Economic Issues for the Cotton Industry

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2003 Conference

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Gold Coast
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Australian cotton producers are vitally interested in export markets

Sources: Cotton Australia; ABARE; DFAT.
The long-awaited upturn in the global economy is now getting under way

Evidence

● As ‘headwinds’ fade, massive policy stimulus is starting to work
● Most US economic data are now pointing to a strong rebound
  – the labour market is the only major exception
● Japan’s economy has been tracking stronger than expected
● Most other Asian economies are reporting weak June quarter numbers (largely due to SARS)
  – (limited) data since then generally points to a rebound in activity
● June quarter numbers for Europe have also been very weak
  – but there are clear signs that ‘animal spirits’ are improving

Implications

● Deflation risks are receding
  – in some economies (particularly China) inflation may surprise on the upside
● The next movements in global interest rates will be upwards
  – albeit not until well into 2004
  – Europe may see one final rate cut
● Market expectations may have run somewhat ahead of reality
  – so that volatility in financial markets will continue
● The fall in the US$ has been halted (for the moment)
  – but will resume as global recovery becomes more synchronized
● ‘Geo-political risks’ could easily flare up again
Policy stimulus is ‘kicking in’ as growth-retarding ‘headwinds’ fade away

- Economic policy settings have for some time been much more stimulative than during the early 1990s global downturn
- Over the past 18 months this stimulus has been blunted by a series of ‘headwinds’
  - including geo-political tensions, falling share prices, high oil prices and SARS
  - additionally it has taken some time to purge excesses and imbalances built up during the 1990s boom
- Although they haven’t gone away completely (and could flare up again), these headwinds have now eased enough to allow policy stimulus to come through

Note: ‘Fiscal policy’ measure is the cyclically-adjusted primary budget balance (ie excluding net interest payments). Sources: Datastream; OECD; Economics@ANZ.
Leading indicators for the global economy have turned around over the past two-three months

Leading indicators of global industrial production

Note: Global IP series constructed by Economics@ANZ from data for 42 countries. Global PMI is a weighted average of PMIs for the US, Euro area, UK, Canada, Australia and (from January 1999), Hong Kong and Singapore. Sources: Datastream, OECD, ISM, CIPS, Reuters, NTC, AiGroup, Economics@ANZ.
Financial and commodity markets have also detected the shift in the global economic cycle.

![Graphs showing financial and commodity markets trends](image)

*Sources: Reuters; Datastream; Metallgesellschaft.*
## Outlook for world economic growth

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<thead>
<tr>
<th></th>
<th>% change in real GDP</th>
<th>1996-2000</th>
<th>2001</th>
<th>2002</th>
<th>2003 (f)</th>
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<tr>
<td><strong>United States</strong></td>
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<td>4.0</td>
<td>0.3</td>
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<td><strong>Western Europe</strong></td>
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<td>2.7</td>
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<td><strong>Japan</strong></td>
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<td>*<em>Industrial economies</em></td>
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<td><strong>China</strong></td>
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<td><strong>Other East Asia</strong></td>
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<td><strong>South Asia</strong></td>
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<td><strong>Latin America</strong></td>
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<td>0.5</td>
<td>-0.5</td>
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<td>*<em>Developing economies</em></td>
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*Includes countries not shown separately. Sources: National statistical agencies; IMF; Economics@ANZ.
Policy stimulus has allowed US households to start rebuild savings while continuing to spend

**Personal income**

Real % ch. from year earlier (3-mth moving average)

- Pre-tax
- After-tax

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<tr>
<th>Year</th>
<th>Pre-tax</th>
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**Personal consumption spending**

Real % ch. from year earlier (3-mth moving average)

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**Personal saving rate**

% of disposable income

- Trend
- Actual

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**Housing starts**

Million units

- Trend
- Actual

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*Note:* ‘Trend’ estimates calculated using ABS formulae. *Sources:* Commerce Department; Economics@ANZ.
Meanwhile US corporate profitability has been largely restored and investment is now recovering.

**Productivity and labour costs**

- **After-tax profits**
  - % change from year earlier
  - **Good result given weak growth**

- **Unit labour costs**
  - % change from year earlier

- **Productivity**
  - % change from year earlier

**Net cash flow margin**

- % of domestic non-financial gross product
  - **Lowest since 1952**

**Business investment**

- % change from year earlier
  - **Business investment (real terms)**
  - **Capital goods orders (excl. defence & aircraft)**

**Sources:** US Bureau of Economic Analysis; Commerce Department; Bureau of Labor Statistics.
While a near-term US recovery seems assured, it’s not yet clear how sustainable it will be.

