Economic Performance and Issues in 2002

Address by Mr GR Stevens, Deputy Governor, to Australian Industry Group 'Economy 2002 – Forecasting Industry Prospects', Sydney, 6 March 2002.

Thank you to the Australian Industry Group for an invitation to return to your annual conference. It is a pleasure to be here.

Since this is my third appearance here, I thought it might be useful to give a brief history of the past couple of years as a prelude to making some observations about the current state of things, and about some of the issues for the year ahead.

The World Economy

As we all know, the year 2000 was a strong year for global growth. In that year, world GDP rose by almost 5 per cent, and growth in the major countries (the G7) ran at about $3^1/_2$ per cent. This was led by the US, which enjoyed a very strong performance through the second half of the 1990s, though the growth was not confined to the US, and a number of countries did quite well, including, in particular, Australia. The Asian region generally recovered from the crisis of 1997 and 1998, with several countries riding the global boom in spending on information technology. Japan was perhaps the most conspicuous exception, with a very weak performance overall through most of the 1990s – which held down the G7 aggregate mentioned above quite noticeably.

But towards the end of 2000, it began to become clear that a slowing in the US economy, which had been talked about, but not seen, for several years, was finally beginning to occur. At that time, expectations were for lower growth in the major economies in 2001 than in the preceding year, but still for growth at about average rates. Then, in the early months of 2001, assessments of the health of the US economy, and by extension much of the rest of the world, were revised dramatically. For those who closely watch the US economy, the bell was rung in early January last year, with a reduction in interest rates by the Federal Reserve, undertaken in between their normally scheduled meetings. That was to be followed by a sequence of policy changes which were aggressive compared with the experience of the preceding decade.

When we met here about a year ago, then, we were in a period in which expectations were moving quickly, both about the international scene and about the Australian economy. Perceptions about the world economy were to worsen noticeably in the subsequent months. Those about the Australian economy worsened as well, though not as far, or for as long, as those abroad. It is reasonable to claim that sentiment about the Australian economy reached a low point around March–April last year. Since then, perceptions have improved, reflecting the actual course of the economy, which has held up well given the global downturn.

Talk of recession in America began to grow, though there was vigorous debate about that for some time. By June 2001, the manufacturing sector of the US economy had been contracting for about a year. The exceptionally strong growth in demand for ITC products initially disguised the weakness more broadly in manufacturing, but that strength itself faded during 2001. Employment began to fall. There was active debate about whether all of this constituted a 'recession' in the normal sense of that word. Then the events of 11 September 2001 occurred, and ended that debate pretty quickly. Pessimists and optimists alike revised down their assessments of growth and worried about the possibility of a much more pronounced and long-lasting contraction in the US economy.

To date, however, such fears have not been borne out. It is true that there was an initial shock to confidence in the US. It is also true that the long-term responses to the terrorist events could well be of considerable importance for economic performance. Higher costs of security and insurance will have to be borne. Ways in which businesses organise themselves, in both the goods and service producing sectors in the US, may well change. On top of this, no-one can foretell the way in which the military response to terrorism may change the world, either strategically or economically.

But so far, the path of the US economy we have observed since the attacks has shown remarkably little lasting direct impact beyond the initial disruption lasting a few weeks. The financial system was quickly back in operation. Patterns of consumer behaviour were apparently only affected briefly. Industrial output, which fell for a year prior to the attacks, looks as though it may have stopped falling not long thereafter, a picture corroborated by some important surveys of that sector. There has been a recession, according to the US National Bureau of Economic Research, but it was not caused by the attacks. That much is clear from the fact that the NBER had the evidence to declare a recession with very little post-attack data: it was the data from earlier in the year on which they mostly relied.

Moreover, if a recession began about March 2001, as the NBER suggests – that is, almost a year ago – we would normally expect to see some signs of a turning point getting close by now. The behaviour of manufacturing production and orders, inventories, some labour market data, and financial market prices are all consistent with that idea. To cap that off, there was of course the news last week that real GDP in the final quarter of 2001 rose a little more than had earlier been estimated.

