Glenn Stevens: Economic update

Speech by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, at the Econometric Society Australasian Meeting and the Australian Conference of Economists, Hobart, 3 July 2014.

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I thank Alexandra Rush for assistance in compiling these remarks and Selwyn Cornish for comments on the historical material.

Thank you for the invitation to visit Hobart – in winter! – and to take part in this conference.

Economics in Tasmania

This year marks a century of economics at the University of Tasmania, dating from the time Herbert Heaton took up duties as a lecturer in History and Economics in 1914. Heaton's pacifist and somewhat left-leaning views apparently caused some controversy, both in Tasmania and subsequently at the University of Adelaide. He left Australia in 1925 for Canada, and later had a successful academic career at the University of Minnesota.[1]

Over the ensuing period, some of the greatest names in Australian economics studied here, taught here or otherwise carried out some part of their professional duties here. It's quite a line-up.

There was LF Giblin, born in Tasmania, sportsman, student at Cambridge, some-time acquaintance of the Bloomsbury Set, Yukon adventurer, enlisted soldier in middle age and wounded three times in the First World War, Tasmanian Government Statistician, adviser to government on economic policy in the 1930s depression and board member of the Commonwealth Bank.

Then there were those called "Giblin's Platoon" in the very nice book of that name by William Coleman, Selwyn Cornish and Alf Hagger:[2]

- Sir Douglas Copland, lecturer at University of Tasmania, the first dean of the University of Tasmania faculty of commerce, Professor at the University of Melbourne, adviser, contributor to Depression era policies, inaugural Alfred Marshall lecturer at Cambridge, diplomat and founding Vice Chancellor of the Australian National University. He was succeeded at the University of Tasmania by James Bristock Brigden.
- Brigden, like Giblin a soldier, also wounded, post-war lecturer in Economics here at the University of Tasmania, Director of the Queensland Bureau of Economics and Statistics, Secretary of a number of government departments during WWII, influential in the development of tariff and wage policies, and diplomat in Washington.
- Sir Roland Wilson, born in Tasmania, completed a bachelor of commerce at the University of Tasmania (taught by Brigden and Copland), where he later lectured in economics. He was later Commonwealth Statistician, turning down a chair at the university here to remain in Canberra, took up diplomatic roles in Washington upon

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1 See <http://adb.anu.edu.au/biography/heaton-herbert-6626>.

2 Coleman W, S Cornish, AJ Haggar, (2006), *Giblin's Platoon: The trials and triumph of the economist in Australian public life*, ANU Press, Canberra. Available at <http://press.anu.edu.au?p=55501>.

Brigden's retirement, became Chairman of the UN Employment Commission and was the longest-serving Secretary to the Australian Treasury.[3]

Coleman *et al.* chronicle the way the relationships between these four bore fruit. It was a remarkable period of activity for the fledgling profession in this country, and people who had been or were associated in some way with the University of Tasmania were in the thick of it. It might be said that, in many respects, much of the genesis of modern policy economics in Australia occurred here in Hobart.

Every generation has its own challenges. In the careers of today's generation of economists we have had, as described by various authors, "the Great Inflation", "the Great Moderation", "the Great Recession". The ensuing slow recovery in the advanced countries could be described as "the Great Disappointment", though one commentator has used stronger language – describing it, rather biblically, as "the Great Tribulation".[4]

Maybe there is undue devaluation of the adjective "great" in such characterisations. Or maybe not. The generation of Giblin *et al.* faced enormous challenges, especially given the much more limited stock of accumulated knowledge at that time and the scarcity of trained economists.[5] But plenty of writers, including some who have been intimately involved in policymaking, have seen the recent episode as potentially as catastrophic as the 1930s, averted only due to interventions framed with the lessons of the 1930s in mind.

But a fuller evaluation of those issues may need to wait for another occasion. Today I propose something less ambitious. In early May, the Bank published its latest *Statement on Monetary Policy*. Since then we have had the Federal and some state budgets, and some further data as well as a couple of interest rate decisions. Hence, it seems appropriate to provide a brief update and some comments on a few issues connected with monetary policy.

Economic update

It appears that the economy's pace of growth increased somewhat in the second half of last year, and that this persisted in the first few months of 2014. Real GDP expanded at an annualised pace of about 3 per cent in the second half of 2013, up from just under 2½ per cent in the first half. Business survey readings are broadly consistent with this picture. The March quarter of 2014 saw a further pick up, to something that was above trend, measured either in the quarter or over the year.

