The Headwinds

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Presentation to Melbourne Institute Economic and Social Outlook Conference, 3 November 2014

Key Point

- The policy responses to Australia's challenges importantly depend on the nature of the shocks that will impinge on Australia in coming years
- Uncertainty is large
  - Some things we know
  - Some things we think we know
  - Some things will surprise

Foreign headwinds

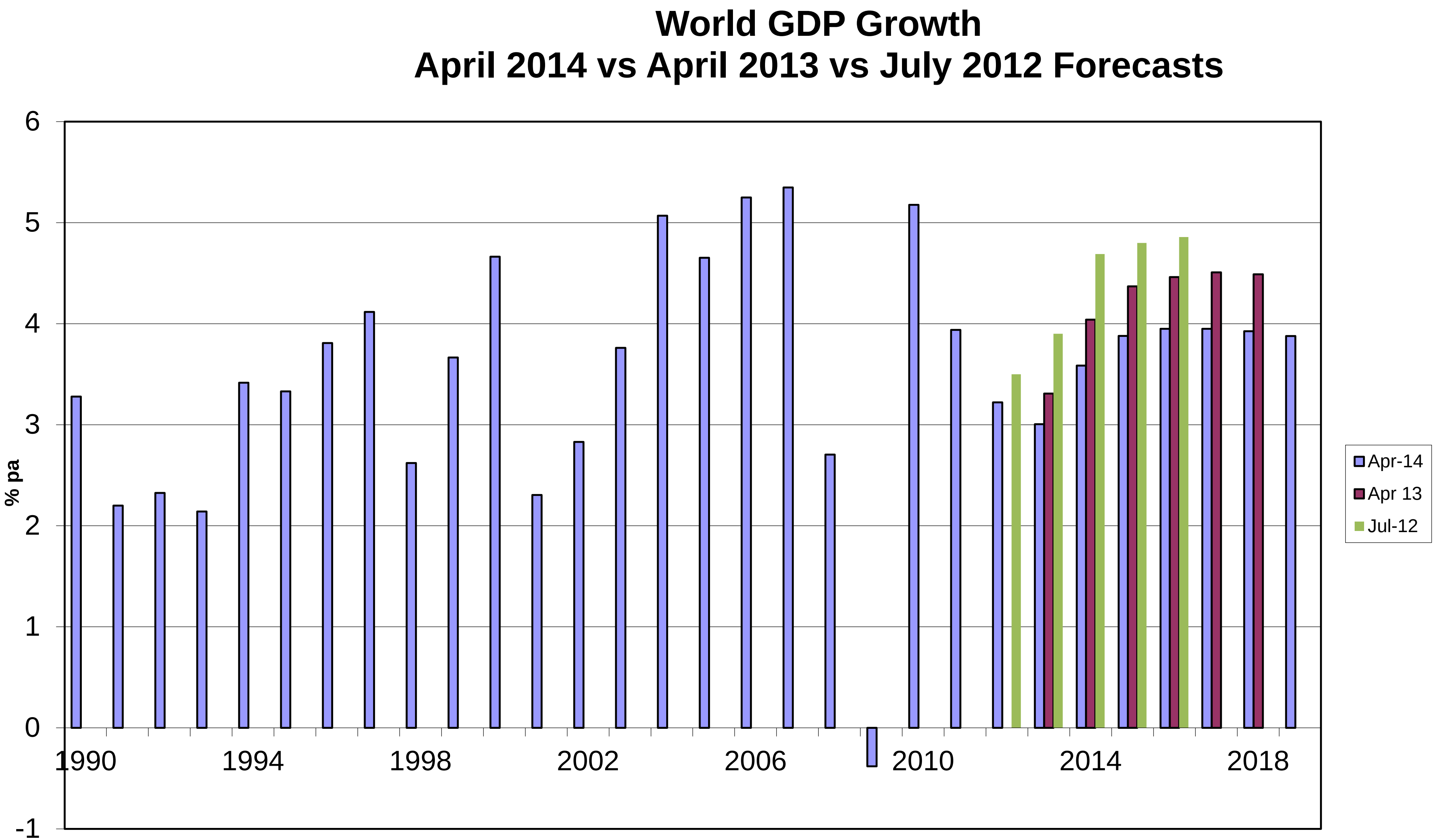
- Shorter term
  - End of Quantitative Easing
  - Contradictions in Europe
  - Structural adjustment in China

- Medium term
  - Fiscal sustainability
  - Productivity slowdown
  - Demographic Adjustment
  - Policies addressing Climate Change

The Global Picture

- The world economy is being fundamentally transformed by the income growth of large emerging economies (China, India, Brazil)
- Individual economies are also going through longer term transformation (excess debt, demographic change)
- Long term trends are impacting on short term rigidities in major economies
- Policies are aimed at short term business cycle problems rather than structural adjustment

