



RESERVE BANK OF AUSTRALIA

SOME CHALLENGES FOR THE FUTURE

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SOME CHALLENGES FOR THE FUTURE

As is now well known, the Australian economy has come through the worst global downturn since at least World War II better than expected, and in sounder shape than most other advanced economies. As a result, many of the economic challenges that we are likely to face over the next few years look to be quite different from those facing most of the other advanced economies.

This morning, I would first like to talk about how we found ourselves in this relatively favourable position, and in particular about the importance of flexibility. I would then like to touch on three of the broad challenges that are likely to lie ahead. The first of these is the need to expand the supply side of the economy. The second is the need to increase the supply of housing for a growing population. And the third is the need to ensure that inflation remains low and stable.

The Importance of Flexibility

Before I look to the future though, it is useful to understand how we got to where we are now.

The various factors that have contributed to Australia's relatively good economic performance are now well understood. They include: the substantial and early easing of both monetary and fiscal policy; the healthy state of our banking system; the rapid rebound in Asia, and in particular China; the depreciation of the Australian dollar in 2008; and the relatively high rate of population growth.

Collectively, these factors helped us get through an extremely difficult period in the world economy. We should not lose sight, though, of the fact that they didn't insulate us completely from the global recession; the clearest example of this is the fall in GDP of almost a full percentage point in the final quarter of 2008. But overall, it is fair to say that we have come through this downturn in much better shape than was widely expected. The latest evidence of this was in the GDP figures last week, which showed that the economy expanded by 2¾ per cent over 2009.

There are various lessons that one can draw from the experience of the past 18 months, but the one that I want to highlight today is the importance of flexibility. Here, there are two aspects that are important: the first is the general flexibility of the economy to adjust to changes in the external environment; and the second is the flexibility that economic policy had to respond to changes in this environment. Without both of these aspects, the recent economic history of Australia would have been quite different.

This flexibility, though, did not just materialise out of thin air. Instead, it was the result of many years of policy reform and hard work by governments and business. What we have seen recently is the dividend of that hard work, with the economic outcomes over the past year or so reflecting not just the decisions made since late 2008, but also the decisions made in the two to three decades before that.

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I would like to touch on a few aspects of this flexibility.

The first is the flexibility of the exchange rate.

This has been one of the great success stories of economic policy making in Australia. Without it, we would have seen bigger booms and busts and more variable and, probably, higher inflation. As Ric Battellino, the RBA's Deputy Governor, discussed in a speech a couple of weeks ago, the floating exchange rate has helped the economy adjust more smoothly to the current boom in the resources sector than was the case in previous resources booms, which always ended in high inflation. It also helped the economy in 2008 when global risk aversion was at its peak, and during both the Asian financial crisis in the mid to late 1990s and the bursting of the tech bubble in the United States a decade ago.

The second area is labour market flexibility.

Over the past year, the unemployment rate rose by considerably less than was expected. While this was partly the result of the surprising strength in the economy, it also highlighted the increased flexibility of the labour market. When demand weakened, many firms and their employees agreed to reduce working hours as a way of preserving jobs. And in other cases, wage rises were reduced or delayed as a way of avoiding lay offs. These responses helped limit the rise in the unemployment rate. In turn, this helped support incomes and the general level of confidence in the community, and ultimately the level of economic activity.

The third area is the flexibility in macroeconomic policy.

When the world economy took a sharp turn for the worse, fiscal policy in Australia responded quickly and on a significant scale. It was able to do this without raising the fiscal sustainability concerns that have come to the fore in a number of other countries. While there will always be differences of opinion about the merits of specific measures, there is little disagreement with the idea that Australia's history of sound fiscal policy provided the government with the scope to act quickly, and on a significant scale, when the outlook deteriorated. One of the obvious benefits of keeping your house in order over a long period of time is that you can more easily respond to changing circumstances if you judge that to be the correct thing to do. Right now, there are a number of other countries that would clearly value that flexibility, but that do not have it because of decisions on fiscal policy running back over the past couple of decades.

Monetary policy was also able to respond rapidly when the outlook turned for the worse, with the cash rate being reduced by 4¼ percentage points over a seven month period. Importantly, we were able to do this without causing inflation expectations and long-term interest rates to rise. The main reason for this is that the monetary policy framework in Australia is seen as credible in ensuring that the inflation rate averages between 2 and 3 per cent over time. But again, the credibility of the

framework did not rise out of thin air. Instead, it is the result of nearly two decades of having delivered low and stable inflation.

So in each of these areas – the exchange rate, the labour market, fiscal policy and monetary policy – the decisions that were made over a long period of time helped us get through the global downturn. Looking forward, it is important that we do not lose sight of this.

