THE RESOURCES BOOM AND MACROECONOMIC POLICY IN AUSTRALIA

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Executive Summary

The puzzle

Australia is in the midst of the most remarkable resources boom in its history: both mining investment and the terms of trade are at record levels and investment is continuing to increase further. But the domestic economy is slowing: real GDP rose by only 1.4% over the past year, while employment has been virtually flat in the first nine months of 2011, with unemployment rising a little. How can both of these things be happening at the same time? The answer to this question is of real importance for monetary and fiscal policy, which are both set to offset the expansionary effects of the resources boom. The continuing uncertainty about the world economy further clouds the issue.

This report seeks to throw light on this puzzle, by examining in detail the various ways in which the resources boom affects the national economy. Our central argument is that the net impact of resources boom – which operates through several channels, both positive and negative – has been strongly positive but has now peaked. With no additional net positive impact from the boom, both monetary policy and fiscal policy need to become more expansionary. This implies a reduction in interest rates and changes to fiscal policy to support the domestic economy in the light of the other domestic and international forces that are producing slower growth.

The resources boom

Traditionally Australia has been said to be experiencing a resources boom if either the level of resource investment as a share of GDP or the terms of trade (the ratio of export prices to import prices) were at high levels. In the current boom both variables are at record levels at the same time, for the first time in Australia's history. This means that the analysis of this unique episode is complex, with interweaving price and volume effects at work.

We analyse the net impact of the resources boom as the overall effect of four key factors: (i) the impact of lower import prices on the real value of domestic incomes; (ii) the impact of higher \$A export prices on the incomes and financial assets of Australian owners of resource companies; (iii) the impact on domestic economic activity and employment of the Australian content of resource investment and (iv) the negative impact of the higher real exchange rate on trade exposed sectors – such as manufacturing, tourism and educational services. While most focus has been on mining investment, the first of these has probably been the most important in macroeconomic terms.

In analysing the overall impact of the boom we distinguish between level and change effects. The positive impact of the boom has been building over eight years, with an increasing impact each year except for the period of the global financial crisis. But the incremental effect – the change in the impact from year to year – is more important for policy formulation, and it is widely assumed the boom will have a continuing positive incremental impact on the economy in the years ahead. By contrast, our assessment is that the net incremental effect has now peaked – the level effect, while still positive, is no longer increasing. Both monetary and fiscal policy need to adjust to this fact.

The changing incremental effect of the resources boom

During the resources boom Australia's export prices have increased by 170% in foreign currency terms, with the increase heavily concentrated on the resources sector. This has led to a rise in the exchange rate and an increase in export prices in $A, each of about 65%. The rise in the exchange rate has led to falling relative import prices and hence to an increase in the real value of domestic incomes (point (i) below). The rise of nearly two-thirds in $A export prices has contributed greatly to the incomes in $A of resource companies and of their domestic and foreign owners (point (ii) below).

(i) Higher real incomes from lower import prices. As a result of the rise of 65% in the real trade weighted $A exchange rate between the December quarter of 2002 and the June quarter of 2011, import prices fell by 35.5% relative to the price of domestic supplies to final demand over this period. Allowing only for direct effects, lower import prices reduced the growth in the implicit price deflator for domestic final demand by 9.7% relative to the case of no fall in relative import prices. These lower import prices increased the real value of most classes of domestic incomes, with higher effects where a higher proportion of income is spent on imports.

For example, real compensation per employee hour grew by 2.1% per annum over this period, by comparison with 1.3% over 1979-2002, and by mid 2011 was 10.5% above the previous trend. Real per capita household disposable income grew by 2.8% per annum over 2002-11, by comparison with 1.0% over 1979-2002, to be 17.6% above the earlier trend level by mid 2011. This rapid growth in the real value of household incomes was substantially due to the import price effects but other factors, also in part arising from the resources boom, are relevant. For example, total hours worked grew by 2.0% per annum over 2002-11 by comparison with 1.5% per annum over 1979-2002.

During the September quarter 2011 the nominal exchange rate fell by 6.3%, although it has shown signs of recovery subsequently. This analysis is undertaken on the basis of fixed exchange rates going forward at their June quarter 2011 levels, an assumption which seems reasonable at the present time. On this assumption the exchange rate boost to (non-export) domestic incomes – arguably the most powerful effect of all - has come to an end, even if the terms of trade rise further.

