

Economic Conditions and Prospects: June 2004

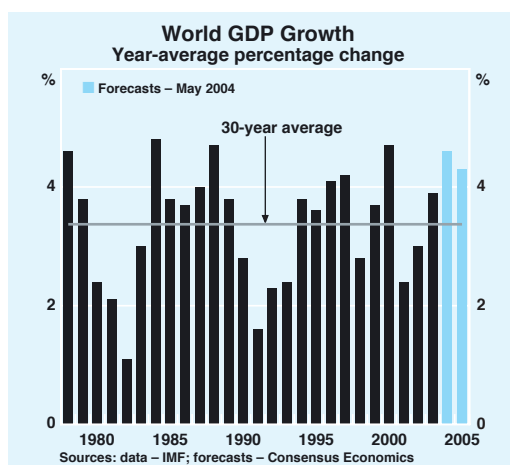
Address by Mr GR Stevens, Deputy Governor, to the Committee for Economic Development of Australia (Queensland Branch), Brisbane, 2 June 2004.

Thank you for the invitation to speak to you today. I plan to cover the evolving economic picture both abroad and at home. As some of you may know, the Bank released a month ago our latest comprehensive treatment of the economy and financial markets. The Governor is also due to appear in front of a Parliamentary Committee on Friday of this week, to speak on the economy. My remarks today, therefore, fit into a rather small window in the unfolding narrative. Accordingly, I will not begin any major new lines of inquiry, but mainly give a brief update on a few of the themes which have been running for some time.

The World Economy

It is still the case that the world economy is gaining strength, and forecasts for economic growth have generally been moving upwards. According to the main official international bodies (the IMF and the OECD), growth in the world economy will be about 4½ per cent in both 2004 and 2005 (Graph 1). If that

Graph 1

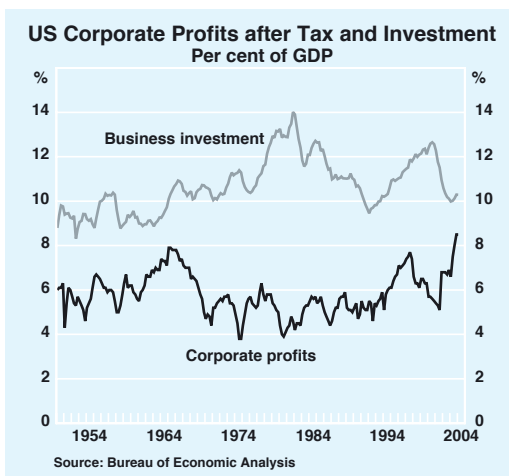


sequence occurs, it will be the strongest two-year growth performance since the late 1970s.

Of course, these figures are just forecasts, not guarantees of performance. But by this stage of the year, it would take something pretty dramatic to change the estimated outcome for 2004 by much. The strong number for next year – which is a fairly recent feature of most people’s forecasts – basically reflects growing confidence that the recovery is well entrenched. It embodies further solid US growth, recognises a marked improvement in economic performance in Japan and ongoing strong growth in Asia. Continental Europe is the main area of softness, though even there things seem to be improving a bit.

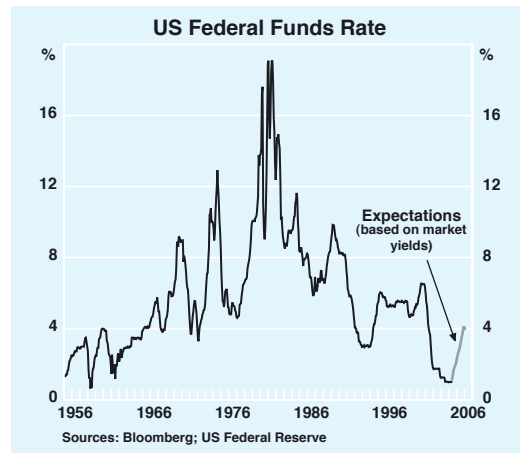
As usual, perceptions about the global cycle have been heavily affected by the ebbs and flows of confidence in the American economy. Following a somewhat hesitant early phase of recovery from early 2002 until mid 2003, the more robust performance of the US through the second half of last year and into early 2004 has been characterised by strongly rising corporate profits and an upturn in business investment spending (Graph 2). Over recent months, it has also driven rises in employment levels. This was the key sign for which most observers had been waiting, to indicate that the recovery had reached the self-sustaining stage, where initial demand expansion has produced enough output growth to push up incomes, which in turn feed back into renewed growth in demand. Confirmation of these trends in the US has greatly enhanced confidence about the global upswing.

