Economic Policy after the Booms

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Thank you for coming out to support the Anika Foundation[1] once again. This annual occasion is one of our key fundraising events and your generosity is greatly appreciated. Today would not be possible without the support of The Australian Business Economists and the Macquarie Securities Group, and so on behalf of the Board of the Anika Foundation, I thank them for their continuing contribution to combating adolescent depression and suicide.

Introduction

We have for the past five years or so lived in 'interesting times'. The shocks to which the economy has been subject have had larger magnitudes than had been the case during 'the great moderation'. The world economy, our terms of trade and the international availability of credit have been a good deal more variable since 2007. For example, the variability of world GDP has roughly doubled – compared with that in the decade or so prior to 2007 – while the volatility of Australia's terms of trade has, on some metrics, quadrupled. In response, our interest rates and exchange rate have also been more variable.

There hasn't been much additional variation, though, in the real economy or the rate of unemployment. Depending on your preferred measure, the variability of real GDP has either increased a little, or declined slightly; a similar story holds for the unemployment rate. There was a pronounced cycle in inflation, peaking in 2008, but since then inflation has been much better behaved. This suggests that the various policy responses and the economy's own adjustment capacity have generally been working as they should towards stabilising overall outcomes, in the face of the much bigger external shocks we have faced.

That said, achieving the sort of growth we aspire to has become more difficult. Average output growth has been lower over the past five years in Australia, as it has in all other advanced economies. Moreover, the challenges ahead are substantial and will require the appropriate responses. In shaping those responses, we need to be sure to draw the right conclusions and lessons from the experiences of recent years. In that vein, as I offer some remarks about the period ahead, I will also draw on those conclusions from recent history that seem pertinent. In so doing I shall be reiterating some themes I have touched on before, including at earlier lunches in this series.

The Resources Boom

It is now well understood that the 'mining boom' is shifting gear, and that we are entering a new phase.

The story of the boom has always had three phases.[2] In the first phase, commodity prices rose to very high levels. As a result, Australia's terms of trade rose to levels not seen in a very long time. These prices had a hiatus in 2009 with the global downturn but resumed their upward trend quite quickly.

In historical context, the high prices have been quite persistent.[3] This led to the second phase, in which resource producers ramped up their investment to take advantage of demand for raw materials, in particular iron ore and natural gas, and to a lesser extent coal. Resource sector investment rose from an average of about 2 per cent of GDP, where it had spent most of the previous 50 years, to peak at about 8 per cent. That big rise is now over, and a fall is in prospect, with uncertain timing. It could be quite a big fall in due course.

The third phase is now under way, in which we will see investment spending fall back, but a lift in volumes shipped of the various commodities. The latter has already started – for iron ore, volumes are rising at about 15 per cent per year – but shipments will probably increase further yet for some time and then stay high. Shipments of natural gas will not start increasing strongly until 2015, and will probably have several years of very strong growth, and then remain high for a few decades.

In that third phase, real GDP will get a lift. National income measured in current dollars will also get a lift from the higher volumes, but that is likely to be offset in part, at least, by lower prices. The lift in real GDP coming from this rise in exports will be driven more by higher output per person; in fact, the level of employment needed to extract and ship the materials will be less than the level needed to build the capacity to do so.

Let's be clear that Australians will continue to benefit from the higher level of resources output for a very long time. There has been a large lift in the global demand for natural resources that our country happens to have in abundance. Most people agree that the *rate of growth* of that demand will be lower in future than it has been in recent years; some say much lower. But the lift in the *level* of demand we have already seen is permanent enough, and large enough, to have a quite persistent effect on our economy. Australian production is meeting much of the additional global demand for iron ore and, prospectively, natural gas. This will be at prices that, although lower than prices observed today, are likely to be higher than the average seen for many years up to the middle of the past decade. Even allowing for the high degree of foreign ownership in the resources sector, flows of income accruing to Australians, through a few different channels, will be high over a long period.

