

Glenn Stevens: Producing prosperity

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Committee for Economic Development of Australia (CEDA) Annual Dinner, Melbourne, 20 November 2012.

* * *

Thank you for the invitation to join you for your Annual Dinner.

Financial markets and policymakers have been living in a more or less continual state of anxiety for over five years. While it was poor-quality lending in the US mortgage market that proved to be a key cause of problems, from quite early on it became apparent that European banks also had serious difficulties, because of their exposure to securities of doubtful quality, their high leverage and their need to fund US dollar portfolios on a short-term basis. It was in August 2007 that those acute funding difficulties first became apparent in European markets.

Five years on, US banks have made a lot of progress in working through their asset quality problems and their capital deficiencies. At times the process was not pretty, but the US system is in better shape today as a result. US taxpayers have earned a positive return on the investments in major banks that were made at the height of the crisis.

In Europe progress has been much slower. There are various reasons for that, not least the sheer complexity of coordinating the process of evaluating and strengthening balance sheets across so many countries, where the national capacities to assist are so different, and within the strictures of a currency union. This exacerbates, and in turn is compounded by, the deterioration in economic conditions in Europe, which feeds back to bank asset quality and sovereign creditworthiness.

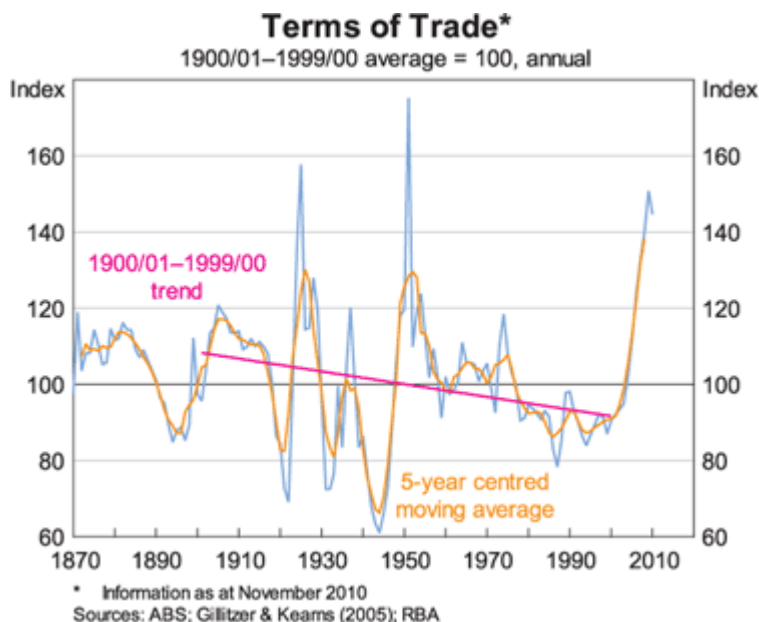
It is perhaps no surprise then that the news seems to have been dominated by the ebb and flow of anxiety over things like: whether or not the “troika” will recommend further funding for Greece; whether a national constitutional court will strike down a government’s participation in initiatives that will assist other countries; or whether the populace in a country under pressure will reach the end of its tolerance for “austerity” – and so on. There is “event risk” almost weekly. This is the European drama.

Unfortunately, it is, I suspect, set to continue that way for quite some time. Over recent months financial market sentiment has improved, from despair to mere gloom, as a result of a number of important steps that have been taken and commitments that have been made. It is right that this improvement in sentiment has occurred – it recognises the determination of the Europeans to save the euro, which should not be underestimated. But there is much more to do, and it will take a considerable time. So while good progress is being made, we will not, any time soon, see a point at which the “euro problem” can be seen as past. The world will have to live with euro area anxiety for some years yet as a normal state of affairs.

In the meantime the US economy has continued its slow healing. The US housing sector has, it would appear, finally turned. Now the election is past, the so-called “fiscal cliff” is rapidly coming into focus – a new source of event risk. But if one is prepared to assume that the US political system will not, in the end, preside over an unintentional massive fiscal contraction next year, the risks to the US economy probably look more balanced than they have been for a while. An upside surprise would be as likely as a downside one. It would be fascinating if, in another year, we find ourselves looking back at a US economy that had outperformed expectations. (There is still of course a critical need for the US to craft a measured and credible path back to fiscal sustainability. That particular drama could continue as long as the European one.)

