related 'risk-off' dynamics contributed to the Australian dollar's depreciation relative to several other currencies. But at the same time some investors have reduced their exposure to US assets, leading to broad US dollar weakness.

The weakness in the US dollar during a period of heightened risk is in contrast with many previous episodes, though it's too early to know whether this dynamic will continue. The return of the trade weighted index to its pre-shock value means that, on average, the price of our exports in foreign currency terms hasn't changed. But the relative move of capital towards Australian assets compared to the United States reflects an increase in capital inflows, which could support domestic investment activity. We'll be monitoring how these channels play out over time.

Graph 5



* Indexed to 1 January 2021 = 100.

Sources: Bloomberg; RBA.

The economy's exposure to the current episode

Trade flows linkages

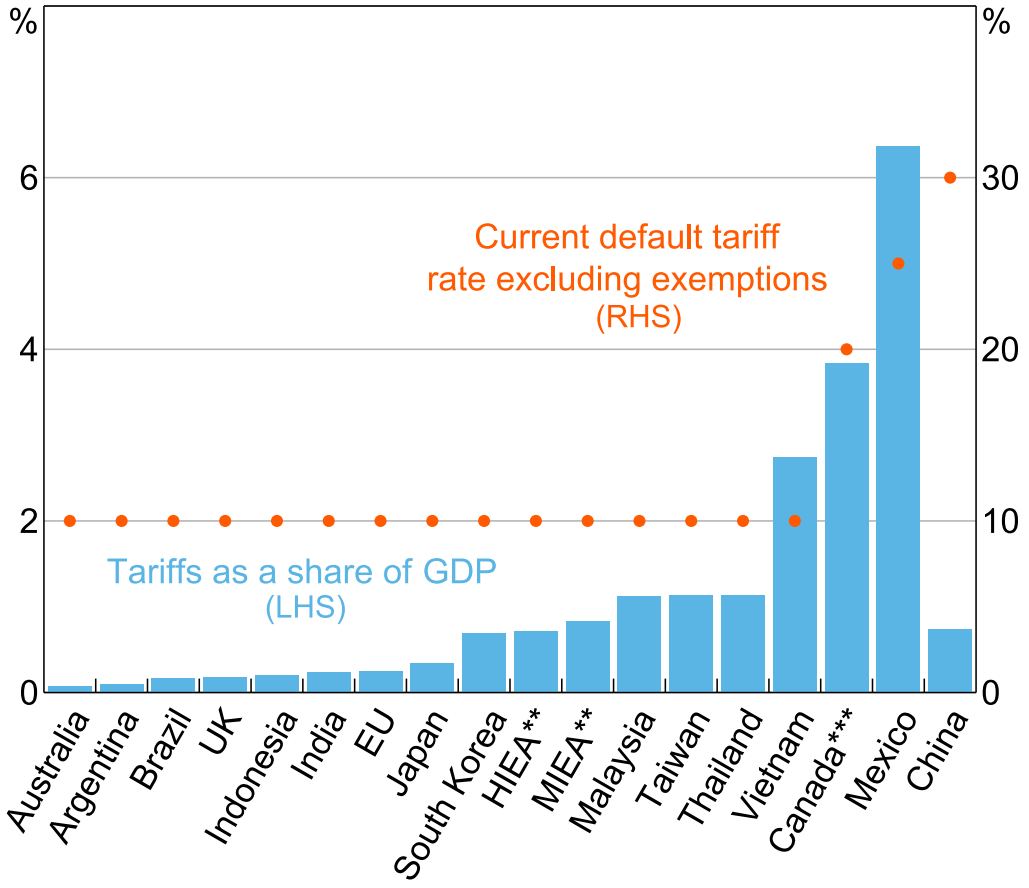
As previously outlined, when global conditions deteriorate and uncertainty increases Australia's exports typically benefit from the currency depreciating, as this improves competitiveness. Although this channel may be less pronounced than in other episodes, Australia's exporters are relatively well-placed to weather the storm.

The fundamentals underpinning our exports make it likely that in volume terms at least they'll be less impacted than other countries. Higher US tariffs on Australian exports are unlikely to have a material direct impact as Australian exports to the United States only account for around 1.5 per cent of Australian GDP, a low share compared with other countries (Graph 6). [9]

Graph 6

Direct Exposure to US Tariffs*

As at 15 May 2025



* Calculated as tariff rate multiplied by value of 2023 exports to the US divided by GDP in current US$; accounts for tariff pauses but not for exemptions, trade redirection, tax incidence, or price changes.

** Middle-income east Asia comprises Vietnam, Thailand, Malaysia, the Philippines and Indonesia; high-income east Asia comprises Hong Kong, Taiwan, Singapore and South Korea.