- Almost all of the ‘adjustment’ to the end of the 1990s bubble has taken place in the business sector.
- Household finances remain very ‘unbalanced’ relative to historical norms, while another major imbalance as opened up (again) in the government sector.
- These imbalances have helped keep the US economy afloat over the past three years – but they cannot be sustained indefinitely.
- US households are vulnerable to any sharp rise in interest rates or persistent weakness in jobs growth.
- The US as a whole is vulnerable to any major shifts in global capital flows.

‘Financial balance’ = saving minus investment.

Sources: Commerce Department; Economics@ANZ.
Partial restructuring in some areas of Japan’s economy is promoting a recovery in investment.

**Labour productivity**

% change from year earlier (6-mth moving avge)

(Manufacturing sector)

**Operating profits**

% change from year earlier

**Business confidence**

Net balance, optimists minus pessimists (%)

**Machinery orders**

% change from year earlier (3-mth moving avge)

(excl. ships & utilities)

Sources: Economic & Social Research Institute; Bank of Japan.
Employment conditions in Japan have stopped deteriorating, giving consumers more confidence.

**Employment**

- Average monthly earnings
- % change from year earlier (3-mth moving avge)

**Consumer confidence**

- %
- Tokyo
- All Japan

**Household saving ratio**

- % (12-mth moving average)

Sources: Health, Labour & Welfare Ministry; Economic and Social Research Institute (ESRI).
Deflationary pressures appear to be easing, which may pave the way to more sustainable growth.

- Protracted deflation has been both a symptom of the scale of Japan’s economic problems and an obstacle to recovery.
- Deflationary pressures have eased noticeably this year. Something which didn’t happen (at the consumer level) during the last short-lived upturn in 2000.
- Since its change of leadership in 2001 the Bank of Japan has been more vigorous in trying to end deflation by ‘unorthodox’ means.
- A return to positive inflation would assist corporate and financial restructuring, and give monetary policy more ‘traction’.

Sources: Bank of Japan; Home Ministry; OECD.
China’s economy is regaining momentum after the temporary jolt caused by the SARS outbreak.
China’s exports are growing rapidly – but its imports are growing even faster

- Chinese exports have risen at an average annual rate of 17% over the past five years – but imports have risen at an average annual rate of 24%
- Contrary to widespread opinion, China’s trade surplus is shrinking
  - China’s bilateral surplus with the US (and Australia) is widening
  - but it runs (growing) deficits with most other countries
- A large part of China’s export growth is being driven by ‘outsourcing’ from other countries
  - ‘foreign-invested enterprises’ now account for over 60% of the growth in China’s exports

Source: National Statistics Bureau.
China’s determination not to revalue the renminbi is causing problems for its monetary policy.

Maintaining the Rmb peg in the face of a dramatic swing in capital flows is forcing China into huge US$ purchases and Rmb sales.

Sources: Institute of International Finance; People’s Bank of China
China faces a (currently small but) growing risk of credit-fuelled ‘overheating’ and inflation

- The massive build-up in China’s FX reserves has a counterpart in its domestic money supply
- Rapid monetary growth is in turn fuelling a boom in bank lending
  - lending for construction has risen by 33%, and to private enterprises by 57%, over the year to July
- This boom will ultimately worsen banks’ bad loan problems
- The central bank and main bank regulator are trying to dampen down this boom by raising bank reserve requirements and issuing lending directives to banks
- Inflation has turned positive this year and is likely to rise further over the next 18 months

Source: National Statistics Bureau.
Other cotton-importing Asian economies should experience slightly stronger GDP growth in 2004

**Sources:** National statistical agencies; Economics@ANZ.
Indonesia’s economic environment is gradually improving ...

Sources: BPS Statistics Indonesia; Datastream.
... but security, regulatory and political risks continue to impede more rapid growth

Rupiah vs US$

- Financial markets have been surprisingly unaffected by the Bali and Marriott bombings
- Concern over heightened security risks to some extent balanced by recognition of greater willingness on the part of Indonesian authorities to deal with it
- Progress in regulatory and legal system reform remains slow
- Political uncertainties will increase ahead of 2004 Parliamentary (April) and Presidential (July) elections
- So far Indonesia has not been able to sustain the 5-6% growth needed to reduce unemployment and poverty

Source: Datastream.
Potentially important developments in trade policy over the next 6-18 months

