A very delicate point in the Australian business cycle

The Australian economy is at the point in the business cycle from which every previous recession since World War II has sprung

As expected the Reserve Bank last week tightened monetary policy by raising its official cash rate ¼ pc point to 5½% - the highest since March 2001.

The announcement of the cash rate increase on Wednesday morning was followed two hours later by the release of the December quarter national accounts which showed that real gross domestic product (GDP) had increased by a mere 0.1% - well below analysts’ expectations which had centred on 0.5% - and (with previously published estimates for growth in each of the first three quarters of 2004 being revised down) by just 1.5% over the year to the December quarter. This is the slowest annual growth since the year ended the June quarter 2001.

A number of analysts, much of the media and (rather less surprisingly) the Government have interpreted the weaker-than-expected GDP numbers as signalling that the chance of another rate increase any time soon has receded. This represents, in our view, a serious mis-reading of the data. Far from undermining the justification for last week’s rate increase (or dampening the likelihood of another one), a detailed inspection of the data contained in the national accounts provides a compelling rationale for tighter monetary policy.

First, the national accounts showed that final domestic demand (that is, total spending by consumers, businesses and governments) rose by 4% over the course of 2004 and was still rising at a 4% annualized rate in the December quarter itself.

Second, the accounts show that demand is being strongly boosted by the Government’s own actions. Bringing together data from some of the less-widely examined tables in the national accounts show that Commonwealth general government own-purpose outlays (excluding payments to State and local governments, interest and defence outlays) rose by over 10% in real terms on average in 2004, a rate exceeded only once since the Whitlam era.

Third, the national accounts highlight the contribution to growth in domestic incomes (and domestic spending power) arising from the improvement in Australia’s terms of trade (ie, rising export prices and falling import prices) – which are now at their most favourable since 1974.
Real gross domestic income (real GDP growth adjusted for movements in the terms of trade, and thereby showing the real value of GDP in terms of its purchasing power over foreign-produced goods and services) rose by 3.5% in real terms over the course of 2004.

Fourth, the accounts highlight the growing significance of capacity constraints (such as shortages of skilled labour, or infrastructure bottlenecks) in limiting the growth in the supply side of the Australian economy (which is what is measured by movements in real GDP). Strong domestic demand is increasingly spilling over into imports or being met by running down inventories, rather than by increased Australian production; while growth in exports is being constrained (in the face of strong global demand for many of Australia’s key export commodities) by ‘bottlenecks’ such as those at railways and ports. This deterioration in net export volumes has more than offset the effects of favourable movements in relative export prices, leading to a marked widening in the trade deficit.

Fifth, the national accounts show that productivity growth has slowed abruptly – more than that, in fact, it has gone into reverse. The measure of output per hour worked compiled by the Statistics Bureau, which rose at an average annual rate of 2.9% pa over the decade ended the December quarter 2003, actually fell by 0.6% over the year ended the December quarter 2004. The productivity measure compiled by the Treasury and published on its website also declined by 0.2% over the course of last year, having grown at an average annual rate of 2% over the previous decade.

The extent of the turnaround in productivity growth may have been exaggerated by cyclical lags between employment and GDP growth; nonetheless, slower productivity growth means that capacity constraints represent an even more binding limit on the rate of output growth; and it also implies that even with unchanged growth in ‘top-line’ wages costs, unit labour costs (which are a key determinant of price movements at the consumer level) will accelerate. Indeed, having risen at just 1.6% pa over the three years to the December quarter 2003, over the past four quarters, nominal unit labour costs rose by 3.4%, the fastest over any calendar year since 1995.

The Australian economy is thus at the point where growth in its supply potential is being constrained both by physical limitations – in a way that it has not been since 1989 – and by an apparent end to the productivity growth of the past decade.
This is a key ‘turning point’ for the economy and for economic policy. Since the recession of the early 1990s, it has been feasible to allow demand to grow at rates in excess of the supply potential of the economy, because there has hitherto been ample ‘spare capacity’ (unemployed labour, idle plant, vacant office space, etc.) in the economy which can be brought back into production as required. And it has been desirable to allow demand to grow faster than supply, because only if demand grows faster than supply can unemployment be brought down.

But it is now no longer desirable for the growth rate of demand to exceed that of the supply potential of the economy – because if it does persist in doing so, then either inflation will begin to accelerate (as costs rise, and firms pass cost increases on to their customers in the form of higher prices; or the current account deficit (already over 7% of GDP for the first time since the early 1950s) will continue to widen); or (more likely) both.

In other words, the Australian economy is at the point in the business cycle at which ‘policy mistakes’ have typically been made (specifically, that of leaving tightening of monetary policy too late), and from which every recession in Australia’s post-war history has sprung (as a result of then tightening ‘too much too late’ after inflationary pressures have become more firmly entrenched).

There are, to be sure, reasons for optimism that the route from this stage of the business cycle to recession will not be taken on this occasion.

- first, the steps taken over the past two decades to de-regulate labour and product markets and expose them to greater domestic and international competition makes it less likely that cost pressures emerging in one or two sectors of the economy will be rapidly spread (eg through national wage cases) to other sectors where capacity constraints are less binding or demand pressures less intense.

