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Current Assessment:

The Impact of Current Instability on the Chinese and Australian Economies

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The Chinese and Australian economies are impacted by the current circumstances in contrasting ways. To stylise somewhat, Australia's contemporary economy has one foot planted firmly in the financial markets of the advanced countries, and the other foot planted squarely in the real economies of East Asia. Adverse developments in either area threaten the maintenance of Australian prosperity. China is exposed to the real economic fallout from financial instability in the advanced countries, but it does not require financial stability in the advanced world to pursue its underlying growth model. This is a profound and fundamental distinction that offers some hope that the third leg of this triangle – China's impact upon Australia – will be a relatively benign one.

For Australia, the distinction between this opening session of the roundtable and the one that follows it is very small. The Australian economy has become reliant on the ability of the financial system to operate freely in liquid international capital markets. The vicious cycle of deteriorating financial conditions in North America and Europe, and the negative feedback loop of these problems impacting upon the real economy, which in turn impact upon the financial markets, has accelerated recently. This has been reflected in both a price and quantum effect on the fund raising activities of Australian financial institutions.

The forecasting puzzle has never been more complex. Prior to the onset of the present climate, a view on the internal demand for credit at a price jointly determined by the local and global monetary stance was a sufficient starting point for a view on the Australian economy. Today, before we can think seriously about the outlook for economic activity, we need a view on:

- The external supply of credit (and at what price)
- The internal demand for credit (and at what price)
- The internal supply of credit (and at what price)
- The external demand for resources (and at what price)

Further, there are additional factors acting to complicate matters. Australia is currently consuming a historically significant boost to national purchasing power via the terms of trade. Large rises in the terms of trade are historically associated with significant appreciations in the real exchange rate. Until very recently, the expected real appreciation had been delivered through a combination of nominal appreciation and a rise in the relative price level.

The change in the RBA's monetary stance around mid-year, and the uber-repatriation of offshore holdings by the US financial community in the post July 15 panic, have combined to push the nominal exchange rate lower. Given that the rise in the terms of trade was not fully accounted for by the scale of the appreciation prior to July, it is far from clear how the real exchange rate will develop from here. A cold theoretical analysis would indicate that the price level will need to bear the upward adjustment if the nominal exchange rate cannot regain traction. That is an awkward deduction for our inflation targeting central bank.

In a structural sense Australia has always been a current account deficit economy. That is not to say that Australia's external financing position is not dynamic. The composition and funding of the deficit have changed markedly over time. Banks¹ now hold net foreign liabilities equivalent to 38% of GDP. That compares to 12% of GDP at the end of 1995 and 25% at the end of 2000. Banks now account for 57% of Australia's total net liabilities. In 1995 and 2000, the respective numbers were 21% and 48%. The banking system has clearly assumed the dominant role in financing the deficit: a point reinforced by the violent "re-intermediation" of business credit in the post August 2007 world.

Recent research by the IMF has observed that the activity cycles of the industrial countries have become more highly correlated than in previous expansions. This is no doubt due to the increasing financial linkages associated with a reducing home bias among investors and the significant increase in financial openness achieved in recent decades. They made the same observation regarding growth within the emerging economy grouping. However, the IMF's researchers also found that the two groups were becoming less correlated with each other. This finding is vividly illustrated by the performance of the Australian economy.

This piece began with the stylized fact that Australia's contemporary economy has one foot planted firmly in the financial markets of the advanced countries, and the other foot planted squarely in the real economies of East Asia. Adverse developments in either area were argued to threaten the maintenance of Australian prosperity. The divergence of regional growth performance within Australia is stark evidence of the extremely powerful countervailing forces operating at present. In those areas of the economy where the white collar sectors are an important swing element of the business cycle, there is no longer any debate that growth is now well below its potential rate and employment growth has

¹ It should be noted that the position of finance and insurance firms overall is substantially different from the position of banks alone. This is due to the strong net foreign asset position of fund managers and insurers. Overall net liabilities of the finance sector are banks (-38% of GDP) and other financial firms (+15%) for a total position of -23%.

materially softened. In those areas more closely related to the basic materials industries, whose destinies are now tied to the emerging market behemoths, activity remains sound and labour markets remain in a state of excess demand.

