

Glenn Stevens: The lucky country

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to The Anika Foundation Luncheon, supported by Australian Business Economists and Macquarie Bank, Sydney, 24 July 2012.

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The Anika Foundation raises funds to support research into adolescent depression and suicide. See: <<http://www.anikafoundation.com/>>. I thank Mark Hack for assistance in preparing these remarks, and Ryan Fox for help in understanding the difficulties in comparing dwelling prices across countries.

Thank you for coming today to support the Anika Foundation.

Before I proceed I want also to thank Macquarie Bank for their support, once again, in providing today's venue and sustenance, and the Australian Business Economists for their continuing organisational support for these annual functions.

It is slowly becoming better recognised that the Australian economy's relative performance, against a very turbulent international background, has been remarkably good. Many foreign visitors to Australia comment on this relative success and I have noticed an increase in the number of foreign companies interested in investing in Australia as a result, notwithstanding our domestic tendency towards the "glass half empty" view.

But some observers – admittedly not the majority – still harbour concerns about the foundations of recent economic performance and question the basis for confidence about the future. There are several themes to these doubts, but the common element is that recent relative success owes a certain amount to things that will not continue – to luck – and that our luck may be about to turn.

Rapid growth in Chinese demand for resources, for example, has been of great benefit to date, but what if the Chinese economy suffers a serious downturn? Another potential concern is dwelling prices. Australia saw a large run up in dwelling prices and household borrowing until a few years ago. Some other countries that saw this subsequently suffered painful corrections and deep recessions, associated with very stressed banking systems. Can Australia escape the same outcome?

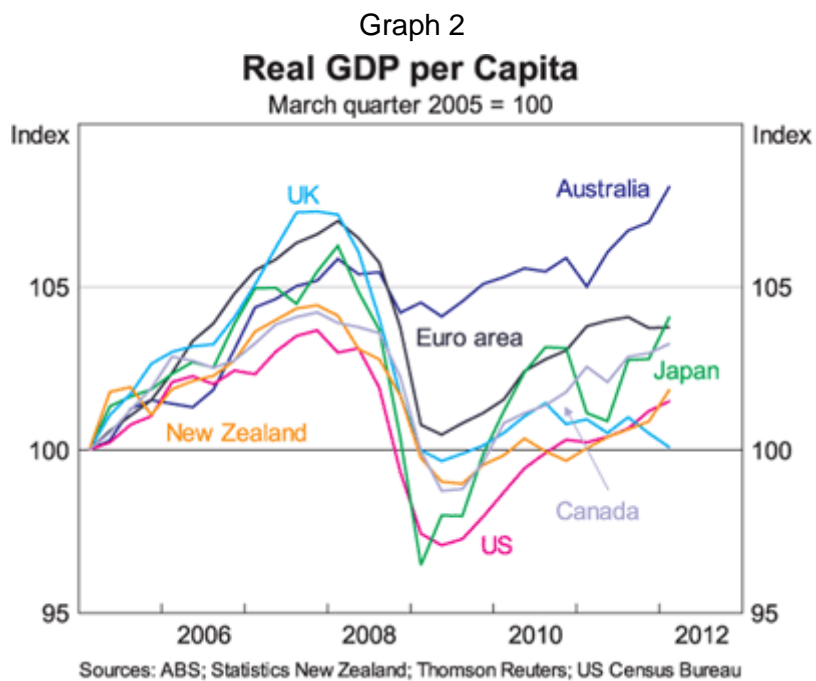
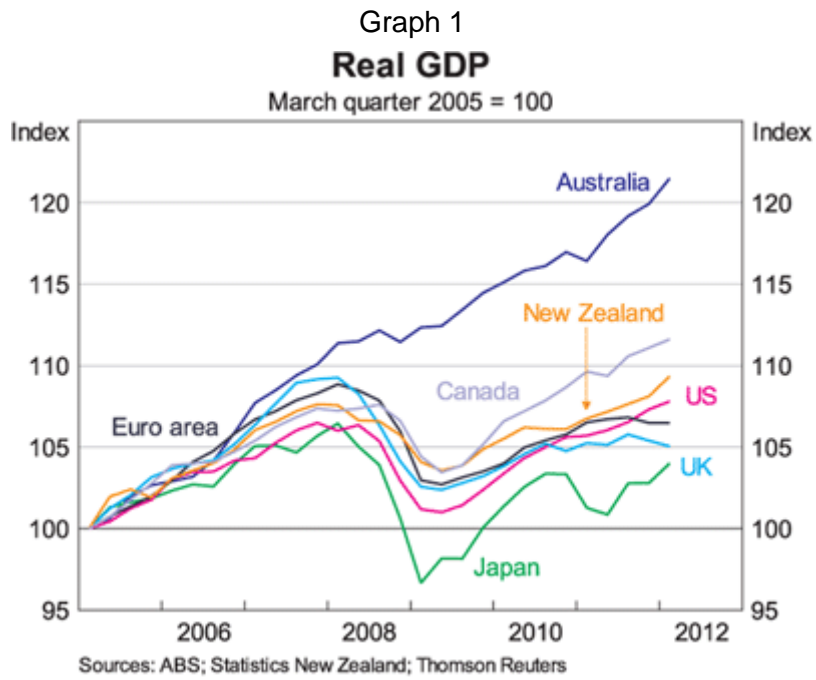
A further theme is the focus on the funding position of Australian financial institutions, insofar as they raise significant amounts of money offshore. Could this be a weakness, in the event that market sentiment turns? Actually, this is another version of the old concern about the current account deficit: what will happen if markets suddenly do not want to fund our deficit? It has long been a visceral fear among Australian officials and economists that global investors will suddenly take a dim view of us. The same sorts of concerns of organisations such as the International Monetary Fund and the ratings agencies seem to lie behind a perpetual question mark about Australia and its financial institutions.

