# Glenn Stevens: Australia's economy against the background of recent global developments

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Canberra, 24 August 2012.

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Since the meeting we had in February, assessments of the global and local economies have waxed and waned. In February, sentiment about the international financial system was recovering somewhat, after a scare late in 2011. The actions of the European Central Bank in extending its liquidity provision to euro area banks had taken major re-funding hurdles out of the picture for a time. This was a critically important action that bought time. It was clear that the European economy had slowed, that the United States was still growing, but at only a modest pace, and that China's growth was moderating to something more sustainable. But high-frequency indicators of the global business cycle were stabilising. So even though forecasts for global growth were at that stage being marked down a bit, we did not seem to be seeing a slump of the kind seen in late 2008. Subsequently, there were actually some small upward revisions to global growth forecasts.

But, as we said at the last hearing, sorting out the problems in the euro area is likely to be a long, slow process, with occasional setbacks and periodic bouts of heightened anxiety. We saw one such bout of anxiety in the middle of this year, when financial markets displayed increasing nervousness about the finances of the Spanish banking system and the Spanish sovereign. The general increase in risk aversion saw yields on bonds issued by some European sovereigns spike higher, while those for Germany, the UK and the US declined to record lows. This "flight to safety" also saw market yields on Australian government debt decline to the lowest levels since Federation. Meanwhile, many European economies saw a further contraction of economic activity. Share markets declined sharply.

Over the past couple of months, assessments of near-term global growth, having gone up a bit between February and May, have been marked back down. Bodies such as the International Monetary Fund are forecasting world GDP growth of about 3½ per cent this year, before picking up a little next year. These seem reasonable estimates at this stage, although the risks still seem weighted to the downside. It is worth noting that we still have not seen, thus far, the sort of collapse in production and trade across a wide range of countries that was observed in 2008. The global slowing we have seen has, so far at least, been of the more ordinary variety. That is not to make light of these developments, only to keep them in some sort of perspective. The kind of growth envisaged for the world as a whole is close to its long-run average.

Of importance to Australia, and as we noted at the February hearing, the Chinese economy looks like it has slowed to a pace of growth that is likely to be more sustainable. This is, though, clearly below the pace seen for much of the recent past and the implications of this new pace of growth for the trajectory of demand for various commodities are still being worked through in the relevant markets. Commodity prices have declined. Australia's terms of trade peaked about a year ago. However, they remain high in comparison with most of the past century. Overall, the developments in key commodity prices do not seem out of line with what we can observe about the progress of the global economy.

Of late, financial market sentiment has again recovered somewhat. This is seen most clearly by share prices in most markets recovering the losses seen in mid-year, while interest rates on "peripheral" European debt have fallen. It could not be said that confidence is strong: uncertainty is high and much of this stems unavoidably from the situation in Europe. European policymakers have continued their efforts both to stabilise the immediate situation, and to craft stronger pan-European structures for financial management so as to provide a more enduring stability. Their actions and commitments to future actions have been important but expectations for further progress are high. Realistically, it will be quite some time before the Europeans will be able to say these problems have been put behind them, even if things go well.

Turning to the domestic economy, the sequence of changes in assessment has tended to be the obverse of what we have seen internationally. At the previous hearing we believed, on the basis of the available data, that overall growth had been close to trend over 2011. Subsequently we could not avoid revising that view downwards a bit, as there seemed to be some emerging evidence that growth had been weaker than that. The most recent data, on the other hand, are suggestive that the earlier assessment may, in fact, have not been too far off the mark. As recorded, domestic final demand rose by 5 per cent in real terms over the year to the March quarter, even with a small contraction in public spending. The strongest growth was by business investment in the resources sector but even consumption spending by households rose by about 4 per cent, according to the national accounts. A good deal of the growth in demand was supplied from abroad but, nonetheless, output is recorded as having expanded by a little over 4 per cent over the year to March. That result includes recovery from the flooding of Queensland coal mines in the summer of 2011, so it overstates the underlying pace of growth. Even so, and allowing for a more moderate expansion of real GDP in the June quarter than in the March quarter, an assessment that economic activity has been growing “close to trend” over both the second half of 2011 and up to the middle of 2012 seems reasonable. Consistent with this, the rate of unemployment remains essentially unchanged from this time last year.

Inflation, at the same time, has declined. The Consumer Price Index (CPI) rose by just 1.2 per cent over the past year. This was the lowest result for some years, though it partly reflects the unwinding of the large rise in some food prices that occurred in the first half of 2011 and which had pushed up the CPI. Using the various measures we have for underlying inflation, we would put it at about 2 per cent over the past year, which is still down a bit on the figure a year earlier. The rise in the exchange rate, most of which occurred over 2009 and 2010, has had a significant impact on prices for traded goods and services, but this dampening effect on the rate of change of those prices looks like it has now started to wane. As it does, the more moderate growth of domestic costs and prices that we have seen will need to continue, in order for inflation to remain consistent with the monetary policy objective. At present our forecast remains that this will be the case.