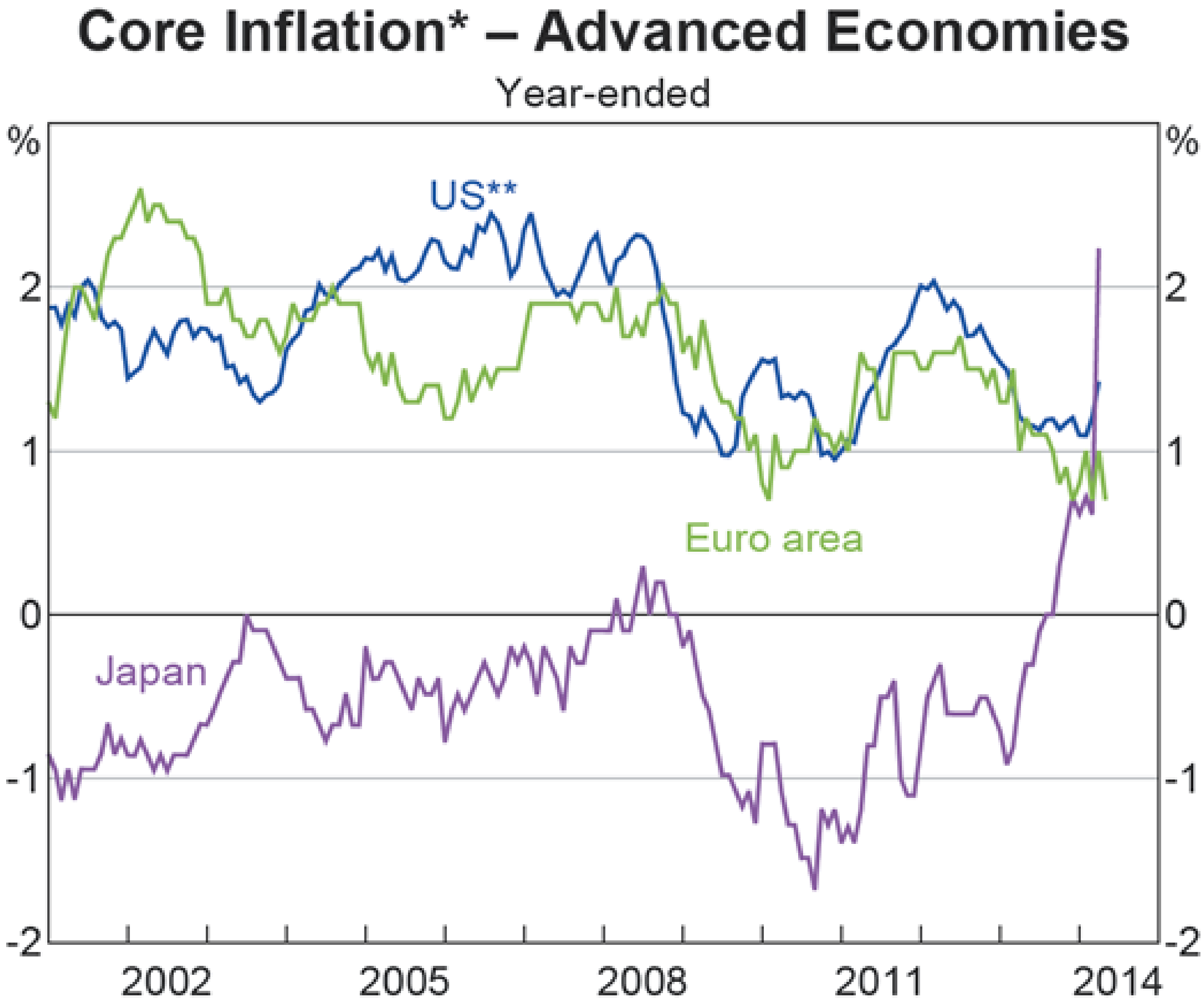
The Global Economic Outlook



Source: IMF World Economic Outlook April, 2014 and April 2013 and July 2012

Near Term Growth Outlook

- Asymmetric and sluggish recovery and many risks
  - US likely to grow strongly
  - Japan will slow unless major structural reforms undertaken (FTA with Australia is important)
  - GFC increased risk which hurt investment and slowed potential growth substantially - similar to the aftermath for crisis economies of 1997/98
  - Global monetary relaxation pushed funds into existing assets pushing up asset prices but not investment