As the Bank has set out a number of times recently, our central scenario for the Australian economy is a reasonably favourable one. In this central scenario, we are likely to face a two-speed global economy for some time. While most of the advanced economies are expected to experience only a subdued recovery, weighed down by balance-sheet problems, Asia is expected to grow solidly, with domestic demand in the region playing a greater role than in the past. If this is indeed how things play out, Australia should be well placed, particularly given its strong trade links with Asia and the generally bright outlook for the resources sector.

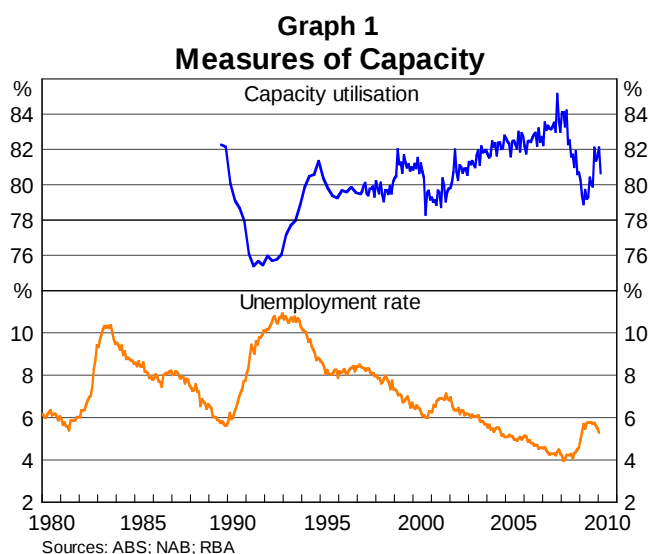
But it is important to remember that this is only the central scenario. As we know, the global economy has a habit of throwing us surprises and there are clearly risks in both directions. Over recent months, the economic data for a number of countries have been better than expected and it is possible that this could continue. On the other hand, it is also possible that financial events in the advanced economies could again derail the global economy, and growth in Asia could disappoint.

We clearly cannot control global outcomes, but what we can do is preserve the flexibility that the economy has, and enhance that flexibility wherever we can. Ultimately, this is the best insurance that we can take out against the uncertain world in which we live.

I would now like to turn to the three issues that I mentioned at the start: expanding the supply side of the economy, housing, and inflation. In each of these areas, the situation in Australia is different from that in most of the other developed economies.

Expanding the Supply Side

Australia starts the current expansion with considerably less spare capacity than earlier thought likely, and with less than at the starting points of previous expansions. This is clear from surveys of capacity utilisation by businesses. It is also clear from the labour market data, with the unemployment rate peaking at around 5¾ per cent, which was around the trough in the previous two cycles (Graph 1).



These outcomes put Australia in quite a different spot from that of most other advanced economies. In both the United States and Europe the unemployment rate is around 10 per cent, and both economies are estimated to be operating at around 5 per cent below their potential.

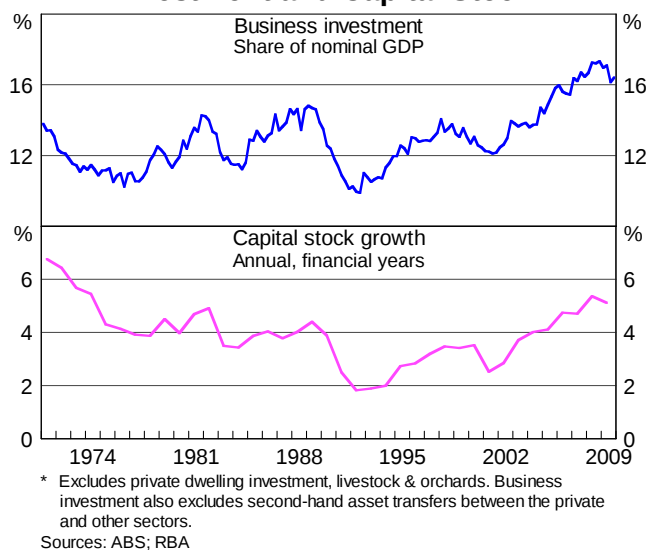
The issues we face are therefore quite different from those confronting most of the other advanced economies. Elsewhere, the challenge is to get private demand to grow on a sustainable basis so that it can catch up with the supply potential of the economy. In contrast, for Australia, the main task is to expand the supply side of the economy so that demand can grow solidly without causing inflation to rise. This is unambiguously a better position to be in, but it does pose some challenges.