It is unlikely we will ever be able to change definitively the views of all the sceptics. And – let us be clear – we should welcome the sceptics. Perhaps some of their concerns are valid. The Reserve Bank gives a lot of thought to these issues; we certainly do not dismiss them. We should always be wary of the conventional wisdom being too easily accepted. We should never, ever, assume that "it couldn't happen here".

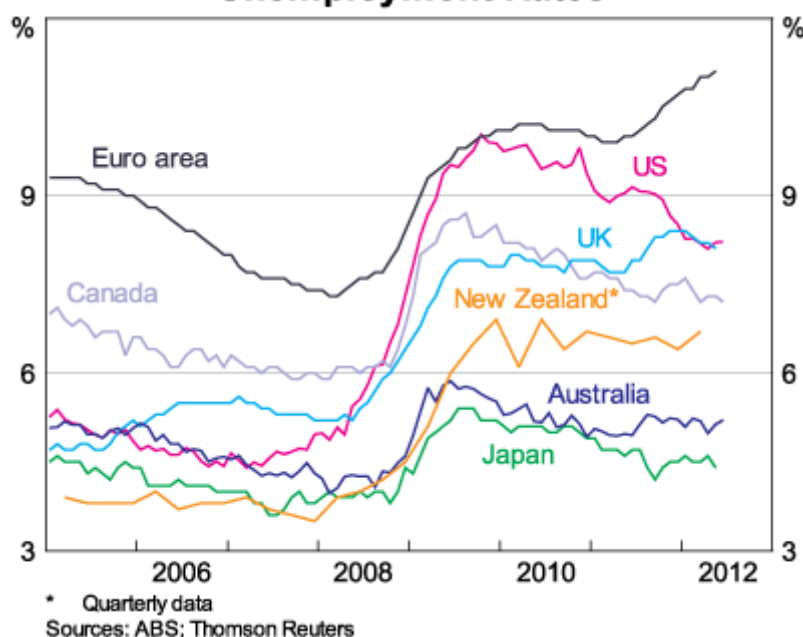
It is in that vein that I wish to pose a set of questions that are thrown up by these sceptical views. In particular:

- How much of the recent relatively good performance was due to luck? To what extent did we improve our luck by sensible policies, across a range of economic and financial fronts?
- Are there signs of any of the things going wrong that people typically worry about?

- And if there are, or were to be, such signs, could we do anything about it?
- To begin, I shall re-state some key metrics.



Graph 3
Unemployment Rates



These charts really require no exposition (Graph 1, 2 and 3). The message is clear. It is fair to conclude that, given the circumstances internationally, the Australian economy has exhibited more than acceptable performance over recent years. This conclusion would stand whether comparisons were made either against most other countries, or against our own historical experience.

Why was it that Australia did not have a deep downturn in 2009 when so many other countries did? And why was it that we have returned to reasonable growth, when others have struggled to do so?

This question has been answered on numerous occasions. There are several elements.

First, the Australian banking system went into the crisis in reasonable shape. To be sure, there were some poor lending decisions during the preceding period of easy credit and there was, in hindsight, too much reliance on wholesale funding. But among major institutions, credit quality issues have turned out to be manageable. Asset quality was not as good among some of the regional banks, and even less so among some foreign banks operating in Australia, but the problems have not been insurmountable.

Some observers might counter that the banks received assistance with wholesale fund raising in the form of the government guarantee. But the banks paid for that, and it was an appropriate response at a time of massive market dislocation when all their peers were receiving like assistance – and much more. Moreover the banks have neither had, nor needed, access to this for some time now and the stock of guaranteed liabilities outstanding has fallen by about half from its peak level, as issues mature or are repurchased.