(ii) Incomes and financial assets. As most mining companies pay only modest dividends and stock markets anticipate the future benefits accruing from current investments, the main benefit to resource owners is through the appreciation of asset values, mainly share prices. From early 2003 to October 2007, before the financial crisis had its impact, the resources index of the ASX increased fourfold. This was dominant reason for the rise of 144% in the ASX All Ordinaries Index and of 151% or $1014 billion in the market capitalisation of domestic equities over that time. Much of this increase in asset values accrued to foreign rather than domestic partners, as the resources sector is about 80% foreign owned (Connolly and Orsmond 2011). Even so, rising share prices stimulated the rise in housing and other asset values; between 2002 and 2007 Australian households saw an increase of 8% per annum in real per capita assets, about three times the long run rate of growth.

This increase in real asset prices driven by the resources boom has also come to an end. The resources component of the ASX index recovered after the GFC fall, but remains below its 2007 peak. The overall ASX index is well below that peak, in part reflecting the impact of the higher $A on the profitability of non-resource companies. More generally, the level of real per capita household assets is lower now than in 2007, and probably still falling. The period of rising asset values driven by the resources boom has well and truly passed.

(iii) Mining investment. One area in which the boom remains strongly evident is in mining investment, which rose as a share of GDP from 1.6% in 2002-03 to 4.8% in 2010-11, and could reach 7% by 2013-14. The impact of this investment needs to be considered in terms of its local content and of trends in other forms of investment. Very limited information is available about the local content of resource investment in Australia. The Reserve Bank concluded, on the basis of its industry liaison work, that 'around half – give or take – of the demand generated by these projects is typically filled locally, though, of course, this amount varies with the nature and details of any specific project' (Stevens 2011), and both of these points are broadly confirmed by the Local Content Report published by the Western Australian Government (DSD and DC 2011).

There is evidence that the local content of mining investment is falling over time, as a result of the changing nature of mining projects and of the impact of the higher $A on the position of Australian suppliers. The pattern of resource investment is shifting sharply to LNG projects, especially large, offshore projects such as the Gorgon ($43 billion), Wheatstone ($29 billion) and Prelude ($12 billion), with much lower local content ratios. In such projects major components of the offshore platform are fabricated overseas, for example in Korea or China, and then brought to the drill location, often by sea. Other information supports this conclusion of lower local content ratios in recent and prospective mining investment. For example, employment in manufacturing in Western Australia rose steadily (by 2.1% per annum) from August 2002 to August 2008, but in the three years to August 2011 it has fallen by 22.4%, or 8.1% per annum. Thus while the Reserve Bank's 50/50 estimate may be appropriate over the boom as a whole, it is likely we are seeing a shift from well above 50% local content in the early boom years to well below 50% in the future. This will temper the impact of rising resources investment on the domestic economy.

Over the course of the boom, resource investment has not displaced other private investment – non-resource private investment stood at 16.9% of GDP in 2002-03 and at 17.0% in 2010-11. But the periods before and after the GFC have been quite different: between 2002-03 and 2007-08 the non-resource investment share rose by about two percentage points of GDP (to 19.0%) but since then it has fallen by the same amount. The outlook for each of the three non-mining components of total investment – dwellings, other private investment and public investment – seem to be subdued at best. Both because of this fact and the falling local content of resource investment it is likely that the effective contribution of investment to local activity has peaked in this cycle as a share of GDP, and may fall over the next two years even as resources investment increases further.

(iv) Competitive impact of the higher $A. The lift in the $A exchange rate since 2003, taken together with the rise of China and other low cost countries and periods of weakness in the global economy, has placed trade-exposed non-resource firms in Australia under continuing competitive pressure. Reflecting these and other factors, the real trade balance on goods and services as a share of total domestic demand has fallen by 15 percentage points over the decade to the June quarter of 2011 – from +11.9% in the June quarter of 2001 to -3.1% in the same quarter of 2011. Nevertheless, it has been the second round of the exchange rise after the GFC that has intensified pressure on manufacturing and service industries, perhaps because it has been combined with weak economic conditions in the USA and the EU and because longer term decisions are being taken as the $A becomes entrenched.