The end of the second phase, the investment phase, of the boom is nonetheless quite a challenging time. The investment spending by the resources sector will no longer be adding to growth in demand in Australia. In due course it will, instead, be subtracting from it. To be sure, a significant part of that investment spend has been supplied by imports, and to that extent its decline will affect imports rather than domestic production. But even allowing for that, there has still been substantial demand for Australian product and labour from the resources sector, which appears likely to abate over the years ahead.

Since we wish to see aggregate demand in the economy sufficient to utilise the productive resources of labour and capital that we have, this means that we would like to see a ‘rotation’ to other sorts of demand as the resources sector demand slows. The ‘post boom’ growth story of the economy would desirably involve stronger expansion in some other sectors, including those that have seen weaker than normal conditions in the past couple of years.

It is reasonable to expect that there will be some pick-up in these other areas, for reasons I have outlined elsewhere.[4] In brief, business capital spending outside the resources sector has been subdued; housing investment likewise has been on the low side. There is ample scope for both to rise. This is by no means a certainty though and while there are signs of an increase in dwelling investment getting under way, a stronger trend in non-resources business investment looks like it is a while off yet.

For a benign outcome to occur, a few things need to be in place. Reasonable global growth outcomes obviously would be a major help. At this stage global growth is sub-par, though not disastrous, with most forecasters saying next year will be better. Most of them quickly add a long list of things that could go wrong. There is nothing we can do about that.

The second condition, which we can do something about, is that macroeconomic policy settings need to be appropriate. Fiscal policy is in consolidation mode, and that seems broadly appropriate. Monetary policy is, by historical metrics at least, very accommodative. The exchange rate has also declined since its recent highs, and doubts about whether it will play its normal role as a shock absorber have lessened of late.

A third condition is that Australian businesses need to be internationally competitive. The exchange rate is helping here but productivity and cost performance will also be key. On these fronts, I think firms have stepped up their efforts considerably.

This combination is a necessary, though not in itself sufficient, set of conditions for the sort of demand rotation likely to be necessary.

The fourth ingredient is ‘confidence’. It is somewhat concerning that the business community's confidence has been quite subdued in recent times. To the extent that substantial structural change has been occurring, and there is inevitable uncertainty over the international outlook, it is quite understandable that some business segments have found the going hard and don't feel very confident. Moreover, the phase shift of the mining boom itself is dampening confidence in some areas.

That said, it would be good if there was a bit more confidence in the business community about the future. Unfortunately, it is not a straightforward thing to turn sentiment around. There's no such thing as the ‘confidence policy lever’. Rather, we have to rely on:

- clarity of policy frameworks and objectives;
- consistent application of policies towards well-understood goals; and,
- attention to avoiding things that can dampen confidence unnecessarily.

All the more reason, then, to make sure that the accretion of regulatory actions being undertaken does not inadvertently make it harder for businesses to plan with confidence, to achieve better cost and productivity performance, or to take a chance on a new product, a new investment or a new worker.

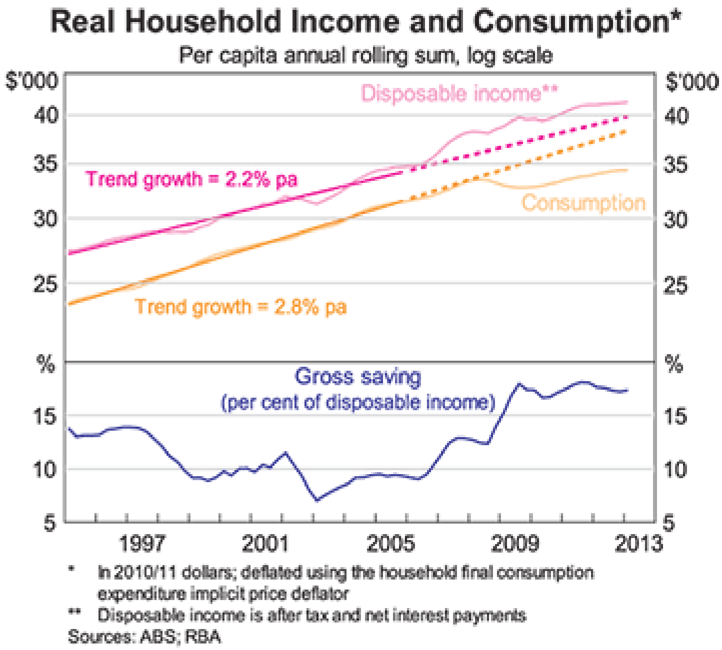
In the case of households, according to surveys sentiment is neither particularly weak nor particularly strong at present. It is reasonable to expect that households will play a role in driving demand over the years ahead – and in due course that will help to lift business confidence. But in thinking about that role we need to understand the ways in which household behaviour has changed.