*** Reflects 10 per cent tariff on energy exports and 25 per cent tariff on all other exports.

Sources: OEC; RBA; UN Comtrade; World Bank.

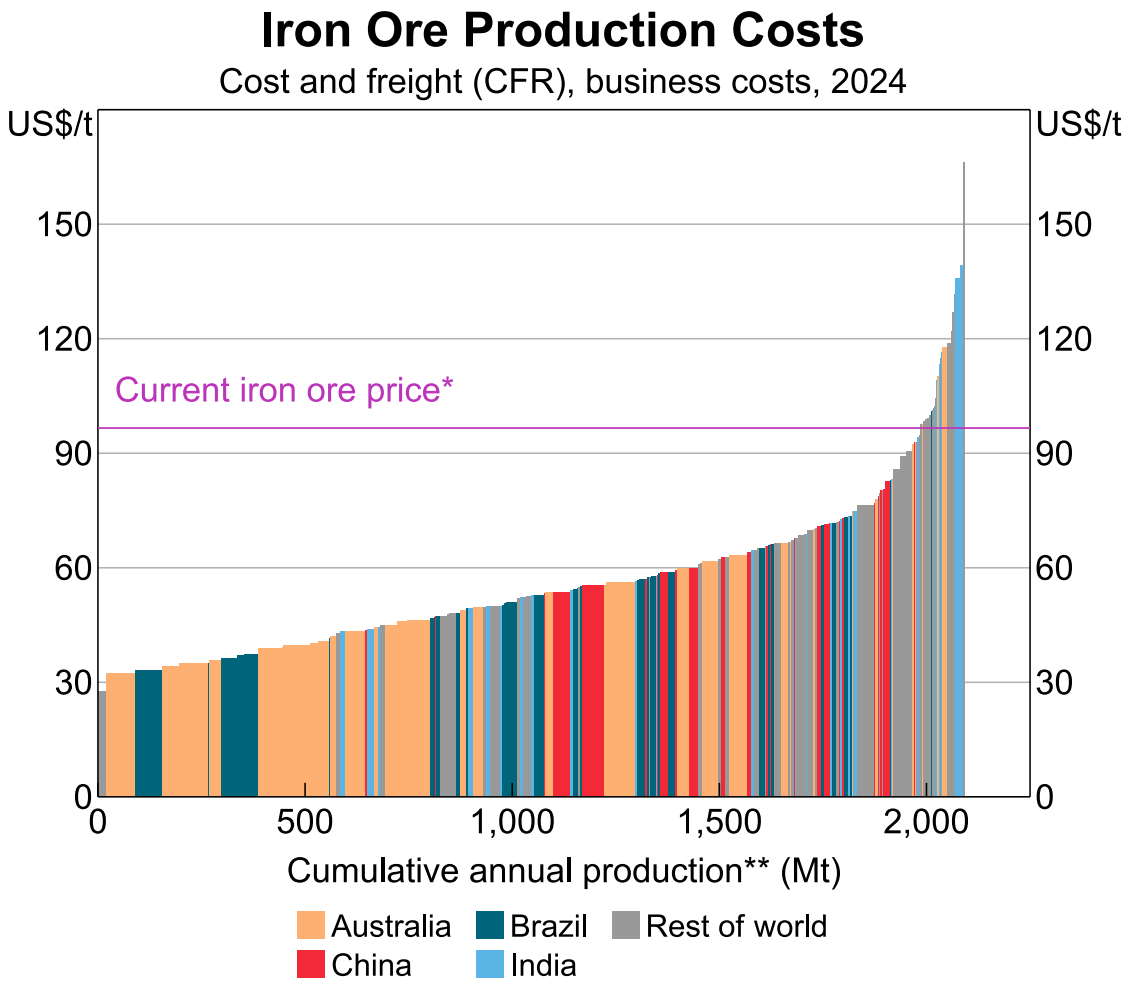
Furthermore, the structure and composition of Australia's exports will potentially provide an additional buffer to export volumes. Resources make up 75 per cent of Australian good exports, and despite the exposure of China and other resource intensive countries to the tariff shock, we might expect export volumes to remain resilient in the short run.

This is because Australia's resource export volumes are less sensitive to movements in global demand than other exports as we are a relatively low-cost producer of bulk commodities like iron ore. You can see this on this chart, where most Australian iron ore miners sit on the lower left end of the production

cost curve (Graph 7). Short-run declines in commodity prices tend to lead to reduced volumes from other higher cost producers, while Australian producers feel the impact via lower prices and so earnings.