But it is appropriate to turn our gaze to our own part of the world, especially in the current period of discussion about “the Asian Century”. Two years ago, when I last spoke to CEDA’s Annual Dinner, a key feature of my presentation was this chart.¹

Graph 1



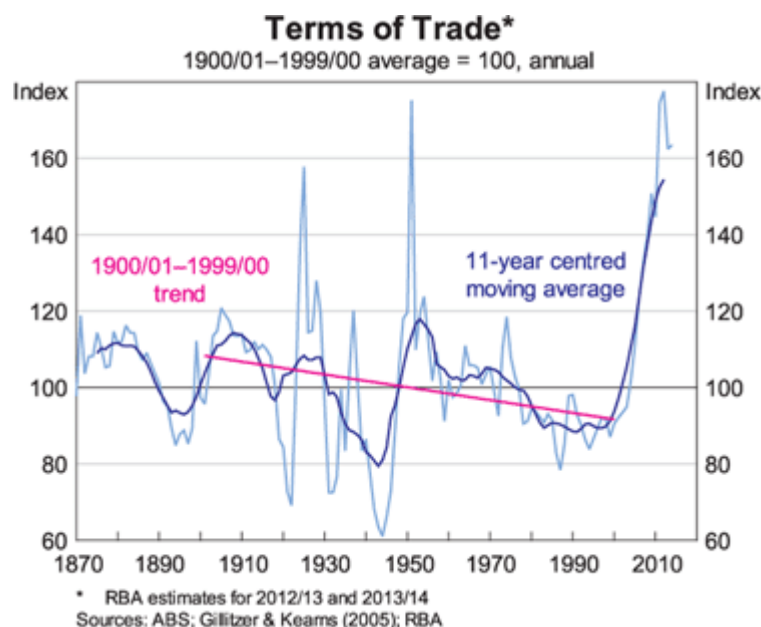
This evening I can show how the chart looks when updated for two more years of data and our revised estimates for the near-term outlook. The terms of trade ended up rising further than assumed two years ago, and have then fallen back from the peak, though the level recorded in the most recent quarter is about 7 per cent higher than was in the forecast two years ago.²

The event is sufficiently unusual that we can add one twist to the chart. Instead of a five-year average, we can show a decade-long average. The chart in fact shows an eleven-year average, which allows the measure to be centred on the current year. To do this of course we need to make a five-year-ahead assumption. We have assumed that the terms of trade decline steadily, at a pace a little faster than implied by forecasts of private analysts. What is unusual about this event is not just the peak level observed, but the apparent persistence of high levels. The terms of trade will very likely record over a decade an average level 50 per cent higher than the previous long-term mean. That is a big deal. Even with a more pessimistic assumption – say that commodity prices fall by twice as much over the next five years – there is no doubt that this is easily the biggest, and the most persistent, terms of trade event for a very long time.

¹ See Stevens G (2010), ‘The Challenge of Prosperity’, RBA *Bulletin*, December, pp 69–75.

² I noted two years ago that a ship load of iron ore, which five years previously had had the same value as 2,200 flat screen television sets, was by late 2010 buying 22,000 such TVs – an increase in that particular “terms of trade” of a factor of ten. As of the current quarter the figure is 28,000. At the peak, it reached 38,000.

Graph 2



Still, the terms of trade *have* peaked, and will probably have fallen by about 15 per cent by the end of this year. Further declines over time are likely. So while a high level of the terms of trade continues to add to the *level* of national income, we can no longer expect that a rising terms of trade will be adding to *growth* in living standards. We are entering a new phase.

