

## Glenn Stevens: Some observations on recent economic and financial trends

Address by Mr Glenn Stevens, Deputy Governor of the Reserve Bank of Australia, to the Institute of Chartered Accountants in Australia, Financial Services Seminar, Melbourne, 22 February 2006.

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### Accounting

Today's program shows that you are looking intently at some of the big forces shaping the environment for the financial services industry. There are a number of forces at work, including changes to regulation, accounting, technology and attitudes in the community.

In the accounting field, Australian entities are, of course, working to implement the change to International Financial Reporting Standards. There is a host of issues associated with all of this, some of which have been quite contentious, particularly for some parts of the banking and finance industries.

So I am relieved to say that the Reserve Bank has no role in developing or enforcing accounting standards, though we do of course have to produce our own accounts consistent with the relevant standards. It may interest you to know in this context that the Reserve Bank has itself made the change to IFRS, and will present its 2005/06 accounts on this basis in the *Annual Report* later this year, just like any listed company. To our knowledge, we are the only major central bank to adopt IFRS in full, as yet. This continues the RBA's practice for many years of adopting commercial standards of financial disclosure.

For the most part, the effects of IFRS on our accounts are fairly small. The main one of substance is the recognition of the surplus in the staff superannuation fund on the balance sheet. This potentially adds some volatility to annual results as measured by the accounting standard, as the position of the fund alters with market prices. But sensibly applied, and combined with the wise provisions of the *Reserve Bank Act 1959*, which govern the way in which the Bank's earnings are distributed to the Commonwealth, there should not be too much additional variability in the dividend.<sup>1</sup>

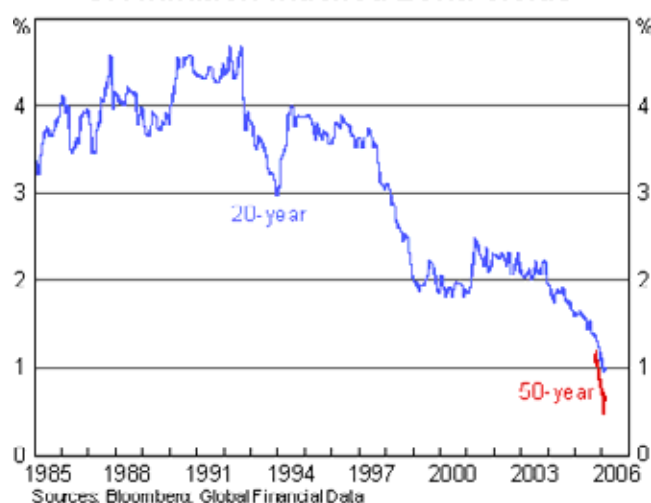
There is an important general point there. Differing accounting treatments have the potential to affect the behaviour of decision-makers in different ways, the more so when combined with regulatory requirements.

A number of commentators have suggested, for example, that one factor behind the extraordinary demand for long-dated government securities we currently observe in several European countries reflects, at least in part, the attempt by trustees and managers of defined-benefit pension plans to restructure their portfolios in response to changes in accounting conventions and regulatory requirements. In the UK, perhaps the most striking case, index-linked government securities have recently traded at real yields of less than half of 1 per cent for a 50-year security. Pension fund buying is prominent among the explanations on offer for this phenomenon.

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<sup>1</sup> In many countries, central bank accounting is regarded as unique and is often subject to particular legislative provisions or tailor-made approaches. In Australia's case, the *Reserve Bank Act 1959* is not prescriptive about accounting, but is quite particular about how the earnings of the Bank are to be distributed to its owner – the Commonwealth. Valuation gains on assets – which can on occasion be substantial – contribute to profits, but are only available to the Commonwealth as a dividend when realised. Unrealised gains are retained in reserves against the possibility of future valuation losses. This is a very sensible arrangement because it prevents a situation where the central bank might come under pressure to distribute unrealised gains, eroding its capacity to cope with inevitable subsequent unrealised losses (and, potentially, requiring re-capitalisation at government expense). It has been a problem for some central banks, but never in Australia.