So far, the current episode has not seen a sharp correction in Australia's key commodity prices, underpinned by a relatively positive outlook for China. This view assumes that the Chinese authorities will support their economy through fiscal stimulus and is embodied in our baseline scenario, with the downside trade war scenario encapsulating a correction. If this were to occur the income flows from commodity exports would fall significantly.

Graph 7



* 62% Fe iron ore fines price (inclusive of freight costs to China from Australia) as at 28 May 2025.

** Each bar represents individual iron ore producers, with production amounts converted to dry tonnes by applying an 8 per cent reduction to wet tonne estimates; extreme outliers omitted.

Sources: Bloomberg; CRU; RBA.

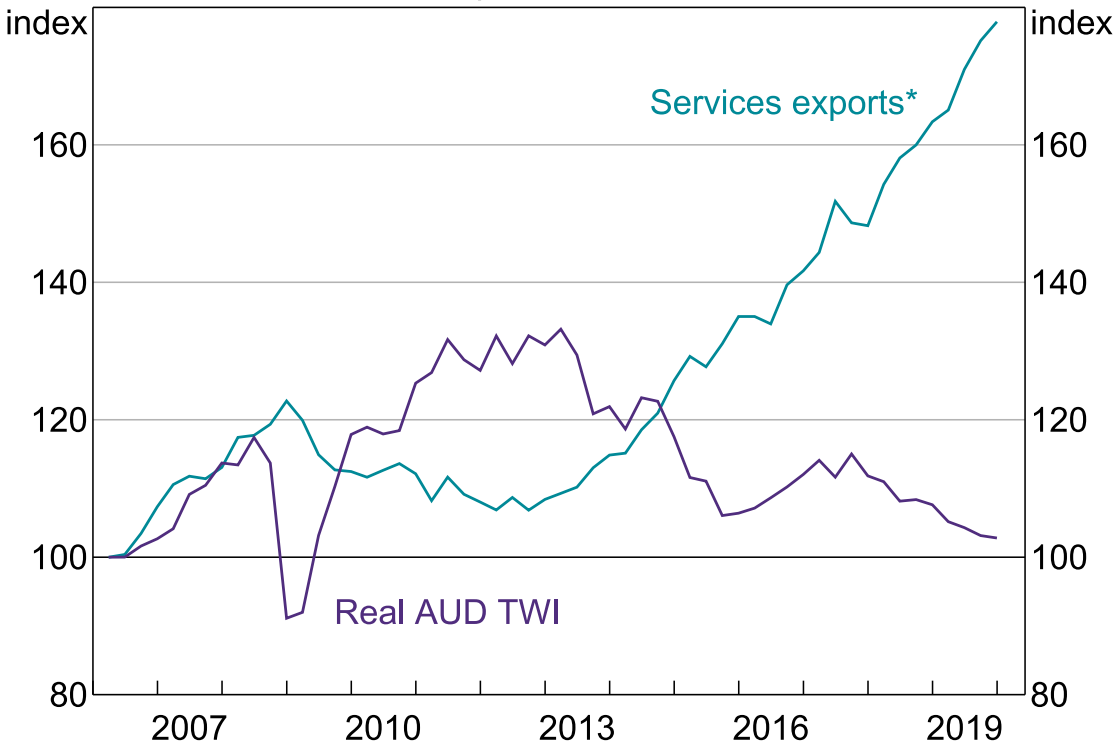
By contrast, trade in services, which comprise around 20 per cent of Australian exports to the world, are more responsive to changes in global demand and the exchange rate.[10] We can see this in the below chart, which shows historically how movements of services export volumes have correlated with changes in the real exchange rate, a measure of competitiveness (Graph 8). In the years following the GFC, the appreciation and depreciation in the exchange rate contributed to a decline and then strong rebound in services export volumes.[11]

Trade in services tends to react more strongly because some exported services tend to be easier to substitute and more discretionary. Travel services, for example tourism, are a key Australian export that might be affected by recent developments. Weaker global growth is likely to dampen demand, but any exchange rate depreciation will make Australia a more attractive destination. Simultaneously, travel service imports (i.e. outward tourism) may decline if the Australian dollar depreciates; holidaying overseas will become more expensive than taking a trip locally.

Graph 8

Services Exports and the Exchange Rate

March quarter 2006 = 100



* Seasonally adjusted chain volume measure.

Sources: ABS; RBA.

