

Glenn Stevens: Reviewing the Australian economy's performance

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Sydney, 4 April 2008.

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Mr Chairman, my colleagues and I are pleased to be able to appear before this newly reformed Standing Committee. I look forward to productive sessions with you over the life of this Parliament.

I shall begin by reviewing the economy's performance over the past year or so. I will then offer some comments about the current conjuncture, and some of the issues that we face in the period ahead. All this provides some context for our discussion about monetary policy.

The Australian economy recorded another very strong year in 2007. Real GDP expanded by about 4 per cent. Growth in domestic final demand was even stronger, at over 5½ per cent. The rate of unemployment declined further, in the most recent readings reaching its lowest level since the mid 1970s. Indicators of capacity utilisation reached their highest levels for two decades, and firms continued to report considerable difficulty in expanding operations, due to shortages of suitable staff.

These outcomes for demand and output growth exceeded those in either of the preceding two years, and were stronger than was expected a year ago, particularly in the case of domestic demand. In explaining these trends, a noteworthy factor is that the global economy continued to offer a very supportive environment for Australia, notwithstanding the evident deterioration in the United States and the serious disturbances in international capital markets in the latter part of the year. The cumulative impact of the very large rise in Australia's terms of trade over a number of years continued to flow through the economy.

Very high levels of confidence in the business community saw robust growth, from already high levels, in capital spending. This was most pronounced in the resources sector, which is not surprising given the level of demand and the record prices being paid for its output, but the strength was not confined to that sector. To this was added the response of governments and associated enterprises to the need for upgrades to public infrastructure and other demands, which saw public final spending rise at about twice its trend pace over the course of 2007. Finally, consumer demand also rose at a pace well above average, fed by a rate of growth of real household disposable income as high as anything seen in the past 20 years. The only major expenditure aggregate that was on the soft side was dwelling investment.

While there continue to be differences in the degree of overall strength of the economy by region, those differences, if anything, narrowed during 2007. Unemployment rates in the big south eastern states, for example, were at generational lows on the most recent reading.

The pace of demand growth in 2007 well and truly exceeded any plausible estimate of the rate of growth of the economy's supply potential. Under these demand conditions, inflation increased. Having apparently moderated a little late in 2006 and early 2007, it began to show higher readings around the middle of 2007 and by the end of the year had reached about 3½ per cent in underlying terms. Measured by the CPI, the year ended inflation rate was 3 per cent, but as is well understood, the next figure is likely to be around 4 per cent.

Faced with this combination – very strong demand growth in what was already a pretty fully employed economy, and inflation moving higher – the Reserve Bank Board, when discharging its monetary policy duties, could draw no other conclusion than that growth in demand needed to slow. The Board had tightened monetary policy on three occasions during 2006. It then stayed its hand for a period in the first half of 2007, as inflation results available at that time suggested some moderation. But as the trends of 2007 and the likely risk they posed to longer run performance emerged, the Board tightened policy further during the

second half of the year and in the early months of this year. The cash rate was raised on a total of four occasions, with the aim of achieving a moderation in demand, which is an obvious necessary condition for reducing inflation over time.

In reaching these decisions, the Board naturally took careful account of the unfolding events in global financial markets. I will not recount the details of those events again now – I and many others have talked at length about them before. I am sure we will return to them in question time. As a daily participant in financial markets, the Reserve Bank was in a position to observe developments very closely. Our senior officers have been in frequent contact with all the significant financial institutions operating in Australian markets, with our colleagues at APRA and other regulatory agencies, and with our counterparts abroad. The RBA Board spent considerable time at its meetings examining market developments and considering their possible implications. The RBA responded to the unusual demand for liquidity on a number of occasions, and made early changes to its practices for open market operations to accommodate dealing in a wider range of assets and over longer terms. These market pressures were, and remain, overwhelmingly a flow on of international forces. They were not mainly a result of local factors. But it is appropriate, in our judgment, to foster confidence to the extent we can during periods of global stress such as we have been experiencing.

Despite those actions, a financial system such as ours cannot be entirely insulated from these global events and, inevitably, the Australian financial system has been affected to some extent. The rise in the wholesale cost of term funding has meant that many non bank and some bank lenders have had to slow the growth of their businesses. The closure, more or less, of securitisation markets for the time being also has made life much more difficult for those lenders which relied heavily on that avenue of funding. Capital market raisings are much more difficult for some corporates as well, and many of these entities are turning to their bankers.

By and large, the major banking institutions have been able to provide support for sound borrowers, and have stepped into the gap left by the withdrawal of funding from the capital markets. They have been able to do this because of their own balance sheet strength, something which is clear from the analysis in the Bank's recently released *Financial Stability Review*. While some of their customers have been excluded from capital markets of late, banks have themselves been able to access segments of the capital markets in sufficient quantity to keep their balance sheets expanding. This has come at a time when wholesale funding costs have been rising by more than the official cash rate, and that has been passed on to end borrowers, while conditions on lending for some borrowers have tightened in response to higher perceived risk. But this outcome is preferable to the alternative of lending drying up.