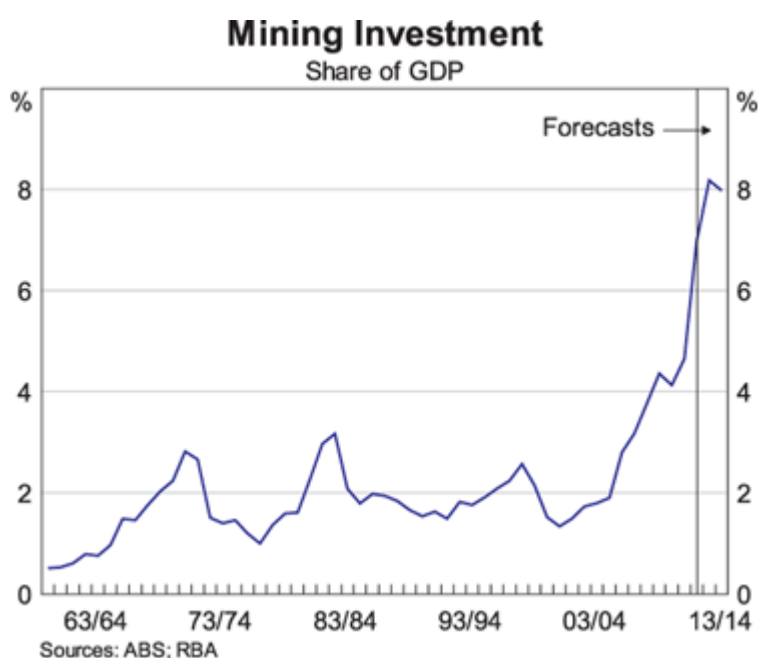
This is not so much because of the “end of the mining boom”. As a matter of fact, talk of the “end of the mining boom” has been somewhat overhyped. The “boom” is not so much ended as simply evolving, as these events would be expected to. Thoughtful commentators have already pointed out on a number of occasions that there are three phases to the “boom”.

The first was the rise in prices – something that began as far back as about 2004. The peak in prices was more than a year ago now. The Reserve Bank began noting that prices had declined in our monthly interest rate announcements in October 2011. But relative prices for natural resources are still high. At this point, the terms of trade are down to the “*peak*” seen in the September quarter of 2008, which was of course a fifty-year high.

The second phase of the “boom” is the rise in resource sector physical investment. This is aimed at taking advantage of expected high demand for iron ore, coal, natural gas and other commodities over the medium term, at prices which are attractive relative to costs of production, including the cost of capital. The peak in this build-up lies ahead. It has, for some time, been our expectation that it will occur in 2013 or 2014; that expectation seems to be firming up. The actual level of the peak is probably going to be a bit lower than we thought six months ago, in view of the somewhat lower, and more variable, prices for iron ore and coal observed in recent months.

But it’s worth putting that downward revision into perspective. For fifty years, resource sector investment was typically between 1 and 2 per cent of GDP, with cyclical peaks at about 3 per cent (Graph 3). The uncertainty now is over whether it will peak at closer to 8 per cent of GDP than 9 per cent. What isn’t uncertain is that either number is very high by any historical standard.

Graph 3



It's also worth observing that, in any episode of this nature, there will always come a point when some potential projects, conceived at the time when prices were at their highest and when costs were about to start mounting quickly as well, have to be shelved. Actually, if projects that rely on extremes of pricing and optimism can be shelved before they get too far, that is preferable to having them continue. More generally some important parts of the resources sector have now reached a point where the costs of further expansion in capacity, relative to those that might be expected elsewhere in the world, are a much more important factor in investment decisions than they were a couple of years ago.

The third phase of the “boom” is when the capacity to extract and export higher quantities of resources is actually used. This phase has begun for iron ore but it is mostly still ahead of us, especially for gas. The main uncertainty is really over the prices that will be achieved as higher supply – and not just in Australia – comes on stream. Such uncertainty is, and always has been, part and parcel of the business of investing in resource extraction.

Perhaps what people have found a little unnerving over the past year is that as the prospect of rising supply of key natural resources gets closer, and prices have declined from their peaks, the Chinese economy has been in transition to slower growth. It was inevitable that China would slow to some extent, from the very rapid pace seen for much of the past decade. The signs it needed to do so were quite evident: increasing general price inflation, escalating property prices, doubts about the process of credit growth and credit risk management, and so on. But just how big a slowing was occurring? For much of this year, that was the question that people have been trying to answer. My assessment is that the slowdown has been more material than had been expected a year ago, but not disastrously so. There are some signs that the moderation may have run its course, though further data are needed before such a view could be offered with confidence.

So the Chinese economy has not crashed. But neither is it likely to return to the sorts of double-digit percentage rates of growth in real GDP, and 15 per cent growth rates for industrial production, that we saw for some years. People expecting that to resume are likely to experience disappointment.

These trends are entirely consistent with two propositions that we have advanced over the past several years. The first was that China's economy would have an important and

increasing weight in the regional and global economies. China's economy is nearly three times the size it was a decade ago. One corollary of this is that even "moderate" growth in China is quantitatively significant. If China grew by, say, "only" 7 per cent in 2013, that would add more to global GDP than the 10 per cent growth recorded in 2003.³

The second proposition was that China, like all economies, has a business cycle. It is affected by what happens elsewhere in the world, and by its own internal dynamics, including the decisions of its policymakers. Swings in China's economic performance are increasingly affecting Australia's economy and that of the region – and the world. Hence the focus on monthly data reports from China these days in our business press, in addition to the focus on the Chinese political situation. The Chinese "purchasing managers index" is now as keenly awaited, and is as potentially market moving, as the original US PMI measure, known these days as "ISM".⁴ There is some tentative evidence that Chinese data "surprises" have become increasingly influential in driving movements in Australian financial prices such as the exchange rate and share prices.