- **Termination on 1 January 2005 of the Agreement on Textiles and Clothing, and removal of all remaining textile and clothing quotas**
  - some countries (including the US) have reserved the right to impose ‘safeguard measures’ to prevent/reverse ‘import surges’
  - these ‘safeguards’ can be directed at specific countries
  - removal of quotas will advantage China in particular
  - but to some extent at the expense of other textile exporters such as Bangladesh

- **Critical milestones in the ‘Doha Round’ of multilateral trade talks**
  - the only hope of eliminating global agricultural policy distortions, including US cotton subsidies of US$4bn on a $3bn crop produced by just 25,000 farmers
  - elimination of all such distortions would produce global welfare gains estimated at over US$56bn, including over US$3bn for Australia*

- **Negotiations on a US-Australia Free Trade Agreement**
  - limited implications for Australian cotton exporters

Movements in the A$-US$ rate in recent years have largely mirrored movements in the US$

Monthly since 1997

Daily during 2003

Sources: Datastream; US Federal Reserve; RBA.
Whether a country has a current account deficit or not matters less than how the deficit is financed

Until the collapse of its equities boom the US was able to finance its ever-growing current account deficit with equity inflows.

Since equity inflows are typically unhedged, they create net demand for US$ which (for a time) more than offset the selling of US$ due to the current account deficit.

From early 2002, the US current account deficit widened again – but the US became more reliant on debt financing, so the US$ fell.

Equity inflows appear to have picked up again recently with improved hopes for the US economy – but this may not be sustainable.

**US current account deficit and its financing**

- **Current account deficit**
- **Net borrowing**
- **Net equity investment** (incl. corporate bonds)
- **Other (incl. central banks)**

**Sources:** US Bureau of Economic Analysis.
Australia is more reliant on borrowing to finance its deficit, and this affects the behaviour of the A$.

- Australia has become a net equity capital, so that we now rely almost entirely on borrowing to finance our current account deficit.
- Most of this borrowing is done by the banks, who typically hedge it – so that the inflows don’t create net demand for A$.
- Over the first half of this year, a turnaround in net equity flows combined with large unhedged A$ bond purchases by Japanese retail investors) drove the A$ up sharply.
- Renewed enthusiasm for equities since late June appears to have drawn capital away from Australia again, resulting in a renewed decline in the US$.

**Australian current account deficit and its financing**

A$ bn - four quarter moving total

- **Current account deficit**
- **Net borrowing**
- **Net equity investment**
- **Other (incl. central banks)**

*Sources: ABS*
Asian central banks have financed half the US deficit in 2002-03 but can’t keep it up indefinitely

- Asian central banks’ reserves have risen by nearly US$270bn since mid-2003, reflecting purchases of US$ undertaken to stop their currencies rising against the US$.
- These purchases would have been sufficient to finance around half the US current account deficit.
- They also deflected most of the adjustment to a declining US$ on to ‘freely floating’ currencies such as the euro and the A$.
- As seen in China’s case, such policies may have other adverse consequences and may not be sustainable indefinitely.
- Changes in Asian currency policy could prompt a renewed US$ fall.

Source: Datastream; Economics@ANZ.
Some time next year the US$ is likely to begin falling again, so the A$ may have another spurt

- The US current account is likely to approach 6% of GDP next year – and it’s unlikely that the US will be able to attract enough unhedged capital inflows to finance it: especially once growth begins to pick up outside the US
- The US$ is thus likely to begin trending down again some time next year – initially against the ‘freely floating’ currencies
- The A$ will trade in a US63-66¢ range near term but may have another spike upwards to around US70¢ during 2004
- While timing remains uncertain, a shift in Asian currency policies may take some of the pressure off the A$ and other ‘free floaters’
Summary and implications for the Australian cotton industry

- The world economy is in the process of picking up again
  - world cotton consumption growth in 2003-04 may be a little stronger than the 1% forecast by ICAC (though still below 2002-03’s 4%)
- There are still significant imbalances within and among the world’s major economies
  - it remains to be seen whether the recovery in the global economy will be sustainable beyond 2005
- Cotton-importing Asian economies should experience modestly stronger growth in 2004
  - but there is a gradually increasing risk of ‘over-heating’ in China which could be followed by a temporary downturn
- Trade policy developments in the next 6-18 months could potentially bring major benefits to Australian exporters
  - but powerful protectionist interests could stymie almost all progress
- The US$ almost certainly has at least one more leg downwards
  - implying that a further upwards move in the A$, perhaps to US70¢, is likely some time during 2004