The Credit Boom

The title of this talk, ‘Economic Policy after the Booms’, uses the plural quite deliberately. There were two ‘booms’. Before the mining boom, or at least before its full flowering from about the middle of last decade, there was an earlier boom. It was global, but Australians took part in it. I am referring of course to a boom in credit, which saw a very significant increase in borrowing by households in particular, and a rise in asset values, especially dwellings. This was associated with a lengthy period of unusually strong growth in consumption.

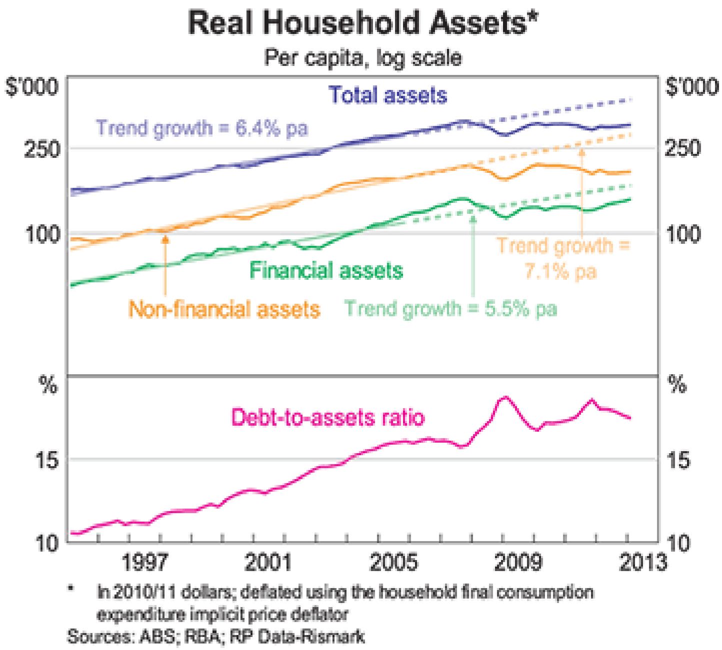
This boom did not end in Australia as painfully as it did in some other places, but end it did. Consider two charts I showed at the Anika Foundation lunch two years ago in July 2011. These have been updated, and use revised data.[5]

Graph 1



[Click to view larger]

Graph 2



[Click to view larger]

It is even clearer now than it was two years ago that the behaviour of households has changed in a very important way. Real consumption per person had risen faster than real income per person for 30 years, from the mid 1970s until about 2005. (Only the last third of that period is shown here.) That changed some years ago now, and after a noticeable fall in consumption in late 2008 and early 2009, spending and income have grown roughly on parallel tracks. Since 2009, trend growth in per capita consumption has been about 1.4 per cent per annum, half what it had been from 1995 to 2005.

One contributing factor is seen in the second of the two charts, where it's clear why people's sense of wealth has not been rising at anything like the pace that it had been up until the financial crisis. Financial assets have begun to grow again, since the share market has risen over the past year and households have also accumulated other financial assets such as deposits. But the value of non-financial assets in particular – mainly dwellings – is lower today in real per person terms than it was five years ago. Total assets per person have risen at a pace of 2½ per cent in real terms since the middle of 2009, which is much slower than in the preceding decade, and even a bit slower than in the period 1975–1994.