**Graph 1**  
**UK Inflation-indexed Bond Yields**



The accounting difference between the discounted value of a fund's future obligations and the value of its assets is these days (quite properly) recorded on the sponsoring company's balance sheet. A market bond rate is used to discount liabilities, as opposed to the older convention of using an assumed fund earning rate. Unless the fund's assets are also placed in bonds, movements in bond rates will affect the solvency position from year to year, which in turn will affect corporate results. At the same time, stricter pension rules now require any measured funding gap between assets and liabilities to be made good more quickly than used to be the case. Perhaps it is not surprising that UK pension trustees have changed asset allocations in the direction of holding more indexed bonds. This lessens the likelihood of nasty solvency surprises in any one year, though the associated downward pressure on bond yields has itself weakened the average solvency position, as measured.

One can, of course, see why accounting rules stipulate that valuations of assets and liabilities should, for most purposes, use market prices and interest rates. Equally, pension rules requiring plan providers to fund adequately their obligations protect the plan beneficiaries against the risk of the company failing and leaving insufficient funds.

But if the behavioural response to all this is a rush into assets yielding a real return of half of 1 per cent per year for 50 years, there will be a very large increase in the long-run cost of providing the pensions which are the whole object of the exercise. That increase in costs will, in turn, eventually place a question mark over the viability of the schemes. Hence, the question in the UK is whether the combination of regulatory and accounting reforms is ultimately going to strengthen the private pension system or hasten its demise.

The point I am making from this foreign example is that accounting matters, and not only to accountants. It doesn't just inform us of the state of an enterprise, it affects behaviour - hopefully for the better, but either way can often have unforeseen interactions with regulatory signals. Stated accounts are also viewed through the lens of market or media perceptions, which all too often are focused on the very short run. These sorts of considerations are, in practice, quite important.

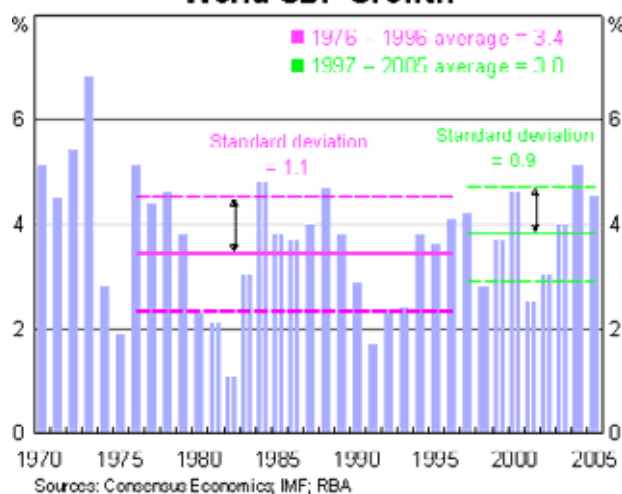
Let me turn now to some remarks about general economic trends, beginning with the external environment.

### **The Global Environment**

We have been living through some remarkable developments in the world economy over the past decade. Growth performance has improved, with global GDP growth averaging 3.8 per cent since 1996, compared with 3.4 per cent for the preceding two decades. That doesn't sound like a big difference but it is: almost half a percentage point extra growth on average, every year, is definitely worth having. What's more, the variability of growth has declined, with the standard deviation of annual growth falling from about 1.1 per cent to 0.9 per cent. The mean growth rate has risen substantially, while variability has declined: any portfolio manager would like to deliver that combination. While all

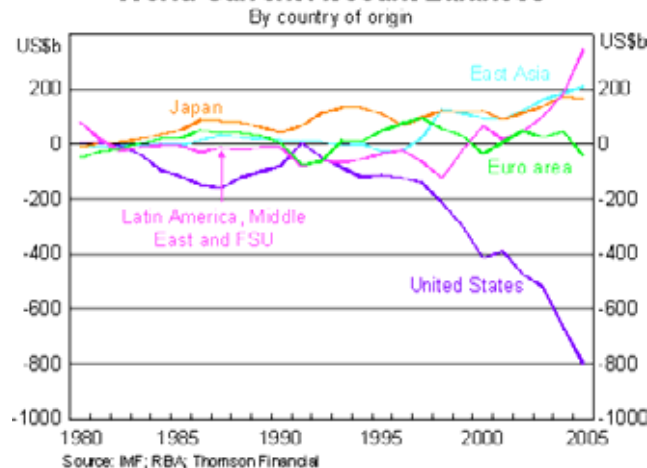
this has occurred, moreover, global inflation rates have declined, become less variable and less dispersed among countries. There are very few countries with seriously high inflation now.

