

Glenn Stevens: Interesting times

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Australian Business Economists Annual Dinner, Sydney, 9 December 2008.

* * *

It is a pleasure once again to address the Australian Business Economists.

It was to this group that I gave my first speech as Governor, in October 2006. Tonight is my 23rd speech since then. Between the two occasions, quite a lot has changed, globally and domestically (though I doubt the speeches have become any more exciting).

Many people have said to me recently that the times are “interesting”. My response has been that they are, perhaps, a little too interesting. I need not remind this audience of the international financial turmoil through which we have lived over the past almost year and a half, nor of the intensity of the events since mid September this year, in particular.

I do not know anyone who predicted this course of events. This should give us cause to reflect on how hard a job it is to make genuinely useful forecasts. What we have seen is truly a “tail” outcome – the kind of outcome that the routine forecasting process never predicts. But it has occurred, it has implications, and so we must reflect on it.

In that spirit, I shall set out a few features of this episode that make it “interesting”.

The most obvious one is the prominence of financial events and particularly financial sector impairment in key countries. There have been other episodes where individual financial institutions or sectors, or even the whole banking systems of small countries, have needed recapitalisation. But the scale of capital needed, the number of countries where it is needed and the extent of counterparty risk aversion because of concerns over solvency have been outside the range of experience of the past half century.

In the near term, financial stress brings the obvious concern about the ability of the financial system to provide credit to the economies in question. As one measure of this concern, the number of loans approved for housing in the United Kingdom in October was 65 per cent lower than a year earlier, and about 50 per cent lower than during the downturn of the early 1990s. The immediate need is to keep ample liquidity, strengthen banks’ balance sheets by adding capital and to help confidence, including by lending the strength of the sovereign’s credit rating where necessary. All this has been occurring.

What may still be needed internationally is attention to the remaining problem assets, since if their prices continue to decline, the capital position of the banks will continue to deteriorate. So while the UK solution has emphasised new capital and the initial US approach emphasised excising the “troubled” assets, the Swiss solution has been to do both: to recapitalise the banks, while getting the worst of the bad assets off their balance sheets. The United States has moved in this direction also more recently. Continued efforts to provide clarity on the state of balance sheets is also important. Surely the lingering counterparty risk aversion reflects uncertainty on this score.

Longer term, some of the implications of the past year’s events will be seen in the regulatory environment. In those countries where the public purse has had to be used to support bank solvency, it can be expected that there will be significant regulatory reform – and rightly so. The real trick, however, will be to make sure that the reforms are not just knee jerk reactions to the symptoms of financial excess – as clear as they are – but well considered, durable and tractable changes that appropriately contain, but do not crush, the financial system’s capacity and appetite to take risk. Certainly, over the past five or so years, too much risk was taken, of the wrong sort. The danger in the next several years, however, will not be too much risk taking, but too little. Regulators will want to avoid compounding that.

While the prominence of financial events has been clear, there has also been a set of “interesting” events in the real economy unfolding at the same time. The fortunes of the Chinese economy are increasingly important, particularly for Australia and other countries in our time zone. The most striking real economic fact of the past several months is not continued US economic weakness, but that China’s economy has slowed much more quickly than anyone had forecast. Our own estimates suggest that Chinese industrial production probably declined over the four months to October. Some of this might be attributable to the effects of the Olympics but surely not much. Some of it reflects the weakening in Chinese exports to major countries. But more than that seems to have been occurring. I am not sure that many economic forecasters have fully appreciated this yet. There is every chance that the rate of growth of China’s GDP is currently noticeably below the 8 per cent pace that is embodied in various forecasts for 2009.

The Chinese authorities, having sought a slowing of their economy after it was clearly overheating, are now moving policies quickly in an expansionary direction. So there is a good chance that China’s economy will be looking stronger in a year’s time than it does today. It is important, though, that this is done in the right way – specifically by boosting domestic demand.

China’s slowing may be part of a third striking fact, namely, the simultaneity of the weakening in economic activity around the world during recent months.

When this occurs, one is naturally led to look for a common shock. The noticeable slowing in many economies in the June quarter seemed at the time to be attributable to the sharp run up in oil prices. That rise has now been more than reversed, but the slowing has, if anything, intensified during the past several months. The more recent weakening might be the result of more widespread and intense tightening of credit conditions that has occurred in some of the major countries. But the state of domestic financial sectors differs across countries. In Australia or Japan or much of east Asia or Canada, while credit conditions have become more difficult, the banks are in much stronger condition than in the United States or Europe or the United Kingdom.