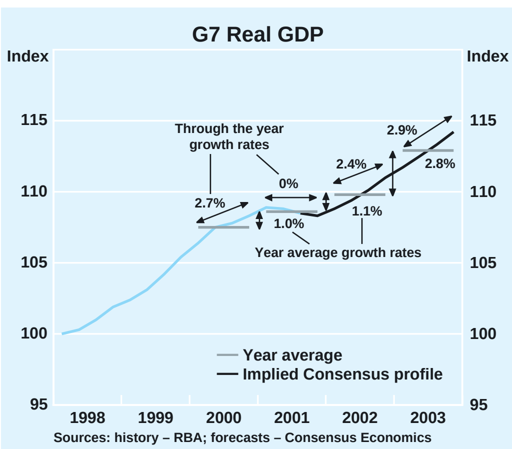
So it is not surprising that people have recently begun to talk increasingly about the shape of a pick-up in US growth. The forecasters polled by Consensus Economics collectively increased their forecasts for US growth in 2002 quite substantially when asked in February – even prior to the latest GDP revision. If what we are seeing is indeed the first stage of a recovery, and if it continues, then the recession of 2001 will have been very mild indeed by historical standards.

That itself may well mean that the recovery will be a pretty moderate affair compared with previous upswings. There are also one or two apparent imbalances which might slow down a business cycle upswing during the coming few quarters. Exceptionally high levels of business investment in recent years raise the question of whether there might be excess capacity in some areas. US equity prices remain high by historical standards, and so may be subject to correction. Certainly profitability of US corporations appears to be particularly poor at present, which ordinarily is not conducive to expanding investment. Some argue that households are financially stretched. How all this will play out remains to be seen. Nonetheless, the weight of opinion has recently become more optimistic than it was a few months ago, and not without reason.

An improved US outlook, if it comes to fruition, will be good for other regions of the world. In Asia, we can already see signs of a stabilisation in industrial output after a pronounced contraction through most of 2001. This was the effect back through the supply chain of the slump in the demand for computer and information technology products last year. While the shape of any pick-up in this area remains far from clear, the contraction at least appears to have abated. European growth slowed more than anticipated in 2001 – indeed the economies of the Euro zone recorded no more growth than the US. Signs of a cyclical turning point are emerging there as well, though again it is early days. Japan, as is well known, is another story altogether. Contractionary and deflationary forces have continued, and arguably become stronger, in the past year. Restoring Japan to economic health will be a long process.

Were Japan to continue its recent performance, but not be materially worse than that – which seems to be the consensus view – growth in the world economy in total should start to look up as 2002 progresses. Measured on a year average basis, Consensus forecasters suggest that the G7 countries will record growth of about 1 per cent in 2002. This number is about the same as for 2001, but as the chart below shows (Graph 1), this conceals a more pronounced pick-up in the profile of growth through the year – from zero through 2001 to 2½ per cent through 2002.

Graph 1



The Australian Economy

Let me turn now to the Australian economy. As I am sure you are well aware, we have been affected by the global recession, through a few channels. The most obvious one is a reduction in export growth. Eighteen months ago, export values were growing at 25–30 per cent, with growth in prices and underlying quantities each contributing about half of the overall increase. That growth has stopped completely over the most recent year. Parts of the tourism sector have been affected quite badly by the decline in international travel and the collapse of Ansett. Australian businesses, especially large businesses, look abroad quite actively, and their confidence cannot help but have been affected by the unfolding global story. My impression is that, across a wide range of firms, managers have responded to the threat of difficult times by curtailing discretionary spending on things like travel, advertising, consultants and the like. They have also, one must presume, looked carefully at planned capital expenditure. In addition, the general populace has had a daily diet of reading about the difficulties in the US and other countries.

In light of all this, it is perhaps all the more remarkable that, on the available evidence, the economy seems to have recorded quite reasonable growth through 2001 and, based on the very preliminary data available, into the early part of 2002. The responses of businesses to surveys suggest that they are beginning to increase investment spending again. Consumer confidence is also holding up very well. Hence, as best we can judge, the economy is not only continuing to expand, but has reasonable prospects of continuing to do so in the near term.

Nor is this all due to the current strength in the housing sector. This is a point I have made in more detail elsewhere, but even stripping out the contribution from housing – which has operated in both directions in recent years – we find moderate growth in the economy over the past couple of years, of the order of $2^1/_2$ per cent. In the past twelve months at least, this compares well with outcomes in the US, Europe, Japan and much of Asia. It is slower, of course, than the 4–5 per cent growth of 1998 and 1999. But some slowing was always going to occur from such levels, and in the context of widespread recession around the world, Australia's performance is good, and much better than would have been anticipated had our performance in previous global downturns been extrapolated.