Graph 2



Once that occurred, it was perhaps inevitable that talk would turn to the question of how much longer official interest rates in the US would remain so low. A point that we have made repeatedly is that, in thinking about interest rates, it is the level of rates which matters and that level has been extremely low in America (and, for that matter, in other major regions or countries like the euro area and Japan) (Graph 3). A setting such as this, designed to ward off the risks of deflation and chronic weakness in aggregate demand, has

Graph 3



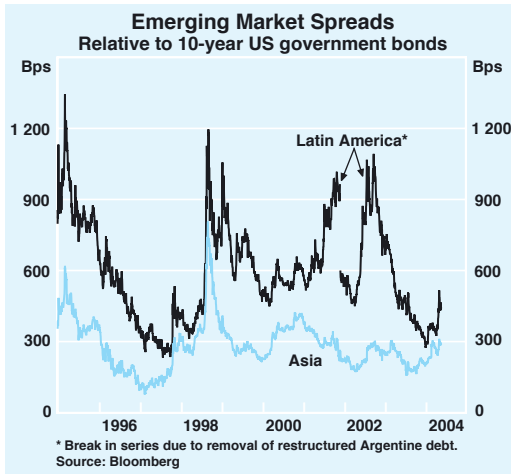
to give way to more normal settings once it is clear that those dangers are abating. The debate the US is going through at present is over when that process of normalisation will start and how quickly it will proceed. Market participants are currently betting that it will begin quite soon – within the next month – but will proceed fairly gradually. In due course, the Japanese and the Europeans will also presumably have such a discussion, though there seems no particular urgency to have it at the moment.

Such an adjustment by the US Fed is unlikely to kill the recovery in US aggregate demand – it is more an indication that the Fed thinks the recovery is in solid shape. It would be more worrying if the return to normal interest rates in the US were not in prospect.

That said, there is obviously a period of adjustment in financial markets under way as the anticipated changes to the cost of US funds are absorbed. Risk is being re-priced in a wide range of markets. Emerging market bond spreads have moved out a little, though US domestic spreads are little changed (Graphs 4 and 5). Share prices have softened recently in a number of countries, and especially in Asia. The US dollar has firmed against most currencies.

To a large extent, these movements reflect the unwinding of positions which were prompted by the very low US short-term rates and the resulting search for more yield – and

Graph 4

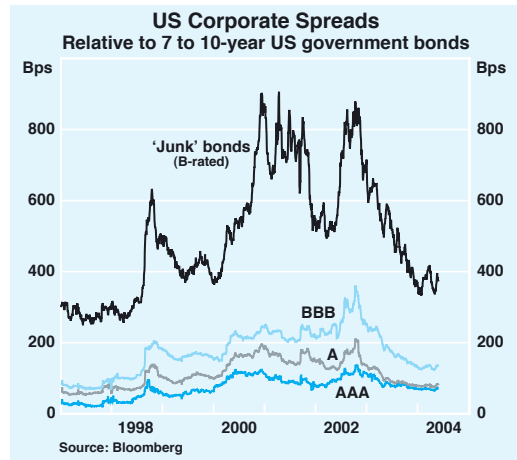


more risk – in various other asset classes. Such adjustments are to be expected once the period of very low US rates looks like it is coming to an end. In fact we should, for the most part, welcome them. On most measures, spreads are still quite low relative to historical norms. Arguably, risk was being underpriced until recently anyway, which is hardly a recipe for longer-run stability. So all in all, a gradual return to a more normal constellation of US interest rates should be seen as a good thing.

All of this attention given to the US economy and the changes to global financial markets as a result of likely changes in US monetary policy is par for the course. More noteworthy of late, however, is the prominence given to the growing role of China in the world economy. China is making a tangible difference to global economic output – and was a key reason, for example, why global output did not slow as much as the output of the advanced country group in 2001 and 2002.

