



RESERVE BANK OF AUSTRALIA

THE ECONOMIC LANDSCAPE IN 2009

Malcolm Edey
Assistant Governor (Economic)

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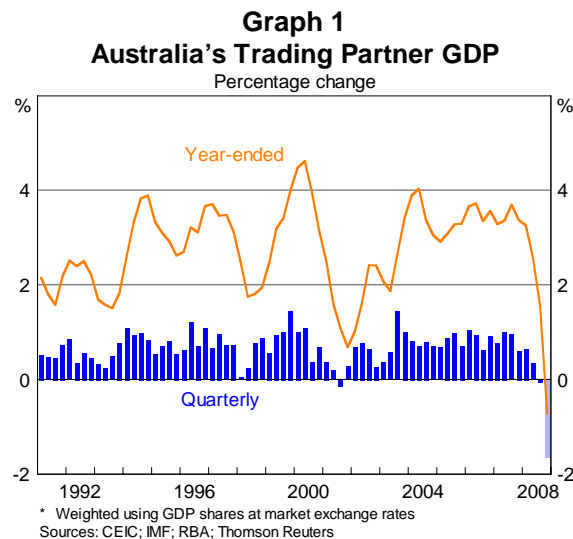
Thank you to Australian Industry Group for the invitation to speak here today.

I'd also like to take the opportunity to say how much I appreciate the good working relationship that we've had with Australian Industry Group over the years. Talking with businesses is a very important part of our work at the RBA and an important input into our reading of the economy. That's especially so at a time when the situation is changing as quickly as it has been in the last few months.

When I spoke here a year ago, I commented on the contrasting trends that were being observed across different parts of the global economy. It was already apparent at that time that the United States and a number of the other advanced countries were entering a period of significant weakness, flowing from the early effects of the financial crisis. In contrast to that, China and much of the developing world were still growing rapidly. They were generating strong domestic demand and that was, in turn, underpinning global demand for commodities. Australia was one of the main beneficiaries of the high commodity prices that resulted from that.

That was the situation a year ago and, in broad terms, these conditions persisted well into 2008. Up until the September quarter, China and the other developing economies in Asia mostly kept growing reasonably firmly, and world commodity prices were still close to their peaks.

But events since then have taken a sharp turn for the worse. In the December quarter, the downturn in the G7 economies intensified, and at the same time it spread to other parts of the world, including Asia, Latin America and eastern Europe.



Based on the information available to date, we estimate that GDP in Australia's major trading partners contracted by 1½ per cent in the December quarter. The falls in output were widespread, but they were particularly pronounced in the Asian region. Output in Japan fell by 3 per cent in the quarter, and contractions of the order of 6 per cent were recorded in Korea, Taiwan and Thailand. China's economy continued to grow, but at a much reduced pace. For the smaller Asian economies, these recent falls in output are comparable to what occurred in the 1997 crisis period. For Japan, it's the biggest fall since 1974.

	Per cent	
	Share of Australia's merchandise exports	GDP growth Dec quarter
Japan	19.3	-3.3
China	14.9	0.6
Korea	7.9	-5.6
Euro area	6.2	-1.5
United States	5.9	-1.6

There were a number of factors that contributed to this sudden deterioration. The most obvious trigger was the collapse of the US investment bank Lehman Brothers in mid September. It was followed, in fairly quick succession, by a string of other announcements of the failure or near-failure of institutions in the United States and Europe. The general turmoil was heightened by intense uncertainties about the nature and scope of various rescue proposals that were being put forward by the governments concerned.

These events brought on a large-scale re-evaluation of financial risk around the world, and a major loss of confidence, both in financial markets and amongst households and businesses. In the weeks that followed, particularly through October and November last year, equity markets recorded some of their largest daily movements in history. In net terms, they fell by around 30 per cent over that period. They have since fallen further, though at a slower rate.