To what do we attribute this favourable outcome? As was pointed out in our most recent *Statement on Monetary Policy*, it is rare for an external event, on its own, to precipitate recession in Australia. To be sure, the impact effect of such events in the past has been quite substantial and, no doubt, there is a 'multiplier' effect of such shocks through the economy. But for an economy which typically grows at 3–4 per cent, a shock which affects production by 1 or even 2 per cent needs something else at work to precipitate a contraction in the economy overall. There usually needs to be a slump in domestic demand to precipitate an outright contraction in overall GDP. That can occur because, say, an excess of capital spending by businesses, or excessive leverage, leads to a sharp correction in investment (and employment), which exacerbates a slowdown which was already under way because of external events. It might occur because some shock comes along which fundamentally erodes business profitability and hence reduces prospects for investment. It might occur because domestic macroeconomic policies, responding belatedly to serious inflation pressure, are faced with a need to tighten abruptly late in the business cycle.

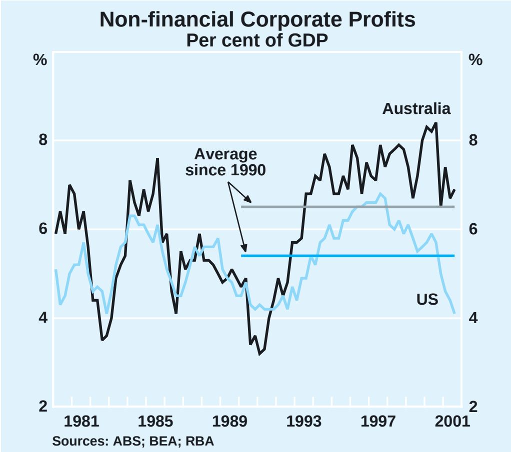
As has been pointed out on several occasions by the Governor, the extent of such problems on this occasion has, we judge, been small. True, a rise in inflation has occurred, but the Bank believes that the tightening phase of 1999–2000 addressed any longer-term problems which might have threatened on this front. We therefore felt we could ease policy in 2001, and did so some considerable time ahead of the likely peak in inflation. That inflation expectations remained well anchored through the past year or more helped in this. Investment has not been excessive overall (though this does not rule out some individual 'mistakes') and, on the whole, businesses do not appear to be over-leveraged. This means that the likelihood is rising, rather than falling, investment during the coming year. The recent survey on capital expenditure intentions confirms that this is occurring; indeed, it suggests the pace will strengthen considerably in the second half of the year – although of course this is a very early estimate of such expenditure.

Profits and Productivity

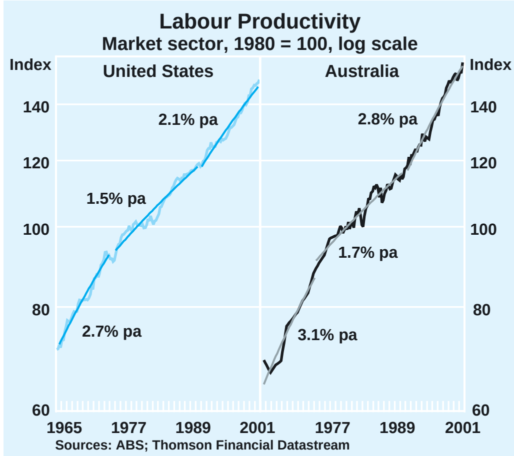
It is probably worth spending a little more time on profits. Businesses were affected by the rise in prices for inputs over the past couple of years, which resulted from the decline in the exchange rate. In addition, the moderate slowdown in the economy itself presumably affected earnings. As a result, corporate sector gross operating earnings tended to weaken, though the most recent data suggest this decline may have ended.

There has been a much larger decline in profits in the US. The chart below, prepared by staff in our Economic area, undertakes a comparison of corporate sector profits in the national accounts as a share of GDP, for the US and Australia (Graph 2). The Australian data here have been adjusted to remove interest costs and depreciation so as to make them more comparable with the way US data are usually published. The Australian profits share is higher than in the US, but we should not make too much of the difference in levels – there are possible differences in the relative sizes of incorporated and non-incorporated sectors, the extent of public versus private sector ownership of the capital stock, and so on.

Graph 2



Graph 3



But the trends, and levels relative to longer-term averages, can be more meaningfully compared. The differences in the extent of the falls in profits since 1998 are quite striking. US profits are back to 1990 levels; Australian profits are similar to the post-recession average, and look nothing like a recession scenario. This is obviously partly because the downturn in the economy itself has been milder. But it also makes for better prospects for growth in the short term, because it greatly lessens the likelihood of abrupt adjustments in investment, or employment.

