Glenn Stevens: Overview of the Australian economy

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Melbourne, 26 August 2011.

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Quite a bit has happened in both the global and local economies since we last met with the Committee. In February, we had seen the Queensland floods, and Cyclone Yasi had just occurred. Tropical storms had disrupted iron ore shipments out of Western Australia. There was understandably a focus on what the economic effects of those events would be. It was thought likely that economic activity as measured would be materially weaker in the March quarter than had been earlier expected, but that there would be a recovery in the middle of the year. It was thought that the rebuilding efforts in Queensland would exert a mild expansionary effect on demand beginning in the second half of the year.

GDP was indeed weak in the March quarter, with the fall in coal and iron ore production more than offsetting a modest increase in output in the rest of the economy. Since then, the rebound in production of iron ore has been more or less as expected and the disruption to general economic activity in Queensland associated with floods has abated. But in the case of coal, largely for environmental reasons, the process of dewatering pits is taking longer than initially expected. The recovery of coal production in Queensland is probably about two-thirds complete at the present time. It may be early next year before production has fully recovered. This has had a material effect on the forecasts for GDP.

It was also understood in February that there would be large effects on the consumer price index because of the loss of key crops. These were expected to be temporary and, indeed, prices for the relevant items are now falling back as crops begin to recover. The Bank has been clear that such fluctuations have had no implications for monetary policy.

We didn’t know in February that a serious Japanese earthquake would have a significant effect on global manufacturing production and sales, including in Australia’s motor vehicle sector. This explains part of the apparent slowing in global growth in the June quarter. Part of the slowing in growth in major countries is also likely to have been caused by the increase in energy prices in the early part of the year, which now appears gradually to be reversing.

Another factor at work, though, has been the concerns about public debt in major countries. These were apparent six months ago, but have escalated markedly in the intervening period. Not only did yields on the obligations issued by so-called “peripheral” euro area countries reach new highs, but interest rates faced by large countries like Spain and Italy also rose to levels that would have made their financial positions much more difficult. The euro area’s response to these issues has had some positive effects, but it remains a work in progress. Meanwhile, the United States is having a very difficult time finding a path that avoids an immediate major fiscal contraction but still puts the US fiscal accounts onto a sustainable medium-term trajectory.

As financial markets confronted all this, and also sought to digest a re-appraisal of near-term global growth prospects, we have seen during August a period of intense turmoil, particularly in equity markets. The net result of this period is that equity prices in most markets around the world are anything from 15 to 25 per cent below their recent highs. Yields on long-term securities for the United States and core European countries have fallen to historical lows as investors have sought safety, despite the US sovereign rating downgrade by S&P. Measures of volatility have increased sharply. There has been a degree of renewed pressure on US dollar funding for European banks. The currencies of certain countries regarded as safe havens, like Switzerland, have soared and the price of gold has reached new highs.

So markets remain on edge. All that said, the dislocation has not, on most common metrics, approached the extent of that seen three years ago. The main effect on Australia’s financial markets has been lower equity prices, which have fallen along with those in major markets. Other Australian markets have, to date, travelled fairly well in the circumstances. Funding costs have, if anything, declined, which is being reflected in lower costs of fixed rate mortgages. Major Australian banks report being offered substantial US dollar funding offshore on account of their relatively high credit standing. In any event, their reliance on such wholesale funding is much reduced from three years ago, with the large increase in deposit funding at home and slower balance sheet growth. There has been no abnormal demand for liquidity by financial institutions from the Reserve Bank in this period and the quantity of settlement funds in the system has been completely normal over the past month. The exchange rate has come off its peaks of a couple of months ago, but it remains quite high compared with most of the post-float experience. Some commodity prices have declined, but they have not slumped the way they did in late 2008 and early 2009, and spot prices for major Australian commodities remain quite high.

People will understandably want to draw comparisons with the financial crisis of 2008. We cannot know, of course, what will transpire in the months ahead, but I think that what we have witnessed is best seen not so much as a new crisis, as part of the long aftermath of the 2008 crisis. Among the countries at the heart of that crisis it was to be expected that, after serious problems in private-sector balance sheets, economic recovery would be a drawn out affair. That is usually the way. This is having a predictable effect on fiscal positions: revenues are weak and budget deficits have remained large. It is not surprising that coping with this is politically difficult and it remains a point of considerable uncertainty what the ultimate resolutions in the various major countries will look like. This may be leading to precautionary behaviour and, as a result, the global growth outlook does not look as strong as it did six months ago, even though it is not necessarily as weak as some of the pessimists fear.

