Glenn Stevens: The economic situation

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to CEDA Annual Dinner, Melbourne, 19 November 2008.

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Thank you for the invitation to renew my association with CEDA, which goes back many years. CEDA has, for half a century, sought to promote informed discussion and balanced development of the Australian economy. That long-run perspective is never more important than at times like the present, when a cyclical event is under way and confidence tends, understandably, to wane.

The global economy is at an important juncture. After a number of years of very strong growth, the latter part of 2008 and 2009 look almost certain to be characterised by the weakest international economic conditions for many years. Of course, global growth had already been slowing, after several years of very heady expansion that had stretched the limits of resource availability and pushed up commodity prices sharply. Inevitably, the slowing was initially uneven and some countries – notably the United States – had been battling economic weakness longer than others.

But global growth prospects have been marked down significantly further in the space of just a couple of months, with the weaker picture led by the United States but by no means confined to it. The proximate trigger for the sudden deterioration in people's assessment of the outlook was a sequence of financial events. It was not that these events initiated the slowdown, but they have led people to think that it will turn out to be a bigger event than hitherto expected.

What had been for over a year a serious dislocation in international financial markets, but one which seemed to be being managed, turned quite suddenly into a very serious crisis during the weeks following the failure of Lehman Brothers on 15 September. In a breathtaking turn of events, the financial landscape changed dramatically, with the failure or rescue and effective nationalisation of a number of systemically important financial institutions in the United States, the United Kingdom and continental Europe. Share markets slumped, currencies moved abruptly, commodity prices continued their sharp decline and investors' appetite for risk contracted further.

Not only that, but the constraints on credit that periodically had been flaring up over the preceding year became more widespread, and are likely, if they persist, to have significant effects on economic activity in many countries and on trade between them. Until September, while the cost of borrowing for banks and low-rated corporates had increased, it had been the case that the most highly rated corporations had not experienced a significant rise in borrowing costs. That has now changed, with spreads for even AAA-rated corporates rising sharply. Likewise, spreads for emerging market sovereigns have increased significantly, for the first time in this episode.

It is not surprising, then, that formal forecasts made by bodies such as the IMF have been in a state of almost continual revision. Their latest incarnation, as released for the annual meeting of G-20 finance ministers and central bank governors recently in Brazil, is for the weakest performance in the G7 group of countries for many years. In addition, emerging market countries, including China, are also being affected more now, and talk of "de-coupling" has gone away. Actually, this was a very unhelpful term anyway, carrying as it did the implication than economies are either mechanically "coupled" or not. Reality is more complex – everything is connected, but the effects across national borders depend on the nature and severity of the originating shock and what else is going on in the other countries around the globe at the time. Given a big enough shock, everyone ultimately is affected.

What then is needed to address the situation?

In facing the financial problems themselves, the most important steps have already been taken by countries at the epicentre of the crisis. Those steps address issues of liquidity, capital and confidence.

In the area of liquidity, central banks have taken unprecedented steps over the past year, and especially the past few months, to add funds to their respective financial systems. This has culminated, through co-operative swap lines between many of the central banks, in the provision of virtually unlimited amounts of US dollar cash, against a wide variety of local-currency collateral, across multiple time zones. This liquidity is on tap at a fixed (low) price: no quantitative limit has been set by the US Federal Reserve. As a result of this, and the expansion of other facilities, the Fed's balance sheet assets have more than doubled in the space of a few months.

In the area of capital, the lessons from earlier crises have been heeded, chief among which is that when a country faces a system-wide question of solvency, the only source of sufficient new capital may be the public purse. Hence, governments in the United Kingdom, the United States, Germany, France, Spain, Portugal, Sweden, Switzerland, the Netherlands, Belgium, Luxembourg and Iceland are offering to take, or have taken, equity stakes in key financial institutions, up to and including full nationalisation in some cases.

As far as confidence is concerned, measures have been taken by a number of governments to secure retail deposits by a guarantee, and to offer a guarantee of eligible wholesale obligations of banks willing to pay for it. This ought to alleviate concerns about riskiness of the institutions concerned, allowing them access to term funding.

These measures are bearing some fruit. Markets are beginning to thaw. Spreads between expected central bank policy rates and term funding costs have come in from the extraordinary levels seen in September and October, though they remain high by historical standards. The actions taken to inject equity are stabilising a situation on solvency that could otherwise have unravelled quickly. There have been substantial issues of wholesale securities using the priced guarantee, mainly by UK banks, suggesting that term markets are opening again. What is needed now is for policy-makers everywhere to specify as quickly as possible the parameters of their various guarantees so that market participants have a degree of certainty about how things will work – while retaining, within reason, the capacity to adjust the parameters in the light of experience.

So a good deal has been done already towards addressing the financial problems themselves. These measures cannot avert a significant slowing in the global economy – it is fairly clear that a recession in the major country group, the G7, is under way. That, in turn, means that credit losses will be incurred by the lenders in those countries as typically happens in a business cycle downturn. But the measures averted, in my judgment, potential systemic collapses that would have had massive repercussions throughout the world.