So our banking system, while not entirely free from blemishes, was nonetheless in pretty good shape overall. Banks were able to raise capital privately in the depths of the crisis. The lowest rate of return among any of the major banks over a year during the crisis period was about 10 per cent. The Australian Government has not needed to take an ownership stake in a financial institution.

Second, Australia had scope for macroeconomic policy stimulus, which was used promptly and decisively. Interest rates were lowered aggressively, from a high starting point, lowering

debt servicing burdens at a rapid rate. The fiscal stimulus was one of the larger ones, as a percentage of GDP, among the various countries with which we can make comparisons. The evidence suggests that these macroeconomic measures were effective in sustaining growth.

Thirdly, the rapid return to growth of the Chinese economy saw demand for energy and resources strengthen again after a brief downturn in late 2008 and the first couple of months of 2009. This reversed the fall in Australia's terms of trade, and in fact pushed them to new highs, which led to a resumption of the historic investment build-up that had already begun. It benefited the whole of Asia, which staged a very pronounced V-shaped recovery on the back both of the Chinese measures and things other countries did themselves.

A fourth element that many people add is that the exchange rate fell sharply, which was an expansionary impetus for the economy. But of course the exchange rate was responding endogenously to the various shocks and policy responses, and has since reversed the fall. It was doing what it was supposed to do. Perhaps the real point is that the right exchange rate system was implemented nearly 30 years ago, and that it was allowed to work.

So Australia had these things going for it.

Was this all just luck?

We could not deny that our geography – thought for much of our history to be a handicap because of the distance from European and American markets – combined with our natural resource endowment has provided a basis for the country to ride the boom in Asian resource demand. We did not create that, though we still have to muster the capability to take sustained advantage of it.

But a well-managed and well-supervised banking system is not an accident.¹ Years of careful work both by banks and APRA went into that outcome.

Nor was the ability to respond forcefully, but credibly, with macroeconomic policy just luck. You don't suddenly acquire the credibility needed to ease monetary policy aggressively while the exchange rate is heading down rapidly. Authorities in lots of countries would not feel they could do that. At an earlier point in time we probably would not have felt we could have done it either. The credibility needed to do it comes from having invested in a well-structured framework, and having built a track record of success in containing inflation, over a long period. The floating exchange rate is an integral part of that framework.

Likewise, you can't have a major fiscal easing and expect it to be effective if there are concerns about long-run public debt dynamics, as recent debate elsewhere in the world shows. You need to have run a disciplined budget over a long period beforehand, so that the amount of debt you have to issue in a crisis does not raise questions about sustainability. In both the monetary and fiscal areas, of course, having used the scope we had so aggressively, it was also necessary, as I argued in 2009, to re-invest in building further scope, by returning settings to normal once the emergency had passed.

So, yes, Australia has had its share of luck. But to explain the outcomes, we need also to appeal to factors that didn't just happen by accident.

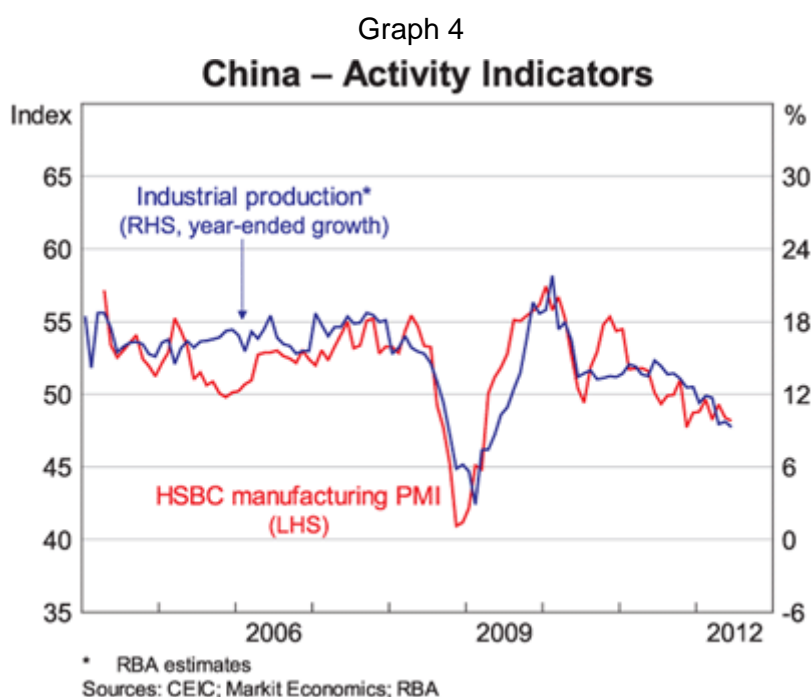
Of course, that doesn't mean we still couldn't have problems. Even if success to date hasn't been due to luck alone, perhaps our luck could turn so bad that all our efforts at good policy making could be overwhelmed.