In manufacturing, for example, real gross value added rose by 1.5% per annum between the second quarters of 2003 and 2008, but has fallen by 4.6% or 1.6% per annum over the three years to the June quarter of 2011. As a result, while manufacturing employment grew marginally in the earlier period it has fallen by 10.2% (or 3.9% per annum) in the three years to August 2011. Similarly, real service exports rose up to early 2008, but have fallen steadily since then, and imports of services have grown rapidly in recent years. As a result the real trade position in services, positive before 2005 and balanced after the GFC, has moved to a deficit of about 2% of domestic final demand by the June quarter of 2011. This reflects, inter alia, a decline in the number of foreign students coming to Australia and a dramatic change in net short-term population movements, as residents departing now far outnumber visitors arriving.

Implications for policy

Economic outcomes are shaped by the interactive effect of many factors, and the data on critical parameters are limited. But in our assessment it is clear that the incremental effect of the ongoing resources boom, strongly positive for so long, has now peaked. Unless the exchange rate rises further the terms of trade boost to non-resource incomes has come to an end; real household per capita assets are now falling, after a strong period of rapid growth; resource investment is continuing to rise as a share of GDP, but its net impact is being eroded by the changing nature of resource projects and the high $A, which is also contributing to weaker investment in other industries; in the context of weak demand in the USA and the EU the competitive pressure from the high $A is mounting on Australian trade exposed goods and service industries.

Monetary policy has been ‘mildly restrictive’, in the words of the Reserve Bank, being directed to offset the presumed net (incremental) expansionary impact of the resources boom and by concern about inflation running above the target band. In our view both of these concerns are no longer relevant, the first for the reasons outlined above and the second because it is clear that there is now no inflationary problem in Australia that needs to be addressed by a restrictive monetary policy.

Over the three years to the June quarter of 2011 five sub-groups, out of a total of 90 in the CPI and accounting for about 12% of the index, have provided 40% the growth in the CPI, and 44% of the growth over the past year. The five groups are lamb and mutton, fruit, vegetables, utilities and tobacco. These five groups in total rose have risen by 11.9% per annum over the past three years, while the rest of the CPI rose by 1.8%; over the past year the five groups rose by 16.7% and the rest of the index by 2.2%. Thus excluding these items inflation has been well within the Reserve Bank’s target range of 2-3% on average over the cycle.

There is no reason for thinking that the rapid growth in prices for these items can be significantly influenced by monetary policy. Prices for the food items reflect seasonal conditions affecting supply, while increases in tobacco prices are driven by regular increases in tax rates. The reasons for the rapid growth of utility charges (11.5% per annum over three years) are far from clear, but it is unlikely that price changes for this group would be greatly affected by a restrictive monetary policy. On 1 November 2011 the Bank recognised that the economy was slowing and the threat of inflation was easing, and cut interest rates accordingly, moving to a more neutral stance.

Fiscal policy is currently severely rather than mildly restrictive, with the Australian Government overseeing the most rapid process of fiscal consolidation for over 40 years. In the context of a perceived powerful continuing stimulus from the resources boom and in pursuit of a balanced budget by 2012-13, the Government proposes to take $50 billion or 3.6% of GDP out of the economy (on an underlying cash basis) over 2011-12 and 2012-13. Again neither of these concerns is currently relevant to Australia's economic situation. Partly reflecting the considerations outlined above and ongoing issues in the EU and USA, the outlook for the Australian economy is now much weaker than that presented in May in the 2011-12 Budget Papers, in spite of the continuing resources boom. Real GDP has grown by 1.9% per annum over the last three years, and GDP growth for 2011-12 in now likely to be closer to that figure than to the 4% forecast in the Budget Papers, while employment growth will fall well short of the 1.75% forecast.

It should be noted that Australia's fiscal position is very strong, with Australian Government net debt at only 6.1% of GDP at the end of 2010-11. It will be strengthened further over the next decade, even under the current taxation regime, as tax revenue from higher resource prices and from projects currently under construction begins to be received. Such revenue is currently being delayed by capital losses incurred in the global financial crisis and by depreciation allowances being generated by high levels of capital investment. The scale of both the investment and of the depreciation allowances being generated is massive, but tax revenues from the resources sector will rise strongly when these allowances are used up.

It is no longer appropriate in current circumstances for the Australian Government to pursue a budget surplus in 2012-13. It should move away from this target and adopt a much less restrictive fiscal policy, more supportive of economic growth.