The slowdown in asset values has been associated with a lift in saving and a slower path for consumption, which has had important implications for the economy. The table below suggests that slower consumption growth is prominent in explaining the slower pace of overall demand growth and output since the middle of 2007.

Table 1: Contributions to Australian GDP Growth*
Per cent per annum

	1995–mid 2007	**mid 2007–2013**
Domestic Final Demand	4.1	2.9

(*) Components are not additive given nature of the chain-volume series.
Sources: ABS; RBA

Table 1: Contributions to Australian GDP Growth*
Per cent per annum

	1995–mid 2007	**mid 2007–2013**
Consumption	2.3	1.4
Business Investment	1.1	1.1
Mining	*0.3*	*1.0*
Other Industries	*0.9*	*0.1*
Dwelling Investment	0.2	0.0
Public Demand	0.9	0.6
Gross National Expenditure	**4.0**	**2.8**
Net exports	**−0.2**	**−0.2**
GDP	**3.7**	**2.5**

One's assessment of prospects for consumption will be driven mainly by one's assessment of the outlook for income, but will also be affected by expectations about asset values and in particular one's view on whether housing prices are overvalued. Those who think they are will be drawn to the conclusion that a number of additional years of flat or declining real per capita asset values lie ahead, for non-financial assets at least; those who are not so worried about housing prices may expect that stronger growth, in real per capita terms, might occur.

Either way, however, it would seem unlikely that we could bank on a resumption of sustained growth in assets, in real per person terms, of 7 per cent per year over the next few years. It follows that the saving rate is unlikely, any time soon, to decline back to where it was in 2005. Average saving rates well above that earlier level seem more likely for some time, even though there will presumably be cyclical ups and downs. While current saving rates have been described as ‘high’, a look at longer-run history suggests that ‘normal’ would be a better description.

Implications that might flow from these observations would include the following.

First, *some* strengthening in consumption from recent rather subdued growth rates is a reasonable expectation, but we should not expect a return to the sorts of growth seen in the 1995–2007 period. Nor, surely, should we try to engineer one, at least *on the back of borrowing*. Households continue to service their borrowings well – the household arrears rate is low and has fallen slightly over the past year – but we would be risking future problems were we to see a big run-up in debt from here. This does not preclude prudent levels of borrowing by new entrants to the housing market, or by investors, nor does it preclude gains to consumers as costs are squeezed out of the system. It doesn't mean that consumers won't respond with their customary alacrity to new products offered at attractive prices. Trend changes in habits – more consumption of services and ‘experiences’, more online shopping and so on – will presumably continue. Moreover, factors that lift disposable incomes – such as higher real earnings on the back of productivity improvements, or sustainable reductions in taxes – could be expected to lift consumption on a sustainable basis. But we are unlikely to see a return to the earlier boom conditions.

Second, all other things equal, interest rates are likely to be lower in such a world than they were in a world in which households were extending their finances. This is a global phenomenon, but it holds in Australia too. A higher desired rate of saving *ex ante* means that the return to saving will, other things equal, be at a lower level as the market clears. Those who have long been savers no doubt feel aggrieved that the returns they have earlier enjoyed cannot be found as easily now. That is in large part because other savers have joined them and the market prices reflect that. Having said that, it is still possible to earn a gross interest rate on a bank deposit that is a bit above the inflation rate.

Third, a desire to hold savings in a less risky form means that the yield give-up to hold a safer asset is larger. The way this is usually expressed is that lower risk appetite, or perhaps more accurate assessment of risk that was there all along, means risk spreads are higher. Spreads are well down on their peaks reached at the height of risk aversion a few years ago, but do seem to have settled at a higher level than in the mid 2000s.