Source RBA Chart Pack July 2014

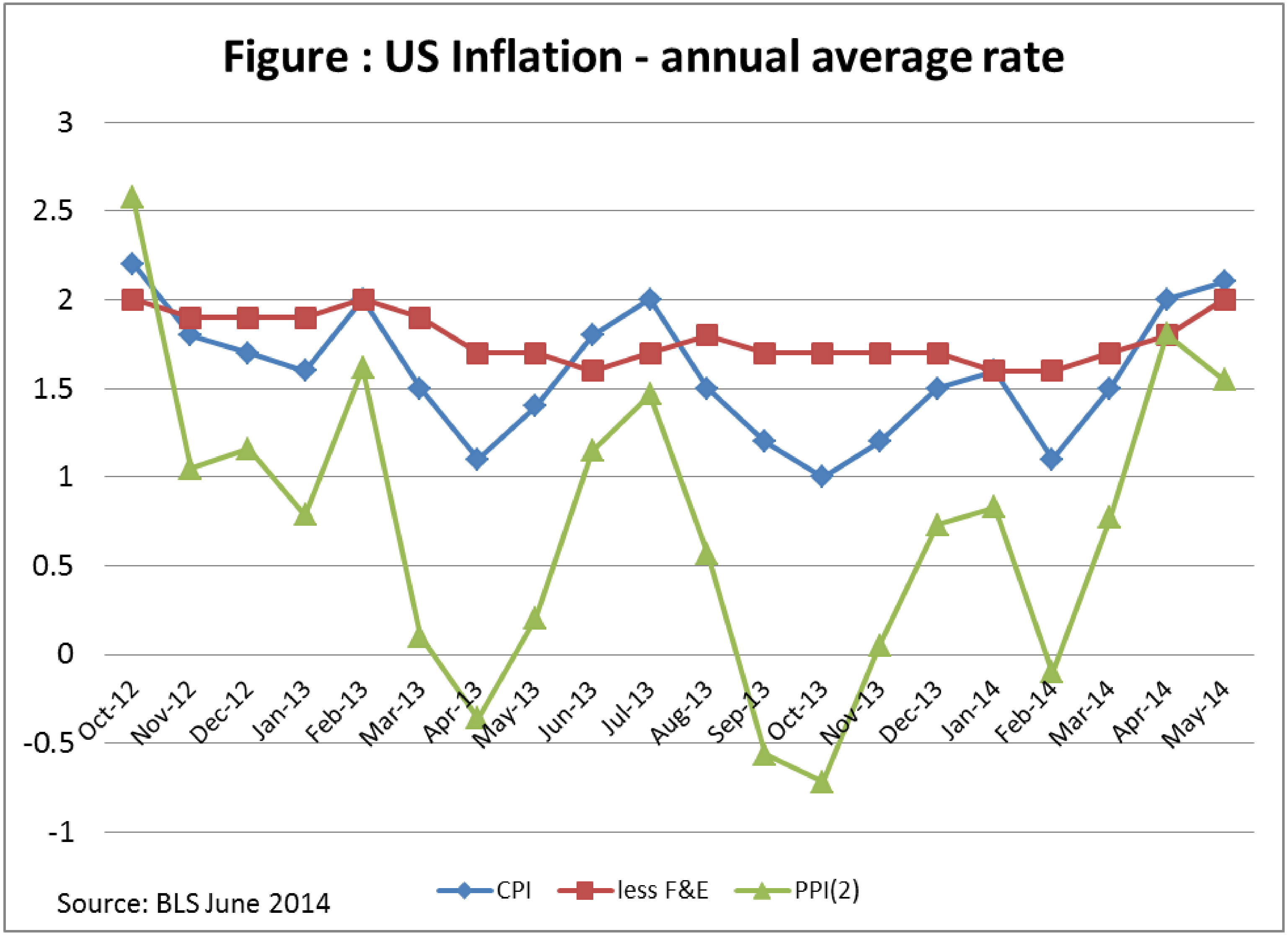


Figure : US Inflation - annual average rate
3
2.5
2
1.5
1
0.5
0
-0.5
-1
Oct-12
Nov-12
Dec-12
Jan-13
Feb-13
Mar-13
Apr-13
May-13
Jun-13
Jul-13
Aug-13
Sep-13
Oct-13
Nov-13
Dec-13
Jan-14
Feb-14
Mar-14
Apr-14
May-14
CPI
less F&E
PPI(2)
Source: BLS June 2014

Short Term Issues for Policymakers

- US
  - How to unwind QE and guide expectations
- Europe
  - How to avoid a Euro collapse from a banking crisis or a sovereign debt crisis
- Japan
  - Implementing the 3 arrows policy
    - Massive monetary expansion
    - Fiscal expansion with long term fiscal contraction
    - Major structural reform to raise long run growth

Short Term Issues for Policymakers

- Emerging Economies
  - Rise is risk associated with the end QE
  - China dealing with major structural issues

End of Quantitative Easing (QE)