In some quarters, the rise of China as a source of supply of manufactured products on world markets has been seen as a cause for concern – since China has such a large supply of low-cost labour, much of which has not yet been tapped. No doubt, the rise of China is changing the economics of global manufacturing – though it is hardly the first time in history that this kind of thing has occurred. But it is also changing the

Graph 5



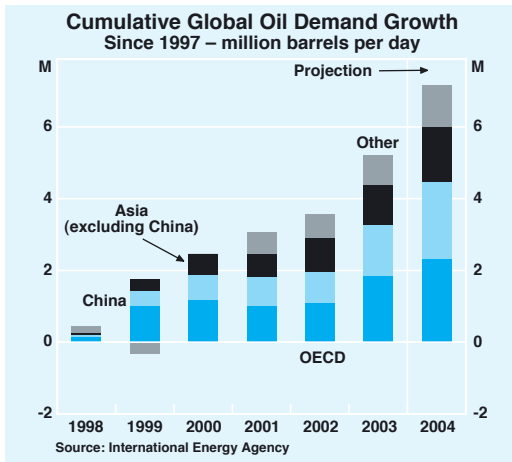
economics of production of other things. China is not just a source of supply for goods, it is a source of demand for goods and services as well. Indeed, China's trade surplus with the rest of the world is quite small, and relatively stable, suggesting that China has been putting as much additional demand as supply into the world economy.

A number of countries have been affected by the demand side of China's expansion, not least Australia, where we now see China accounting for about 10 per cent of our foreign trade, up from 5 per cent as recently as 1998. China's demand for resources to supply its industrial expansion has put upward pressure on prices for steel and its raw materials (iron ore, coking coal), and on the costs of shipping. These effects have amplified the normal cyclical pick-up caused by general recovery in the industrial economies around the world. The Australian resource sector might have been able to supply even more of this demand had more capacity been available, but constraints seem to have been binding in some areas (which, of course, is one reason the effect on prices has been so strong). Presumably there are good prospects for expanding investment in various parts of the resources sector in the years ahead.

The rapid growth of China's demand for energy has also surely had a tangible impact on oil prices. While there are apparently some short-term special factors at work in the most

recent very high oil prices, the trend increase in the global demand for oil is now strongly influenced by China (and other rapidly growing countries in Asia), as shown in the chart below (Graph 6). The figures which put this trend at its most stark are as follows. Over the two years to March this year, global demand for oil rose by about 4 million barrels a day. About 1.5 million barrels of this came from the OECD countries as a group – who use over 60 per cent of supply. About 2.1 million barrels a day in additional demand came from Asia including India, with 1.5 million barrels of that from China alone.¹

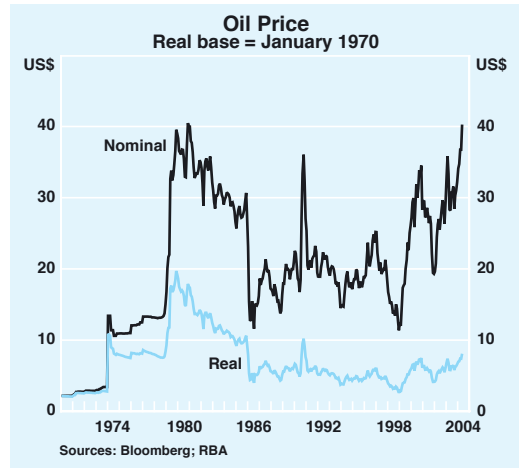
Graph 6



Now it is important to keep the recent rise in oil prices in perspective: it is nothing like as large in proportionate terms as occurred in the ‘OPEC’ shocks of 1973 and 1979. The level of real oil prices remains much lower than in either of those episodes and the share of oil in total production costs for advanced economies is much lower than it was in those days (Graph 7).

However, given the extent of Chinese and Asian demand generally, and their likely trend growth in the future, it seems entirely possible that the level of real oil prices of the 1990s will turn out to have been on the low side of what could be the norm in the future.