That leaves an international business cycle event to be addressed. So what are the ingredients for doing that?

The slower growth in demand occurring now, and likely to be seen over the coming year, has had the effect of lowering the most flexible set of prices, namely those for raw materials and energy. The price of crude oil has fallen, measured in US dollars, from nearly US$150 a barrel at mid year to under US$60 today. Prices for metals and soft commodities have also declined considerably. It now looks as though prices for iron ore and coal, critical cost components for steel and electricity, are declining too.

Other prices around the global economy are typically slower to respond to the shifting balance between demand and potential supply, but with global output expected by the IMF to be growing during 2009 at its slowest pace for two decades or more, spare capacity is likely to be increasing, so we could expect these slower-moving prices to moderate over the next couple of years.

This outlook has increased the scope for many central banks to reduce interest rates. Until quite recently, concerns about inflation saw a majority of central banks tightening monetary policy. Through to the September quarter of this year, those central banks raising interest rates had consistently outnumbered those reducing them, by a significant margin. There is now, however, a preponderance of reductions, in expectation of falling inflation. Some of the reductions have been quite large.

So monetary policy is easing. In circumstances where the financial markets are seriously impaired, of course, the central bank reducing the overnight interest rate may not make much difference to the price of credit to ultimate borrowers. This is not a major problem in Australia, but in the United States rates paid by many borrowers have not fallen much, if at all, over the past year. It is also possible in some countries that, even at lower interest rates, neither the demand for credit nor the willingness of banks to supply it will be increased as much as would normally be the case. This does not mean that monetary policy in those countries has become completely ineffective – in many cases, it may simply lead policy-makers to lower overnight rates by more than usual. Nonetheless, it is handy in such circumstances to have an additional channel – namely, fiscal policy – that can affect aggregate demand if needed.

Moreover, as the private sector in many countries is seeking to conserve wealth in the face of weakening incomes and lower asset values, it will presumably attempt to save more of its current income; this might be particularly so for households. The problem is that, for the economy as a whole, if everyone attempts this change simultaneously, the "paradox of thrift" says that the economy will contract. So if that were indeed the situation that some countries faced, the stabilising policy would be for the government sector to decrease its saving, so as to accommodate the rise in saving by the household sector.

So, in addition to monetary policy easing, fiscal policy adjustments are being made or contemplated in a number of countries. The question is how much scope the relevant governments have for such actions, before encountering the potential limits to credibility of their own balance sheets. Those who already had largish deficits – which will get bigger as economic activity weakens – and/or who had high levels of public debt, presumably have less scope for fiscal action. Calls for fiscal expansion around the world are accordingly being accompanied by calls for credible statements of how the long-run soundness of public finances will be maintained.

There is an important point to make here, which generalises to monetary policy as well. It is that those countries which went into this episode having practised disciplined macroeconomic policies over many years, and I would include Australia in this group, will tend to be the ones which find themselves with the most scope to move in an expansionary direction, should they need to do so. And that, of course, is the whole point of the earlier discipline.

That said, it is still important for fiscal measures to pass the "good policy" test. Poor public policy proposals should not be accepted simply because they are presented as boosting short-term aggregate demand.

One of the countries of most importance to Australia is China. It has been said that the full emergence of China is a structural phenomenon that has many years to run and which is profoundly changing the world economy. I still believe that to be true. Nonetheless, as I have remarked before, the Chinese economy has a business cycle, like all economies, and it is apparent that this cycle is in the down-phase at present. While it is very difficult to get a full economic picture of China, it appears that the slowing may be much more pronounced than most people, including the Chinese authorities, expected. That change in trend has had major effects on prices for commodities, including ones important for Australia.

But the Chinese authorities have now responded quite forcefully to the emerging weakening in their economy. Details of the recent fiscal package are still difficult to assess, but new demand may be as much as 2 per cent of GDP or more in each of the next two years; and

monetary settings have been eased noticeably over the past two months. So I suspect that, while China is weakening at present, it will be strengthening a year from now.

These various policy responses are acting to limit the downside risks attached to the outlook over the next couple of years. It will be six to nine months before their effects begin to be seen in the statistics. Whether enough has been done adequately to restore conditions for sustainable growth, it is too soon to know yet. But if not, it is a safe bet that more will be done before long, if the recent comments by the authorities in various countries are any guide.

What then of the outlook for Australia?

Thus far most indicators have suggested that the economy has been slowing, after a period of excessively strong growth in demand that had pushed up inflation. Absent the sudden recent deterioration in the global outlook, I think we would in due course have looked back and seen that the slowing had been similar to that observed in 2001, albeit with differences by sector. But with recent international economic and financial events, the economy will probably now experience a more significant slowing than was otherwise going to occur. That is barely detectable yet in some of the key official datasets. Employment, for example, remained quite solid, and unemployment very low, through into October, consistent with the gradually moderating growth of mid year, but not yet showing the effects of the more cautious mood in the business community that is now taking effect. Nonetheless, in the period just ahead, we are likely to see, for a time, growth at quite a slow pace. That is the outlook embodied in the Reserve Bank's Statement on Monetary Policy released last week.