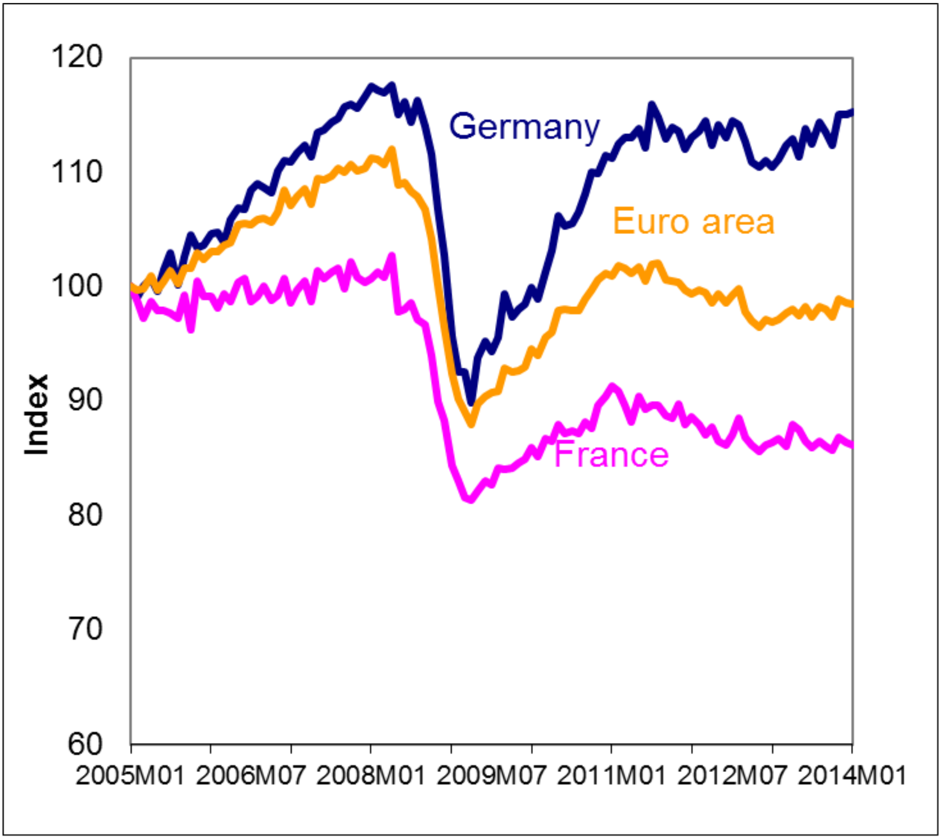
End of QE

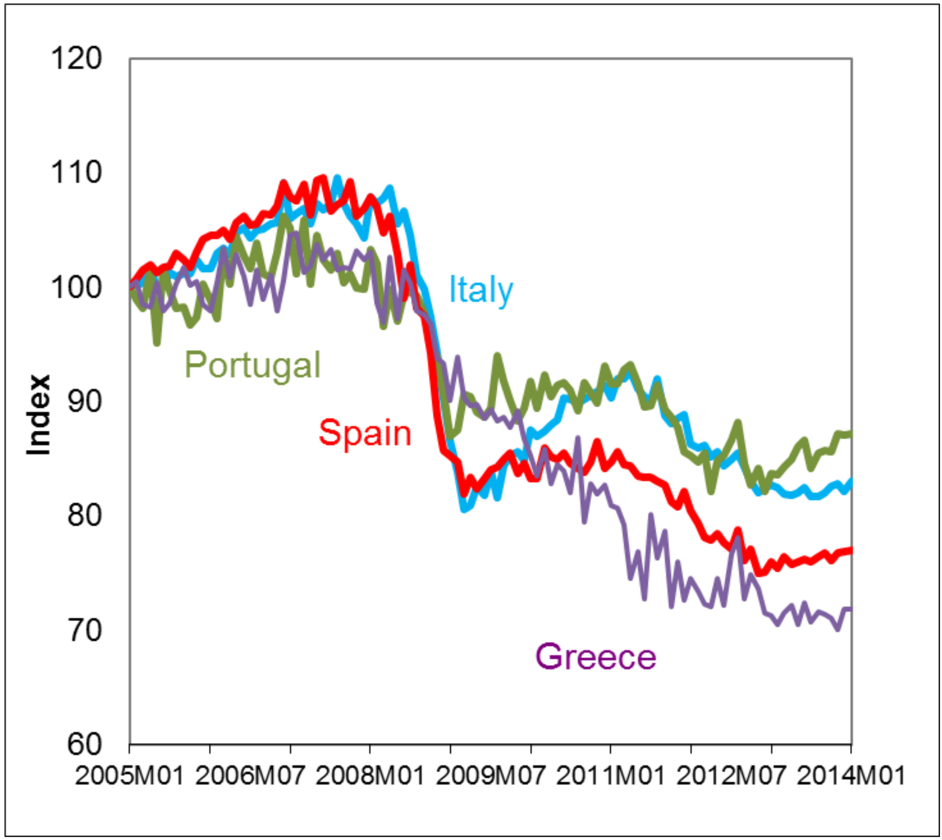
- US economy is recovering
- Expect interest rates to rise in the US (question of how much)
- Good news for global demand through trade
- Bad news for poorly performing economies as capital flows out of these economies towards the US (and into other well performing economies like Australia)
- Bad news for economies with large sovereign and private debt exposures