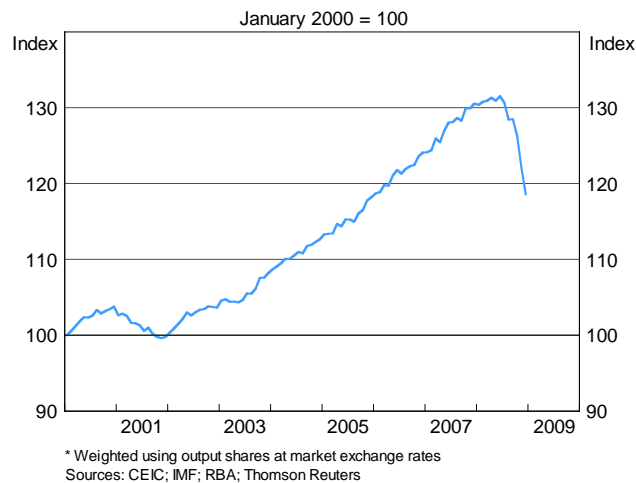
Graph 2
US Share Prices



The financial turmoil was accompanied by a sharp decline in survey-based measures of business and consumer confidence around the world. Households and businesses seem to have made a rapid re-appraisal of their spending plans, and in particular they cut back their discretionary spending. One very clear example of that was a sharp drop in the demand for motor vehicles in the final months of last year.

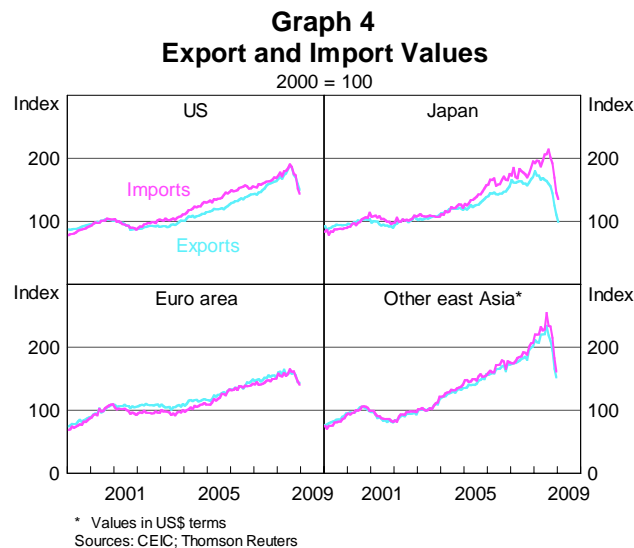
In fact, demand for manufactured goods has weakened more generally. We can see the effects of that on global industrial production. After growing at an average rate of about 6 per cent per annum over the last few years, it fell by 10 per cent from its peak over the final months of 2008.

Graph 3
Global Industrial Production*



So the shock to confidence that followed the Lehman collapse seems to have been a major factor in the recent global deterioration. But there were also other factors at work. One was a further tightening in credit standards in the major economies. This showed itself, among other things, in disruptions to trade credit and insurance, and in a tightening of lending for consumer and business spending.

Another factor was the rapid transmission of these effects around the world through trade linkages, as businesses cut back on production in response to reduced orders. The graph illustrates the unusually large falls in exports and imports that were recorded across the major economic regions in the final months of last year. This included export falls of the order of 20 per cent or more in Japan and some of the smaller east Asian economies. Thirdly, there seems to have been a sharp inventory adjustment in a number of countries, as firms cut back production in response both to weaker-than-expected demand and reduced availability of working capital.



Most of the gloomy economic news that I've just described relates to the December quarter of last year. We don't yet have sufficient data to get a good reading on the trends that might be emerging in the early part of 2009.

But, in thinking about the outlook, it's important to recognise that governments and central banks around the world have taken some very significant steps to support growth. Interest rates have been cut to low levels in most countries, and there are some very large fiscal policy initiatives in the pipeline around the world. In a number of countries, including the United States and China, discretionary fiscal expansions of the order of 2 per cent of GDP look like being implemented in the next couple of years.

