# Ric Battellino: The Reserve Bank of Australia's thinking on the economy over the past year

Address by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, to The Economist's Bellwether Series: Australia, Sydney, 23 August 2011.

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Over the past year, the Australian economy has been subject to a number of strong, often countervailing, economic forces: strong demand for commodities, rising global inflation, global financial market instability, consumer caution, slower population growth and slow productivity growth. The economy has also been affected by severe weather events. Today I would like to look back over the year and review how these forces have shaped the economy and the Reserve Bank's thinking on monetary policy.

If we start by casting our minds back a year ago, you will recall that the Bank at that time was starting to contemplate whether it should move from a relatively neutral setting of monetary policy to one that was slightly restrictive. The global economy was growing at a solid pace, though with clear downside risks. Domestically, a rebalancing in demand, from public to private spending, was starting to take place; the outlook for business investment was particularly strong. Employment was growing very quickly, unemployment had fallen back to just above 5 per cent, and inflation was forecast to reach the top end of the target range over the subsequent couple of years.

The Board's assessment of these circumstances was that, if they continued and the economic outlook evolved as expected, there would be a case to raise interest rates a little at some point. However, the uncertainty in global markets, due to the spread of sovereign debt concerns beyond Greece, was seen as posing downside risks to the global economy, and consequently to Australia. Also, the strong exchange rate and weak demand for credit pointed to financial conditions perhaps being somewhat tighter than might be indicated simply by reference to interest rates. These considerations were seen as reasons for caution and, in the event, the Board held interest rates steady through to November 2010.

By the November meeting, financial market volatility had declined and the Chinese economy was continuing to grow strongly. Earlier downside risks to global growth had diminished somewhat and it was becoming clear that global GDP would record a very strong increase for 2010 as a whole. Domestically, employment had continued to grow very quickly. While there were significant differences in the performance of various sectors of the economy, overall it appeared that resource utilisation in the economy was tightening. The CPI outcome for the September quarter had been a little lower than expected, but the assessment remained that the downward trend in inflation had largely run its course. The forecasts envisaged a strengthening economy, with the effects of the rising terms of trade more than offsetting those from fiscal tightening. Also, inflation was testing the top of the target range by the end of the forecast period. The Board therefore concluded that the balance of risks had shifted to the point where a move to a slightly restrictive stance of monetary policy was prudent, and it decided to lift the cash rate by 25 basis points to 4.75 per cent.

Banks responded to the November increase in the cash rate with substantially larger increases – around 40 basis points – in interest rates on housing loans. The size of this increase, and the controversy it created, seemed to have a noticeable impact on household behaviour. Consumer confidence fell, though to levels that were still above average. Coincidentally, there was a renewed step up in financial market volatility, stemming from the widening government debt problems in Europe; this probably also contributed to households becoming less confident.

At the same time, however, the prices of commodities important to Australia – i.e. coal and iron ore – continued to strengthen and prospects for the terms of trade were revised up further. The outlook for investment in the resources sector remained very strong.

The Board concluded at its December 2010 meeting that, having moved in a forward-looking way in November, there was scope to hold rates steady for a while to see how conditions in Australia developed and how the various risks to the economy evolved.

As we moved into the early months of 2011, domestic economic activity was severely disrupted by floods and cyclones. The two main economic impacts were the sharp fall in coal production, and the destruction of the Queensland banana crop. The former meant that GDP was likely to fall in the March quarter, before recovering in the June and September quarters, while the latter meant that CPI inflation would spike higher over the year ahead due to a sharp, yet temporary, increase in banana prices.

Neither of these factors, by itself, was seen by the Board as having direct implications for monetary policy, although it was recognised that they would make reading the underlying economic trends more difficult over the months ahead.

Global economic data generally continued to be strong in the early months of 2011, particularly in Asia but also in the United States and Germany. Commodity prices continued to rise, and there were increasing signs that this was feeding, via rising cost pressures, into inflation outcomes in a wide range of countries. As a result, there was a general trend towards tightening monetary policy through Asia and Latin America.

Domestically, the effects of the floods were becoming clearer in the data, and liaison with mining companies was starting to point to a more protracted recovery in production. Economic indicators were mixed: business conditions were around average, the outlook for investment was strong, unemployment was holding steady at a low level but retail sales had been growing only modestly. Financial market uncertainty had lessened following further measures taken by European governments, though social unrest in the Middle East and North Africa was keeping markets on edge. Against this background, the Board saw little need to change the level of interest rates at its February, March and April meetings.

