Glenn Stevens: Overview of the Australian economy and challenges ahead

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Canberra, 11 February 2011.

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In the relatively short period since we last met, the global economy has continued to expand and, if anything, looks a little stronger than it did. China and India have sustained a strong pace of expansion and the United States seems to be gaining a bit more momentum lately though it still faces considerable problems. Conditions in Europe remain quite mixed and the interplay of sovereign and bank creditworthiness continues to be a source of great uncertainty.

Observers have been revising up both their estimates of global growth outcomes for 2010 and their forecasts of growth in 2011. The IMF is now saying world GDP growth was about 5 per cent in 2010, which is well above the 30-year average. For 2011 the IMF has lifted its forecast to 4.4 per cent, which is still noticeably above average.

Global commodity prices have risen further in recent months. This has been quite widespread – from metals, to minerals, to energy and foodstuffs. In a number of countries, measures of consumer price inflation have reflected this rise in commodity prices, particularly in the case of food. China, India, indeed most of Asia, and Latin America are all facing these issues. Managing these pressures is shaping up as one of the major international economic policy challenges of 2011.

The commodity prices most important for Australia are at very high levels. In the case of coal, this reflects in part the supply tightness resulting from the Queensland floods, which have reduced national production by something like 15 per cent and had a material effect on the global supply of traded coal. But supply of iron ore has not been much affected by the weather and its price has risen above the highs of 2008, driven by strong demand.

As a result, Australia's terms of trade are higher than assumed three months ago and look like they will peak higher and later than we had previously assumed. A large build-up of capacity in iron ore, natural gas and coal is planned. Over the summer, there have been further announcements of projects that had been proposed being given the "go-ahead", principally in the gas sector.

In broad terms, therefore, the main medium-term story the Bank has been pointing to for some time still seems to be in place: we are experiencing a terms of trade event of very large size, of the type that happens only once or twice in a century. Our job is to try to manage this so as to avoid, as far as possible, the instability that has accompanied most previous such episodes.

To date, something that is probably a bit unusual in the face of such developments is the relatively cautious attitude of households towards their finances. This has been much remarked on over the recent period, but in fact looking back it seems that the rate of saving from current income has been rising for several years now. With the caveat that saving is not very accurately measured, it looks like the propensity to save out of new income has been quite high, and that people are working to reduce debt more quickly, and are more demanding of value in their purchases than they had been for some time.

This is quite a difficult environment for retailers. But from a macroeconomic point of view, perhaps it is, on balance, not entirely unwelcome in the current circumstances. If consumption were to boom at the same time as we try to expand the resources sector, upgrade urban infrastructure and increase our pace of housing construction to house a growing population, it would be harder to avoid the economy overheating. The more cautious behaviour is also building resilience into household balance sheets, which will be a good thing to have in the future should developments turn in an unfavourable direction. The ratio of household debt to income seems to have stabilised, having risen continually for two decades. I might add that this is happening in many countries, not just in Australia. But we have the good fortune to be seeing this financial consolidation happening at a time when our incomes are being increased by other factors.

Locally, attention has been focused on the devastation caused by extreme weather across several states, most particularly Queensland. The human cost cannot be quantified in dollars. The people affected are still absorbing that cost, and some will do so long after the economic effects have passed. Those of us not directly affected have admired their courage and resilience.

The Reserve Bank, for its part, has an obligation to consider the potential impact on the national economy. We have to ask at least three questions:

- how large are the effects on output and prices that we should expect to see?
- are they due to demand or supply disturbances? and
- how long they will last – do they change the medium-term outlook?

We have set out some estimates in our *Statement on Monetary Policy*. This was finalised after the Queensland and Victorian flooding had been observed, but before the impact of Cyclone Yasi could be assessed. I should emphasise that these estimates are preliminary and that a good deal of uncertainty inevitably surrounds them.

With those caveats, we expect real GDP will be noticeably lower than it would otherwise have been in the December and March quarters. By the March quarter, it could be about a percentage point lower than the pre-flood forecast.

As to the reason for this effect, it is not primarily because demand for goods and services has suddenly slumped, but because the economy's capacity to supply goods and services, and especially some key commodities, has been disrupted. It will most likely recover the bulk of those supply losses in the June quarter as production, particularly coal mining, resumes. Nonetheless, for many businesses there has been a period of lost income, as indicated by the reduction in the level of GDP for the 2010/11 financial year of about half a percentage point compared with earlier forecasts.

After the initial recovery in production over the next few months, the process of rebuilding damaged structures, accommodated in part by deferral of some other spending, will see a modest increment to demand over the coming year or two compared with what we expected three months ago.

Since these estimates were put together, Cyclone Yasi has done major damage to some crops. Some very early intelligence we have received suggests that the damage to crops may not be quite as great as occurred with Cyclone Larry five years ago and that recovery of some crops might be a bit faster than in that episode. Nonetheless, there has clearly been a very substantial impact and a big rise in the prices of some fruits is already occurring, on top of the increases in prices for some foodstuffs as a result of the earlier flooding. The result of this is likely to be a temporary rise in the CPI inflation rate, to around 3 per cent in the June quarter. This is higher than the figure in the *Statement* because the impact of Cyclone Yasi could not be included in that forecast. The combined contributions to this outcome of all the summer flooding and the cyclone add up to about half a percentage point or a little more. These effects should begin to reverse in the second half of the year and should have largely dissipated by the end of 2011.

We do not think the effects on activity of these events will derail the expansion. Nor should the price effects pose a serious threat to the achievement of the medium-term goal for inflation, provided the community can understand their temporary nature and expectations of ongoing inflation remain well-anchored.

Accordingly, the view of the Board at the recent meeting was that while the impact of the floods on the short-term path of output and prices would be quite substantial, monetary policy should not respond to those effects. Likewise, while the recovery efforts may add a little to aggregate demand over the latter part of 2011 and 2012, those effects should be manageable. While we could not assess the impact of Cyclone Yasi at the Board meeting, our assessment of the medium-term outlook is not very different now.

The outcomes for inflation in the latter part of 2010 were quite moderate and a little lower than we had thought they would be at the time of the last hearing. To what extent this represents a genuinely lower trend, as opposed to noise, is, as always, difficult to say. There would appear to be some association between consumer caution, reports of widespread discounting in the retail sector and the very high exchange rate. If that connection is in operation then the question arises as to how long such cautious behaviour might continue – and this is one of the uncertainties to which we point in the section on "risks" in the Outlook chapter of the *Statement*. There are of course other uncertainties as well. But stepping back, underlying inflation has fallen by a substantial amount from the peak in 2008. It is worth recording that a combination, on the latest figures, of a 5 per cent unemployment rate and an inflation rate clearly "in the 2's" is a pretty favourable one by the standards of recent decades.

Turning finally to monetary policy itself, as a result of the adjustment to the cash rate made in November, and the changes made by financial institutions to lending rates, interest rates being paid by borrowers are a bit above average compared with the past 15 years. Household credit growth is quite modest and business credit is still declining, as firms continue to consolidate balance sheets and, in the case of larger companies, to access capital markets directly. Reports suggest that there is some easing of lending conditions in some areas but my sense is that, generally, lenders remain quite cautious. The exchange rate is at peak levels for the floating rate era. This is not especially surprising given the level of the terms of trade, but nonetheless it is exerting dampening pressure on the traded sector outside of the resources sector.

So, overall, financial conditions are on the firm side. In view of the general outlook that I sketched at the beginning, that seems to us to be appropriate. Having reached that position in a fairly timely fashion, the Board has judged it to be sensible of late to leave the cash rate steady.

My colleagues and I look forward to your questions.