Glenn Stevens: Latest economic and financial developments in Australia

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Sydney, 24 February 2012.

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When we last met with the Committee in August, we had entered a period of heightened uncertainty about the global economy and financial system. The investment community was focusing increasingly on the high levels of public debt in major countries, and especially on the situation in the euro area, where budgetary pressures, banking pressures and competitiveness issues within the single currency area make for a very difficult set of problems. There was considerable instability in markets. But our view at that time – tentatively – was that we were not witnessing a repeat of the events of late 2008.

Admittedly, the second half of 2011 saw some very anxious moments. There was a flight from risk that pushed up borrowing costs for major countries like Spain and Italy, but pushed them down for countries like Germany and the United States to the lowest levels for more than 50 years in spite of the fiscal challenges the US itself faces. Funding markets for European banks in particular effectively closed for a few months, and for other banks became much more difficult and certainly more expensive.

The palpable fear before Christmas that Europe was on the brink of some sort of very bad financial event has lessened over our summer. The anxiety has not gone entirely away, and nor will it for some time. But the worst has not happened. Financial markets, while hardly brimming with confidence, have recovered somewhat over the past couple of months. Banks are able to access term funding markets again, albeit at higher cost. High-frequency gauges of business conditions and confidence have stabilised over the past couple of months in Asia and North America, and even in Europe. We have not seen the very steep fall that we saw in all these indicators in late 2008.

The actions of the European Central Bank contributed greatly to the stabilisation of financing conditions, essentially by removing, for a time, questions over the funding of European banks. The efforts of European leaders to craft a stronger framework for euro-wide governance on the fiscal side have also continued. A great deal more needs to be done to place European banks and sovereigns onto a stable footing, and to boost potential growth in Europe. But progress is being made.

Forecasts for the global economy in 2012 have been marked lower, mainly due to the effects of the problems in the euro area. Revisions to the IMF's forecasts in particular have been given great prominence. Our own forecasts have come down too, though they had already been a bit weaker than the IMF's. On these forecasts, global GDP will grow by about 3¼ per cent in 2012. That is down from about 3¾ per cent in 2011, which was about the average rate of growth over the past 15 years. On its face, this performance, should it occur, would be no disaster. After all, growth is going to be below average some of the time.

If we look for things to worry about, we will certainly find them. The global outlook has a very uneven composition: some countries, particularly in Europe, will record very weak outcomes. Moreover it is unlikely that a moment will come any time soon when we will be able to say the problems in Europe are behind us. Progress will be slow and there will be periodic setbacks and bouts of heightened anxiety – that is the nature of these things.

But equally, we should recognise that things have not been uniformly bad recently. The US economy has not experienced the "double dip" some had feared six months ago, but instead has continued growing. The US corporate sector is in very strong shape, is cashed up and will at some point be able to start moving ahead more quickly. It appears American corporations have stepped up the pace of hiring in the past few months.

In China, the slowing in growth we have seen seems to have been roughly what the policymakers were looking for, and they appear to be getting on top of their inflation and housing boom problems. Around the rest of Asia, activity has also slowed, in part reflecting trade links with Europe. But it has not slumped and as inflation comes down, policymakers have increased room to respond. The pressure on European banks to shed assets has led to some tightening of trade credit in the Asian region, but at this stage the system seems to be adjusting to that without major drama. We have not, to date, seen the collapse of trade credit and trade flows we saw in late 2008.

Commodity prices, which had declined noticeably from their peaks in the first half of 2011, have actually moved sideways, or in some cases picked up a bit, for a few months now. They remain high by historical standards. That seems roughly consistent with the group of countries that makes up Australia's main trading partners expanding at a reasonable pace – expected by the IMF to be over 4 per cent this year, not very different from last year. Again, we do not, at this point, see the signs of the rapid collapse in global demand we saw three years ago.

At home, most of the information coming in suggests the economy has grown at close to an average pace over the past year. This outcome was weaker than we had expected a year ago. It was partly due to the effects of flooding on resource production but also due to softer outcomes in the non-resource side of the economy. CPI inflation has come down, as expected, as the impact of last summer's floods on food prices reverse. In underlying terms, inflation was about 2½ per cent over 2011, also a slightly lower outcome than we had, at one point, thought might occur. The labour market was generally softer in 2011 after a year of unusual strength in 2010 (though the unemployment rate at its latest reading was virtually unchanged from a year earlier).

These changes to the macroeconomic picture, against a backdrop of a period of intensified international turmoil, saw the Board lower the cash rate by 50 basis points in the closing months of 2011. Perhaps surprisingly in the face of developments in wholesale funding costs, this was initially fully reflected in a reduction in most lending rates, though there has been a partial reversal of that recently. We have repeatedly made clear that the shifting relationship between the cash rate and other rates in the economy is a factor the Board takes into consideration in setting the cash rate. That will remain the case. Recent developments do not materially affect the capacity of monetary policy to achieve its goals.

Looking ahead, the Bank's central expectation is for growth to be close to trend, and inflation close to the target, over the coming one to two years. There are, naturally, risks surrounding this central view. Those are spelled out in the latest *Statement on Monetary Policy*.

Perhaps what is most noteworthy about the Australian economy is the way in which the drivers of growth have changed in recent times. The Bank has spoken at length before about the terms of trade, and the resulting resource investment boom, which is still building and which will take the share of business investment in GDP to its highest level for 50 years. We have spoken also about how, on the other side, household behaviour has changed – people are saving more and borrowing less. Spending is growing in line with income, but people are spending their money differently. The retail sector is finding it has to adapt to this changed environment. Some other industries are struggling with the high exchange rate. Meanwhile certain service sectors are growing quite smartly. Hence, while the economy overall has recorded "average" growth, few sectors are in fact experiencing "average" performance themselves – some are clearly quite weak relative to average, while some others are much stronger.

The Bank is quite aware of these differences and the pressures they bring to businesses and individuals. But we also know that monetary policy cannot remove the forces generating different paces of growth in our economy. We have to keep our eye on the overall performance of demand and prices. We are acutely conscious that history may offer limited guidance in assessing the net impact of the disparate and very powerful forces that are at work. Nonetheless, that is the assessment we must try to make.

Our most recent assessment was that, with growth near trend, inflation consistent with the target, interest rates about average and an outlook suggesting more of the same, the setting of policy was about right for the moment. Of course, we continue to reassess things each month.

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