**Graph 2**  
**World GDP Growth**



Yet while the aggregate performance has improved, we hear more talk than ever before about so-called 'imbalances'. By this, people mean that the expansion in the world economy has been associated with a largish and growing deficit on trade and current accounts for the United States, the counterpart of which is a string of surpluses in a number of other countries. (Indeed, one of the few countries with which the US does *not* run a trade deficit is Australia.) It is historically a bit unusual for a country as large and wealthy as the US, issuer of the world's main reserve currency, to sustain deficits of this size, and increasing, over a lengthy period.

**Graph 3**  
**World Current Account Balances**  
By country of origin



There are three questions worth posing about all this. First, how did it come about? Second, was there an alternative path available for the United States (and the world) which would have been more attractive? And third, what might happen from here?

It is worth recalling that rising US trade deficits were regarded as a concern as far back as the mid 1980s.<sup>2</sup> It was a common view then that deficits much smaller than today's were unsustainable. There has been a trend going on here for 20 years at least. Hence, we should be wary of explanations that rely only on factors which have been at work just lately; something structural in American behaviour, prompting a lower rate of saving out of current income, has been going on for a long time. That is a topic for a whole speech on its own. For today, I will take it as a given.

But if that were all there was to it, one would expect that long-term interest rates would be rising: other things equal, a lower rate of saving by the world's largest economy ought to be reflected in a higher scarcity value for saving. Yet over recent times, as the US current account deficit has continued to grow, long-term interest rates have remained low, and are lower today than 10 years ago. How so?

Over the past seven or eight years, it seems that behaviour in other countries has had a lot to do with the pattern of capital flows. Internationally mobile capital that had flowed into east Asia earlier in the 1990s reversed course and flowed out after mid 1997. (Something similar happened a little later in Latin America.) Domestic investment activity collapsed, and there was a surplus of saving over desired investment.

Subsequently, the Asian countries also made voluntary outflows of official capital. Seeing the crisis as a result of not having had enough foreign reserve assets to defend their currencies against speculative attack, and judging that the international insurance offered by the IMF was insufficient and came at unfavourable terms, many policy-makers in Asia decided to self-insure against another crisis of the same kind. They did so by intervening to build up large holdings of US dollars (and, in the process, offering their traded-goods producers a competitive advantage as a way of fostering recovery from recession). China was not badly affected by the crisis but nonetheless for its own reasons has been following a similar strategy. While China's investment rate is extremely high, its saving seems even higher, and it has accumulated a large stock of dollar assets.

So it appears that there has been in a number of countries an excess of saving over national investment needs, which has flowed abroad looking for returns. All other things given, this puts downward pressure on the international cost of capital.

In which regions of the world would such capital end up? The answer is that it would be expected to gravitate to those regions where the demand for capital is most likely to rise in response to a decline in its price. Those regions have tended to be mainly (though not exclusively) the English-speaking countries with well-developed and innovative financial systems, optimistic populations and high levels of home ownership, the US foremost among them (but also including the UK and Australia). The households of these countries responded to a decline in the cost of capital by using more of it. Countries where populations were inherently pessimistic rather than optimistic about the future - some parts of continental Europe, say, or Japan - seemed less interested in using that cheaper capital.

Other factors have also been at work, of course. No single cause ever explains everything. But the above, I think, explains a lot of the pattern of global growth and the payment 'imbalances' that have characterised it in recent years.

Was there a more 'balanced' path of global expansion that could have been taken instead?