Turning then to Australia, two years ago I noted that we could not know how much of the rise in the terms of trade would be permanent, and that there was therefore a case to save a good proportion of the additional national income until it became clearer what the long-run prospects might be. In a manner of speaking, we have, as a community, done something like that. The marked rise in the rate of saving by households in 2008 and 2009 has been sustained. Corporations have also increased their saving considerably over the past five years, opting to repay debt and lower their gearing ratios.

Admittedly, government saving has been lower for a time, for countercyclical purposes, though that is now scheduled to rise as well. For the nation as a whole, the fact that the current account deficit has been lower on average in the past few years than in the period from 1985 to 2005, at the same time as the share of business investment in GDP has been exceptionally high, indicates that national saving has been higher. In fact it has been at its highest share of national income since the late 1980s.

This change can be seen as a sensible response to an unusually high level of the terms of trade. Something else has also been at work, though, in household behaviour. I have spoken about this before but it bears saying again, because it is fundamental to understanding the current economic situation.⁵ After a period in which high levels of confidence, macroeconomic stability, easy availability of credit and rising asset values saw Australian households borrow more and save less, households have over recent years changed their behaviour in respect of spending, saving and borrowing. They have gone back towards what was once considered as "normal".⁶

This really had nothing to do with the resource boom. But it has had important implications for some key business sectors. Financial institutions are finding that growth in credit is now a single-digit number, not a double-digit one as it had been for so long. Businesses that in the earlier period of optimism derived earnings from high rates of turnover in asset markets – real estate agents, stock brokers, for example – face challenges, given that turnover is now greatly reduced.

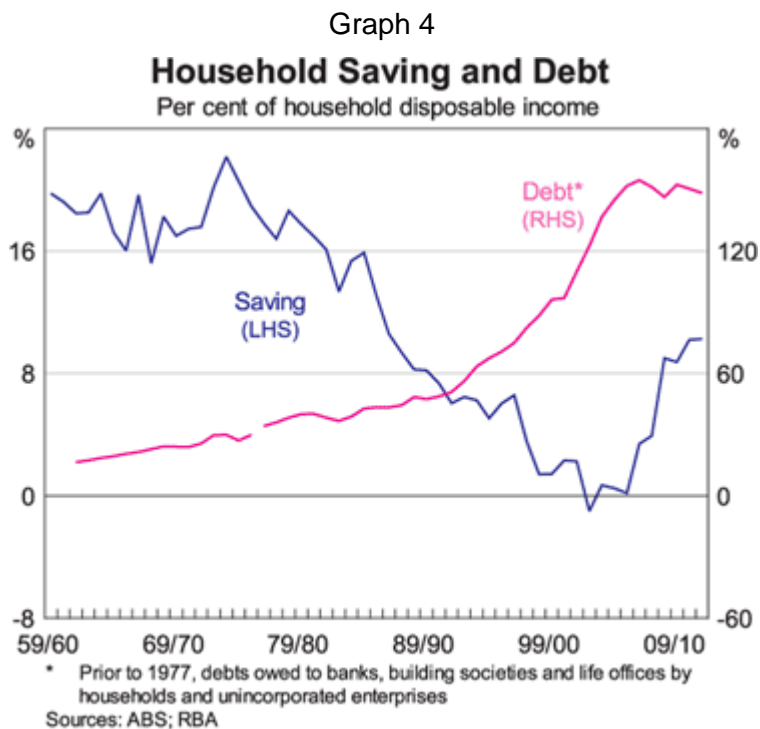
³ In 2003, China's growth in real GDP of 10 per cent added 0.8 of a percentage point to global GDP. If China's growth in 2013 is 7 per cent, that will add a full percentage point to global GDP.

⁴ I am old enough to remember when the ISM index was referred to as the "NAPM" index, compiled by the National Association of Purchasing Management.

⁵ Stevens G (2011), 'The Cautious Consumer', RBA *Bulletin*, September, pp 77–82.