Risks in Europe

Euro Area – Industrial Production

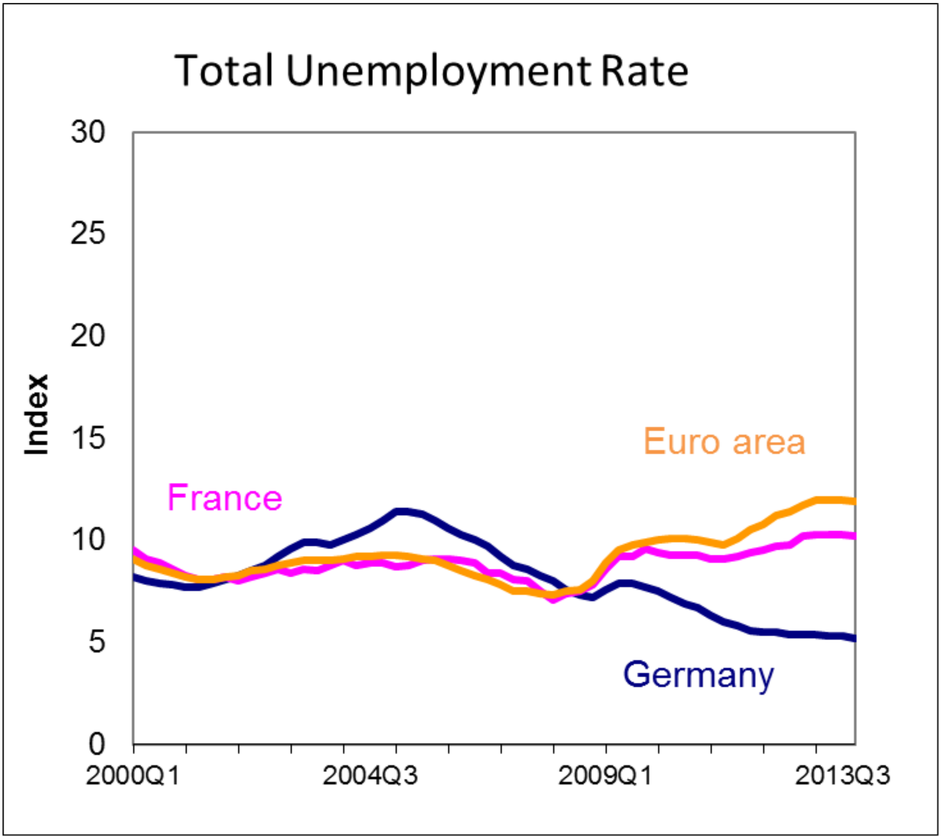
2005m1 = 100

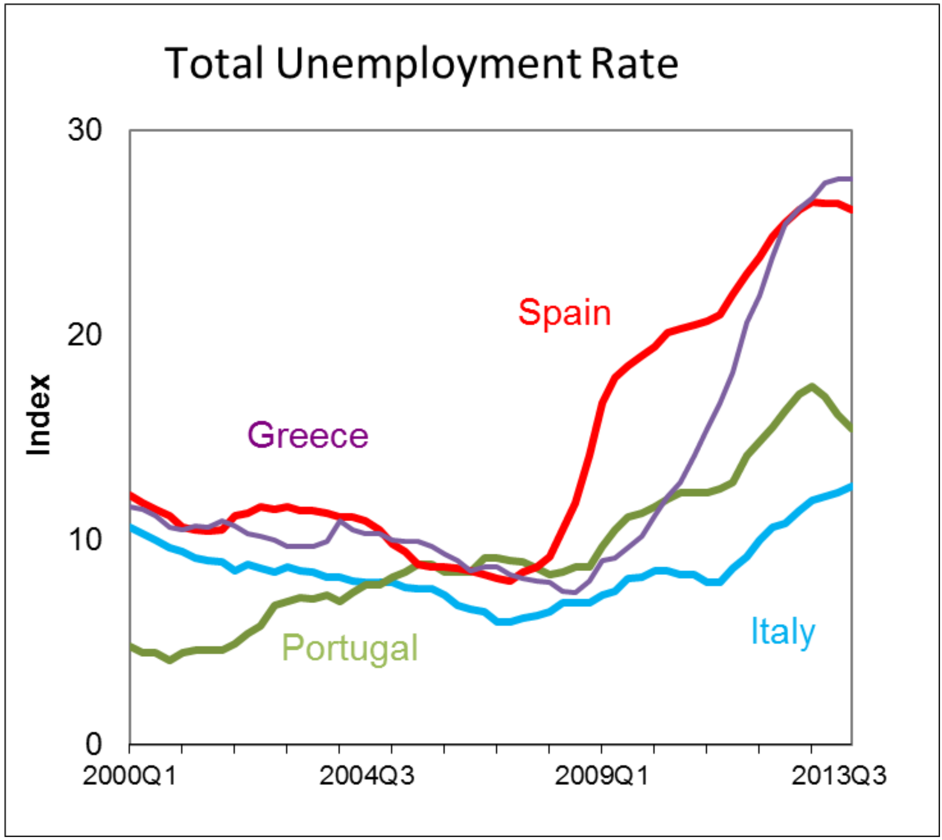




Source: Eurostat April 9, 2014

Labour market divergence still exists





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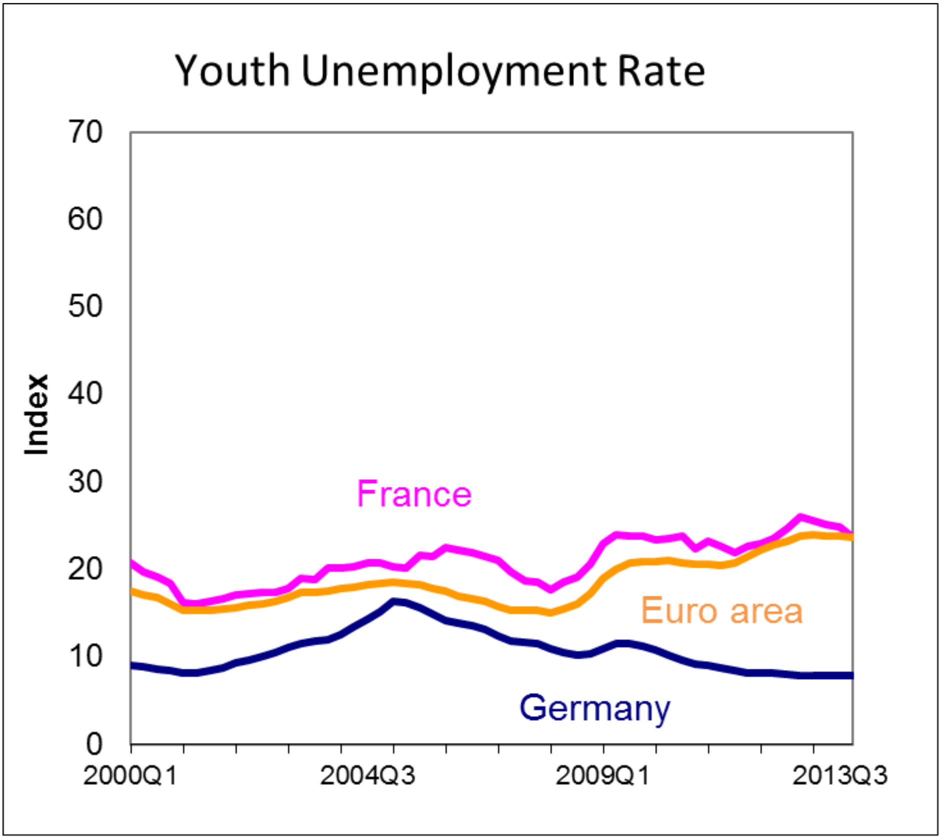
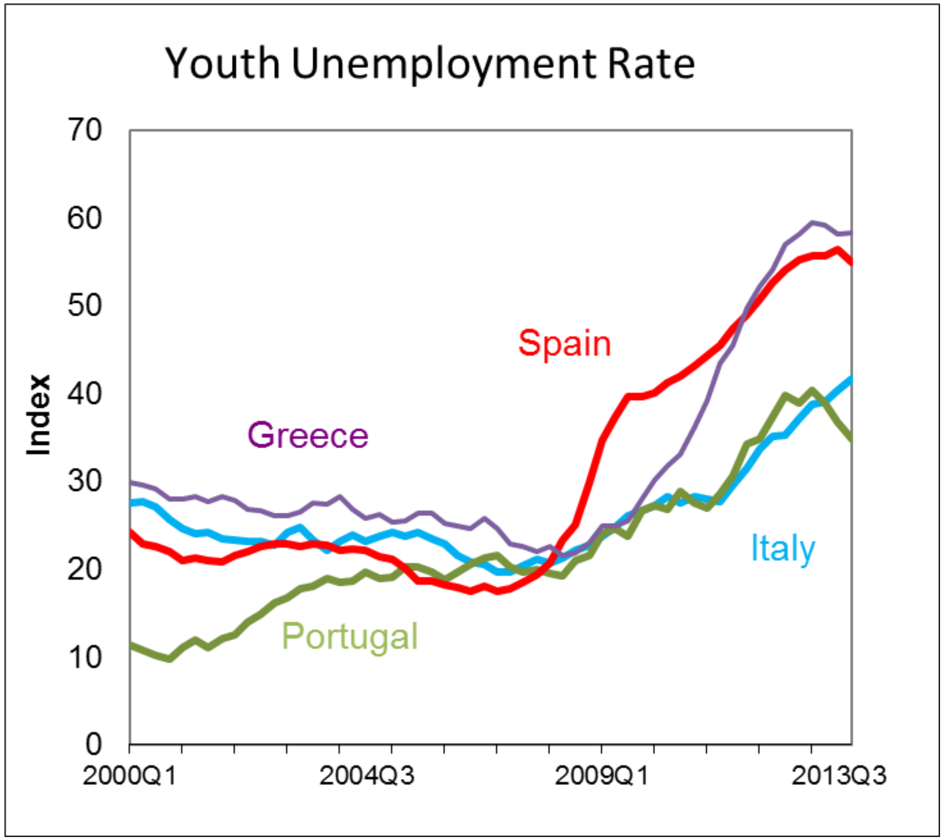