The obvious keys to improving the supply side of the economy are investment and productivity growth.

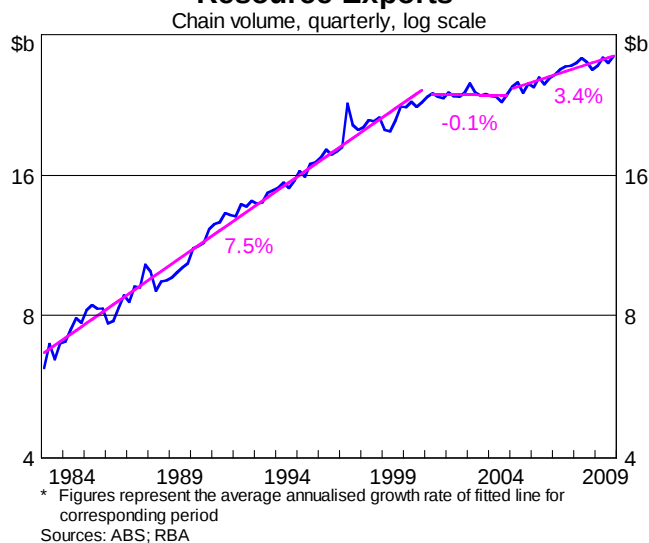
In terms of investment we are doing well, with Australia having become a high investment country over recent times. Currently, business investment is equivalent to around 16 per cent of GDP – not far below its peak level in the past four decades – and is expected to rise a little further over the next couple of years (Graph 2). Investment in the resources sector has been particularly strong, and this is now starting to bear fruit, with resource exports rising recently following a number of years where there was little growth (Graph 3). Over the years ahead, further significant increases in resource exports are expected.

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Graph 2
Investment and Capital Stock*

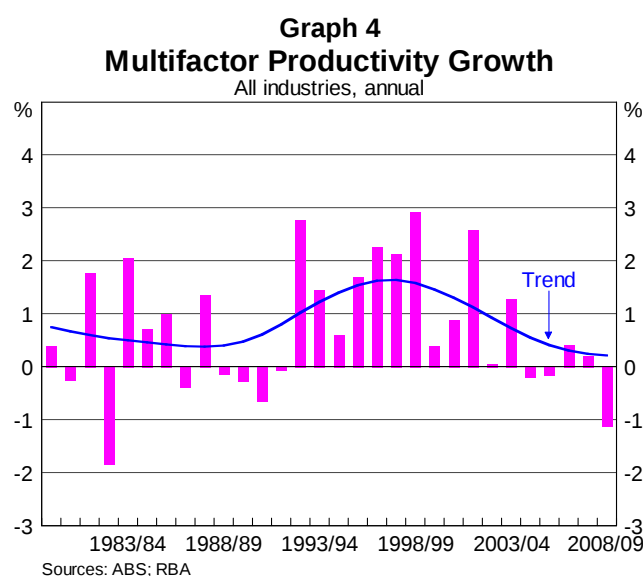


Graph 3
Resource Exports*



The high overall rate of investment means that the capital stock is increasing at a faster pace than over recent decades, and this should underpin continued growth in the supply potential of the Australian economy. In contrast, in a number of other advanced economies, including the United States, there is currently little net growth in the capital stock, with the investment that is taking place barely enough to offset depreciation. The fact that investment is high in Australia reflects the high expected return on capital, particularly in the resources sector. Given that countries with relatively high returns on capital typically have relatively high real interest rates, it should not be surprising that interest rates in Australia are above those in other countries where the return on capital is currently much lower.

In terms of productivity, the story is not as positive, although, as always, measurement issues cloud the picture. According to the Australian Bureau of Statistics (ABS) data, since the mid 2000s, almost all the increase in output in Australia has been accounted for by a rise in hours worked and an increase in the capital stock. Or put another way, there has been very little underlying productivity growth over this period (Graph 4).



The reasons for this are not particularly clear. Some slowing in productivity growth might have been expected in the mature stage of the business cycle, as the economy was operating against its capacity limits and skill shortages emerged. A second possibility, relating to the mining sector, is that high commodity prices allowed lower grade resources to be mined. The lag between the construction and production phases of large resource projects may also have lowered measured productivity growth, at least until these projects come on line.

More generally though, it is important to remember that one of the least productive things that a society can do is to leave large numbers of people sitting at home who actually want to work. From this perspective, the productivity performance over the past decade looks to be quite a lot better. The Australian economy has done well at bringing in to paid employment those who actually want to work and the unemployment rate has fallen significantly. While one side effect of this may have been to contain productivity growth as conventionally measured, from a broader perspective it represents a considerable success.