It is far from clear that there was. Suppose, for example, that the authorities in the US, concerned about a rising trade deficit, had slowed their economy in order to reduce imports. All other things equal, the world economy would have grown more slowly as a result. The recovery we have seen in Asia from the crisis would have been slower and more difficult, and there would have been insufficient global demand to utilise the available productive resources. It is possible that the surplus countries would have reacted by expanding their domestic demand sufficiently to offset the weaker demand from the US, but in my judgement this would have been unlikely. Hence, what might perhaps have

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<sup>2</sup> The following was fairly representative of the consensus at the time: "The United States cannot continue to have annual trade deficits of US\$100 billion, financed by an ever-increasing inflow of foreign capital. The US trade deficit will therefore soon have to shrink ... Indeed, within the next decade the United States will undoubtedly exchange its trade deficit for a trade surplus." (Martin Feldstein, *Foreign Affairs*, 1987 - available at <http://www.foreignaffairs.org/19870301faessay7841/martin-feldstein/correcting-the-trade-deficit.html>). Since that time, the US trade deficit has averaged US\$227 billion per year, and is currently running at about US\$730 billion per annum. The point here is not that deficits don't matter, but that the willingness of capital to flow across national boundaries seems to have greatly increased. Hence, notions of what was sustainable that were predicated on observations from an earlier era of limited capital mobility proved not to be very useful in making predictions.

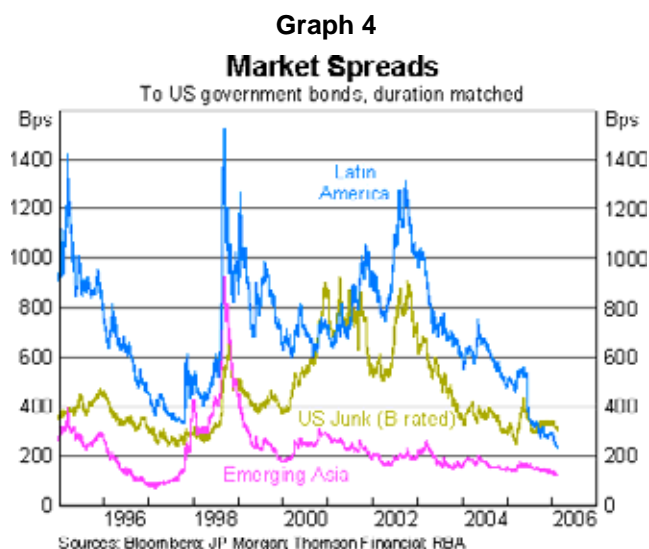
been a more balanced global path with smaller current account deficits and surpluses would almost certainly have been a weaker one for all countries.

As it was, policy-makers in the US (and a number of other countries) sought to combine full employment and price stability by allowing domestic demand to run ahead more strongly. This provided enough demand both to absorb the Asian trade surplus and keep the output of their domestic economies near full capacity. These policy-makers didn't do this out of altruism; they did it because they judged it to be in their nations' best interests. Nonetheless, their behaviour was, in my view, a stabilising force. 'Unbalanced' growth has, so far, been better than the likely alternative.

Has this strategy carried risks? Yes, it has. In the faster growing countries, household debt levels have increased, and asset prices have risen. Higher leverage, other things equal, means that households would be more exposed if economic activity turns down than they would have been otherwise. These risks have been weighed against the risks in the alternative path, and policy-makers are managing them as best they can.

As for what might happen from here, it is common for observers to warn against the risk that the 'imbalances' may unwind in a disruptive fashion. Often this is not spelled out. What is sometimes meant, I think, is that those currently accumulating dollar-denominated claims suddenly change their minds, precipitating abrupt movements in exchange rates and interest rates. Such developments might, in this view, lead to a pronounced weakening of domestic demand in countries like the US if long-term interest rates rose abruptly, while a big decline in the dollar might affect the ability of areas like Europe to export.

One can never rule out the possibility that financial markets will suffer a sudden and dramatic loss of confidence. But it is not as though markets are unaware of the various 'imbalances' or the associated risks – they read about them on a daily basis. Yet the actual pricing for risk in markets apparently suggests an assessment that risks in general are of relatively little concern at present.