Source: Eurostat April 9, 2014

Three major problems in Europe

- Southern Europe needs a large real exchange rate depreciation because of large productivity differences
- Fiscal positions unsustainable because
  - debt is too high,
  - financing costs will surge when interest rates rise,
  - negative economic growth

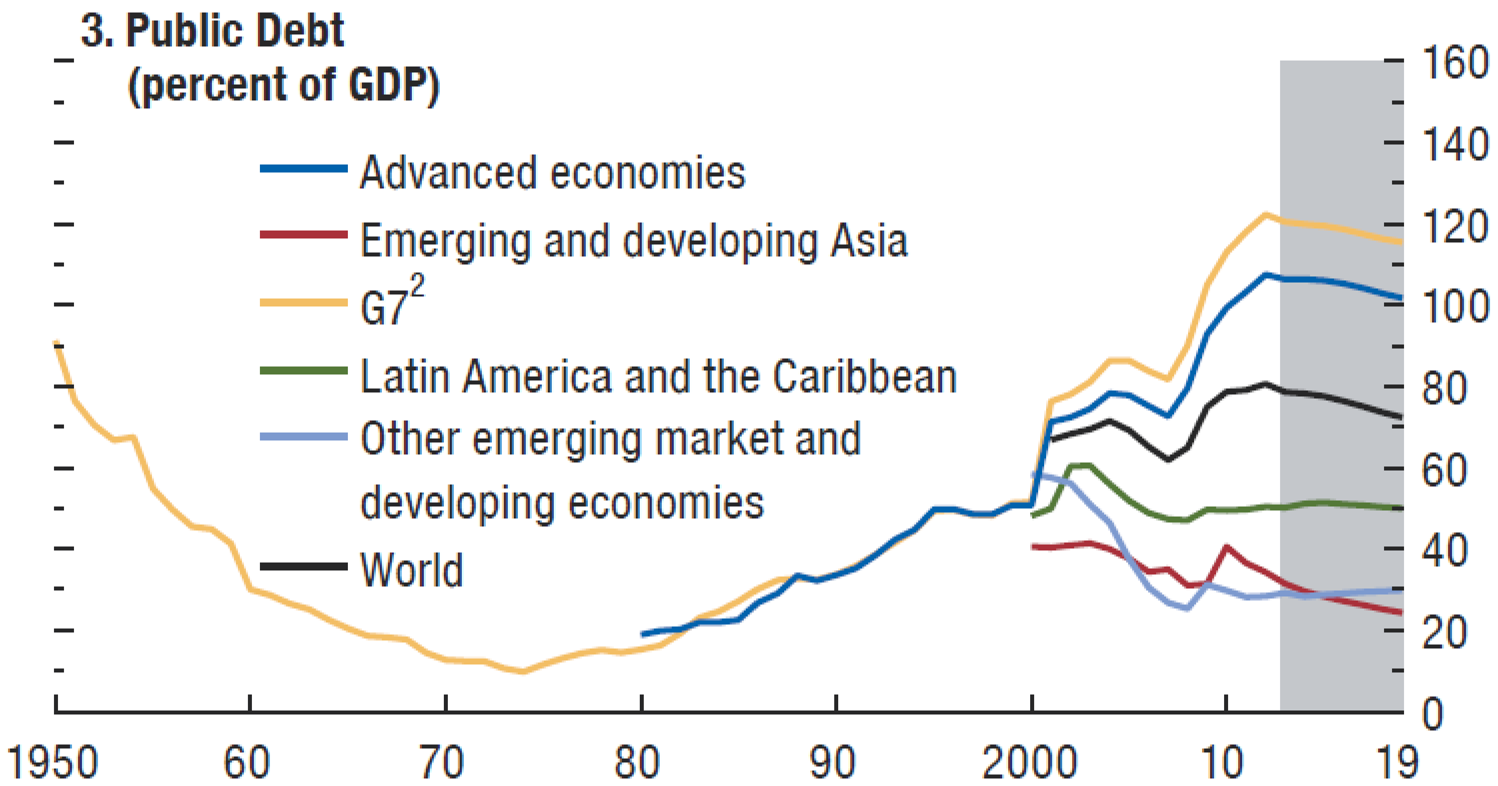
- Most of the Banking System is insolvent