Uncertainty dampener on households and businesses

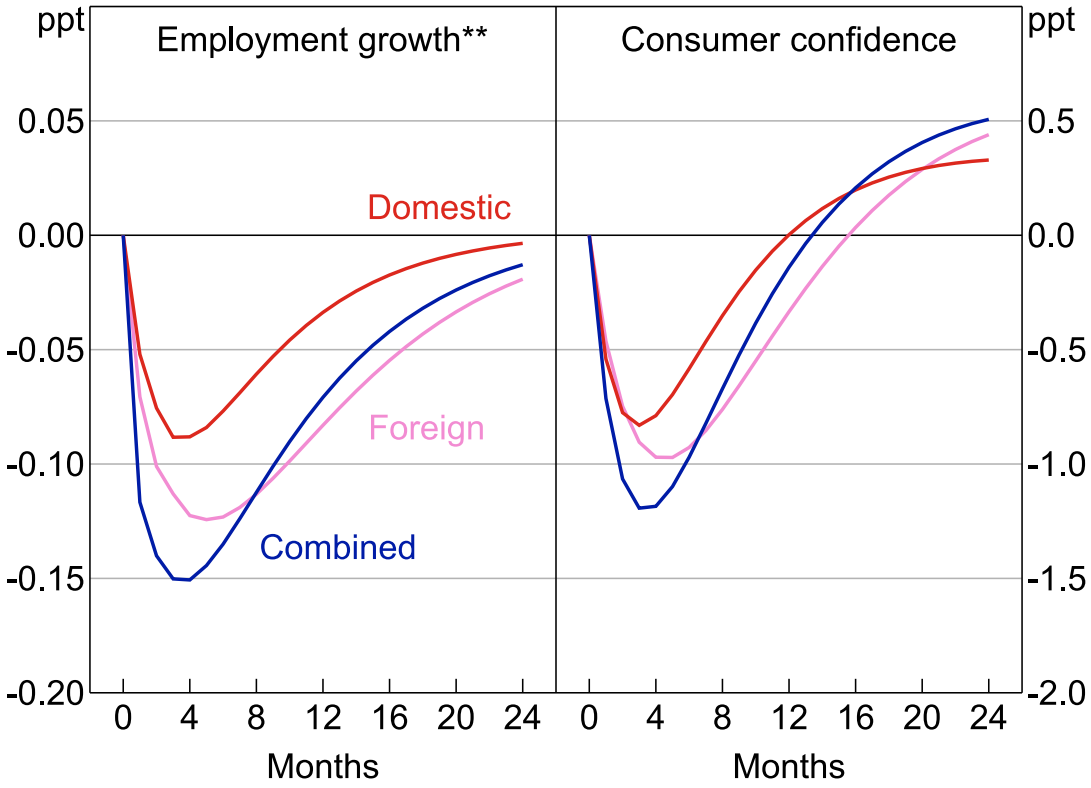
While key parts of Australia's export volumes may be relatively resilient to global demand conditions and uncertainty, domestic demand is unlikely to be completely insulated. As discussed earlier, greater uncertainty about the future can lead households and businesses to save instead of spending and investing, and this is likely to be the case for Australian households and businesses too. And increased borrowing costs and risk premia in global financial markets are likely to spill into domestic markets, further weighing on activity.

Previous research by RBA economist Angus Moore found exactly this. Higher global uncertainty has a large negative effect on Australian business investment, while the negative effect on consumption is more modest (Graph 9).[12] Though the magnitude of these effects is itself very uncertain, this does suggest that global uncertainty may weigh substantially on domestic activity if uncertainty remains elevated. As with all of the other channels, we explore different assumptions for the size of this channel in the scenarios in the May SMP.

Graph 9

Foreign and Domestic Uncertainty Shocks*

Impulse responses from monthly VAR



* Estimation covers October 1986 to December 2014.

** Calculated as annualised rate.

Sources: Moore (2016); RBA.

Putting it all together for policy

So how will the current unpredictable and uncertain global environment transmit through to the Australian economy? The short answer is we can't be completely sure. The framework I have outlined identifies what we think are the key transmission channels, and we have used scenarios to simulate different alternatives. Within this range, the baseline forecast is for recent global developments to contribute to slower economic growth in Australia and a slightly weaker labour market. We also anticipate that, overall, the price of tradable goods will be slightly dampened. Together, these two outcomes mean that inflation is forecast to be a little lower than at the February SMP, settling around the midpoint of the 2–3 per cent target range.

This forecast is based on several judgements, and assumptions about the potency of the transmission channels I have discussed today. These include how tariff policies evolve, how fiscal and monetary authorities around the world respond, whether trade diversion reduces the price of imports or global supply chains become heavily disrupted, and how much uncertainty weighs on economic activity.

By using the framework and scenarios together we have anchored our thinking and cut through some of the uncertainty about the outlook. These were provided to the Monetary Policy Board to help inform their decision-making; taking all the information into account and considering the risks to the outlook, they decided to cut the cash rate by 25 basis points.