Table 2: Discretionary Fiscal Easing – Selected Economies

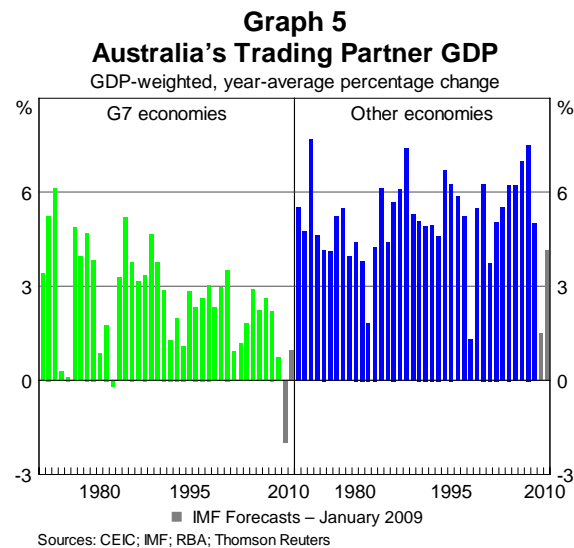
	Per cent of GDP	
	Estimated easing*	
	2009	2010
United States	1¼	2¾
United Kingdom	1¼	½
Germany	1½	¾
Japan	1¼	-
China	over 2	over 2
South Korea	over 2	over 2
Taiwan	over 2	over 2
Australia	2¼	1¾

* Based on policy announcements and media reports

In addition to that, the major economies have taken a range of steps to provide direct assistance to their financial sectors. These have taken several forms – including central bank actions to improve access to liquidity, direct injections of capital into financial institutions and the provision of government guarantees.

More needs to be done in the major countries on this front. But there are some tentative signs, at least, that these steps are contributing to some improvement in the functioning of financial markets. The extreme volatility that followed the Lehman collapse has eased off in the last couple of months. And the availability of government guarantees has seen a recovery in bond issuance by banks around the world. This is helping to put banks in a position where they can be more confident of their long-term funding.

Overall, there's no doubt that 2009 is shaping up as a very difficult year for the global economy. IMF forecasts released in late January were for world growth of half of 1 per cent this year, with the G7 economies contracting by 2 per cent. If these forecasts are realised, it would amount to the weakest year for the global economy, and for the advanced industrial countries, in the post-war period. The forecasts do, however, imply some pick-up towards the end of the year and into 2010 as the expansionary measures take hold.

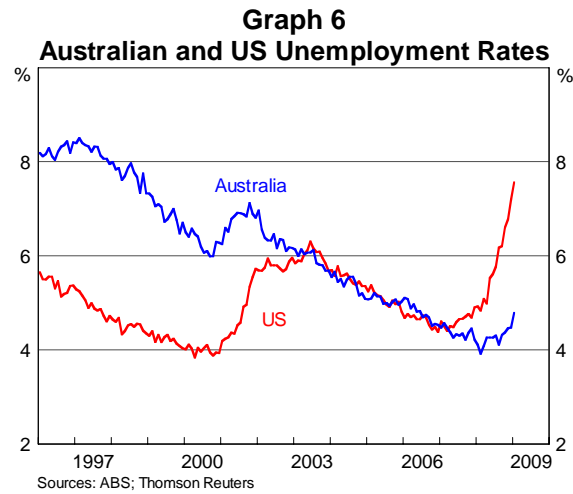


How are these global developments affecting Australia?

Given the abrupt deterioration in the world economy, it won't be possible for Australia to avoid significant short-term weakness. We'll have some more information later today, when the national accounts are released, about how the economy performed in the December quarter.

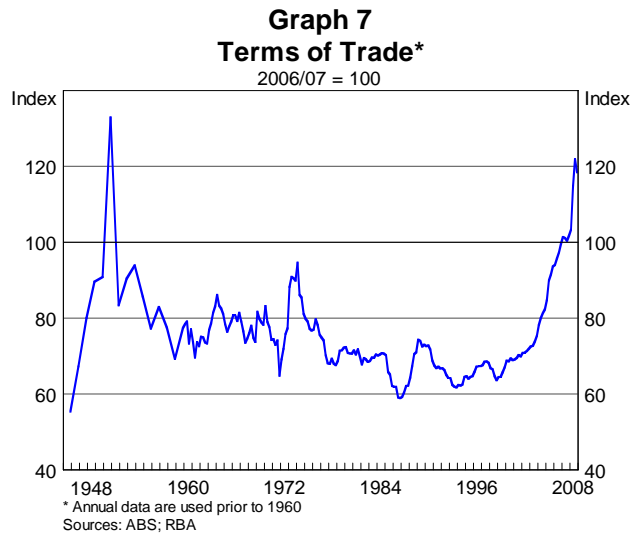
But prior to receiving that, it's worth noting that the Australian economy came in to this crisis period with stronger momentum than most other advanced economies. On the latest figures we have (which of course are subject to revision later today) GDP expanded by just under 2 per cent over the year to the September quarter. Comparable figures for other economies over that period were 0.7 per cent growth for the US, a similar figure for the euro area, and a contraction of 0.2 per cent in Japan. Growth of domestic spending in Australia over the year was even stronger, at 4 per cent.