Big Question

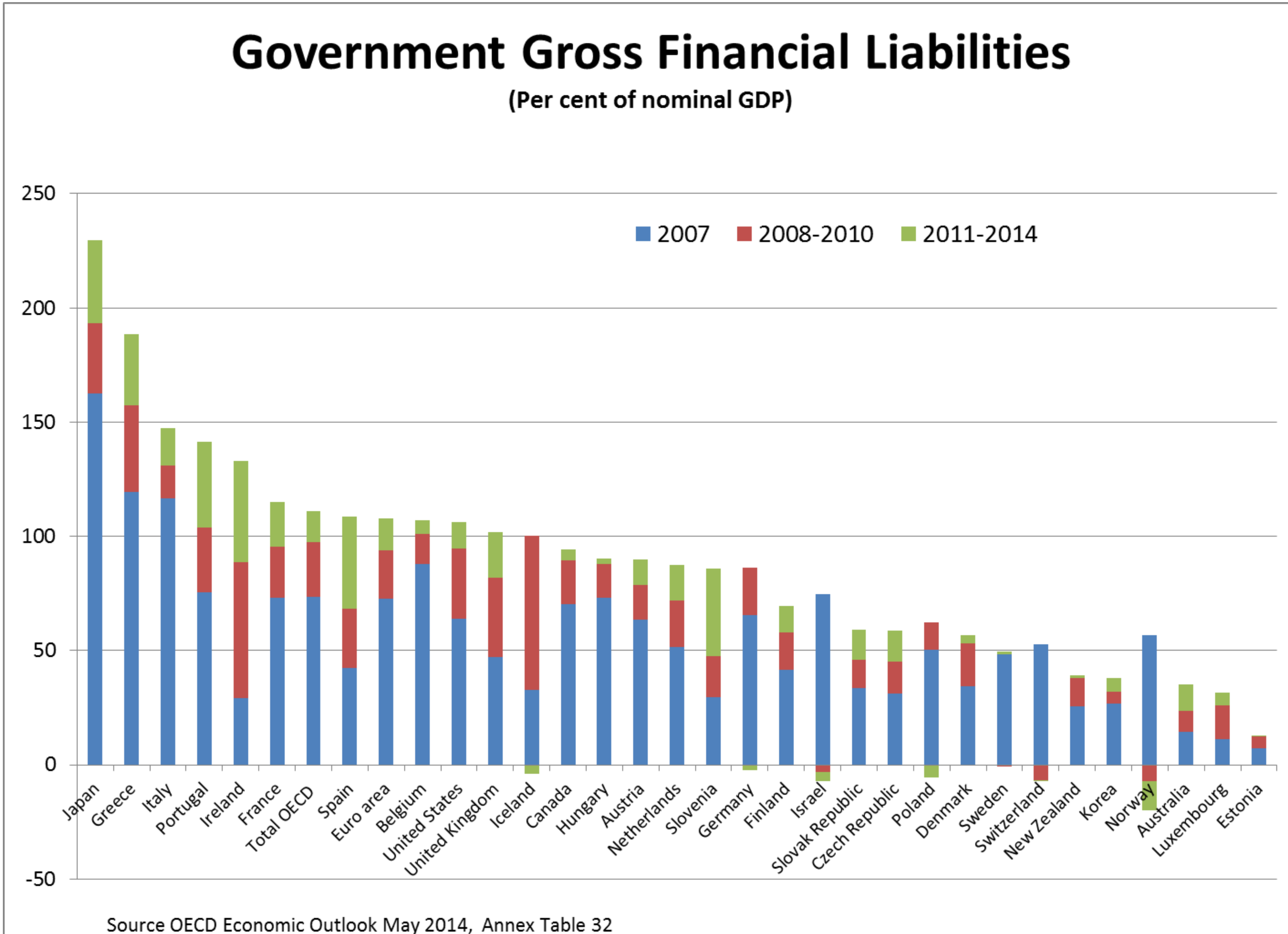
- Will the US recovery by sucking capital out of Europe worsen the state of the periphery economies that have large government debts and are susceptible to a rise in world interest rates?
- Key is Germany as a counterbalance in Europe

Fiscal Sustainability

Global Government Debt



Source: IMF World Economic Outlook April 2014


Government Gross Financial Liabilities
(Per cent of nominal GDP)
2007
2008-2010
2011-2014
250
200
150
100
50
0
-50
Japan
Greece
Italy
Portugal
Ireland
France
Total OECD
Spain
Euro area
Belgium
United States
United Kingdom
Iceland
Canada
Hungary
Austria
Netherlands
Slovenia
Germany
Finland
Israel
Slovak Republic
Czech Republic
Poland
Denmark
Sweden
Switzerland
New Zealand
Korea
Norway
Australia
Luxembourg
Estonia
Source OECD Economic Outlook May 2014, Annex Table 32

