**Glenn Stevens: Overview of the Australian economy and future challenges**

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Canberra, 19 February 2010.

* * *

Since we last met the global economy has continued an expansion that started around the middle of 2009. It appears that world GDP grew at an annualised pace of about 4 per cent in the second half of last year. Many forecasters now expect a similar result in 2010. International financial markets have generally continued to thaw, with most capital markets functioning again and the use by banks of exceptional support from central banks and government guarantees being wound down. These are, needless to say, very welcome developments.

Having said that, the situation is not without some challenges. I will mention just two.

The first is the two-speed nature of the global recovery. Normally after a sharp downturn, the ensuing upswing is correspondingly strong. This has been the case among a number of Asia-Pacific economies, which take half of Australia’s exports. The strength is not confined to China: India, Korea, Singapore, Taiwan and others have all seen a significant pick-up in production and trade. In several of these instances the term “v-shaped recovery” would be apt. Around the region, secularly rising incomes, generally healthy banking systems and relatively low public debt levels allow considerable room for confidence of a sustained expansion in demand. In fact in some cases the issue of overheating is arising and the authorities in both China and India have begun to tighten their policy settings.

In the large industrial countries, on the other hand, the rebound has been more tentative, and driven more by the turn in the inventory cycle and temporary policy measures than a strong pick-up in private demand. It is not unusual, at this point of the recovery, for the inventory dynamics to be playing a prominent role in pushing up output. Nonetheless, the question is the extent to which a durable upswing in private final demand in the various countries will become established. Most observers expect this to be a fairly gradual process, given the lingering effect of the strain on banking systems and ongoing de-leveraging, not to mention the need, at some point, to begin the process of fiscal consolidation. Growth in these cases is therefore expected to remain modest and, as a result, these economies are likely to be characterised by a lot of spare capacity and ongoing high unemployment.

So the historic shift in the centre of economic gravity to the Asian region is continuing, and if anything it has been highlighted by the different performances during the crisis and initial recovery. The differences in speed of recovery between the emerging world and the advanced world, and the likely persistent differences in growth trajectories into the future, will increase the pressure on exchange rate arrangements in the region.

The second challenge is the increasing focus on sovereign creditworthiness. We saw a brief period of turmoil regarding Dubai late last year, and more recently the public finances of Greece have been under the spotlight, with some other European countries just in the background. Going beyond just these instances, government balance sheets in numerous countries have taken on considerable burdens as a result of the crisis, and markets are beginning to focus on issues of sustainability. It will be a very delicate balancing act for those governments to strengthen their fiscal positions without undermining the upturn in their economies.

Happily, in both these areas, Australia is relatively well-placed. We are located in the part of the world that is seeing the most growth. And in terms of fiscal sustainability, Australia’s position is, by any measure, very strong indeed.
Turning to Australia, we think on the basis of available data that real GDP grew by about 2 per cent through 2009. We expect that it will grow by a bit over 3 per cent for 2010 and about 3½ per cent in 2011 and 2012.

Notwithstanding reports of patchy retail sales through the Christmas period, we judge consumption to have held up reasonably well after the various fiscal boosts faded. But in the future consumption is unlikely to be a leading driver of growth to the extent it was a few years ago. Households seem to be adopting a more cautious position regarding saving and borrowing, which is appropriate.

A turnaround in private housing construction is under way. The effect of the temporary first-home buyers’ boost is fading, but underlying demand is solid as a result of population growth and there is something of an “underhang” of earlier low construction to work off. Credit costs and availability are adequate for households. While for developers credit remains quite difficult to access, it looks like we have seen a turning point in approvals for multi-unit construction. Housing prices have been rising quite smartly over the past year.

Government spending is having an impact on demand, holding both residential and non-residential construction at higher levels than would have resulted from private spending alone. This effect will gradually diminish over the next year. At the same time, a large build-up in energy and resource sector investment is under way, prompted by optimism about long-run prospects for resource demand. The terms of trade are rising after last year’s sharp fall, as the strength of demand has pushed up key commodity prices. In 2010 they could once again reach a very high level, exceeded in modern times only by the extraordinary level reached in 2008.

Inflation has been falling, in line with recent forecasts. It is important to remember that inflation reached 5 per cent in 2008, or just over 4½ per cent in underlying terms. This was much too high. The earlier period of tight monetary policy, and the weakening in demand in late 2008 associated with the escalation of the financial crisis, has seen inflation come down. Over the past year, it was about 2 per cent on a CPI basis and about 3¼ per cent in underlying terms. Over the past six months, underlying inflation ran at an annualised pace of under 3 per cent. We think it will be about 2½ per cent in 2010. It is normal, given the lags in these processes, for inflation to keep declining for a while after the economy begins to firm.

With the economy having had only quite a mild downturn, however, we start the new upswing with less spare capacity than would typically be the case after a recession. One measure of this is that the rate of unemployment peaked at less than 6 per cent, much lower than we or most others forecast. Only a few years ago, unemployment rates like this would have been seen as a good outcome in strong times, let alone in times of economic weakness. The general flexibility in the labour market, including the ability of firms and employees to adjust hours of work, limited the rise in numbers unemployed. But the overall size of the downturn in economic activity also proved to be considerably smaller than thought likely a year ago.

This is of course a very good outcome. But it also means that there is less scope for robust demand growth without inflation starting to rise again down the track. Monetary policy must therefore be careful not to overstay a very expansionary setting.

This situation is quite different from those faced by the major countries. Whereas many of them had their worst recession since World War II, Australia probably had its smallest. As such, it should not be surprising that Australia was among the first countries to begin to raise interest rates, once it was clear that the danger of a really serious contraction in economic activity had passed. The Board lifted the cash rate in October, November and December.

Most lenders raised borrowing rates by a little more than the cash rate. Allowing for these margin changes, borrowing rates are still below average but not by as much as the cash rate. We have taken careful note also of non-price credit conditions. For large firms, access to capital market funding, both debt and equity, has been good. For some other business borrowers, access to credit has remained difficult, though we have some suggestions in our
liaison now that this may be starting to ease. Furthermore it appears that the rate at which lenders are having to make provisions for bad loans has slowed noticeably, which is not surprising given that economic conditions have been improving. Given that, it is reasonable to expect that lenders will become more willing to lend over the coming year.

That said, it seems unlikely that we will return to the easy credit conditions of three years ago. The world has changed, for a while at least. Moreover, the likely course of international standards for regulation over the next few years will probably, at the margin, act to raise the cost of intermediation by requiring banks to hold additional capital and liquidity.

If economic conditions evolve roughly as we expect, further adjustments to monetary policy will probably be needed over time to ensure that inflation remains consistent with the target over the medium term. This is a normal experience in an economic expansion: as economic activity normalises interest rates do the same – though of course it is the interest rates borrowers actually pay, and that savers receive, that are important rather than the cash rate per se. The Board sets the cash rate with that in mind.

Mr Chairman, I have previously said that Australia would come through the global crisis well placed to benefit from renewed expansion. For a time, the challenge was to sustain confidence, and to support the economy and financial system through some exceptionally demanding circumstances. By and large those efforts were successful. Now we must turn our attention to the challenges of managing an economic expansion. Issues of capacity, productivity, flexibility, adaptation to structural change and so on will once again come to centre stage, as they should. For our community to tackle those challenges successfully, monetary and financial stability are important conditions. The Reserve Bank will do all that it can to secure them.

I look forward to your questions.