Labour market indicators, which are more up to date, suggest that, even though conditions have weakened recently, the Australian economy remained more resilient than many others. Total employment was up by 1 per cent over the past year. The unemployment rate has started to rise, but it's still historically low.



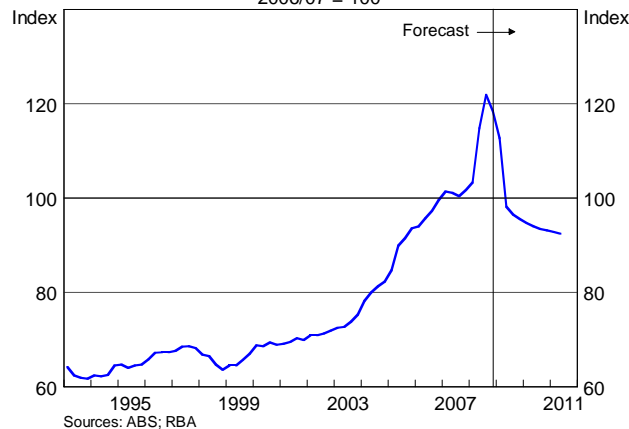
Nonetheless, recent events clearly represent a major change to the environment for the Australian economy from the one prevailing as recently as six months ago.

One important dimension of that is the effect on Australia's terms of trade – the ratio of our export to our import prices. In broad terms, the recent movements summarise the effect on national income from the changing relative price of Australia's resource exports. Over the past five years, rising world commodity prices have lifted Australia's terms of trade by an average of 10 per cent per annum – the largest cumulative increase since the early 1950s. In the year to the September quarter, which is when the peak was reached, the increase was 20 per cent. The effects from all this have been seen, among other things, in the boom in mining and construction over recent years, with significant spillovers to the rest of the economy.



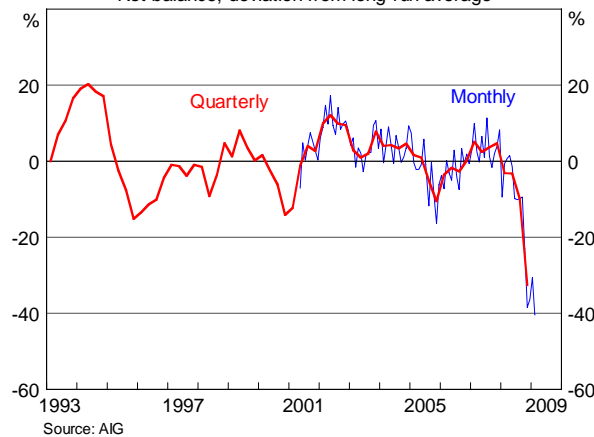
It now looks likely that this last 20 per cent rise will be roughly reversed in the year ahead. That will still leave the terms of trade at a high level, but in the near term, it means this effect will be subtracting from, rather than adding to, the growth of national income. On a more positive note, it's worth pointing out that the very sharp falls in resource commodities prices that occurred in the December quarter don't seem to have continued in the early part of 2009.