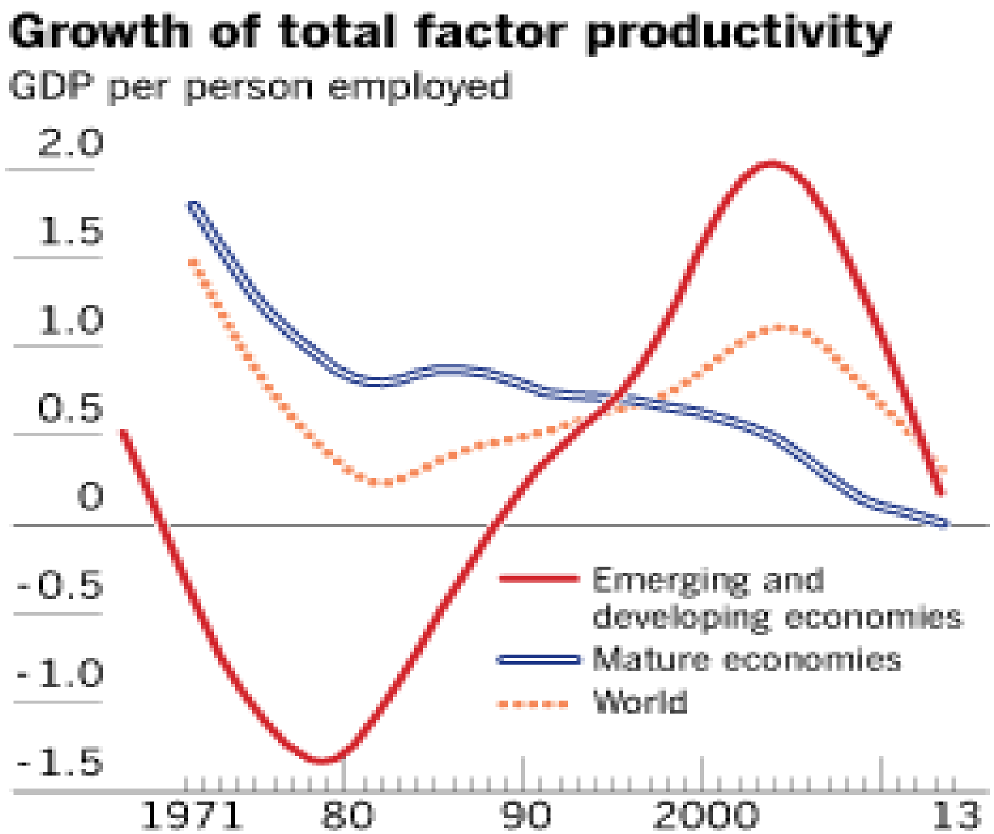
Key Issues

- Fiscal problems accentuated by
  - Rising interest rates
  - Low rates of economic growth
- Countries will need to cut deficits substantially over coming years
  - Very different adjustment across countries
  - Fiscal Deficit reduction raises national savings and if private investment does not rise, savings will flow overseas depreciating the exchange rate and improving the trade balance

Fiscal Adjustment

- Potentially a rise in global savings pushing down world interest rates
- Countries not cutting likely to see large capital inflows, a strong exchange rate and a decline in competiveness

Global Productivity Concerns



Source: Conference Board, TED database February 2014

What does a global productivity slowdown imply?

- Depends if it is temporary or permanent
- If permanent then current capital stocks probably too high in many sectors/countries
  - Investment rates need to fall
  - Real interest rates will fall (savings glut)

Demographic Change

Key point

- Not only the demographic change in Australia but the demographic change across all countries that matter
- See McKibbin W. (2006) "The Global Macroeconomic Consequences of a Demographic Transition", *Asian Economic Papers*, vol 5, no 1, pp 92 – 141, MIT Press

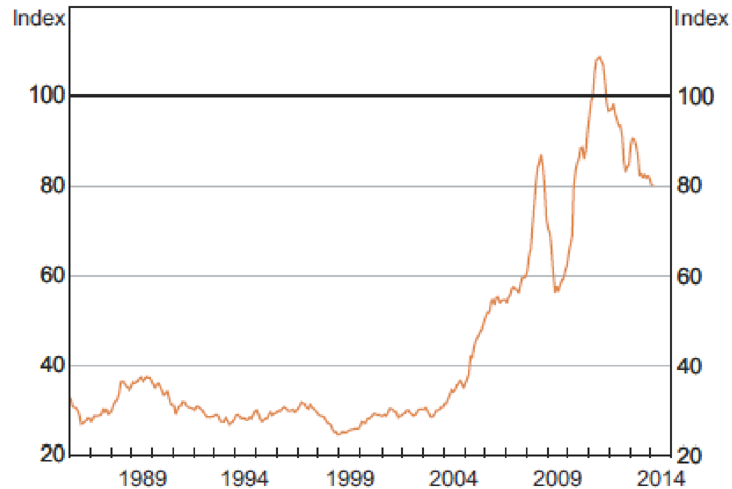
Australia

- Not an island in an economic sense
- Facing potential crises in other economies
- Likely to be seen as a safe haven in global capital markets
- Likely that global real interest rates will remain low and as a net borrower with enormous growth potential this is good news for capital deepening and widening

Commodity Prices

RBA Index of Commodity Prices

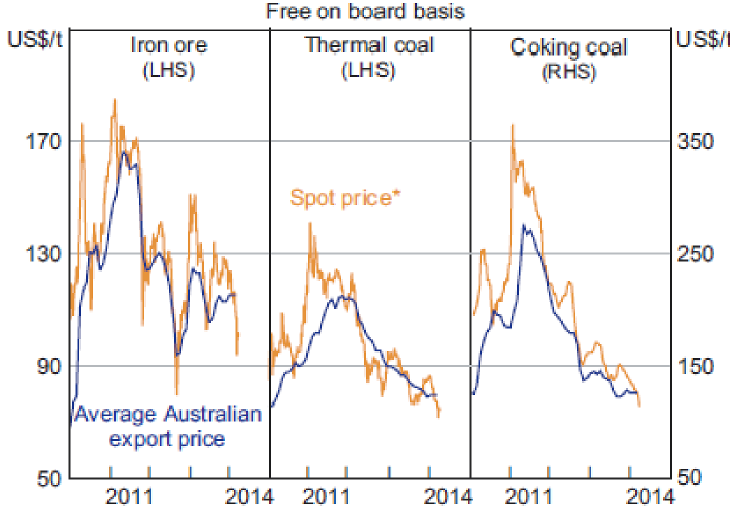
SDR, 2011/12 average = 100



Source: RBA

Bulk Commodity Prices

Free on board basis



* Iron ore fines, Newcastle thermal coal and premium hard coking coal

Sources: ABS; Bloomberg; Citigroup; IHS Energy Publishing; Macquarie Bank; RBA; Thomson Reuters

Implication for $A

- Commodity price weakness - a lower $A
- Tapering and the end of QE – lower $A relative to $US but a stronger $A real effective er
- Increased preference for $A assets - $A higher
- Shifts in global fiscal policies will cause capital to flow out of countries with large fiscal debt - $A higher
- Global productivity slowdown - $A higher if Australia can undertake key reforms to raise productivity

Summary

- World is exposed to a number of large risks in the short term despite positive long term potential as poor countries become richer
- A recovery in the US is seen as good news for all but it also contains risks for countries that have large sovereign and external debt problems

Summary

- Australia is well positioned but needs to
  - deal with significant domestic reforms to improve competitiveness in the face of a continually rising currency
  - take advantage of (posssibly) a long period of low world real interest rates to build the infrastructure and finance human capital investment needed to sustain productivity growth

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