In our own region, indicators suggest some moderation in growth in the Chinese economy, but it appears to be still pretty solid. Around Asia, inflation rates have generally tended to rise over the past six months. A key question for the countries in the region is whether enough has been done to contain the inflation pressure, which does look to have spread beyond initial rises in food and energy prices. Asia's management of these challenges will ultimately matter a good deal for Australia, and for the world.

In the meantime, Australia's terms of trade are very high and the investment expansion in the resources sector is proceeding. On the indications available it has quite some distance to run yet. This is having positive spillovers to some parts of the Australian economy. Our liaison suggests that, beyond the benefits being experienced by equipment hire, engineering, surveying and consulting firms, businesses as diverse as those supplying modular housing, laboratory services and the training of semi-skilled, trade and other workers are seeing effects of the expansion.

Meanwhile, other sectors are being squeezed by the high exchange rate or by the much-touted household caution. Now it is important not to overstate the degree of caution. Some areas of household spending – like overseas travel – are growing very strongly. But overall it is, in my judgement, increasingly clear that we have seen a significant change in household behaviour. There was a lengthy period in which households saved progressively less from current income, increased their leverage and enjoyed a sense of rising prosperity from the increase in asset values. That was most likely a one-time, if rather drawn out, adjustment to a number of important factors. It is quite understandable that it occurred – and it should be equally understandable that it wasn't going to continue like that indefinitely. The "new normal" – which is actually the old normal – is where households save a non-trivial fraction of income and keep their debt levels more in line with income. One positive is that the adjustment to this "new/old" normal has been pretty fast, which means that a lot of it may already have been accomplished. Nonetheless, in view of the financial turmoil of recent weeks, it would not be surprising if a degree of caution remained for a while yet.

Three months ago, the Bank voiced concerns over the outlook for inflation in Australia, on the basis that measures of underlying inflation looked like they had ended a decline that had lasted for more than two years, were starting to turn up and were forecast to rise over the three-year forecast horizon. That outlook suggested that policy would need to be tightened "at some point". The Bank did not have a pre-committed notion of when that point might be. Such indications are, in any event, always conditional on the ongoing assessment of the outlook. The policy decision must consider not only the central forecast but also the possibility that things turn out differently from that forecast.

In the intervening period, the international situation has become more clouded and evidence of caution at home has, if anything, intensified. Asset prices have declined, credit growth has moderated further and the exchange rate remains very high. While each of these is affected by factors other than monetary policy, together they suggest a fair degree of restraint is being exerted by financial conditions. Under the circumstances, the Board judged the most prudent course was to sit still through this period, in spite of inflation data that, on their face, continue to be concerning.

Looking ahead, the year-ended CPI inflation rate will probably remain well above 3 per cent in the September quarter. It is then likely to come down as the impact of last summer's floods on food prices continues to unwind; we will see those effects around the end of the year and the early part of next year. After that, the assumed impact of the carbon pricing scheme, which we have now put into the forecasts, starts to affect the headline inflation figures.

We have been very clear that the Bank will abstract from those carbon price effects in setting monetary policy, just as we did with the implementation of the GST a decade ago. It is the more persistent path of inflation on which the Bank must focus.

In that regard, the question is whether recent events will have a bearing on the medium-term inflation outlook. It would be reasonable to anticipate that a decline in confidence arising from the recent events internationally may well dampen demand somewhat compared with the outlook set out in the *Statement on Monetary Policy* published in early August. That, together with the increased visibility of structural change in the economy, may also condition wage bargaining and price setting. If these forces persist, they may act to lessen the upward trend in inflation pressures that appeared to be in prospect. At the same time, significant rises in a range of administered prices are still set to occur over this period and unit costs have been rising quite quickly given the fairly poor performance of multi-factor productivity growth over recent years. So as usual, there are varying factors about which the Board will need to make careful judgements over the months ahead.

In summary, there is a heightened degree of uncertainty at present. There are major challenges in the global economy and significant forces at work in the Australian economy. But at this point in time, our terms of trade are at a record high, while our unemployment rate remains low. Inflation bears careful watching, but we can keep it under control. Our banks are strong, our currency is sound and our sovereign credit position is in the international top tier. Consumer "caution", while making life hard for the retail sector, is also building resilience in household balance sheets. If we are entering another period of weaker international conditions, this is a pretty good starting point from which to do so.