A key question is the extent to which these recent national accounts data in particular illustrate the likely ongoing pace of growth. The results owed a lot to a very substantial rise in resource exports. This in turn reflected new capacity coming on stream and also unusually benign weather. While further rises in resource export volumes are expected, they are unlikely to be at the same pace.

Hence, the most recent set of GDP figures, while certainly encouraging, probably overstate somewhat the true ongoing pace of growth in the economy. The Bank's forecasts from early May, which we have not materially changed, embody ongoing growth but, in the near term, probably a little below trend. We will provide an update of forecasts next month.

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3 We could add Sir Edward Ronald Walker, professor of Economics at the University of Tasmania, adviser to the State government, head of the delegation to the 1945 Paris Conference, diplomat and chair of the UN Committee on Full Employment in the late 1940s. We could also mention Professor Gerald Firth, who travelled from the UK to take up the Ritchie Research Fellowship funded by Giblin at the University of Melbourne, was a senior economist in the Department of Post-war Reconstruction and was Professor of Economics at UTAS for around 30 years.

4 See Charles Bean, <http://www.bankofengland.co.uk/publications/Pages/speeches/2014/729.aspx>.

5 It's remarkable that Sir Roland Wilson was, according to Coleman et al., the first university graduate appointed to an administrative position in the Commonwealth Public service, in 1932.

What are some of the key features of this outlook?

The world economy continues to show moderate growth, probably a little below average but not by all that much. The advanced countries are seeing somewhat better outcomes than last year overall, while some emerging market economies slowed somewhat during the first half of 2014, including China.

Looking at domestic economic policies, the stance of monetary policy is very accommodative, certainly when measured by the metric of interest rates. The level of rates, including for borrowers, is at a 50-year low. The cash rate measured in "real" terms is approximately zero. In either nominal or real terms the cash rate is well below "normal" levels, and comfortably below even the mooted lower "new normal" levels. Moreover, we still have "ammunition" on interest rates – we have not got close to the zero lower bound that has afflicted some other countries.

The low interest rates have been having many of the effects they normally do. Savers have altered their behaviour to look for returns in slightly more risky assets; asset prices have risen; demand for credit has strengthened; and interest sensitive areas of spending, like some areas of consumption and especially dwelling construction, have firmed. The exchange rate also declined, though not by as much as might have been expected. The full effects of the very accommodative stance of policy have not been seen at this stage. It will be supporting demand for some time yet.

The Federal Budget seems unlikely materially to change the near-term outlook. Over the next couple of years the estimated impact of the budget is not very different from what we had previously been assuming, and the extent of fiscal contraction, as conventionally measured, is actually not particularly large when compared with past episodes of fiscal tightening.

Beyond that period, the measures in the budget will result in a more significant consolidation than earlier assumed. It was over that more medium-term horizon that the Commonwealth's finances, left unattended, looked like they were going to start going more seriously off course. So the timing of the intended consolidation seems broadly sensible.

That having been said, the fact that the real issues with public finances are medium-term ones is not a reason to put off taking decisions to address them. On the contrary, as experience in so many other countries demonstrates, by the time these sorts of problems have gone from being out on the horizon to on our doorstep, they have usually become a lot more difficult to tackle. Early, measured actions that have effects that build up over time are a much better approach than the much tougher response that might be required if decisions were delayed.

There has been discussion about confidence effects of the budget. Some surveys do suggest some decline in household confidence of late. It is important, though, to ask how persistent such effects might be. Last year's budget, which contained some tough messages, also seemed to be associated with a decline in such measures of confidence. They recovered after a few months. We can only wait to see whether that pattern will be repeated this year. Measures of business confidence don't show any obvious response to the budget.

While there has been much focus on budget measures, the biggest sources of uncertainty about the pace of private demand growth remain the speed of the impending large decline in capital spending by the resources sector, and the timing of the recovery in non-mining capital spending and non-mining activity more generally.

The biggest and most persistent terms of trade gain in at least a century ushered in a capital spending response by mining and energy companies that saw the private business investment share of GDP reach a 50-year high, even though investment outside the mining sector approached recession-level lows. Now, the terms of trade are falling, and the investment part of the boom has peaked. Mining investment, as a share of GDP, has probably already declined by about 1 percentage point, and is expected to fall by another 3 or 4 percentage points over the next few years.