Absolute borrowing costs for most borrowers are very low despite higher spreads, because the return on one of the least risky assets – the cash rate – is the lowest for 50 years or more. The market yields on government securities, the lowest risk assets of all, have likewise been very low. In other words, with many investors wanting safety, the price of safety has risen. It has to rise by enough to prompt at least some people to start to shift their portfolios in the direction of taking *some* more risk – by holding equities, physical assets and so on, though obviously we don't want *too much* risk-taking. One of the things we have been watching for as we have been reducing interest rates has been an indication of savers shifting portfolios towards some of the slightly more risky asset classes, as that is one of the expected and intended effects of monetary policy easing. There are clearly signs of policy working in this respect, though not, to date, by so much that we see a serious impediment to further easing, were that to be appropriate from an overall macroeconomic point of view.

Policy after the Booms

In the third phase of the 'mining boom' and post the credit boom, our economic challenges are changing in nature. In the next few years our task will involve supporting, so far as it is in our power, a change in the sources of demand that affect the economy. As resources sector investment declines, other sources of demand need to strengthen, but in a way that is sustainable. The fact that consumption is likely to provide only a modest impetus to any acceleration in domestic demand suggests that other areas will be important. As I noted earlier, at least some of the conditions are in place for stronger trends in dwelling investment and, in time, non-resources business capital expenditure. And exports of resources will continue to pick up strongly.

But successful 'rotation' of demand will probably also involve more net foreign demand for other Australian output of various kinds. Given that, the recent decline in the exchange rate seems to make sense from a macroeconomic perspective. It would not be a major surprise if a further decline occurred over time, though of course events elsewhere in the world will also have a bearing on that particular price.

The conduct of monetary policy must, and does, take account of the various features of the environment we face. Calibrations drawn from an earlier part of history can't be assumed to have the same reliability. Elements of the monetary policy transmission process are probably working somewhat differently than on other occasions. To take one example, the fact that policies in major economies have been at very unusual, or extreme, settings for some time is a complication because of the potential effects on the exchange rate – though, as noted, the exchange rate appears to have been behaving more normally of late.

The fact that the rest of the world has had such low interest rates, that the desire for safe assets has been so strong, that the spreads between the cash rate and the rates that matter most for the economy have widened, and that people have sought to get to a position of lower leverage – all these have been important in explaining why the cash rate has been so low compared with what we had been used to until the mid 2000s. That this has occurred while we have had the peak of the resources investment boom is all the more remarkable.

This has been guided by the flexible inflation targeting framework we have had in place for 20 years now. This framework has prompted appropriate and timely action when needed. It has seen a substantial easing in monetary policy since late 2011. We have been saying recently that the inflation outlook may afford some scope to ease policy further if needed to support demand. The recent inflation data do not appear to have shifted that assessment.

More generally, the credible and sensible approach to policies is:

- to keep our eyes on the main objectives;
- to preserve sound frameworks;
- to act consistently with these frameworks and in ways that support confidence; and,
- to keep looking for ways to enhance the flexibility the economy itself has demonstrated in adjusting to the shocks of recent years.

Failure to do this would be costly. But the rewards from consistent application of good policies are known, from our own experience, to be big, even if not immediate. Remembering that is the challenge we face.

Thank you once again for coming along today.

Endnotes

1. See Anika Foundation. [back to text]
2. See Stevens G (2012), 'Producing Prosperity', RBA *Bulletin*, December pp 81–87. [back to text]
3. At this point the terms of trade have fallen by 15 per cent since the 2011 peak (back to their 2008 peak!). Assuming a further fall of 15 per cent over the next few years, the terms of trade will still have a 10-year average level 50 per cent higher than the 20th century average. [back to text]
4. Stevens G (2013), 'Economic Conditions and Prospects', Address to the Economic Society of Australia (Queensland) 2013 Business Luncheon, Brisbane, July. [back to text]
5. The level of household financial assets from June 2002 has been revised almost 15 per cent higher on average, predominantly reflecting upward revisions to estimates of households' holdings of unlisted equity. As a result, the debt-to-assets ratio has been revised lower by 0.8 percentage points on average. Trend growth in household assets was also revised slightly lower. In contrast, growth in household disposable income

was revised slightly higher, leading to a small upward revision in the saving ratio in the 2000s. [back to text]