Graph 7



More generally, we can see a quite important change in relative prices occurring associated with the rise of China: prices for many manufactured goods are declining relative to those of resources. As a supplier of resources and a consumer of manufactures, Australia benefits from this relative price change. No-one can say for sure, of course, whether it will continue for a long time, but it does appear to be in distinct contrast to the previous long-term downward trend in Australia’s terms of trade. Certainly, it is beyond serious dispute now that the weight of China in the world economy – both in its secular growth rate, and the dynamic of its business cycle – is something which has to be carefully considered.

China has problems, of course – as with any country trying to industrialise rapidly, balancing the rapid growth in demand and supply, and avoiding other problems, is no easy task. Right now the Chinese authorities are attempting to moderate the economy’s growth rate, given clear signs of overheating. Some of those pessimistic about global prospects in 2005 worry that the slowdown will turn out to be abrupt. The fact that China has had a very large build-up in credit, and that its banks carry the legacy of decades of lending to state enterprises on non-

1. Source of these figures is the International Energy Agency (IEA), an inter-governmental body within the OECD.

commercial criteria, make the job harder. Equally, the authorities have for the past decade shown an impressive capacity to manage the economy quite successfully through some difficult times. Hence, while there is some risk of a slump in China, we should not assume it. Even if an unexpectedly large slowdown did occur, it would be very unlikely to change the long-run outlook for China of strong growth and continuing emergence as one of the world's largest economies.

I haven't even mentioned India yet but one should mention it, as an economy with a very large population, and turning out quite strong growth rates over the past few years. We will be hearing a lot more about India's impact on the global scene during this decade.

The Australian Economy

The Australian economy has continued to grow. In the second half of 2003, real GDP expanded at an annualised pace of over 5 per cent, as the farm sector gained ground on the back of better climatic conditions, and the non-farm economy continued to expand, helped by strong domestic spending and the early stage of a recovery in exports.

It was unlikely that growth at that pace would persist, and according to figures released earlier today, the speed of growth early in 2004 was noticeably more moderate. A range of business surveys suggest that conditions experienced in the first four or five months of 2004, while not as strong as those of late 2003, were nonetheless better than average.

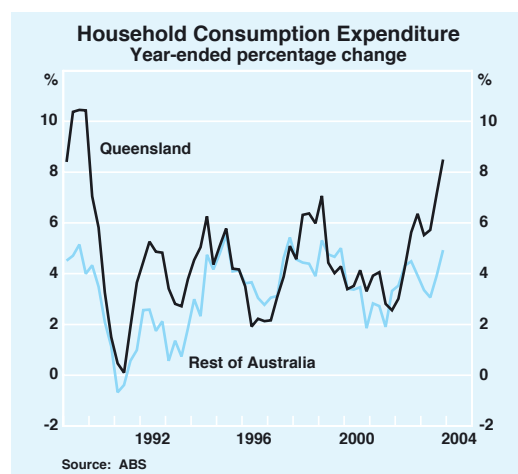
Consumer demand is not advancing at the same pace this year as it did in the second half of 2003, though tax reductions in the coming year will presumably offer support to consumer spending. Employment has continued to rise, and the rate of unemployment is at its lowest for over 20 years. While employment growth last year

owed a good deal to the effects of high levels of residential construction and the associated demand for materials, of late it looks as though employment in some of the professional services sectors has begun to increase again, after a slower period since mid 2001. Hence, as the anticipated decline in dwelling construction takes shape this year, overall employment levels should continue to increase, even if at a reduced pace from that seen over recent months.

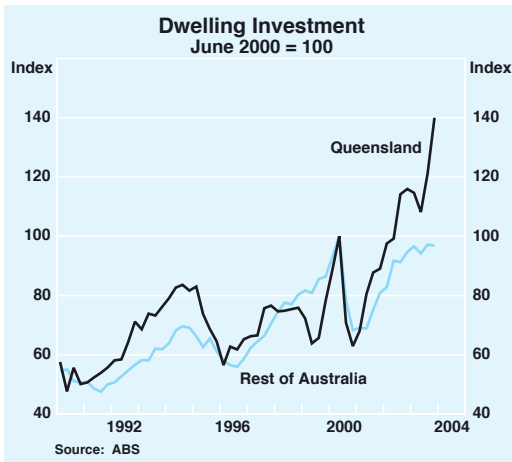
Growth in the state of Queensland, in particular, has been very strong indeed over the past year, and much faster than for the nation as a whole. Consumer spending is recorded as having grown by over 8 per cent through 2003, compared with 5 per cent for the rest of Australia (Graph 8). Dwelling investment spending surged to an all-time high in Queensland at the end of last year, while for the rest of the country it was high, but no higher than the pre-GST peak in 2000 (Graph 9). Employment growth has also been faster in the sunshine State than in virtually all the other states.