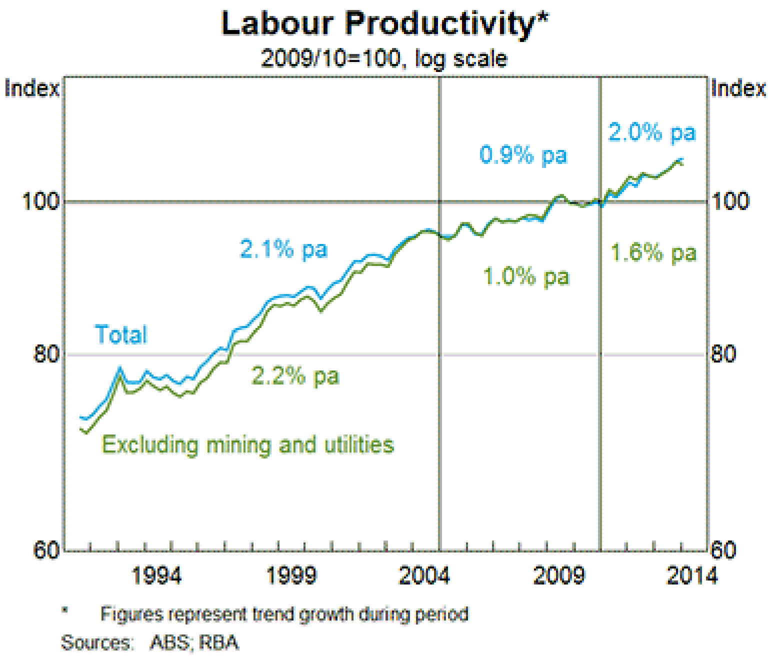
Unlike in all previous such booms, we did not experience serious overheating in the upswing. What is being attempted now is to negotiate the downswing phase without the slump that characterised the aftermath of all the other booms.[6] The fact that the upswing was managed without the excesses of the previous episodes is no guarantee of success in the next phase, but it has to be a good starting point.

We have seen some encouraging early signs of the "rebalancing" taking place. Consumer demand has been rising moderately, even if recently perhaps a little more slowly than it did over the summer. Residential construction is moving up strongly, and intentions to invest outside the resources sector have started to improve, from very subdued levels. The labour market has also shown some early indications of mild improvement.

But these signs remain early ones. There is quite some way to go yet before the episode is completed.

Meanwhile, the environment seems likely to be one in which a number of sectors are making serious efforts to contain costs and lift productivity (Graph 1). That amounts to an outlook for wages and prices that does not appear to threaten the inflation target, even were we to see a somewhat lower exchange rate. Perhaps more fundamentally, a better trend for productivity, if we can sustain it – and especially if it can be further improved – would be a reliable basis for optimism about the longer-run prospects for the economy and our living standards.

Graph 1



Communication about monetary policy

It is in that context that the Board has left the cash rate unchanged at 2.5 per cent for almost a year now.

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[6] For an insightful treatment of the previous booms, see Ric Battellino's speech "Mining Booms and the Australian Economy" (2010).

For rates to have been stable for this long isn't unprecedented. But since markets and media commentators find the idea of masterly inaction neither appealing nor interesting, this has put more focus on communication.

The Bank's language has evolved, given the passage of time and the flow of new information. Up to the time of last August's meeting, the post-Board statement for some months included language about the inflation outlook, as then assessed, providing "scope" to ease further should that be appropriate to support demand. At the May and August 2013 meetings the Board used some of that scope. Subsequent post-meeting statements did not include that phrasing. The minutes of those meetings simply recorded the Board's view that "the Bank should neither close off the possibility of reducing rates further, nor signal an imminent intention to reduce rates further". That phrasing was retained until the December minutes.

The data that emerged over the summer saw somewhat firmer growth, a lower exchange rate and higher inflation than had been embodied in the outlook as at the end of last year. This led the staff forecasts for both growth and prices to be revised higher for the February meeting and the subsequent *Statement on Monetary Policy*. The December quarter CPI in particular was something of a surprise. We interpreted those data as containing a degree of noise but could not entirely discount the possibility that they may also contain some signal. Hence, the inflation forecast was revised up somewhat.