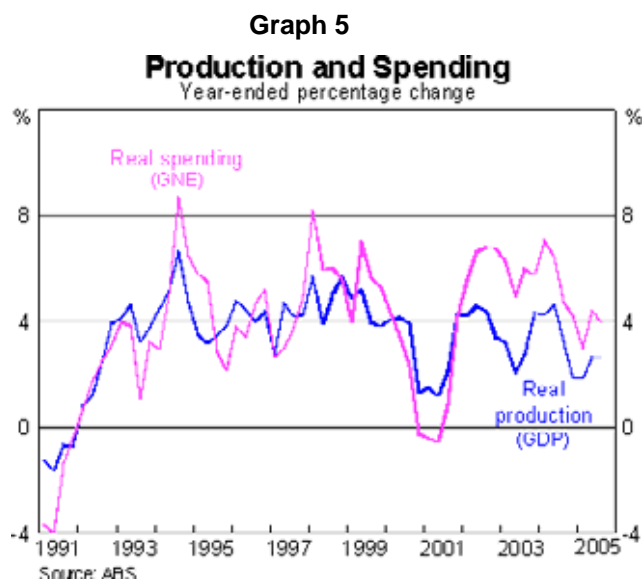


In the event that there is some market discontinuity, I suspect that it is more likely to be sparked by some sort of credit event that prompts a change in appetite for risk in general, than by reactions to current account positions *per se*. It is not obvious that US interest rates would rise, or the dollar fall, in the face of such an event.

That is not to say that there are no adjustments to various national strategies which would be in the interests of the countries concerned, and which would assist in re-balancing global growth while retaining global full employment. But that proviso - retaining full employment - is key. If the adjustment is undertaken only by the countries with large current account deficits, it is hard to see how it could not be contractionary for growth everywhere. That would not be the ideal solution.

## Australia's Domestic Economy and Monetary Policy

There is not very much I can say that is new on the domestic economy, given the recent release of our *Statement on Monetary Policy* and our appearance before the House Economics Committee last week. Let me reiterate the main themes.



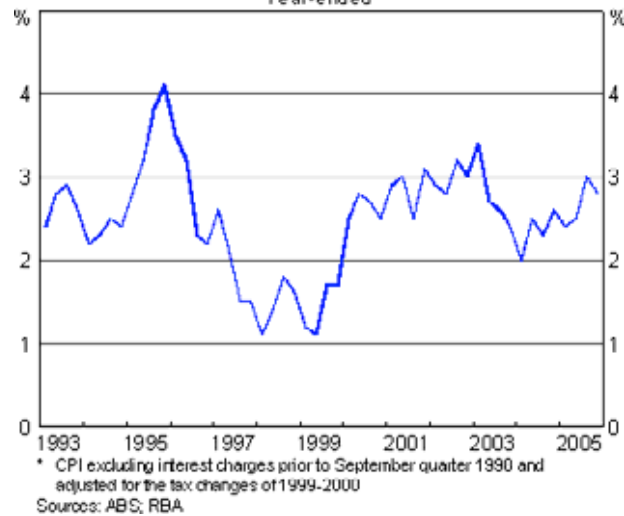
Growth in domestic demand in Australia has moderated somewhat over the past year and a half. This is not unwelcome, as continued expansion at an annual pace of 6 per cent, which we saw for several years, was unlikely to be able to continue without causing overheating. As it was, some individual sectors were overheating at times. The residential construction sector, for example, operated at peak levels over a few years, and saw shortages of tradespeople, construction delays and substantial increases in costs. Pressure was also transmitted to those parts of the manufacturing sector which supply materials. Had this been a more general story across the economy, we would have witnessed a significant rise in overall inflation, necessitating a much more active tightening of monetary policy. But because some other parts of the economy were for a time growing more slowly, and because prices of tradeable goods were reduced owing to global competition (and an appreciation in the currency), the policy response was very gradual. It was essentially limited to returning interest rates to approximately normal levels after a period in which they had been unusually low.