¹ Canada's banking system was sound like Australia's, which has helped it outperform their G7 peers. But the large neighbour to which Canada exports about 20 per cent of its GDP has held it back. Australia's exposure to Asia, as opposed to Canada's exposure to the United States, presumably helps to explain Australia's stronger growth outcome relative to Canada's. Australia's terms of trade experience has also been stronger than Canada's.

Let us then take a look at some of the potential pressure points that people sometimes worry about. The first is the Chinese economy.

One of the data series people pay a lot of attention to is the Chinese version of the so-called “Purchasing Managers’ Index”. The usual commentary surrounding such indexes invariably refers to the “50” level as the threshold between growth and contraction in the sector of the economy being examined.

But what have these PMIs actually been saying about the Chinese economy? Properly calibrated, as in this chart, they suggest that growth in China’s industrial production has been running at about 5 percentage points below average, which means it is just under 10 per cent (Graph 4). But it is a long way from a contraction. We did actually see Chinese IP contract for several months in 2008; we are not seeing that at present.



The conclusion I draw is that the Chinese economy has indeed slowed over the past year or so. It was intended that a slowing occur. But the recent data suggest that, so far, this is a normal cyclical slowing, not a sudden slump of the kind that occurred in late 2008. The data are quite consistent with Chinese growth in industrial output of something like 10 per cent, and GDP growth in the 7 to 8 per cent range.

To be sure, that is a significant moderation from the growth in GDP of 10 per cent or more that we have often seen in China in the past five to seven years. But not even China can grow that fast indefinitely and there were clearly problems building from that earlier breakneck pace of growth. Inflation rose, there was overheating in property markets and no doubt a good deal of poor lending. It is far better, in fact, that the moderation occur, if that increases the sustainability of future expansion.

Moreover, the Chinese authorities have been taking well-calibrated steps in the direction of easing macroeconomic policies, as their objectives for inflation look like being achieved and as the likelihood of slower global growth affecting China has increased. Prices for key commodities are lower than their peaks, but are actually still high.

So far, then, the “China story” seems to be roughly on course. It is certainly true that we will feel the effects of the Chinese business cycle more in the future than we have been accustomed to in the past. That presents some challenges of economic analysis and

management. But even so, it may be better to be exposed to a Chinese economy with a high average, even if variable, growth rate, than, say, to a Europe with a very low average growth rate that is apparently also still rather variable.

Next I turn to dwelling prices. As everyone knows, dwelling prices rose a great deal over the decade or more from 1995, and not just in Australia. This occurred globally. The fact that it was a widespread phenomenon is a hint that we should be wary of explanations that are solely domestic in their focus. It suggests that the global dwelling price dynamic had a lot to do with financial factors – and there is little doubt that finance for housing became more readily available.

In various countries prices have subsequently fallen. In the United States, for example, prices are down by about 30 per cent from their peak, though they look like they have now reached bottom. In the United Kingdom the fall was smaller – at about 15–20 per cent. In Australia, the decline since the peak has been about 5 to 10 per cent, depending on the region. There are of course prominent examples of particular localities or even individual dwellings where price falls have been much larger.

Scaled to measures of income, Australian dwelling prices on a national basis have in fact declined and are now about where they were in 2002 (Graph 5). That is, housing has become more “affordable”. Four or five years ago we supposedly had a housing affordability “crisis”. Now it seems that the problem some people fear is that of housing becoming *even more* affordable.

