

Ric Battellino: An update on the economy and financial developments

Address by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to the Urban Development Institute of Australia, National Congress 2009, Brisbane, 31 March 2009.

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Introduction

The past six months have certainly proved that we live in a globalised world. Last September, the US investment bank, Lehman Brothers, collapsed and several other major US financial institutions came under immense stress. These events transformed what was a difficult but manageable situation in global markets into a full-blown financial crisis.

The consequences for the global economy have been severe. Up until these events, most forecasters had been predicting that the major economies would have a relatively mild slowdown in 2009, and that Asia would be largely unaffected. Those predictions have since been replaced by forecasts of a major global downturn, with all significant countries affected.

Australia entered this difficult period in much better shape than many other countries. Disciplined monetary and fiscal policies in earlier years, sound regulation and a prudent approach to lending by our banks meant that the country was largely free of major problems. It is not surprising therefore that, so far, we have weathered this global downturn better than most. We have had more scope than others to move policies in the expansionary direction and our banks, being largely free of problem assets, are in a position to keep supplying credit to the economy.

Having said that, no amount of good economic management can totally shield us from what is happening in the global economy.

In my talk today I would like to review how the global economy is evolving; update you on how we are seeing the domestic economy; and say a few words about household sector finances and the housing market.

The global economy

We all know by now that the global economy is going through a recession. In itself, this is not unusual; the world economy has tended to experience a downturn every 7-10 years.

The current global downturn is, however, more severe than we have experienced for a long time. This is because in some important countries a banking sector crisis has been overlaid on the regular economic cycle. This has added to the severity of the downturn because:

- it has undermined the confidence of the community; and
- it has led to a sharp slowdown in the availability of credit.

This cycle is also highly synchronised, with every significant country in the world affected. Household and business confidence collapsed simultaneously in every country late last year, as we all reacted in the same way to the dramatic news being transmitted around the world.

The events of the past six months have resulted in big changes in the forecasts for the global economy. Mid last year, official international bodies were generally forecasting that the world economy would grow by around 4 per cent in 2009, only a little below average. Now they are forecasting that global GDP will fall by around 1 per cent in 2009, the weakest outcome in the post-war period.

It is widely accepted that a precondition for economic recovery is the restoration of financial stability. Markets have at times been frustrated at how long it has taken countries with

banking problems to implement measures to restore the health of their financial institutions. But these are very complex problems and it takes time for consensus to build about the solution. Another complication is that, not surprisingly, a common initial reaction is to want retribution from the financial institutions that are seen as having caused the problem. While this is understandable, it makes it difficult for the political process to support making public funds available to stabilise the financial system.

These issues are not new and, by the standards of some past banking crises, the US, the country at the heart of the current crisis, is making reasonable progress. The US authorities last week announced further plans to restore the health of their financial sector. These were followed by a solid rise in share prices, particularly for banking stocks, though market sentiment is clearly still fragile.

On the real economy, we are starting to notice the odd positive economic indicator in the run of US monthly data, in contrast to the universally negative outcomes a few months ago. Let's hope this continues.

From Australia's perspective, no discussion of the global economy is complete without reference to China. Like other countries, China experienced a sharp slowdown in the second half of last year, after a couple of years of extraordinary boom in which output growth increased to around 12 per cent per year. The downturn in China has been of great significance to Australia, given that China is now our largest trading partner.

My guess is that the Chinese authorities, like everybody else, were caught by surprise at the suddenness of the downturn. But they have since reacted with great speed and vigour in implementing monetary and fiscal measures to stimulate their economy. There are some signs that these measures are starting to work. While China is not going to return to a 12 per cent growth rate any time soon, it is quite possible that the past six months will turn out to have been the period of maximum weakness in the Chinese economy. Of course, it will be a while before we know one way or another.

The Australian economy

Like all other economies, the Australian economy was very much affected by the extraordinary events of last September. As in other countries, confidence was severely eroded by the spectacle of large US financial institutions either collapsing or coming under immense financial strain. Concerns began to arise about the safety of our own financial institutions, even though they were in a very strong position. The Australian Government therefore elected, as did governments in other countries, to guarantee the debts of banks.

In addition to these adverse confidence effects, the Australian economy was also affected by the collapse of commodity prices. Mid last year, commodity prices were at boom levels; six months later, many had broadly halved. This has resulted in a large loss of real income to the economy.

The fall in commodity prices has also caused businesses to revise down sharply their investment plans in the year ahead. Households have also become much more cautious, cutting back on spending and increasing saving. All this meant that there was a sharp change in the outlook for the economy in the closing months of last year.

The Reserve Bank responded to this with a very substantial lowering of interest rates: between September last year and February this year the cash rate was reduced from 7¼ per cent to 3¼ per cent.

Other central banks have also cut official interest rates sharply, but in many cases, because of problems in their banking sectors, this did not flow through to any great extent to interest rates faced by households and businesses. In essence, the monetary policy transmission mechanism in many countries has become severely impaired, which is why some central banks have resorted to non-traditional monetary measures.

This problem has not arisen in Australia. The monetary policy transmission process has been effective and there remains scope to ease policy further if circumstances require.