With both growth and inflation forecasts moving higher, it would have been odd to continue with the earlier language. After all, policy had been eased a great deal, it seemed to be having many of the expected sorts of effects, inflation wasn't threatening to be too low and, if anything, was going to be higher than earlier expected, and there was mildly better news on output. Accordingly, the Bank's communication continued to evolve in light of new information.

Although this shift in language was quite gradual, the problem we can sometimes have in such periods is that people may react by thinking that, if the Bank is not thinking about easing, then it must be thinking about tightening. But we were not contemplating tightening. In fact, the conclusion we had reached was that we might be on the brink of sitting still for some time. That is why we adopted language about "stability" in interest rates, the intended effect of which was to be clear to people that we did not think that higher interest rates were imminent. That has not stopped people from opining about the timing of possible future increases – or, indeed, decreases. That's what makes a market – people have differing views, for various reasons.

Overall, I judge that language to have served its intended purpose. Present market pricing suggests that market participants expect interest rates to remain low for some time yet. If anything, pricing in recent days has suggested that, if a move were to occur over the next several months, markets expect it would be down, not up. Any increase in rates is thought by market participants, on average, to be unlikely for quite some time.

The evolution of language should be expected to continue, as more time passes and further information comes to hand. Long before any thought were to be given to an increase in rates, it would probably be sensible for the Board to cease references to a future "period of stability" and revert to the more normal formulation that the stable policy settings "remained appropriate" or something like that. Such an evolution would amount to no more than a recognition that a "period of stability" had in fact already been occurring and wasn't *entirely* in the future, but wouldn't imply any particular change in the Bank's views about the future course of policy. It should go without saying that those seeking to understand our thinking should, in any event, look not just at the wording in the post-Board statement, nor just that in the minutes, but also at the whole analysis of the economy and the outlook in the regular *Statement on Monetary Policy*.

The exchange rate

Another issue in communication has been how to describe the exchange rate. For a period we described it as "uncomfortably high". It subsequently declined, though we suspect that was due more to a change in mood in global capital markets than to our words *per se*. We altered our language to reflect that decline, and then adjusted it again as the currency re-traced some of that rise.

There seems to have been a very strong focus on whether the adjective "uncomfortable" would be put into use once more in the post-Board statements. It hasn't been, though I don't regard that to be as significant as many people seem to think it is. We have tried to avoid frequent and large language shifts about the exchange rate. It can vary enough from month to month that we risk chasing our tails if we seek to engage too actively in "jawboning" each month.

But lest there be any uncertainty about this, let me be clear, again, that the exchange rate remains high by historical standards. There is little doubt that significant parts of the trade-exposed sectors still find it quite "uncomfortable": it continues to exert acute pressure for cost containment, productivity improvement and business model change. When judged against current and likely future trends in the terms of trade, and Australia's still high costs of production relative to those elsewhere in the world, most measurements would say it is overvalued, and not by just a few cents. Of course, we live in unusual times, with interest rates at the "zero lower bound" in several major jurisdictions. Nonetheless, we think that investors are under-estimating the likelihood of a significant fall in the Australian dollar at some point.

Housing prices

Finally on communication and monetary policy generally, there is the question of housing prices. Few issues seem as capable of sharply dividing opinions as this one. Some use the "B" word, sometimes followed by calls for interest rates to be higher. Others regard it as unthinkable that interest rates would ever respond to housing prices. Still others call for regulatory actions to constrain housing lending, which, by the way, has overall remained quite moderate so far.

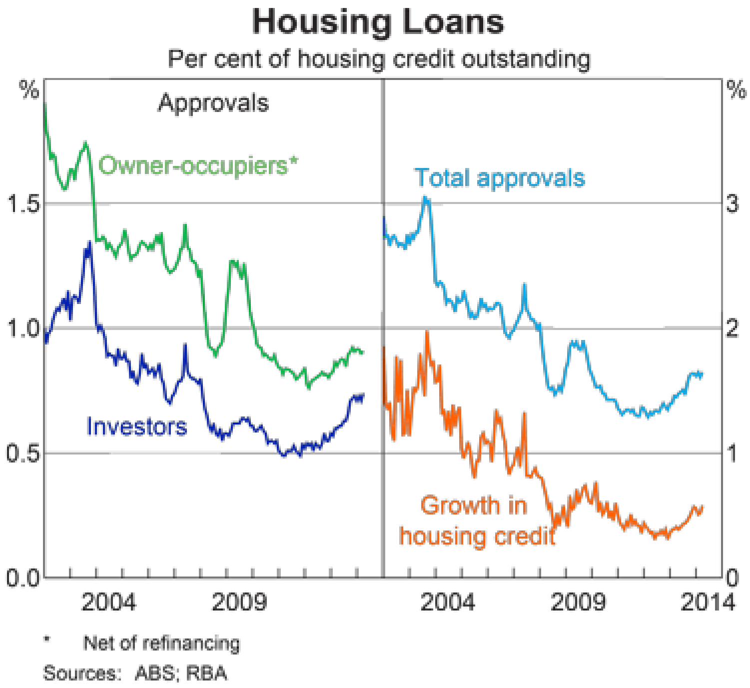
The Bank's views on this have been quite consistent. We have made four points.