⁶ The focus on households is not to deny that businesses have also become more circumspect about debt as well. But corporate leverage did not really rise much in the preceding decade, at least outside a few celebrated instances. It was the change in household debt that was the defining feature of the period from the early 1990s to about 2008.

The retail sector now faces different consumers. It is not actually that consumers have no income to spend, nor that their confidence levels are *that* low, nor that their saving rate is *that* high. Measures of confidence that date back to the 1970s show it to be roughly at its long-run average. The household saving rate as measured by the Australian Statistician, at just over 10 per cent, is not, in fact, high in the broader sweep of history (Graph 4).



To be sure, confidence was persistently very high for years up to 2008, and saving was very low – even falling to about zero, as measured, at one point. But that period was unusual. I don't think it will return. Moreover consumers are much more knowledgeable about prices as a result of information technology, and have at their disposal ways of responding to that information that a decade or more ago they did not have. This is putting pressure on retail business models, on wholesaling and distribution, and also on segments of the retail property sector.

Given that the change to household behaviour was probably inevitable, the income boost from the terms of trade arrived at a rather fortuitous time. It helped to accommodate a rise in household saving and a slowdown in the build-up of debt in a fairly benign fashion. The weakness of some other parts of private demand, and openness to imports with a high exchange rate has also meant that a very large expansion in mining investment has been accommodated without overheating the economy overall. As it was, total real private final demand in Australia rose by 6 per cent in 2011/12, well above trend.

With the peak in the investment phase of the mining boom now coming into view, the question naturally arises as to how the balance between the various types of demand in the economy will unfold. Mining investment will contribute less to growth in domestic demand in the current fiscal year than it did last year, and less again next year. Working in the other direction, it is likely that export volume growth will begin to strengthen as the capacity being installed in the resource sector is used. That would show up as GDP growth, though it may be predominantly reflected as higher measured productivity rather than generating a large volume of extra employment.

The question will be whether other areas of domestic demand start to strengthen. Many households have made progress in reducing debt burdens. At some point that might be

expected to lead to such households feeling more inclined to spend. But a complex interaction of factors – asset values and expectations about job security to mention two – will be at work in ways that are not amenable to accurate short-term forecasting. Overall, our assumption is that consumption will probably continue to grow at about trend pace, in line with income.

Public demand is scheduled to be subdued as governments seek to return budget positions to surplus. The near-term outlook for business investment spending outside the resources and resource-related sectors is subdued, judging by currently available leading indicators. In most cycles, it takes time for this sort of investment to turn; this episode looks like no exception. The exchange rate may also have some role in helping the needed re-balancing. While it's not surprising that the Australian dollar has been very strong given the terms of trade event we have had, it is surprising that it has not declined much, at least so far, given that the terms of trade peaked more than a year ago. A lower exchange rate would, of course, need to be accompanied by a pace of growth of domestic unit costs below that seen for much of the past five years, in order to maintain low inflation.

One area of stronger potential demand growth is dwelling construction, which has been unusually weak. It is not clear, actually, that the degree of weakness has been adequately explained. Various explanations have been offered – interest rates too high, housing prices falling, zoning restrictions, planning delays, construction costs, lack of “confidence”, all have featured. At present, at least some of the pre-conditions one might expect to be needed for higher construction seem to be coming into place. Interest rates have declined, dwelling prices seem to have stopped falling, rental yields have risen, and the availability of tradespeople is assessed as having improved. We have, moreover, seen a rise in approvals to build. So there is some evidence of a turning point, albeit a belated one.

Will the net effect of these developments mean that aggregate demand rises roughly in line with the economy's supply potential over the next couple of years, or will a significant gap emerge? That is the question the Reserve Bank Board is trying to answer every month when it sits down to decide the stance of monetary policy.

As of the most recent meeting, as the minutes released earlier today show, the Board felt that further easing might be required over time. The Board was also conscious, though, that a significant easing of policy had already been put in place, the effects of which were still coming through and would be for a while. In addition, the latest inflation data, while not a major problem, were a bit on the high side, and the gloom internationally had lifted just a little. So it seemed prudent to sit still for the moment. Looking ahead, the question we will be asking is whether the current settings will appropriately foster conditions that will be consistent with our objectives – sustainable growth and inflation at 2–3 per cent.