One thing that stands out as closely related across countries, however, is the fall in share markets. These changes are to some extent themselves a reflection of a weaker set of expected economic outcomes. But with closely linked financial markets and rapid communication, changes in sentiment are transmitted very quickly across countries and it appears that those changes in sentiment are themselves affecting behaviour. People have, understandably, become very uncertain about the outlook and are correspondingly more cautious in their spending behaviour.

In essence, we are now in a period when the essential nature of events is not so much a crisis in the financial system. It is a crisis of confidence on the part of households and businesses, and it is global in nature. Hence the need for actions that are internationally consistent to deal with the situation.

On that score, a fourth “interesting” feature is the speed with which official institutions seem to be reacting to the economic fallout now unfolding. To take one example, IMF forecasts, and associated policy advice, are being revised more often and faster than I can recall in the past. Perhaps this is simply because of the greater number of international meetings at which the Fund is asked for its view, but my sense is that international official bodies and their domestic counterparts are shifting their assessments unusually quickly as they attempt to grapple with the unfolding situation.

Monetary policy is being eased aggressively around the world. So is fiscal policy. One of the striking features of the recent G 20 meetings was the way the need for fiscal stimulus, where debt levels permitted, was readily agreed between participants, and actively encouraged by the IMF. Of course, agreeing to things in general at a meeting is only the first, and the easiest, step. Actual policies have to be delivered and in a timely and effective – and hopefully consistent – way. I use the word “consistent” because it is preferable, in my

judgment, for action to be broadly consistent and timely, than for it to be precisely coordinated but delayed. It also remains to calibrate the extent of the measures appropriately for the circumstances, which is no easy matter. Nonetheless, it seems to me that all this is happening faster than on previous occasions.

It would not be realistic to suggest that this response has been, or ever could be, so fast and so well targeted that significant near term weakness in the global economy can be avoided. The data coming in by the day confirm that there is an international downturn taking place, and that it shows every sign of being a deeper one than the rather shallow affair of 2001.

The question is whether we have reasonable grounds to expect that the combination of private and public efforts to address the financial problems, a subsidence of the sheer panic in financial markets and the use of macroeconomic policy to provide stimulus to weak economies will establish sound foundations for a renewed period of expansion beginning some time in 2009.

The inauguration of a new US Administration is a key opportunity. The economic downturn has been deepening during the transition period. But if the new team can announce credible plans to accommodate the required adjustments in the US economy, confidence in medium term prospects can be re built. This would assist both the US economic recovery and conditions elsewhere.

Thinking ahead, the next international expansion will no doubt have some different characteristics from the previous one. It cannot be based on a continual gearing up by consumers in developed countries and associated asset price escalation. For that reason, neither can it be characterised by the continued large build up of balance of payments surpluses by the emerging world. The secular increase in living standards in emerging countries ought to play a bigger role in driving global demand – and that will depend on appropriate policies in both those countries and the developed world. It looks like there will be a fairly prominent role in the near term, in many advanced countries, for the government sector through the recapitalisation and/or guarantees of banks, or fiscal expansion, or both. But for sustained growth, there will also need to be a role for innovation and prudent risk taking in the private sector – even though, at present, that is in retreat.

Turning closer to home, the Australian economy has seen a significant change in circumstances over the past six months. The biggest terms of trade boom in half a century is over, and has partly unwound. I still think that China's emergence is far from complete and that, as a result, the terms of trade will be higher on average than they were until a few years ago. But over the next year they will be well below their peak.

Our households, like those elsewhere, have observed financial turmoil and a decline in share prices and have become more cautious. Consumer spending, which slowed significantly in the period from about February to June as interest rates and petrol prices rose, has remained slow since, even as interest rates and petrol prices have fallen significantly. I think we can expect that households will be more cautious about debt over the next couple of years. Business investment and government spending have remained pretty strong – so that domestic demand was still 4 per cent higher in the latest data than a year earlier. But businesses are currently in the process of scaling back plans for investment and hiring. This is partly in response to slower consumer demand, but the dramatic change of view about international conditions and the general uncertainty reflected in financial market prices are surely playing a major role. So in the period ahead, private demand could look weaker than it has for some years.