The outlook for the key emerging market economies and regions is quite diverse. I will quickly survey my thinking here before I conclude with some comments on China. The Indian economy is slowing under the weight of a somewhat restrictive monetary stance, declining terms of trade and a more difficult time financing its modest external deficit. Russia has recently had the vulnerability of its feeble financial infrastructure exposed by the global funding crunch. Inflation is rising and institutional credibility on either the fiscal or monetary side is lacking. Over-riding this is a massive boost to the terms of the trade and an aggregate current account surplus. Net-net, growth will decelerate, but it will still achieve a healthy enough headline outcome. Emerging Europe - a deficit region relying on liberal inflows of FDI and bank loans from old Europe for its financing – looks susceptible to a downswing in growth in the current climate.

Latin America, like Russia, is benefiting from a large terms of trade boost. Also like Russia, it suffers from a weak institutional backdrop that goes unnoticed when external conditions are benign. For Latam, those economies with a dependence on foreign banks (Ibero-American, European or North American) are a real concern. Brazil is one of the least exposed on this angle, and it is also absorbing the largest terms of trade boost, via its diversified resource endowment.

Emerging Asia kept up formidable momentum through to the March quarter of this year, but that was the peak. Outside of Indonesia, material decelerations in growth were observed in Q2. Exports and domestic demand are both softening in the majority of jurisdictions, and leading indicators are predicting growth will be well below potential in the second half of this year and early in 2009.

China itself has had a remarkable year. A string of natural disasters, lower credit growth, a declining terms of trade, a softer export profile, softening asset prices, the anti-inflation stance of policy and the man-made disruption of the Olympic Games have seen GDP growth decelerate quite steeply. However, once net exports are excluded, activity has been firmer than the headline GDP figures might suggest.

China's banking system, as I am sure will be highlighted by other delegates, is almost entirely funded by deposits. The loan-to-deposit ratio of the largest banks is in the mid 0.7 range – around 100bps lower than in the Australia system. The smaller banks have been squeezed by the administration's liquidity management operations. The lowering of required reserve ratios for banks below the top tier is timely, as are the range of policy responses to the softening growth profile put in place in recent months. My intuition is that the Chinese economy will be responsive to stimulus, both fiscal and monetary, and should be back on its feet again soon after a modest hiatus to catch its breath after doubling its GDP per capita between 2002 and 2007.²

² In nominal local currency terms.

From an Australian perspective, the Chinese growth story will be less supportive in 2009 than it was through the heights of the global boom. However, the resource intensity of the economy will continue to rise in coming years as development levels ascend. The rotation of investment towards the hinterland regions and basic infrastructure bodes well for future commodity demand. Depending upon the speed of this rotation, and the rebalancing of the economy generally, China has the potential to surprise forecasters on the upside in 2009: if not with aggregate growth, then in its composition/resource intensity. Further, ongoing diversification of China's foreign exchange and sovereign wealth holdings should assist with Australia's external financing requirements. This last point should be of considerable interest to policy makers with an encompassing grasp of Australia's national interest.

Australia's status as a major importer of capital and a major exporter of basic materials presents a very complex forecasting problem in the current climate. Adverse developments in the external financing environment are an unambiguous negative for the domestic growth profile. The dynamics of the real exchange rate are a further cause for caution. The global economy is decelerating, but Chinese growth should be quite resilient due to an assumed sensitivity to policy stimulus and a lack of financial linkages to the rest of the world. The final picture then is one of deceleration for Australia, with downside risks extant. There are also upside risks, mainly deriving from potential scenarios for China itself. These arguments are subordinated in our minds for now, for tabling at a later date when the mood of the markets has repaired sufficiently to hear them.