First, with dwelling prices having fallen between 2010 and 2012, some recovery was not in itself particularly cause for concern, certainly not initially. Moreover, if we think there is a need for higher construction, which we do, an environment of declining prices is probably not conducive to that outcome. Some pick-up in housing prices as a result of lower interest rates was to be expected; it shows that monetary policy is working and is part of the normal transmission process.

Of course, this argument becomes less persuasive if valuations reach new highs and keep rising. So, second, were there to be a further big run-up in prices, with past increases leading to overconfident expectations of continuing gains, it would be a different matter. If this were accompanied by a return to significant increases in household leverage, from already high levels, that would be a matter for concern. It would be adding risk to the system.

But, third, to date the amount of new borrowing does not appear, overall, to be imprudent. The rise in the value of loan approvals over the past year of around 20 per cent is certainly significant. It's important to note, however, that scaled by the amount of credit outstanding, the rate of this flow over recent months, while clearly well off its 2011 low point, is actually not that high compared with longer-run history (Graph 2). It's only a little above 2008 lows, in fact. The growth of credit outstanding for housing is about 6–7 per cent per annum, or slightly above trend nominal income growth. It's hard to mount the soap box to complain about that pace.

Graph 2



Nonetheless, fourth, investors should take care in the Sydney market, which is the main area where a large increase in borrowing has been occurring. The total value of credit approvals for investor loans in New South Wales as a whole is about 130 per cent higher than in 2008, and it is in the investor segment where there has been evidence of some increase in lending with loan-to-value ratios above 80 per cent in the past couple of quarters.

Here we continue to have two messages.

The first is that in forming expectations about future price gains and deciding their financing structure, people should not assume that prices always rise. They don't; sometimes they fall.

The second is that banks and other lenders need to maintain strong lending standards. APRA has helpfully been reinforcing this point directly with bank boards, as well as stressing the importance of having adequate, higher, interest rate buffers in place, given the current very low level of rates in the market.[7] The maintenance of strong standards will be all the more important given the significant improvement in access to funding via the securitisation market over the past year and the associated increase in competition to lend.

Some segments of the housing market do appear to have been calming down lately. Prices have flattened out in several cities and even in Sydney the pace of increase has lessened.

It remains to be seen whether this slower pace of growth in dwelling prices is temporary or more persistent. It would in my opinion be good, for a range of reasons, if it did persist for a while. If the next couple of years saw an unremarkable performance on prices, and construction staying at the higher levels that will clearly be reached over the coming year, it would be an outcome that would contribute to a balanced growth path for the economy and to housing more people at manageable cost.

Overall, the Bank has not seen developments in the housing market as warranting higher interest rates than the ones we have had, in the current circumstances. This isn't because we think that financial stability considerations should be ignored in the policy decision. On the

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7 See <http://www.apra.gov.au/adi/Documents/Draft-PPG-APG223.pdf>.

contrary, they should be, and have been, given due weight, along with all the other factors we have to take into account, in deciding the interest rate path we have chosen. We judge that path to have best balanced, to date, all the various considerations.

Conclusion

I wonder whether Giblin and his “platoon” could have imagined a meeting like this: hundreds of economists and econometricians converging, from around the country and around the world, on Hobart for just a few days, travelling not at stately pace in ships and trains, as they would have, but through the stratosphere at just under the speed of sound. Probably not.

But at least some of the issues about which we talk today would sound familiar to them. Swings in the terms of trade, the effects of massive international financial events with all their spillovers, policymakers grappling with events they had not seen before, come to mind. They would have seen a need, as should we, for the economics profession to make a constructive contribution to national debate about economic matters.

I hope the discussions today and over the course of the conference will help us all to play our parts.