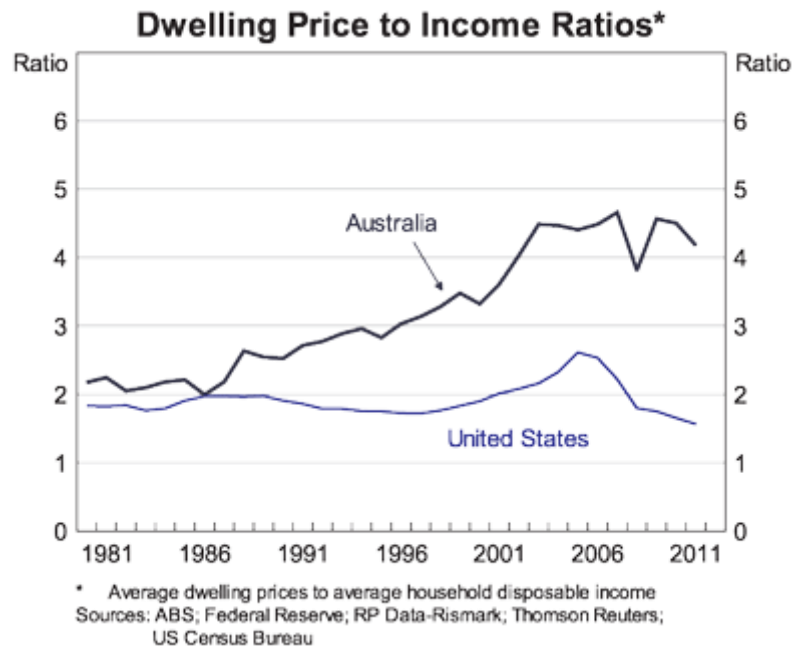
Are dwelling prices overvalued? It’s very hard to be definitive on that question. There are two aspects to the claim that they might be. The first is that prices relative to income are higher than they were 15 or 20 years ago. If this ratio is somehow mean-reverting, then either incomes must rise a lot or prices must fall. It could be that this analysis is correct, but the problem is that there is no particular basis to think that the price to income ratio 20 years ago was “correct”. There are reasons that might be advanced for why the ratio might be expected to be higher now than then – that the mean has shifted – though again there is little science to any quantification for such a shift. In any event, arguments that appeal to historical averages for such ratios lose potency the longer the ratio stays high. In Australia’s case the ratio of prices to income on a national basis has been apparently at a higher mean level – about 4 to 4½ – for about a decade now.

The second support for the claim that dwelling prices are overvalued is the observation that they seem high in comparison with other countries. In seeking to make such comparisons, though, there are serious methodological challenges. The key difficulty is in sourcing comparable data on the *level* of prices across countries. Such data are, at best, pretty sketchy. With that caveat very clearly in mind, consider the following two charts.

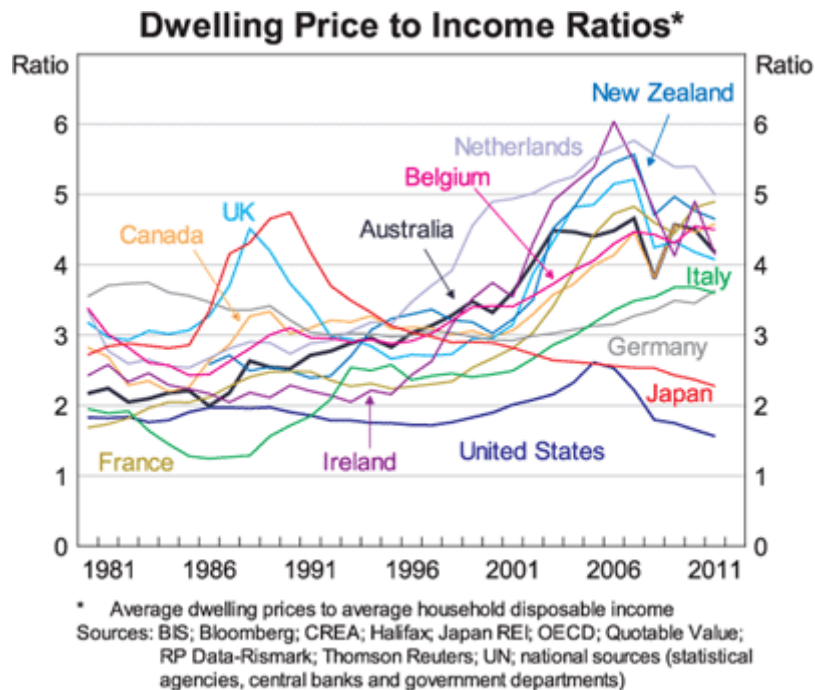
Simply comparing Australia and the United States, it is hard to avoid the impression that gravity will inevitably exert its influence on Australian dwelling prices. But if we put these two lines on a chart with a number of other countries with which we might want to make comparisons, the picture is much less clear (Graph 6).² To the extent that we can make any meaningful statements about international relativities, the main conclusion would be that Australian dwelling prices, relative to income, are in the pack of comparable countries. In this comparison, the United States seems the outlier.

² These comparisons use average (rather than median) dwelling prices and average household income. Average dwelling prices are estimated using nationwide (urban and regional) prices for both houses and apartments (mostly for the privately owned housing stock); dwelling price data are taken either from transaction price information or from data on national capital stocks. Average household disposable income is sourced from national accounts data. Note that alternative income measures give slightly different results, and Australia’s relativity is somewhat higher when using broader income measures that incorporate the taxation and social welfare system.