At present, the international environment remains very difficult. The US economy is experiencing very subdued conditions, as the weakness that had for some time been confined to the housing sector has spread to other areas over recent months. Losses incurred by major international financial institutions associated with previous risky lending have continued to come to light, even during this week. Valuing certain classes of assets remains very difficult and some quite sound assets appear to be priced currently at less than their likely underlying value. A process of deleveraging is continuing among hedge funds and other complex financial vehicles, as the retreat from risk by their lenders forces a winding in of positions. While all this has been occurring, participants in financial markets have understandably remained very nervous, and day to day volatility in a range of markets has been much higher than participants had become accustomed to over recent years.

In the meantime, real savings are still flowing into the accounts of institutional investors – pension/superannuation funds, insurance companies and so on. Given the present level of uncertainty, those responsible for investing these funds are remaining very cautious, fearing further write offs by the large international banks and declines in asset values. Hence, they are sticking to very large positions in very short term liquid investments. There is little

appetite just now to commit funds to more risky or longer term uses. The normal functioning of capital markets can really resume only when these sorts of investors regain the confidence to make those commitments.

As a result, the outlook for the United States, where credit concerns are most acute, where capital markets are most important for the flow of credit, and where house prices are falling, is for weakness in the near term, and most forecasters have been revising down their numbers for 2008. Considerable stimulus has been applied by the US authorities to this situation, with policy interest rates declining sharply and a fiscal stimulus package imminent. The US Federal Reserve has also taken some forceful actions to stabilise the financial system.

Growth in the euro area appears to be moderating as well, though at this point not by as much as in the US, and the euro area authorities continue to express concerns about inflation. Japan's economy is also weakening, partly as a result of international forces but also partly due to purely domestic events.

Economic conditions in the rest of Asia, on the other hand, have continued to be quite solid. Growth in industrial production and exports has been strong in the first couple of months of 2008. Weaker US conditions are affecting Asian exports to that country, but to date exports to other countries have compensated for this. The Chinese economy, with its demand for natural resources, has continued to expand strongly. The impact of the global turmoil via financial linkages has affected share markets in the region, but there does not appear, so far, to have been any noticeable effect on the capacity or willingness of Asian banks to extend credit. In fact, domestic financial conditions in Asia remain quite expansionary, which is contributing to considerable strength in domestic demand. Inflation remains a concern in many of these countries and, if anything, that concern could be said to be growing.

The net effect of all these forces is such that Australia's trading partners as a group is likely to record below average growth in 2008, reflecting weak outcomes in the developed world, and slower but still pretty good growth in Asia. But at the same time, expected higher contract prices for coal and iron ore, which are about to take effect, will, all other things equal, lift Australia's terms of trade by perhaps a further 15 per cent, adding some 2 to 3 per cent to national income over the next year or so. This expansionary impetus comes after the earlier rise of some 40 per cent over the previous five years. So the world economy presents some considerable cross currents for Australia. The biggest terms of trade boom for 50 years is coinciding with one of the most serious malfunctions in developed country capital markets for a long time.

Looking to domestic conditions, most indicators of actual economic performance for the early part of 2008 have remained quite strong. Employment has been very robust, and survey based measures of actual business conditions have remained strong, even if off their late 2007 highs.

We do think, however, that demand growth in Australia is now in the process of moderating. The demand for credit by households has also been weakening over recent months. Measures of confidence have declined. While those measures can provide false signals, our assessment is that a change in trend is occurring, and we are hearing that from businesses we talk to. A tightening in financial conditions, lower share prices and heightened concerns over the global financial problems will all have played a part in this change.

The likely extent and persistence of this slowing in demand is quite uncertain, as these things usually are. There remain powerful conflicting forces at work, so we can expect that difficult issues for judgment will remain with us for some time.

These are issues with which the RBA Board has to grapple. At its meeting this week, the Board reached the view that, for the time being, policy settings should remain unchanged. The current rate of inflation is clearly uncomfortably high, and were expectations of high ongoing inflation to take root, it would be even more difficult to reduce inflation again. Hence,

policymakers are obliged to have in place a policy setting that represents a credible response to evident inflation pressures. But the significant tightening in financial conditions that has occurred since mid 2007 is a strong response. Short term interest rates are towards the top end of the range experienced during the low inflation period. The Board is also conscious that some non price tightening of credit conditions is probably occurring at the margin. These factors should be working to slow demand. There is at least some evidence that a moderation in demand is occurring. That, if it continues, should in due course act to slow prices.

We will be receiving a round of prices data in a few weeks' time, which will afford another chance to review both recent performance and the outlook. As I noted earlier, the headline CPI rate is likely to be high. We will naturally examine the outcome for new insights about the extent of inflation currently occurring. But as well as that, it will be important to make continuing assessments of the extent both of the likely moderation in demand and its effect on inflation over time. This will by no means be an easy balance to strike. But if, by restraining demand for a while, we can secure a gradual reduction in inflation over the period ahead, then an important foundation of Australia's good macroeconomic performance over the past decade and a half will remain in place. That, in turn, will offer the prospect of good sustainable growth into the next decade. That is the goal of monetary policy.

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