Queensland has, of course, the highest rate of population growth of any of the states, with net migration from Victoria and NSW in particular. So we would expect most aggregates to be rising faster than elsewhere, but in 2003 growth in spending *per head* still outstripped the rest of Australia, and the

Graph 8



Graph 9



employment growth sufficiently exceeded growth in the labour force that Queensland's unemployment rate – which is routinely higher than the national average – closed quite a bit of the gap to the other states (Graphs 10 and 11). In short, Queensland had a pretty good year.

The housing market has been a key issue for the economy over the past couple of years and, as you would know, the RBA has had quite a bit to say about it. A misconception that we still see from time to time is that some people seem to think we have been concerned mainly about excessive rates of construction. Construction has been very strong, and there

may be over-supply in some areas. But our main concern has *not* been about the addition of 130 000 to 150 000 new dwellings each year. Rather we have been worried by the market for the existing 7½ million dwellings and the way in which they were changing hands for higher and higher prices, with an associated build-up in debt levels. That is, we have been worried about the housing market as an *asset* market, and about the borrowing behaviour of participants in that market. The concern was not out of a desire to *target* house prices, but more over the potential risks to macroeconomic stability from a major boom – and possible bust – in the household sector's main asset class.

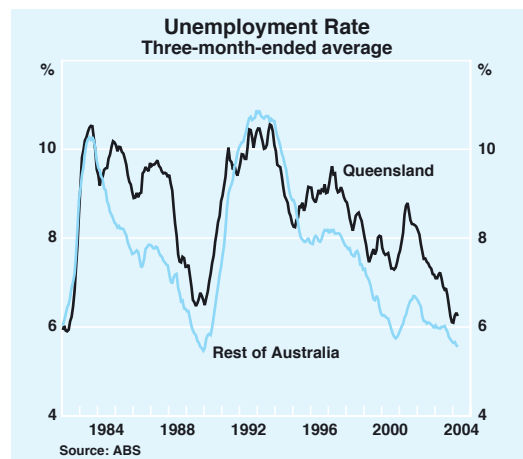
On the most recent readings, there has been a distinct softening in most of the major housing markets, with more than one data series showing an outright fall in prices in the March quarter in several cities (Graph 12). This was associated with a decline in the demand for credit, though on the most recent data that demand still seems very strong. House prices in Brisbane and the Gold Coast declined a little on these measures, though not by as much as those further south.

In our judgement, this is a welcome development. While various fundamental reasons can be advanced for dwelling prices to have risen noticeably in the 1990s, it was hard to avoid the conclusion that strong

