Glenn Stevens: Overview of the Australian economy and future challenges

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Canberra, 26 November 2010.

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When we last met with the Committee in February this year, it was becoming clear that the recovery in the global economy was proceeding faster than many had expected. It was also clear that the strongest performance was in the emerging world, while recoveries in countries that had been at the centre of the financial events of 2007 and 2008 were relatively subdued. Global financial markets had continued to improve, but were paying close attention to the rise in sovereign debt in a number of countries.

At that time, people were talking about an expansion in global GDP of something like 4 per cent in 2010. As it turns out, it looks like the outcome will be stronger than that: current estimates for the year are about 4¾ per cent, which is above trend. The pattern of growth is still rather uneven. The additional strength has been concentrated in the emerging countries, with growth in China and India running at a pace of around 10 per cent in 2010. In contrast, growth of about 2½ per cent for the G7 group, after a contraction of around 3½ per cent in 2009, will leave a considerable margin of spare capacity and particularly of unemployed labour.

Financial markets and policymakers have maintained, and indeed increased, their focus on issues of sovereign debt sustainability. First Greece, and now Ireland have sought financial assistance from European partners and the IMF, after a change in economic circumstances and a large rise in market borrowing costs left authorities with little other option, even with deep cuts to spending. Across continental Europe and the United Kingdom, governments are embarking on a path of fiscal consolidation, in order to put public finances on a sounder footing in the face of increased obligations and reduced revenues. These programs will unavoidably have some short-term dampening effects on economic activity, which will likely become clearer during 2011. But the scope of alternative possibilities open to the governments concerned is really rather limited.

In this environment it is no surprise that the major central banks are mostly maintaining very low interest rates and in some cases increasing the sizes of their already expanded balance sheets via asset purchases. These actions are designed to impart some further stimulus through reducing long-term interest rates even further or via effects on private-sector balance sheets. Yet at the same time many other countries have moved to tighten their monetary policies this year, in recognition of the robust recovery in output. In most cases in Asia – Japan being an exception – the rise in activity along the upward part of the "V" has now been seen and the pace of growth has to moderate if overheating is to be avoided.

The combination of very low interest rates in the world's developed financial centres, on the one hand, and strong growth and tightening monetary policies in Asia and Latin America, on the other, could be expected to place pressure on exchange rate regimes, and so it has proved. There have been substantial capital flows seeking the expected higher returns in emerging economies and a rise in asset values in many of the recipient countries. A number have responded with the imposition of capital controls and other measures to contain leverage, especially in housing markets. In this environment, where the policy imperatives differ so much across countries, the intensity of international discussion about exchange rates was bound to escalate, and it has done so, quite markedly.

A year from now we will probably have observed some moderation in global growth, from this year's above-trend pace to something closer to trend. That is the assumption we are making. The emerging world clearly needed some moderation, while the major countries working through the aftermath of banking crises are still likely, if history is any guide, to find it hard

going for a while yet. How much progress we will have made in resolving the "imbalances" issue remains very unclear.

But the strength of global growth thus far, and the particular pattern of growth in key emerging economies, with its very strong impact on demand for steel, has had a major effect on Australia's terms of trade. These have returned to, and in fact exceeded, the six-decade highs seen two years ago. It is our assumption that prices for key resource exports will not remain this high, but will instead decline over the next few years. Even so, developments in the period since February have led us to lift our estimates for the terms of trade in the 2010/11 year.

In February I suggested that real GDP growth in the Australian economy would be a little over 3 per cent in 2010, and a little higher than that – about 3½ per cent – in 2011 and 2012. It would take only pretty moderate growth in the second half of the year to achieve that forecast for 2010. Next year, growth could be stronger than we had expected nine months ago, though obviously there are still numerous areas of uncertainty. Measured in nominal terms, the rise in GDP is running at about 10 per cent per annum just now, because of the rise in the terms of trade.