- second, the strong A$ is exerting more competitive discipline on price-setting behaviour than has typically been the case at this stage of previous cycles.

- third, and most important, the RBA no longer needs to seek the permission of the Treasurer to tighten monetary policy – as it did prior to the early 1990s (ie, at this stage of every previous business cycle), and is thus in a position to implement more timely increases in interest rates on its own initiative than it was permitted to in previous cycles.

Thus, the RBA is still likely to raise the cash rate another ¼ pc point, either at the April Board meeting or, if they wish to wait for the March quarter CPI result to provide additional justification for that move, at the May meeting. Thereafter, the Bank is likely to pause (as it did after the two rate rises in mid-2002 and the two at the end of 2003) to assess the impact of these moves on the outlook for growth and inflation.

At this stage I do not envisage that these rate rises will precipitate a recession. The Reserve Bank is unlikely to tighten monetary policy aggressively. And although the household sector is undoubtedly more sensitive to movements in interest rates than ever before, the corporate sector (and, hence, employment) is much less sensitive to movements in interest rates than it was at this stage of the 1980s cycle, having spent most of the period since then substantially reducing its financial leverage.

At the onset of the late 1980s cycle of rising interest rates, the non-financial corporate sector’s debt-to-equity ratio was over 150%, and its gross operating surplus covered its net interest payments barely 1½ times; whereas by 2004, the debt-to-equity ratio of the non-financial corporate sector was down to around 75%, while aggregate interest cover was over 5 times.

Thus, whereas in the late 1980s and early 1990s, the damage wrought by rising interest rates was inflicted primarily on the business sector and transmitted to households.

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1 As an aside, the reaction of the Treasurer, the Prime Minister and other Ministers (with the conspicuous exception of Finance Minister Nick Minchin) to last week’s rate increase suggests that, were it still necessary for the RBA to secure their permission to raise rates, it might not have been readily forthcoming - underscoring the wisdom of their decision in 1996 to grant the RBA de jure the independence in setting rates which it had secured de facto in the early 1990s.
primarily through the channel of rapidly rising unemployment, on this occasion the admittedly greater direct impact of rising rates on household finances should be to some extent ameliorated by the smaller impact of (smaller) increases in interest rates on business finances and on employment.

Nevertheless, we have lowered our growth forecast for (calendar) 2005 from 3% to 2¼% which would be the weakest outcome since 1991. (Note that this forecast is tentative and subject to revision over the next few weeks).

Against this background it obviously becomes increasingly important to maintain a close watch on factors which might detract from the confidence expressed above that 'this time it will be different' (always a highly dangerous thing for an economic forecaster to say).

Apart from watching closely for evidence of cost pressures becoming more widespread, or (rather less likely), the Reserve Bank succumbing to political pressure to refrain from interest rate increases that it thinks are warranted, movements in the exchange rate may also assume heightened importance.

Further sharp appreciation of the A$ (for example, because of a further sharp depreciation of the US$ against other major freely-floating currencies) would dampen inflationary pressures, but would also likely result in significant pressure on profit margins in trade-exposed sectors of the economy (other than resources producers).

Conversely, a significant depreciation of the A$ - something which we think is increasingly possible after around mid-year as US interest rates continue to rise, eroding the spread between Australia and US (and other) rates which has to date made relatively effortless the financing of Australia’s large and growing current account deficit - would result in a relaxation of the restraint currently being exerted on the pricing behaviour of Australian firms, and thus potentially unleash greater inflationary pressures².

² Note that the Reserve Bank does not make an exchange rate forecast in constructing its inflation forecast, but rather (and, for a central bank, not unreasonably) assumes that the A$ remains unchanged at its value when the forecast is constructed. It does this, not only because of the poor track record of exchange rate forecasts but also to prevent any forecast being mis-interpreted as some kind of exchange rate ‘target’.

In short, not only is this the point in the cycle where (as I’ve observed on a couple of occasions publicly over the past week) the economic management credentials of Treasurers are truly tested, it is also where the capacity of economists to identify major cyclical turning points in the economy also stands or falls.

Incidentally, New Zealand is in more or less the same situation as regards monetary policy and the business cycle. Indeed capacity constraints are if anything even tighter on that side of the Tasman than this – the unemployment rate in the December quarter was 3.6%, the proportion of businesses encountering labour shortages is the highest since 1961, and capacity utilization the highest in at least 25 years.

My colleagues at ANZ National Bank in Wellington last week revised their monetary policy outlook to incorporate ¼ pc pt increases in the RBNZ’s official cash rate (OCR) at its March and April reviews, taking the rate to a peak of 7% - the highest since OCR targeting was introduced in March 1999, and implying the highest short-term rates in NZ since July 1998 (when the RBNZ unnecessarily brought on a recession by allowing the ‘monetary conditions index’ framework under which it then operated to force interest rates up sharply in response to the fall in the NZ$ which occurred in the wake of the Asian financial crisis).

The revision to the New Zealand monetary policy outlook reflects a recognition that economic growth momentum is stronger than previously foreseen, and that the upside risks to inflation are therefore greater; our ANZ National Bank colleagues have thus raised their forecast for 2005 economic growth from 2½% to 3%; but lowered their forecast for 2006 from 2½% to 1¾%.

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