What then do we need to be doing to ensure as far as we can that the period of weakness is brief, and that prospects for longer-term sustainable growth are maintained?

Of course, we cannot change the course of the world economy. But we can keep our own house in order to maximise our chances of good performance. On this score, as I have remarked before, Australia has scope to use macroeconomic policy to support the economy

in the weak part of the cycle. That scope was earned by being prepared to run budget surpluses and run down public debt when revenues were strong, and by raising interest rates to contain inflation when the economy overheated.

The scope to ease policies is now being used. On the fiscal side, the “automatic stabilisers” will reduce the budget surplus as the economy weakens, cushioning the economy in the process. That is what they are designed to do. There has also been a front loaded, discretionary easing that is starting to arrive in recipients’ bank accounts this week. Of course, a good deal of this may be saved, but even if it is, that presumably takes the place of private saving that would otherwise have been done over a longer period, so it brings forward the point at which households become confident enough to lift spending. Also on the fiscal front, there is no reason why worthwhile public investment decisions that are currently planned should not proceed, as long as they really are worthwhile.

On the monetary front, interest rates right across the spectrum have fallen. Some fairly elementary calculations suggest that, as a result of the decline in interest rates that has occurred already, the fall in the household sector’s gross debt-servicing burden will be almost 3 per cent of household income. This is roughly equal to that seen in the early 1990s, when the cash rate fell from 18 per cent to 4.75 per cent. But on that occasion it took two and a half years; this time it will take place over about four or five months. The decline in borrowing costs for businesses has generally been smaller and slower to appear, but there has been some faster pass through of the most recent reduction in the cash rate. These transmission channels of monetary policy are still operating in Australia, unlike in some other countries.

In addition, the exchange rate is playing its normal role of adjusting to changed circumstances in a way that stabilises the economy. It has declined by about 25 per cent in trade weighted terms since mid year, just about the largest movement we have seen in such a short period.

These are quite big changes. They will take time to have their full effect, but they will be making a significant difference to conditions over the next year. There is scope to do more with macroeconomic policy settings, if needed, given the strength of the public accounts at the federal level, and the outlook for declining inflation. In assessing whether more is needed, and if so, how much, we will naturally need both to maintain a close watch on the data and to remember the extent of stimulus that is still in the pipeline as a result of past actions.

Other supportive factors include the state of the financial system. This has been said many times but bears repeating. Of course credit conditions for some sectors, notably property, have tightened. And overall, credit to business is rising much more slowly now than a year ago. But even so, over the three months to October, credit provided by intermediaries rose at an annualised pace of about 12-13 per cent. On a broader definition, which includes capital market raisings, the pace was about 9 per cent. Both numbers are actually a bit higher than they were around mid year. In most developed countries, this would be considered a very satisfactory pace (if not a little fast). Credit growth to households has recently been very slow, by historical standards, at about 4 to 5 per cent. Margin loans in particular are contracting quickly as people reduce their leverage. Lending for housing is starting to pick up now, however, from the early impact of interest rate reductions. Australian banks, having raised very large quantities of deposits in the past couple of months, are now turning back to offshore markets, making use of the government guarantee. They do not appear to have had much trouble raising capital from private markets when they wanted it. Overall, while not without its difficulties, this situation remains a much better one than seen in a number of other countries.

These are the key elements of handling the cyclical episode. Longer term, performance will depend on the quality of investment, both public and private, on productivity increasing innovation and reform, and on getting the right balance on regulation. All that is hard, but at various times over the past couple of decades, Australia has made considerable progress in

these areas, and has a pretty good record overall of responding to the need for change, especially in times of adversity. There is no reason we should not maintain that record.

As I said at the outset, we are indeed living through “interesting” times. They are tough times, for businesses, financial markets, households and policy makers. Given the global situation, we have a very difficult period to negotiate. But we can negotiate it. The long run prospects for the Australian economy have not deteriorated to the extent that some people may presently be feeling. We do have reasonable grounds for some quiet confidence about the future, however bad the storm at present may be.

A period of reflection and recharging of batteries over the break will be helpful. At the conclusion of a hectic year, therefore, I wish all of you a Merry Christmas – and a much less interesting 2009.