Consumer price inflation has returned to rates consistent with the medium-term target, running at about 2½ per cent in underlying terms, and 2¾ per cent in CPI terms, over the past year. This is clearly a marked improvement from two years ago, when the CPI inflation rate reached 5 per cent. A significant decline in inflation was expected at the time the Board started to reduce interest rates in September 2008.

Sometimes, the process of disinflation can be quite costly in terms of economic activity. That is often the case when higher inflation lasts long enough to become embedded in expectations. That did not occur this time and the result was that inflation came down with relatively little short-run cost to output, very much as was the case in 2001 and 1995. It is, of course, one of the intended effects of having an announced objective for inflation that inflation expectations be well anchored, which aids economic stability and efficiency.

It is unlikely, though, that we will see inflation fall much further from here. We will probably see some ongoing dampening effect on inflation of the rise in the exchange rate, as this usually takes some time to flow through fully. Growth in labour costs, however, is no longer declining, but rising. The overall pace could not be described as alarming at this stage, but the turning point is behind us. Nor is the growth of the economy falling short of potential growth; if anything, over the past year aggregate demand has risen considerably faster than potential output (something that is possible only with either considerable spare capacity or a rise in absorption from the rest of the world). At this point, the gap between actual and potential output is probably not that large. Moreover, while the annual pace of growth of utilities prices – a prominent feature of the past couple of years – has probably peaked, it is likely to remain high.

Over the coming year, we think that inflation will be pretty close to where it is now, consistent with the target. But looking further ahead, in an economy with reasonably modest amounts of spare capacity, the terms of trade near an all-time high and the likely need to accommodate the largest resource-sector investment expansion in a century, it is pretty clear that the medium-term risks on inflation lie in the direction of it being too high, rather than too low.

Last time we met, I explained it was important that monetary policy not overstay a very expansionary setting once it was clear that the danger of a really serious downturn in economic activity had passed. At that stage the Board had lifted the cash rate three times in late 2009. Most lenders raised borrowing rates by more than the cash rate, given that their costs of funds had moved up relative to the cash rate. I noted the Board was taking account of these shifts in deciding the appropriate setting of the cash rate. Most rates remained below normal at that stage. I also said that, if economic conditions evolved as we expected, further adjustments to monetary policy would probably be needed over time to ensure inflation remained consistent with the target.

In the first half of 2010 the Board did indeed make further adjustments, lifting the cash rate to 4.5 per cent. This was roughly 100 basis points lower than what we would once have described as “normal”. In fact it was close to the *lowest* point reached by the cash rate in the two preceding interest rate cycles. But it resulted in borrowing rates pretty close to the average of the past decade or more, and so was what could be considered as “normal”, allowing for the changes in margins. The Board judged this to be an appropriate point at which to rest for quite some months. This allowed some time to assess the effects of earlier decisions and also to gauge what was happening in the rest of the world.

Most recently, as you know, the Board decided to lift the cash rate by 25 basis points. Many lenders raised their loan rates by more than this. These moves have left the overall setting of monetary policy a little tighter than average, as judged by interest rate criteria. Of course, we are aware as well that, particularly for business borrowers, non-price conditions remain tighter than they were for some years prior to 2008. Overall, and also taking account of the exchange rate, which has risen substantially this year, we judge this to be the appropriate setting for the period ahead.

As the minutes from the Board meetings show, recent decisions were finely balanced. Quite reasonable arguments could have been made to wait a little longer before taking this step. Good arguments could also be offered as to why, when we looked ahead, it was prudent to take an early modest step in the tightening direction. On balance, the Board judged that to be the better course.

This sequence of decisions was taken in the same framework that has guided our monetary policy for nearly two decades now: seeking to keep the growth of demand sustainable so as to achieve an average inflation rate of between 2 and 3 per cent. It is worth noting, incidentally, that the recently re-elected Government has once again committed, as have I, to this framework, which will continue to guide our decisions.

My colleagues and I are here to respond to your questions.