

Export price surge doesn't fit with slowing economy

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AMID the gathering signs of a slowing economy one factor doesn't fit: our soaring export prices.

This week has seen further evidence that the economy is slowing rapidly. Retail sales fell 1% in June in nominal terms and real retail sales fell 0.6% in the June quarter, after a 0.3% fall in the March quarter.

The private sector's total debt ("credit") increased just 0.4% in June, with the level of personal debt falling 0.4%.

Such clear signs must surely bring forward the day when the Reserve Bank considers cutting the official interest rate.

If the economy continues slowing this sharply, the risk of the desired "soft landing" turning into a hard one will mount. But as one economist remarked to me recently: "I can't see how you can have a recession when export prices are going through the roof."

Fair point. The two stories are hard to reconcile and the reality of the further leap in our terms of trade — export prices relative to import prices — cannot be brushed aside.

Under this year's contracts, the prices we receive for iron ore and steaming coal (for making electricity) have roughly doubled and those for coking coal (for making steel) have trebled.

These changes mean our terms of trade will improve 20% over the first three quarters of this year, taking the total improvement since 2002 to nearly 70%.

When the prices we receive for our exports rise faster than the prices we pay for our imports this increases the nation's real income. When that increased income is spent, the economy grows and jobs are created.

So, how can the evident signs of slowing borrowing and spending be reconciled with the rising real incomes?

I think the explanation comes on two levels. First, there is no law saying increased income has to be spent.

It seems possible a lot of it won't be.

The mining companies have already done a mighty lot of investing in expansion and the construction industry must already be close to full stretch; so maybe the miners will choose to save much of their extra after-tax income.

We know the Government has promised to save any additional tax revenue that comes its way, and it may well be that people directly and indirectly employed in the mining industry will choose to increase their precautionary saving in view of these more uncertain times. But at the second level it may be that the mining states of Western Australia and Queensland continue sailing along reasonably strongly while the other states take the brunt of the slowdown.

if the slowdown never reaches the point of producing the two successive quarters of "negative growth" in the national economy needed to give the media permission to cry "recession", the continuing growth in the mining states could well be the reason.

But that is unlikely to be much consolation to people in Sydney, Melbourne, Adelaide and Hobart. To them it may feel as bad as the real thing.

I confess that I don't enjoy giving more air to all the talk of a "two-speed economy". Many people — particularly self-pitying Sydneysiders — have a quite exaggerated notion of the extent to which, and the time during which, it is possible for there to be a big discrepancy in growth rates in different parts of the country.

That is because, in truth, we live in one national economy, not eight state and territory economies. There are no government-created barriers to trade between the states, and much interstate trade occurs.

It is also because of something every economics student understands: the "circular flow of income".

When people in the mining states spend their income, that spending often becomes the income of people producing goods and services in the other states.

The fact is that, until this latest surge in export income, the gap between the states in terms of rates of economic activity had been narrowing, not widening.

That is only to be expected.

A rise in export income has its initial and greatest effect on the mining states but, as each month passes, economic links between the states cause the income boost to flow to the others.

So, while the latest boost in export income may lead to rewidening in the gap between the states' performance initially, over time we can expect the renewed gap to diminish again.

But when we are thinking about the extent to which activity in the mining states will stay strong despite the general slowdown, some research by Kieran Davies of ABN Amro is relevant.

Davies found that retail sales, building approvals and home loan approvals had been weaker in Western Australia this year than in the rest of Australia, while the index of consumer sentiment had fallen significantly.

This suggests that the switch from optimism to pessimism that has done so much to slow spending in the non-mining states is also occurring in the mining states.

If so, the continuing mining boom may not be sufficient to keep us out of trouble.

Source: Ross Gittins