Graph 8
Terms of Trade
2006/07 = 100



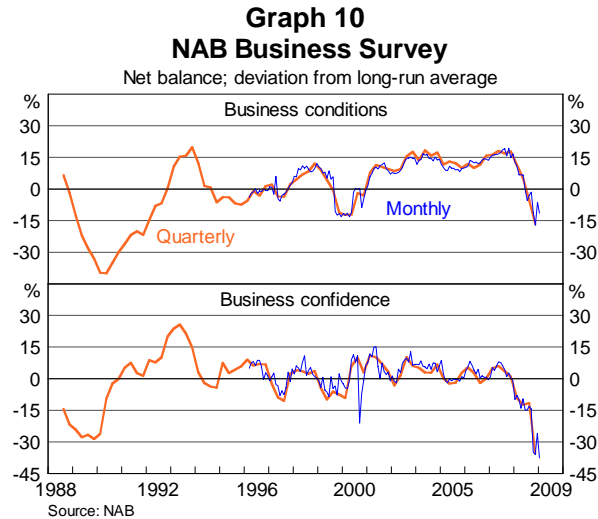
Another way that the global crisis has begun to affect Australia has been the impact on business and consumer confidence. The survey of manufacturers conducted by Australian Industry Group shows that there's been a sharp decline in perceptions of current conditions over recent months, with the biggest falls happening in October and November. That result is not surprising, given the drop in global demand for manufactured goods that I discussed earlier.

Graph 9
AIG - Performance of Manufacturing Index
Net balance; deviation from long-run average

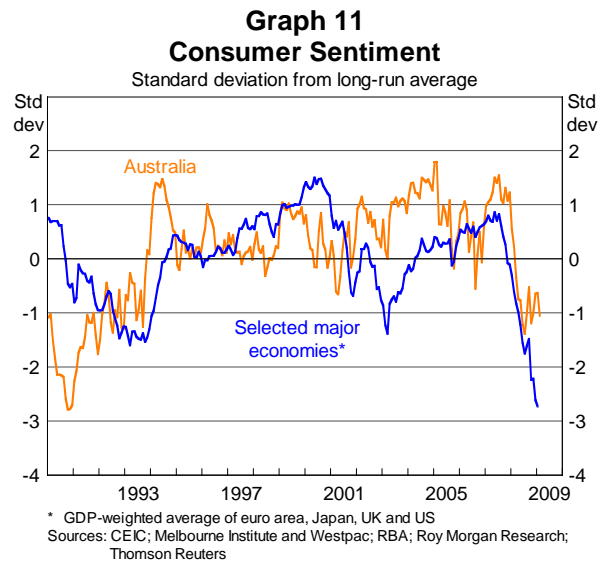


The broader NAB survey, which has a longer history, reports that confidence across the non-farm economy has fallen to levels comparable to the trough reached in the

early 1990s. It's interesting to note, though, that the indicator of actual business conditions from the same survey has fallen noticeably less, by an amount more akin to the slowdown in 2001.



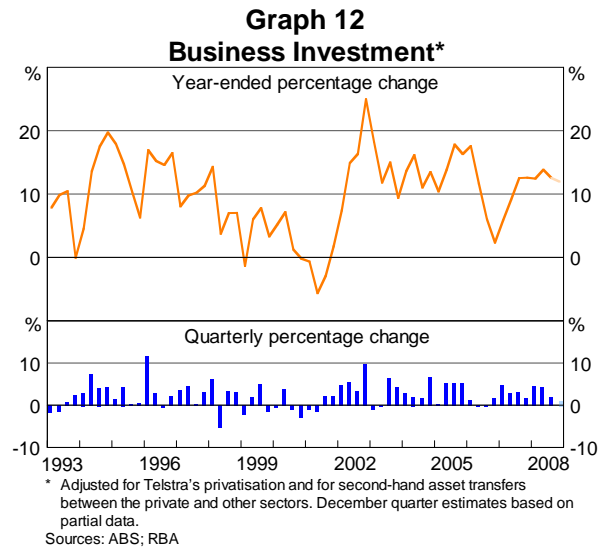
Consumer confidence also fell during this period. But relative to history, the fall in Australia seems to have been less pronounced than what has occurred elsewhere.



Overall, these falls in confidence can be expected to weigh on spending decisions in Australia, as they have elsewhere in the world. But I'd like to make a couple of more positive observations.