Graph 5

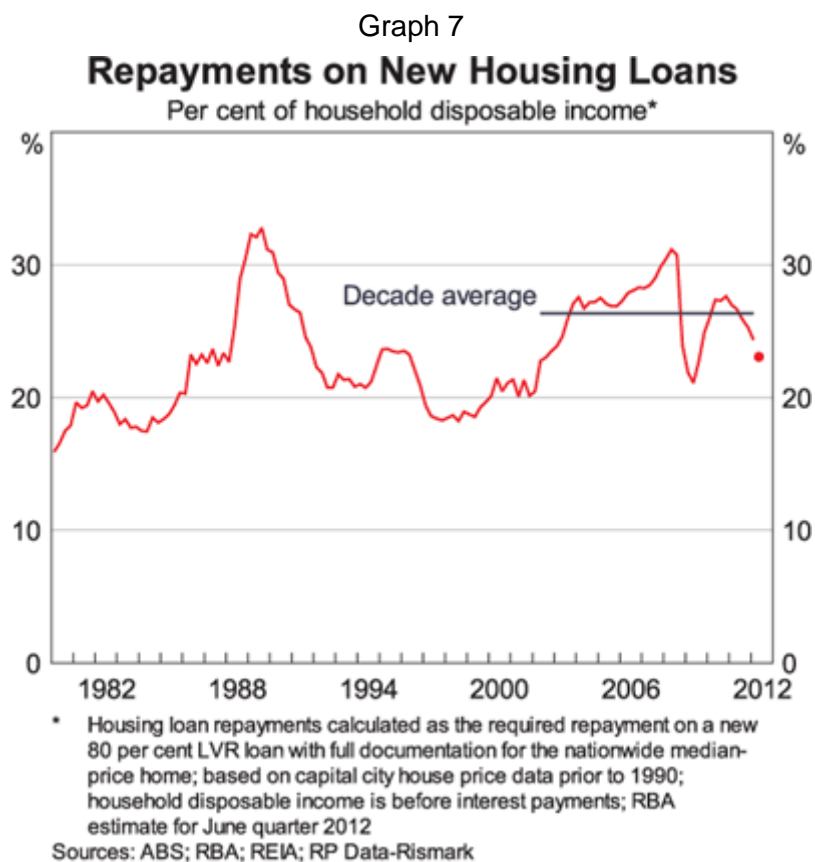


Graph 6



None of this can be taken to say definitively that Australian dwelling prices are “appropriate”, or that there is no possibility they will fall. It is a very dangerous idea to think that dwelling prices cannot fall. They can, and they have. The point is simply that historical or international comparisons, to the extent they can be made, do not constitute definitive evidence of an imminent slump. At the very least, the complexity of making these comparisons suggests we ought to look at some other metrics in thinking about the housing market.

One would be the performance of the associated mortgages. Here, the main story is that not much has changed. Arrears remain low and if anything have been edging down over the past year. That in turn is not altogether surprising given that debt servicing burdens have declined (Graph 7).



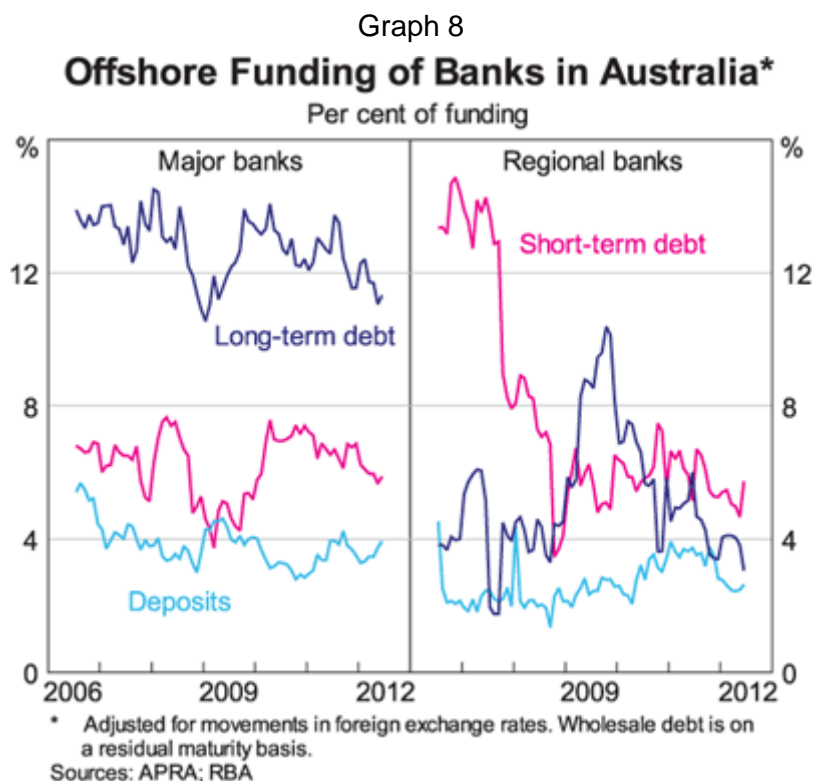
As a result of lower house prices and therefore lower loan sizes, somewhat lower interest rates and a good deal of income growth, the repayment on a new loan on a median-priced house as a share of average income is now at its lowest for a decade (except for the “emergency” interest rate period in 2009).