This means that, over time, the extent of capacity utilisation will decline and pressure on prices will abate, though that could take some time to be apparent. The lower exchange rate will tend to push up prices for traded goods, though the weak global environment may mean this effect could be muted somewhat. Lower raw material prices will also be of considerable assistance in slowing manufactured prices – again subject to the exchange rate. Of course, many of the items pushing up inflation in Australia of late have been in the services sector, but the likely moderating trend in labour cost growth over the next couple of years should help here. Overall, our view is that after a fairly extended period of above-target inflation, we will see the CPI inflation rate moving back to its target over the next two to three years. Should demand in the economy weaken further than we expect, that would be likely to be accompanied by a downward revision to the inflation outlook.

Given this outlook, the Reserve Bank has been lowering the cash rate. We have chosen to do so quite quickly, well before a decline in inflation is evident in the data, in recognition that the international circumstances had changed quite sharply, which have increased the risk of a more abrupt slowing in demand. That is, we have been pursuing the inflation target in a forward-looking way, and paying due account to economic activity considerations. In the period ahead, we shall be seeking to strike the right balance between, on the one hand, the need to have inflation come back down, albeit slowly, and on the other hand, the desire to avoid as far as possible an unnecessary weakening in demand.

Looking beyond the near term, what needs to be done to make future growth less likely to be disrupted by the sorts of financial problems we have seen emerge over the past 15 months?

Every episode of crisis provides some new lessons and these can be incorporated into regulatory and supervisory practice as appropriate. Various proposed reforms in the area of financial regulation are on the table, many of them developed under the auspices of the Financial Stability Forum.[1] These include likely adjustments to the Basel II arrangements for

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[1] Established in 1999, the Financial Stability Forum brings together senior representatives from international financial institutions, international groupings of regulators and supervisors, committees of central bank experts and national authorities responsible for financial stability to promote international financial stability through enhanced information exchange and co-operation in financial supervision and surveillance.

the capital requirements of banks, including efforts to make them more anti-cyclical; more focus on liquidity risk management; attention to the conduct of credit rating agencies; the increased use of central counterparties to control the risks in some derivatives markets; and the establishment of cross-border supervisory "colleges" for the largest internationally active banks. Much work remains to be done, and if past experience on finding international agreement on regulation is any guide, it will be hard, slow, grinding work. But the call of global leaders last weekend in Washington for this work to be expedited gives it an important additional impetus and a greatly strengthened focus.

But we need to approach the task of reform with realism. The cycle of greed and fear cannot be regulated away. To assume that unrealistic optimism will not again, at some point, overwhelm the more sober instincts of investors, bankers, commentators and others would be a triumph of hope over experience. Regulation can be improved, but there will always be an unregulated part of the system, the more so the tighter regulations are; there will always be those who put at risk some of their capital in that sector; there will always be a business cycle, and there will always be some who take excessive risk near the peak of the cycle and get caught out. The genius of the market economic system is that so much of the risk that is prudently taken, much of the time, turns out to reward the risk-taker, and indeed all of us, with the profitable deployment of capital, jobs, more choice, higher productivity and better living standards. It will be important not to forget that in the next year or two.

Nor is it realistic to assume that regulators and central bankers will always have the wisdom and prescience, or even the scope, to deploy their few instruments such as to ensure that an ideal combination of financial stability and high growth can be achieved consistently. The world will never be that perfect. Nevertheless, in addition to the many useful steps being planned by regulators, perhaps we could pay more attention to the low-frequency swings in asset prices and leverage (even if that means less attempt to fine-tune short-period swings in the real economy); we could have a more conservative attitude to debt build-up; and we could exhibit a little more scepticism about the trade-off between risks and rewards in rapid financial innovation. This would constitute a useful mindset for us all to take from this episode.

To conclude, we face difficult circumstances. Policy-makers and regulators both here and abroad will need to stand ready to act promptly to provide any necessary support for the financial system and sustainable economic activity. In doing so, though, we need not, and should not, abandon the well-established and tested policy frameworks that are in place. In fact, it is these that have given Australia, in particular, ample scope to do what is needed in the current situation.

Given that we have that scope, and given the underlying strengths of the economy, about the biggest mistake we could make would be to talk ourselves into unnecessary economic weakness. Yes, the situation is serious. But, as I suspect CEDA members know well, the long-run prospects for the Australian economy have not deteriorated to the extent that might be suggested by the extent of some of the gloomy talk that is around. If businesses remain focused on the long-term opportunities; if markets and commentators do the same; if banks remain willing to lend on reasonable terms for good proposals; if governments are able to so order their affairs as to continue supporting worthwhile – and I emphasise worthwhile – public investment (even if that involves some prudent borrowing); then Australia will come through the present period. We ought to go forward with some quiet confidence in our own abilities and in the opportunities that are on offer. I wish you all well in that endeavour.