Longer term, prospects for profits rely heavily on productivity performance, an issue in which the business and policy-making community both have a vital interest. Productivity is key both for businesses in sustaining profitable performance and for the community as a whole since it is productivity growth which is ultimately the source of higher living standards. It is well known that Australian productivity growth accelerated during the 1990s, to a rate about one percentage point per year higher than what had been observed during the preceding ten to fifteen years (Graph 3). (This was, incidentally, both a higher average rate of productivity growth and a greater degree of acceleration in productivity than seen in the US over the same period.) It is no coincidence that profits did relatively well through most of that period, and that this was able to co-exist with rising real wages.

During the past couple of years, the rate of expansion in productivity first slowed markedly, then sped up again. This is a standard cyclical pattern, in which employment moves in response to economic activity, but with a lag. Hence employment lags the slowing in activity, and measured productivity slows or even declines. The reverse happens when growth picks up, as it did during the first three quarters of 2001.

The extensive program of liberalisation of the economy during the past couple of decades was a major driving force behind the improvement in trend productivity growth. As a side note, we in Australia have not tended to allow much role for ‘new economy’ developments, such as the adoption of information technology, though some research does suggest that this may have played a greater role than conventional wisdom has allowed.

But the bigger question is the future. Leaving aside recent cyclical ups and downs, will the strong trend productivity growth of the 1990s continue into the next ten years? On this there are, I suppose, optimists and pessimists. Optimists would argue that the faster productivity growth we have seen in the past decade represents an accelerated process of 'catch-up' to the leading edge levels of productivity we see globally, usually in the US economy. Moreover, they accept that there is still some gap between productivity levels in Australia and those of the world frontier in at least some sectors. Hence the catch-up is not complete, and a process of good productivity growth can continue for some time yet. Pessimists tend to point out that this depends on the right policies. They worry that if the process of liberalising markets does not continue, or is even reversed, productivity performance will suffer. They voice the concern that it is getting harder to build support for liberalising ideas. Both of these views have some merit, and it is possible to have an optimistic outlook, but equally to see the importance of sustaining the liberal market arrangements which already exist, and of being disposed towards further sensible reforms that may be possible over time.

Good policies will be important, of course – that goes without saying. But policies can only establish pre-conditions conducive to enhanced productivity. The outcomes will depend quite heavily on you, the business community. It is you, after all, who, in the pursuit of profit, have to seek out the opportunities for new products and markets, better ways of organising business activity, and better ways of motivating your employees and tapping and developing their human capital. In the simple growth accounting exercises used to measure productivity, the *source* of the genuine improvements in productive techniques is not considered (though there is a considerable separate literature aimed at establishing that). But productivity does not get handed down from somewhere – it is the outcome of the efforts of people across the economy to find better ways of doing things.

What macroeconomic policy can contribute to this endeavour is a measure of stability. We will never be rid of the business cycle, nor of the tendency for businesses, households and especially financial markets, to alternate between moods of optimism and pessimism. But through the past decade or so, the Australian economy has been somewhat less volatile from year to year than it used to be. That may be explained partly by smaller shocks hitting us from abroad for much of the 1990s (though both the Asian crisis and the global recession of 2001 were big shocks). The economy's capacity to handle shocks has also improved, a factor due in some degree to the liberalising reforms themselves. I would argue that macroeconomic policies have played a role too, and in particular that a monetary policy regime which seeks to respond to the likelihood of significant build-ups of inflationary or disinflationary pressure, has made its contribution. It is, of course, our intention to continue in that vein.

Conclusion

In most respects, the global situation, while not without uncertainty, is better than it was a year ago. A renewed expansion in the world economy may well be beginning, though it will probably be moderate, rather than strong. Even though we do not want to throw our hats too far in the air just yet, it is very encouraging to see such signs.

Australia has come through the international difficulties well to date. In an underlying sense, we have slower growth than we experienced in the late 1990s, and slower growth than we would ideally like to sustain in the medium term. But we have not had the deep slump characteristic of earlier world downturns, and the probability of experiencing one soon seems recently to have diminished. This is good news, and perhaps should have us all casting our minds past the short term, towards the question of how to sustain good, stable growth, and good productivity performance, into the medium term. I am sure you will all be doing just that. ✠