It is true that a low unemployment rate is a key factor helping here, but it is also true that the proportion of households that are ahead on their mortgage payments is also high – with some evidence pointing to over half – which would provide a buffer of some months for those households in the event a period of lower income was experienced. If we look at applications for possessions of dwellings, they have been running at about 0.15 per cent of dwellings on an annualised basis. Such applications have actually declined since their peak in both NSW and Victoria, though they have risen over the past couple of years in WA and Queensland. In the United States the most comparable figure for repossessions – “foreclosures started” – peaked at over 2 per cent of dwellings.

The conclusion? We should never say a crash couldn’t happen here, and the Reserve Bank continues to monitor property markets and the performance of mortgages quite closely, as we have for many years. But it has to be said that the housing market bubble, if that’s what it is, seems to be taking quite a long time to pop – if that’s what it is going to do. The ingredients we would look for as signalling an imminent crash seem, if anything, less in evidence now than five years ago.

What then about funding vulnerabilities?

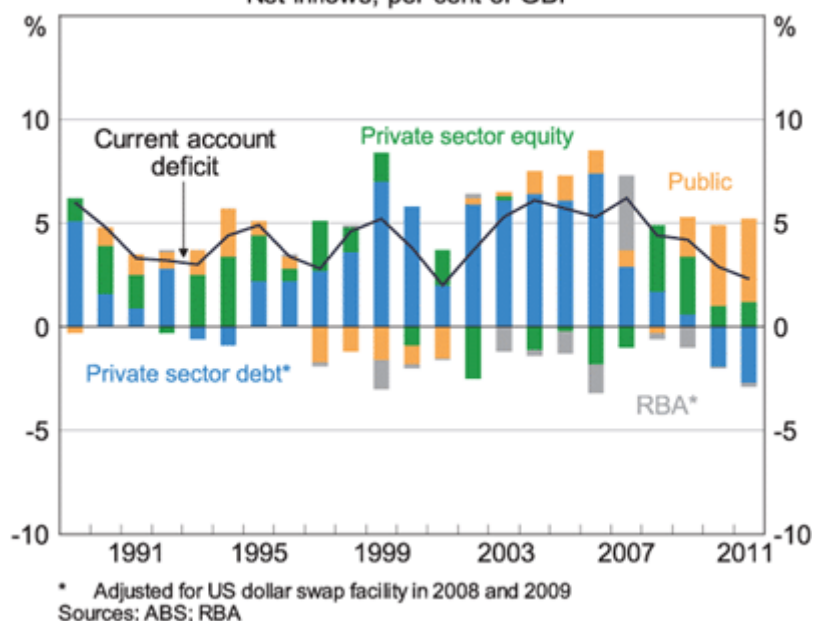
The pre-crisis period saw too much “borrowing short to lend long”, and too much reliance on the assumed availability of market funding. Banks everywhere have been adjusting away from that model over recent years, Australian banks among them. The share of offshore funding has fallen, and its maturity has been lengthened (Graph 8).



The flip side of this is of course the rise in domestic deposit funding, which has occasioned such competitive behaviour in the market for deposits.

Interestingly enough, while we have been told over the years how Australian banks were doing the country a favour by arranging the funding of the current account, they have stopped doing this over the past year without, apparently, any dramatic effects. As measured in the capital account statistics, there has been a net outflow of private debt funding over the past two years, offset roughly by increased inflow of foreign capital into government obligations (Graph 9). This has occurred with a net decline in government debt yields and a net rise in the exchange rate. The current account deficit has, in other words, been easily “funded” without the assistance of banks borrowing abroad – in fact, while they have been net re-payers of funds borrowed earlier.

Graph 9
Australian Capital Flows
 Net inflows, per cent of GDP



A reasonable conclusion is that the degree of vulnerability to a global panic of any given magnitude appears to have diminished, rather than grown, over the past few years. It hasn't completely disappeared, and it would not be sensible to expect it would, unless we were pursuing a policy of financial autarky. But there is little reason to assume that Australian institutions are somehow unusually exposed to these risks compared with most of their counterparts overseas.