As we go forward, if we are to grow strongly on a sustainable basis we will need to ensure that both our capital and our workforce are used as efficiently as possible. Returning to my earlier theme, maintaining flexibility in the economy is important here. Under the central scenario that I sketched earlier, the economy is likely to undergo considerable structural change, particularly as the resources sector expands.

How well we deal with this change will have a significant impact on how the overall economy performs.

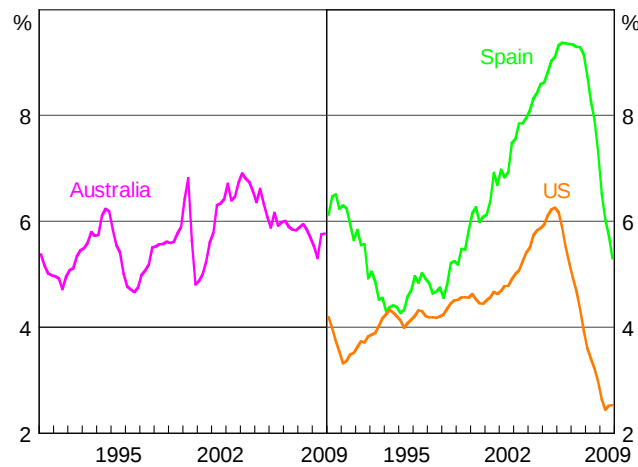
Housing

Now to the second issue, that of housing.

Here again Australia finds itself in quite a different position from that of many of the other advanced economies, both in terms of the construction cycle and prices.

One challenge we face is to satisfy the increase in the demand for housing from a growing population, particularly given that we start the current upswing in the economy with a tight housing market. Unlike a number of other countries – most notably the United States and Spain – Australia did not have an unsustainable surge in dwelling investment in the middle years of the 2000s that resulted in over-supply of housing (Graph 5). Indeed, over recent years, the rate of increase in the number of dwellings has been below the average of the past 50 years (Graph 6). In contrast, the rate of increase in the population has been around the fastest in 50 years.

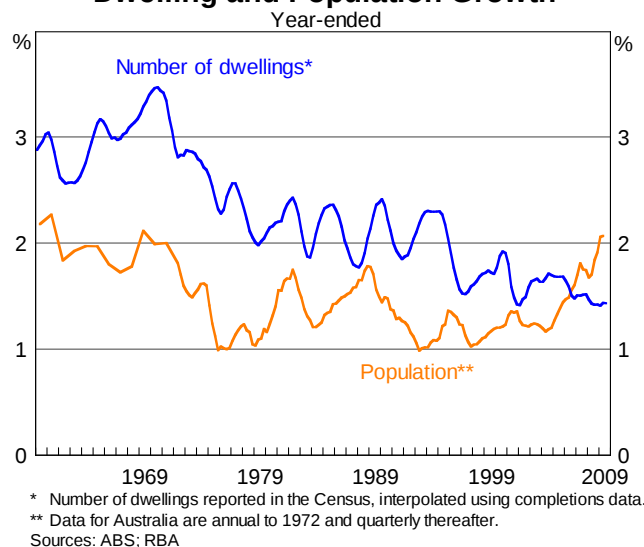
Graph 5
Dwelling Investment*
Share of nominal GDP



* Australian data include private and public new dwelling investment and private alterations and additions investment. Spanish data include private and public dwelling investment.

Sources: ABS; Eurostat; RBA; Thomson Reuters

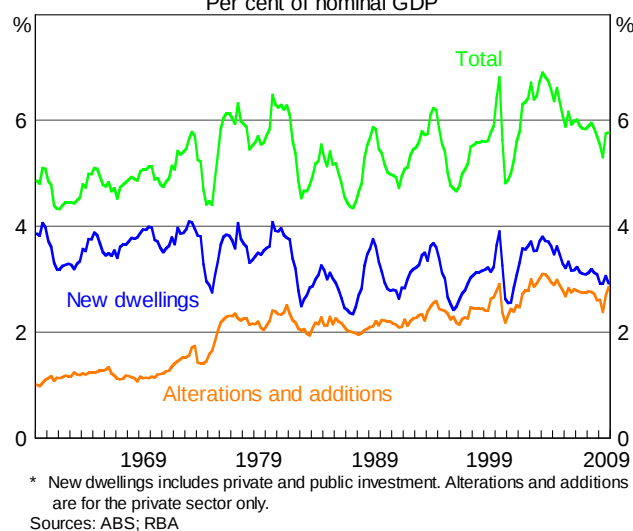
Graph 6
Dwelling and Population Growth



Consistent with this, rental vacancy rates in Australia are low by historical standards, although they have increased a little over the past year. There has also been a reversal of the decades-long trend of fewer people living in each dwelling. While demographic factors have been important here, including a rise in the birth rate and the increase in the number of students undertaking post-secondary education, the increase in the cost of housing has also played a role. With population growth above average, and growth in the housing stock below average, it is not surprising that there has been upward pressure on housing costs as part of the process of balancing supply and demand, with the higher housing costs leading to people economising on housing services. Obvious examples of this are the trend towards young adults staying in the parental home longer, and a rise in the number of people sharing accommodation.