First, regarding the business sector, last week's capital expenditure survey reported continued strength in investment spending through to the end of 2008. In fact the recent period has been one of remarkably strong investment, with growth averaging

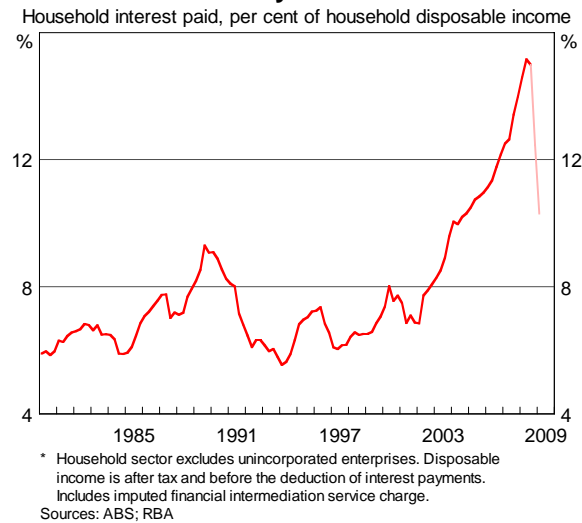
in the double digits for the past five years. The high level of investment will in turn have longer-term benefits for the growth of Australia's productive potential.



It's to be expected that, in an environment of weak global demand, falling commodity prices and reduced confidence, investment plans are going to be wound back. The expectations component of last week's survey confirmed that, as have a range of earlier private-sector surveys. I don't want to downplay all that, but it's worth making the point that investment spending in Australia did finish 2008 with a surprisingly strong overall momentum, given the very unfavourable global backdrop.

A second point to keep in mind concerns the household sector. At present, household disposable incomes are getting a substantial boost from the combination of falling net interest payments, fiscal transfers and falling petrol prices. We estimate that in the past two quarters, household interest payments have fallen by an amount equivalent to about 5 per cent of disposable incomes – a sizeable cost reduction especially over so short a period. I recognise that these effects are not evenly spread across households. For households who are interest receivers, there is a loss of income from that source. But for the sector as a whole, the net effect is a significant addition to disposable income, which in turn can be expected to support spending.

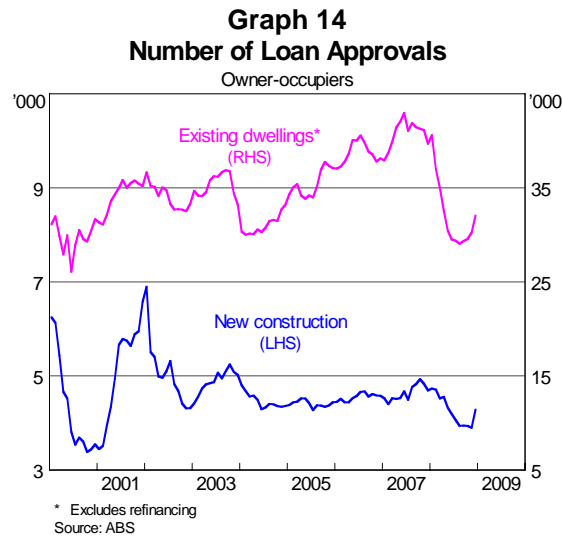
Graph 13
Interest Payments Ratio*



In addition to that, fiscal transfers of the order of 3 to 4 per cent of incomes are being paid out to households through the December, March and June quarters.

The main effects from these income gains still lie ahead, but we saw some early effects with a sharp rise in retail sales in December. We learned yesterday that those gains were maintained in January, with a further rise in sales occurring in the month.

As we think about prospects for the Australian economy, the RBA has also been making the more general point that our financial system is in much better shape than its overseas counterparts. The reason why we have been able to have the large reduction in household interest costs that I just described is that the monetary transmission mechanism is working. Reductions in the policy interest rate have flowed through substantially to end borrowers. That hasn't been the case to anywhere near the same extent in the United States and some of the other major economies. We're seeing some early effects of these interest rate reductions on household demand for finance, with loan approvals starting to pick up over the final months of 2008.



Let me summarise briefly.

There's no doubt that world economic conditions deteriorated sharply in the final months of last year. Governments and central banks around the world have taken actions to support growth in response to these events, and to assist their financial sectors. But these measures will take time to work, and 2009 is looking to be a very tough year for the global economy.

Australia is being affected by these events. The international deterioration has been so abrupt that it won't be possible to avoid some short-term weakness here. Nonetheless, Australia came into this period with better momentum than most, and with more scope than most to take expansionary policy measures. That scope is being used. The transmission channels are working, and we can expect the measures that have been taken will increasingly support demand as the year goes on.

Thank you again to Australian Industry Group. It's been a pleasure to participate in this event over the years, and I thank you for the invitation today.