In the end, of course, any bank's ability to maintain the confidence of its creditors is mainly about its asset quality. That brings us back to lending standards, the macroeconomic environment, and so on. One would think that, overall, things look relatively good in Australia, compared to the world's trouble spots. Think for just a moment about the holdings of government debt on the books of banks in any number of other countries, and about the state of public finances of many of those countries.

The arguments I have presented amount to saying that some necessary adjustments have been occurring gradually and reasonably smoothly. China's growth had to moderate. It has slowed, but it hasn't collapsed. Housing values and leverage in Australia couldn't keep rising. They haven't. Dwelling prices have already declined, relative to income, and it is in fact not obvious that they are particularly high compared with most countries. Housing "affordability" has improved significantly; over 99 per cent of bank-held mortgages are being serviced fully.

Banks have reduced their need for the sort of funding that might be difficult to obtain in a crisis situation. The current account deficit is being funded by a combination of direct equity investment, and flows into high-quality Australian dollar-denominated assets, the latter at costs that have been falling. In fact, the Commonwealth of Australia, and its constituent States, are at present able to borrow at about the lowest rates since Federation.

Markets do not, then, seem to be signalling serious concerns about Australia's solvency or sustainability. But markets can be wrong sometimes. They can sometimes be too optimistic (and other times too pessimistic). So even though we don't face immediate problems, we should ask: what if something went wrong? Below I consider a few possibilities.

If the thing that goes wrong is a major financial event emanating from Europe, the most damaging potential transmission channel would be if there were a complete retreat from risk, capital market closure and funding shortfalls for financial institutions. Let me emphasise, importantly, that this is not occurring at present and if it did occur it would be a problem for a great many countries, not just Australia. But in that event, the Australian dollar might decline, perhaps significantly. We might find that, in an extreme case, the Reserve Bank – along with other central banks – would need to step in with domestic currency liquidity, in lieu of market funding. The vulnerability to this possibility is less than it was four years ago; our capacity to respond is undiminished and, if not actually unlimited, is not subject to any limit that seems likely to bind. An alternative version of this scenario, if it involved the sort of euro break-up about which some people speculate, could be a flow of funds *into* Australian assets. In that case our problem might be not being able to absorb that capital. But then the banks would be unlikely to have serious funding problems.

If the thing that goes wrong is a serious slump in China's economy, the Australian dollar would probably fall, which would provide expansionary impetus to the Australian economy. But more importantly, we could expect the Chinese authorities to respond with stimulatory policy measures. Even if one is concerned about the extent of problems that may lurk beneath the surface in China – say in the financial sector – it is not clear why we should assume that the capacity of the Chinese authorities to respond to them is seriously impaired. And in the final analysis, a serious deterioration in international economic conditions would still see Australia with scope to use macroeconomic policy, if needed, as long as inflation did not become a concern, which would be unlikely in the scenario in question.

If dwelling prices in Australia did slump, then there would be obvious questions about how that dynamic could play out. In such circumstances people typically worry about two consequences. The first is a long period of very weak construction activity, usually because an excess of stock resulting from previous over-construction needs to be worked off. But we have already had a fairly protracted period of weak residential construction; it's hard to believe it will get much weaker, actually, at a national level. The second potential concern is the balance sheets of lenders. This scenario is among those routinely envisaged by APRA's stress tests over recent years. The results of such exercises always show that even with substantial falls in dwelling prices, much higher unemployment and associated higher levels of defaults, key financial institutions remain well and truly solvent.

Of course, it can be argued that the full extent of real-life stresses cannot be anticipated in such exercises. That's a reasonable point. But we actually had a real life stress event in 2008 and 2009. The financial system shows a few bruises from that period, but its fundamental stability was maintained

Conclusion

Most Australians I encounter who return from overseas remark how good it is to be living and working here. We are indeed "lucky" in so many ways, relative economic stability being only one of them.

But what matters more is what we do with what we have. Not every good aspect about recent performance is down to luck. By the same token there are things we can do to improve our prospects – or, if you will, to make a bit of our own future luck. Some of the adjustments we have been seeing, as awkward as they might seem, are actually strengthening resilience to possible future shocks. Higher – more normal – rates of household saving, a more sober attitude towards debt, a re-orientation of banks' funding, and a period of dwelling prices not moving much, come into this category.

The years ahead will no doubt challenge us in various ways, including in ways we cannot predict. But what's new about that? Even if the pessimists turn out to be right on one or more

counts, it doesn't follow that we would be unable to cope. Acting sensibly, with a long-term focus, has as good a chance as ever of seeing us through whatever comes our way.

Most of all, and to return to the whole point of today's event, we have much to live for. We want to do everything we can to ensure the next generation can share the positive outlook that most Australians have (almost) always had. That is why the Anika Foundation's work is so important, and why your presence here today is so valuable. Thank you again for your support.