Over the long run, though, the bigger question, for all of us here tonight and in the business and policy making community generally, isn't about the monthly interest rate decision. The big question is: what is the sustainable growth rate of the economy? Beyond its role of preserving the value of money, monetary policy can do little to affect that sustainable growth rate. Moreover, the initial contribution of rising mineral prices to our standard of living has now run its course. To be sure, a higher capital stock devoted to extracting resources at high prices, assuming they continue, will make its contribution for many years – to the extent that Australians own some of that capital, work with it or receive tax revenues. But the biggest contribution to growing living standards will be what it has always been other than in periods (usually not long-lived) of exceptional luck, and that is productivity performance. I noted two years ago that while our terms of trade are handed to us, for better or worse, by international relative prices, the efficiency with which we work is a variable we can actually do something about.⁷

⁷ See Stevens G (2010), 'The Challenge of Prosperity', *RBA Bulletin*, December, p 75.

For some years there had been evidence of a slowing in productivity growth, beyond the unusual factors clearly at work in a couple of sectors (mining and utilities). The most recent data on productivity show signs of a pick-up in the year 2011/12, which is encouraging (Graph 5).

Graph 5



It is much too soon to conclude that a new, stronger trend is emerging – in this field much longer runs of data are needed. In my opinion, the accelerated structural change we are seeing in the economy for various reasons is likely to result in some improvement in productivity performance. But the most that can be said, at this stage, is that the data are not inconsistent with that hypothesis.

At this point when talking about productivity, I usually become circumspect. One reason is that I know that people might ask what we might do to improve productivity performance, and I am acutely aware that the improvement has to be delivered in enterprises all around the country – the ones associated with CEDA and millions more. Productivity does not rise simply because of exhortation or official pronouncements.

As for policy measures, at a meeting in Brisbane earlier this year, I said:

The Productivity Commission has a long list of things to do. My answer to what we can do about productivity is: go get the list and do them.⁸

⁸ The background to this is that, as part of our preparations for possible questions about productivity from the House Economics Committee, I had at one stage asked the Reserve Bank staff to compile a list of areas of reform that the Productivity Commission had covered at various times. It was this list I had in mind when I made the comment in June. At one hearing of the House Economics Committee I in fact read from such a list. See House of Representatives Standing Committee on Economics (2011), *Reserve Bank of Australia Annual Report 2010*, HRSCE, Melbourne, 26 August. Available at <http://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/306ee889-2f7e-4661-964b-5264b58b7169/toc_pdf/Standing%20Committee%20on%20Economics_2011_08_26_393_Official_DISTRIBUTED.pdf;fileType=application%2Fpdf#search=%22committees/commrep/306ee889-2f7e-4661-964b-5264b58b7169/0001%22>.

That comment elicited some attention. The Chairman of the Productivity Commission was, I am led to understand, inundated with media demands for “the list” and had to explain that it didn’t quite exist in that form. But Chairman Gary Banks has very kindly drawn one together, in his final public speech at the end of a very distinguished tenure in that position.⁹ His list is a rather more complete one than mine. In fact it is a set of lists, under three headings: things that affect incentives, things that affect capabilities and things that affect flexibility. What was perhaps most striking was the comment in the conclusion that no single policy offered the secret to success.

To quote:

Rather, what is needed is an approach to “productivity policy” that embraces both the drivers and enablers of firm performance, and is consistently applied. That in turn requires policy-making processes that can achieve clarity about problems, reach agreed objectives and ensure the proper testing of proposed solutions (including on the “detail” and with those most affected). The beneficial and enduring structural reforms of the 1980s and 1990s are testimony to the value of these policy-making fundamentals. Good process in policy formulation is accordingly the most important thing of all on the “to do list”, if we are serious about securing Australia’s future productivity and the prosperity that depends on it.¹⁰

It couldn’t have been better put.

As the “mining boom” moves from its second to its third phase over the next year or two, the world economy will continue to present its own challenges. Australia will, as always, need to adapt to the changing circumstances. Looking much further ahead, to “the Asian century”, our opportunities are large. But to grasp them, that same adaptability, combined with a clear focus and steadiness of purpose will be key. We need to produce our sought after prosperity; it won’t just come to us. All of us have our role to play, CEDA and its members included. I wish you every success.

⁹ See Banks G (2012), ‘Productivity policies: The “to do” list’, Speech at the Economic and Social Outlook Conference, ‘Securing the Future’, Melbourne, 1 November. Available at <http://www.pc.gov.au/__data/assets/pdf_file/0009/120312/productivity-policies.pdf>.

¹⁰ See Banks G (2012), op. cit. p 20.