The shift in the composition of demand is also welcome. Household spending had risen rapidly for several years, outstripping income gains, boosted in part by the exuberance associated with the housing boom. As that boom subsided - as it turns out, so far, in a very benign way - so household demand has gradually slowed. Businesses, meanwhile, have continued to ramp up investment spending, in response to the widening incidence of capacity constraints in the economy - something which has been an increasingly prominent theme in our regular discussions with companies across the country in the past couple of years. With global demand for resources strong and prices high, the resource sector is prominent in the pick-up in investment, but other sectors too are responding to the need for more capacity. Business profitability, though squeezed in some areas by rising costs of materials and labour, remains in good shape, and of course the cost of external finance remains quite favourable. So conditions seem quite propitious for further growth in investment.

Over the medium term, the resulting increase in capacity will help to accommodate good, non-inflationary growth. In the short term, though, the act of adding to capacity itself adds to demand, potentially putting pressure on productive resources. So it is fortuitous that household demands have moderated at the same time as business investment has increased.

Inflation is well contained at present, despite a number of forces being at work which ordinarily could be expected to push it noticeably higher. A tight labour market has been putting pressure on labour costs. A strong world economy has pushed up demand for various commodities, whose prices have responded, raising input costs for businesses.

**Graph 6**  
**Inflation\***  
Year-ended



Through all that, CPI inflation has risen to 2.8 per cent in 2005, from 2.4 per cent in 2003. The Bank computes a range of measures of core or underlying inflation, designed to abstract from temporary price movements so as to show the longer-term trends. In our most recent *Statement on Monetary Policy*, these were characterised as running at about 2½ per cent, little changed from the outcomes of the preceding couple of years. In summary, despite a fully employed economy and higher oil and raw materials prices, overall inflation has remained quite well behaved. If anything, it is probably running slightly lower than we expected six months ago. While small deviations in outcomes from those forecast are not unusual and are not necessarily of significance - we are talking about fractions of a percentage point here, which certainly are not significant in the statistical sense - it is worth contemplating what might account for lower than expected inflation.

There are two hypotheses on offer. The first is that the steady internationalisation of trade in goods and services continues to exert pricing discipline on domestic producers, and that this discipline is, at the margin, a bit more powerful when growth in demand has softened, as it seems to have done. Hence, this hypothesis holds, while a number of costs are rising, firms are working hard to find offsetting savings and absorbing some of the impact in their margins. It might be argued that this price discipline coming from international trends will persist, as the emergence of China and India continues.

The alternative hypothesis is one of lags: that the full impact of the cost increases seen over the past couple of years will show up in time even with the discipline of foreign competition. Unless demand conditions are particularly weak, firms will manage to pass on cost increases and restore margins. On this view, noticeably higher inflation is not far away, even if it is taking a little longer to arrive than initially expected.

In forming its judgement about the outlook, the Bank has contemplated both these possibilities. The forecast for inflation we set out in the recent *Statement* is one that allows for some passing on of higher costs that have already been incurred, but not by as much as historical experience would indicate. This sees inflation running at 2½ to 3 per cent for the next couple of years. The risks around this forecast could be described as balanced. It is possible that a rise in inflation in response to the cost imposts of the past few years will arrive more suddenly; but it is also possible that the international and domestic competitive forces will be strong enough for long enough that those imposts will be offset elsewhere, and never show up in prices.

Given this outlook, it follows obviously that the Bank is more likely to tighten policy than to ease in the foreseeable future. An assessment of balanced risks, around a forecast of 2½ to 3 per cent inflation, means that it is more likely that a surprise will take inflation above the target of 2-3 per cent than below it. Hence, a rise in rates is more likely than a fall. That is a statement of probabilities, rather than one of near-term intent.

In fact, that has been our thinking for some time. Through most of last year, we felt that inflation would probably tend to rise, and we would probably need to tighten further at some stage to limit the rise. But

we also thought that the rise would be gradual, against a backdrop in which inflation expectations were pretty well anchored. Hence, we felt that in formulating our policy response, we had time on our side, a luxury previous generations of policy-makers usually did not have. We took advantage of that to wait, evaluating further information before acting. Thus far, I judge that to have been an appropriate strategy, especially given the inflation outcomes of late. Nonetheless, the Bank has to remain watchful in the face of a number of factors which obviously could push inflation higher. We will be ready to respond as needed so as to maintain low inflation.