The 400 basis point reduction in the cash rate since last September has reduced the overall cost of funds to banks by 340 basis points, after taking into account movements in interest rates in global capital markets. On average banks have cut interest rates on loans by the same amount – i.e. they have on average fully passed on the fall in their cost of funds to borrowers. Interest rates on housing loans have fallen by more, while interest rates on some consumer and business loans have fallen by less. As a result of the reductions that have occurred, both housing interest rates and business lending rates are at historically low levels.

In the case of housing, this has produced a very quick response in terms of the pick up in loan demand. Housing loan approvals are up 20 per cent since their low point in July. This has been concentrated almost entirely among owner occupiers.

It is not hard to understand why demand for housing loans has responded so quickly. With interest rates on housing loans around 5½ per cent, the cash payments involved in servicing a housing loan are now not much more than those involved in renting. Combined with the First Home Owner Grant, this has attracted a lot of first home buyers into the market.

Governments are also supporting the economy with increased spending. Perhaps the best single measure of this is the change in their fiscal position. Across all levels of Australian governments, last financial year there was a fiscal surplus of 1½ per cent of GDP. This year, it is estimated there will be a deficit of 2½ per cent of GDP. This turnaround – about 4 per cent of GDP – is the largest in the post war period.

These measures will go a long way to offsetting the negative influences on the economy coming from abroad, but the reality is that we cannot fully insulate ourselves from what is happening elsewhere in the world. As such, GDP is likely to fall in 2009.

Even so, Australia will remain one of the better performing economies in the developed world and be well placed to benefit from the renewed global expansion when it comes.

Household finances and housing

As I am sure you are all acutely aware, households have experienced a large reduction in wealth over the past year or so. Mainly this is the result of the fall in the share market. As incomes have grown, we have accumulated more financial assets and an increasing proportion is held in market-linked investments such as equities and unit trusts. This is the natural outcome of financial development and is generally beneficial. It does mean, however, that there is more variability in the returns on our investments.

Many people regard a fall in the share market as an aberration but the reality is that share markets produce negative returns every few years. This should be factored into our return expectations. If we don't, we will be over-estimating the long-run rate of return that can be achieved on savings.

It is important that we be realistic in our expectations about returns if we are to achieve our financial goals. Assumptions about investment returns have a big impact on decisions about how much we need to save out of income, and for how long we need to work, in order to accumulate a given amount of money. As a rule of thumb, for every one percentage point reduction in the long-run average return on savings, households would need to increase the proportion of income saved over their working lives by 3 per cent in order to accumulate a given amount of assets. Alternatively they would need to work for an additional 3 years. It is interesting that, over the past year, as the share market has fallen, the household saving rate has increased substantially and more older workers are either remaining in, or returning to, the workforce.

Even after the large fall in wealth over the past year, the household sector is still in a relatively sound position. If we look at household balance sheets, we see that, on the liabilities side, households on average have debt equal to about one and a half year's income. On the assets side, they have a property valued about 4 years' income and financial assets equal to 2½ years' income.

Let me end with a few words on the housing market.

This market was fairly subdued in 2008, with prices falling on average by 3 per cent across Australia. Some states – such as Western Australia which had a late boom – are now experiencing larger falls than average. Prices at the top end of the market have also been softer than other segments, no doubt reflecting the deleveraging that is taking place among high income households following the global financial crisis.

Overall, however, the housing market in Australia has held up pretty well compared with that in countries such as the US and the UK, where prices have fallen in the order of 20 per cent.

We continue to believe that the market here will hold up better than overseas. There are a number of reasons why this is likely to be so, but perhaps the most important is that we did not have the same deterioration in lending standards that occurred elsewhere. By and large, the great bulk of Australians who took out housing loans have been able to afford the repayments. Notwithstanding some rise over the past year, the 90 day arrears rate on housing loans is only 0.5 per cent, which is broadly in line with its long run average and well below that in countries such as the US and UK.

In the period ahead, there will be forces pulling the arrears rate in opposite directions. On the one hand, as unemployment rises, more households will have difficulty continuing to service their housing loans. On the other hand, the very large reduction in interest rates has greatly reduced the debt servicing burden of households. On an average-sized mortgage, loan repayments are now \$7,000 a year less than they were six months ago. This is a very large reduction, equal to about 8 per cent of average household income.

The majority of households have chosen not to spend the money that has been freed up. Rather, they have maintained high repayments and are therefore moving ahead of schedule in repaying their loans. This will give them breathing space if they do subsequently find themselves in circumstances where their repayments are interrupted.

Conclusion

Let me sum up by saying that the past six months have been a very difficult time for the world economy. There are some tentative signs of improvement, but in reality it is going to take quite some time for the world to recover from the financial shock that has occurred.

While the Australian economy has also weakened, it has held up better than most during this difficult period, helped by earlier disciplined policies and prudent financial behaviour. However, there are limits on how much we can insulate ourselves from what is happening abroad, and therefore there are probably still some difficult times ahead. Nonetheless, the underpinnings of the Australian economy are sound so we are well placed to benefit from the global economic recovery when it comes.