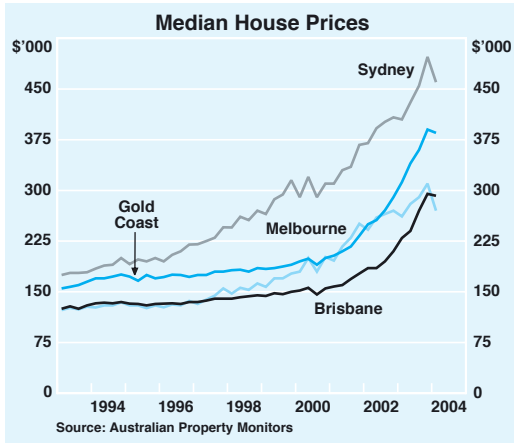
Graph 10



Graph 11



Graph 12



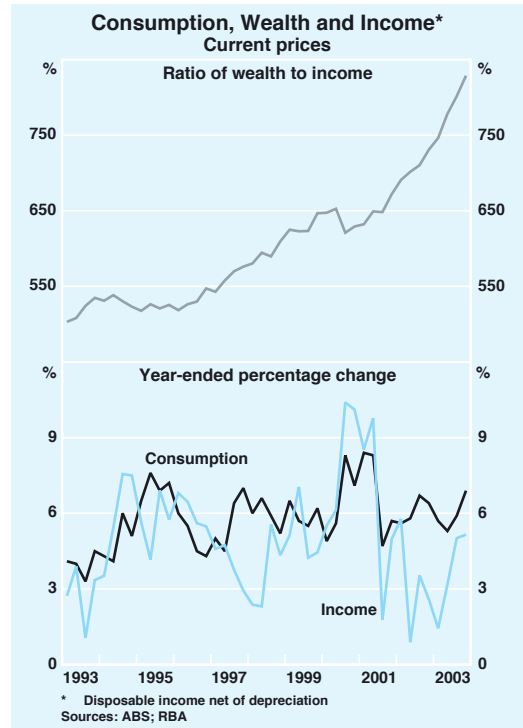
speculative forces were at work over the past couple of years. That was not a healthy state of affairs and the sooner it passed, the better.

It is just about impossible, of course, to predict with any precision how all of this will unfold from here. Much will depend on what else is occurring in the economy. In individual cases, the extent of leverage will be very important. My own view is that the palpable sense of disappointment being felt by many leveraged investors in residential property is likely to grow further for the next year or so, possibly longer. For many owner-occupiers, on the other hand, a moderate decline in prices should not create major discomfort, in an environment of ongoing growth in employment and wages, as well as reduced taxes. In fact, it is hard to imagine a much more benign backdrop for the aftermath of an asset and credit boom than one where growth in employment and income is continuing, the world economy is picking up and the Australian economy is relatively free of other domestic imbalances.

Even so, we anticipate that housing market developments will be a factor at work in reducing the rapid pace of growth in domestic spending to something more moderate. Rising house prices and the capacity to collateralise the higher wealth has accommodated a rise in consumption which has consistently outpaced the rise in income over several years

(Graph 13). In a world where dwelling prices have stopped rising and even declined somewhat, perceptions of ongoing rapid increases in wealth are presumably now in the process of dissipating. This will weaken positive wealth effects, and could possibly lead to a partial reversal in time. On the other hand, the earlier increases in dwelling prices were very large, and even with the latest data showing declines, a big cumulative rise in wealth has occurred over the past decade, most of which has not been tapped. So there may yet be some expansionary impetus in the pipeline from those earlier gains.

Graph 13



The net effect is therefore hard to judge, but on balance, we are inclined to think that consumer demand will grow more in line with income over the next year or two – that is, by something less than last year’s cracking pace. That, together with some decline in dwelling construction activity, will result in slower growth in overall domestic spending.

With the world economy doing quite well, on the other hand, external demand is expected to be stronger – the international environment will be boosting Australia, rather than restraining it. It is encouraging that this picture seems, slowly, to be emerging in the available data. Risks to this outlook stemming from a rising Australian dollar have abated somewhat of late. The result then is expected to be good growth overall, and more balanced growth (as between external and domestic demand) than seen for some time.

Inflation will be affected over the period ahead by the fluctuations in the exchange rate and oil prices, but most likely will be consistent with our 2–3 per cent medium-term target. Internationally, the scene has turned (in the space of only 12 months) from one of concern about *deflation* to one of *inflation* going higher. Fears of widespread deflation were, in my view, always a little overdone, and the swing in some quarters to fear of inflation might also be unduly

pessimistic. Nonetheless, it seems we are in a new phase of the international cycle and these developments will bear close watching. At this stage for Australia, though, prospects seem to be for acceptable inflation performance over the coming year or so. I will leave further elaboration of the Bank's view of the outlook, since the Governor will do this on Friday.

Conclusion

Overall, this is a pretty positive picture for the Australian economy. 'Beautiful one day, perfect the next' would perhaps be an overstatement. But generally good economic conditions offer, I trust, ample opportunity for profitable enterprise on the part of CEDA members and others here in Queensland. I wish you every success. ✧