In May, the Board again held the cash rate steady. However, the CPI outcome for the March quarter was higher than expected and inflation forecasts were scaled up somewhat. Global economic growth was expected to continue at an above-trend pace, notwithstanding the disruption to global supply chains caused by the Japanese earthquake in March; commodity prices were higher than earlier expected; and global inflationary pressures had risen. Therefore, while the Board saw the existing mildly restrictive stance of monetary policy as appropriate for the time being, its assessment was that if conditions evolved in line with the outlook, another rise in interest rates would likely be required, at some point, if inflation was to remain consistent with the medium-term target.

By the June meeting, signs were emerging that economic growth in many developed economies had lost some momentum. Increased financial volatility, as the debt problems within Europe spread, added to the downside risks. Growth in China and most other parts of Asia, however, remained a bright spot.

The March quarter national accounts suggested that the impact of the floods on Queensland coal production had been significantly larger than expected and the timing of the recovery in production was pushed out further. While the outlook for mining investment was very strong, non-mining investment was looking softer and households were showing more signs of caution, with confidence declining; households' perceptions of their own personal finances over the coming year were particularly weak. It was also more apparent that employment growth had slowed, though this appeared to be taking place against a background of slowing population growth, and unemployment was holding steady at a relatively low rate of around 5 per cent.

While the Board remained of the view that, if conditions evolved in line with the forecasts, further tightening of monetary policy would be necessary at some point, the recent flow of data had not added any urgency to the need to adjust policy. Accordingly, the cash rate continued to be held steady.

At the time of the July meeting, global economic growth had eased, and the downside risks stemming from the European debt problems looked more significant. In Australia, households remained cautious and the housing market was soft. Also, it now appeared that the slow recovery in coal production would mean that earlier GDP forecasts for 2011 would not be met. Nonetheless, the medium-term outlook for the Australian economy remained strong. In these circumstances, the Board continued to hold rates steady, noting that the CPI outcome to be published in the next month would provide an update on inflation.

The state of the global and domestic economies had not changed much by the time of the August meeting, but the CPI outcome for the June quarter again surprised on the upside. Price increases for a range of manufactured goods were larger than expected in light of the appreciation of the exchange rate and the ongoing caution among consumers. There was the possibility that the slower growth in productivity that had been evident for some years was pushing up unit labour costs at a pace faster than was consistent with the inflation target. At the August meeting the Board therefore discussed whether there was a case to tighten monetary policy further. The general case to do so was that the economy was continuing to operate with relatively little spare capacity, and the staff forecasts showed inflation rising above target during the forecast period. On the other hand, activity in parts of the non-mining economy was subdued and downside risks to the global economy had increased significantly due to the volatility in financial markets. Also, the softness in credit demand and the high exchange rate pointed to financial conditions exerting a reasonable degree of restraint. These considerations led the Board to conclude that it would be prudent to continue to hold rates steady.

Summarising all this, the general pattern that has emerged over the past year has been as follows:

- First, the effects of the mining boom have turned out to be stronger than expected a year ago. The terms of trade are noticeably higher and forecasts for national income and mining investment have been revised up over the year.
- Second, despite this strength in the mining sector, overall economic growth is turning out to be weaker. The forecasts published earlier this month reduced growth in GDP for 2011 to 3¼ per cent, versus 3¾ per cent expected last November. Part of this downward revision reflected the higher exchange rate as well as a softening in some components of demand, stemming partly from consumer caution. However, some of the revision also reflected a slowing in the economy’s capacity to supply goods and services, due to weather events and slower growth in the labour force. In recent quarters, growth of the working age population has been running at an annualised rate of only a little more than 1 per cent, down from a peak of around 2¼ per cent a few years ago. In these circumstances, while employment growth has slowed noticeably, there has been little change in the unemployment rate.
- Third, inflation outcomes for 2011 are likely to turn out to be higher than thought last November, both in headline and underlying terms. Inflation forecasts for the longer term have risen to be a little above the top end of the target range.

This was the situation as it stood at the time of the last Board meeting. As you know, since then market volatility has become more extreme. An important issue ahead of us will be to assess what impact this is likely to have on global and domestic economic activity, commodity prices and inflation. As yet, there is little information on which to base such judgements.

## Conclusion

Let me conclude.

The main reason for running through this material has been to make the point that the environment for monetary policy over the past year has been challenging. As the year has progressed, the resources boom has strengthened, but the divergence between the mining and non-mining sectors of the economy has increased and the mix of growth and inflation has turned out to be less favourable than expected a year ago – i.e. there has been less growth but more inflation.

Decisions about monetary policy through the year have sought to balance these various forces. This challenge remains. In fact, with the recent volatility in financial markets adding to the uncertainty about the economic outlook, it does not look like the challenge will become any easier over the months ahead.