What will happen from here? Going forward, the RBA will continue to monitor domestic and international outcomes and global policy developments. Benchmarking these against the scenarios in the May SMP will help us identify the scenario that best reflects current conditions and the outlook, enabling the Board to adjust policy settings accordingly.

Endnotes

[1] See Hauser A (2024) 'The Ghost of Christmas Yet To Come', Speech to the Australian Business Economists' Annual Dinner, Sydney, 11 December.

[2] See, for example, Auclert A, M Rognlie and L Straub (2025), 'The Macroeconomics of Tariff Shocks', NBER Working Paper No 33726, which presents a theoretical model and discusses the conditions under which tariffs will be contractionary in the short term; Furceri D, SA Hannan, JD Ostry and AK Rose (2019), 'Macroeconomic Consequences of Tariffs', IMF Working Paper No 2019/009, which analyses the effects of tariffs over the medium term from 1963–2014.

[3] In early 2025, US imports surged as businesses looked to beat the imposition of tariffs. This response is likely to unwind once the new regime has been put in place.

[4] In the longer term, once the supply side of the economy has had time to adjust (and assuming tariffs are expected to remain at higher levels), tariffs are still likely to weigh on economic growth. But over this horizon, this would appear as a shift from imports to less efficient domestic production. That said, there may be other reasons a country may want to promote domestic production.

[5] Londono, Ma and Wilson summarise the different varieties of economic uncertainty – including policy uncertainty – and the literature on their economic effects: Londono JM, S Ma and BA Wilson (2025), 'Costs of Rising Uncertainty', FEDS Notes, 24 April. See also Baker SR, N Bloom and SJ Davis (2016), 'Measuring Economic Policy Uncertainty', *The Quarterly Journal of Economics*, 131(4), pp 1593–1636 and Caldara D, M Iacoviello, P Molligo, A Prestipino and A Raffo (2020), 'The Economic Effects of Trade Policy Uncertainty', *Journal of Monetary Economics*, 109, pp 38–59, which develop measures of economic and trade policy uncertainty respectively and study their impacts on economic activity.

[6] Deputy Governor Andrew Hauser spoke about the varieties of uncertainty and the challenge of quantifying them in his speech earlier this year: Hauser A (2025), 'Monetary Policy in a VUCA World', Speech to the Australian Financial Review Business Summit, Sydney, 5 March.

[7] It's worth keeping in mind that standard measures of equity risk premia are imperfect. They tend to rely on lagged measures of expected earnings. Moreover, standard approaches estimate them as the gap between the required return on equity and the return on government bonds, which are assumed to be riskless. But recent events have potentially seen risk premia on US bonds increase. This would lead to an understatement of the increase in the equity risk premia.

[8] There is a large body of research undertaken by the RBA and elsewhere that has shown that the floating exchange rate typically absorbs a great deal of the effect of global shocks over the past 40 years, meaning smaller effects on activity. See as one recent example Hendy P and B Beckers (2024), 'How Do Global Shocks Affect Australia?', Research Discussion Paper No 2024-10. See also Stevens G (2013), 'The Australian Dollar: Thirty Years of Floating', Speech to the Australian Business Economists' Annual Dinner, Sydney, 21 November; Debelle G and Plumb M (2006), 'The Evolution of Exchange Rate Policy and Capital Controls in Australia', *Asian Economic Papers*, 5(2), pp 7–29.

[9] There will also be limited effect on indirect demand for Australian exports from higher US tariffs on other countries, as accounting for this indirect demand only raises Australia's export exposure to the United States to a little over 2.25 per cent of Australian GDP.

[10] This services export share can be as large as 25 per cent under different accounting frameworks, such as when the share includes the price of getting exports to destination.

[11] Cole and Nightingale identified the relative responsiveness of services exports to exchange rate movements: Cole D and S Nightingale (2016), 'Sensitivity of Australian Trade to the Exchange Rate', RBA *Bulletin*, September. Through the years following the GFC, a number of other elements played into the strong rise in resource exports – namely strong demand from China, which drove both exports and the exchange rate.

[12] See Moore A (2016), 'Measuring Economic Uncertainty and Its Effects', Research Discussion Paper No 2016-01.

The Reserve Bank of Australia acknowledges the Aboriginal and Torres Strait Islander Peoples of Australia as the Traditional Custodians of this land, and recognises their continuing connection to country. We pay our respects to their Elders, past and present. Aboriginal and Torres Strait Islander peoples should be aware that this website may contain the names, images and voices of people who are now deceased.