Interestingly, the relatively slow growth in the number of dwellings does not reflect historically low levels of dwelling investment. In fact, the share of GDP devoted to the construction of dwellings over recent years is above the average of the past five decades (Graph 7). However, within total dwelling investment, renovation activity now accounts for a higher share than was the case historically, and the average size and quality of new dwellings has also increased substantially. The result of these developments is that for a given share of GDP devoted to housing investment, there is a smaller increase in the number of dwellings than was the case previously. In a sense, as a society there has been a trade-off between quality and quantity; in particular, we have implicitly chosen to build bigger and better-appointed dwellings, rather than more dwellings.

Graph 7
Dwelling Investment*
 Per cent of nominal GDP



Looking forward, if population growth were to remain strong for an extended period, and we do not change the mix of housing that is being constructed, it is likely that we will need to devote a higher share of GDP to housing than has been the case historically. If this does not happen, further adjustment in housing prices and rents is likely to occur to balance supply and demand.

This raises two important issues that we need to think about. The first is the constraints that exist on increasing the supply of dwellings. If we are to build more dwellings, we need to ensure that planning guidelines and infrastructure provision can accommodate this. This will pose challenges for all levels of government. And the second issue is the capacity of the economy to deal with an increase in dwelling construction at a time when investment elsewhere in the economy is also very high. If housing construction is very strong at the same time that the resources sector is expanding, there will be competing demands for a range of skilled workers and specialised services. Managing these competing demands and ensuring the adequate supply of workers with appropriate skills will be a challenge.

Inflation

The third issue is inflation.

In all of the advanced economies, inflation – in both headline and core terms – has fallen and, in most cases, is currently below the relevant target or medium-term average. Given the considerable excess capacity that currently exists, most of these countries are likely to continue experiencing disinflationary pressures for some time yet, and have inflation rates that are below target.

In Australia, inflation has also fallen, but unlike for most of the other advanced economies, it is not expected to be below target for an extended period of time. In the December quarter, underlying inflation was running at an annualised rate of around 2½ per cent – right at the mid point of the target range. In annual terms, underlying inflation was higher than this, reflecting the higher quarterly outcomes in the early part of 2009. Looking forward, we expect broadly similar outcomes over the next year or so to that recorded in the December quarter, as the lagged effects of the slowdown in wage growth last year and the appreciation of the exchange rate work their way through. As set out in our latest *Statement on Monetary Policy*, we expect inflation in both headline and underlying terms to be around 2½ per cent in 2010, and just a little higher in 2011.

Recently, there has been some discussion, prompted by senior staff at the International Monetary Fund (IMF), that central banks might aim for high inflation – say 4 per cent – as a way of giving them more scope to reduce official interest rates in future downturns. This idea does not seem particularly sensible. As history has taught us, inflation distorts decision-making in the economy, discourages saving, and increases uncertainty about the future. None of this is helpful for expanding the supply side of the economy, and ultimately higher inflation means higher nominal interest rates.

Equally importantly, a global shift to allow higher inflation would run the very real risk of undermining trust in central banks and their commitment to price stability. The public might rightly wonder whether inflation targets might shift up again at some future point as other problems arose. If this loss of trust were to occur, we would have given up the hard-won credibility of the monetary policy frameworks that has been built up over the past couple of decades.

Conclusion

The central scenario for the Australian economy is a positive one, with growth over the next couple of years at, or above, average, a relatively strong labour market, and inflation consistent with the medium-term target. There are, however, risks around this central scenario that we will need to watch carefully. Recent experience has reminded us of the importance of flexibility of both the economy and macroeconomic policy in managing these risks.

As we look forward, if something like the central scenario were to eventuate, we will need to keep a strong focus on improving the supply side of the economy so that demand can grow solidly without putting upward pressure on inflation. We also face the significant challenge of increasing the supply of housing at a time when business investment is also very high. While meeting these challenges will require hard work by both governments and businesses, they are surely better ones to face than those being confronted by other advanced economies.