In May and June, the Board eased monetary policy, lowering the cash rate by a total of 75 basis points, following the two adjustments made last year. These decisions were made based on the Board’s assessment of economic conditions and the outlook, and with regard to the balance of risks. They have resulted in borrowing rates being a little below their medium-term averages.

Since then, with growth close to trend and inflation consistent with the target, but the global outlook weaker than it was earlier in the year and confidence a bit on the subdued side, we have judged this to remain the appropriate stance. It is too early to tell how much difference the sequence of decisions to lower interest rates late last year and in the middle of this year has made to the economy, though we can observe that dwelling prices may have stopped their earlier gentle decline, and business credit has been growing at its fastest pace for three years. Consumption spending has been stronger over the first half of the year, but recent strength may in part be due to the effects of government compensation payments associated with the introduction of the carbon price. The exchange rate remains quite high, even with the decline in the terms of trade over the past year.

Looking back, then, the economy appears to have been recording reasonable overall growth, relatively low unemployment, and low inflation. Looking ahead, the peak of the resource investment boom as share of GDP – the highest such peak in at least a century – will occur within the next year or two. After that the rate of resource investment is likely to decline, while the export shipments of the resources themselves will pick up. By then we might expect that some other sectors that have been weak of late, like residential and non-residential construction, might be starting to pick up. Overall, growth is forecast still to be close to trend, albeit with a different composition from that seen in the past year or two, and inflation consistent with the target.

That is the central forecast. It is conditional, of course, on a range of assumptions and there are, as always, risks and uncertainties, some of which we spell out in the *Statement on Monetary Policy*. At a time of significant global uncertainty, and of important structural changes in the Australian economy, the degree of confidence we can attach to particular forecasts is, unavoidably, reduced. We remain prepared to respond to significant deviations from the central outlook, to the extent that it is prudent and possible to do so, within the framework that aims to foster sustainable growth and inflation at 2–3 per cent over time.

Madam chair, I feel that it is important for me to make an additional statement, anticipating that the Committee will be interested once again in the matters that we have been discussing for some time now in Note Printing Australia (NPA) and Securency, and which have been prominent in the media over the past few days.

The Reserve Bank condemns corrupt or questionable behaviour of any kind. We have done a lot of work to tighten controls in the two companies. We have sought at all times to deal appropriately with all the issues that have arisen, and to cooperate with the legal authorities. We have also sought to respond honestly to questions from this Committee.

I have previously given evidence to the Committee on the sequence of events as we saw them unfold. It is worthwhile to try to draw that together. In so doing, it is important to keep clear the distinction between the two companies in that sequence.

In 2006, following the events at the Australian Wheat Board, the Reserve Bank Board asked questions about the policies for the use of overseas agents by the two companies. In the case of NPA, the Bank's questions prompted the company to begin a process of developing stronger policies.

RBA management asked for an update on progress at NPA in early 2007, and the NPA Board appropriately sought a paper from management on dealings with sales agents. After considering that paper, the NPA Board decided that an audit should be undertaken of past practices and compliance. That audit raised several very concerning things. It recommended that, apart from discontinuing the use of agents, the NPA Board undertake an urgent investigation of the role of relevant management and staff in dealing with agents to ensure compliance with Australian law. On receiving this report, the NPA Board took the decision to cease the use of agents, and through a Board sub-committee commissioned Freehills to provide an assessment of the standards and compliance questions. It was while all these processes were under way that concerns held by a member of NPA's management over the company's conduct became known to a Reserve Bank Assistant Governor who sat on NPA's Board. The NPA manager was asked by the then Deputy Governor to make a written statement. This document was part of the material examined by the Freehills team that was asked by the NPA Board to examine the matters. I have conveyed these facts to the Committee over the course of questioning at previous hearings.

The document provided by the manager at NPA was held in strict confidence at his request. This was a condition required by him, and the Bank agreed to it because it valued his willingness to come forward. Seeking professional legal expertise to assess the matters contained in this document, and the concerns raised in the audit, was a mark of how seriously they were taken.

The decision to seek an external legal review was an important one. In the Bank's view, it was imperative to establish a process to investigate the issues thrown up by the audit findings and to ascertain and evaluate the facts regarding the NPA manager's concerns. This required an assessment by qualified experts on the legal questions. The Bank did not believe that it should itself seek to make such an assessment. There are many precedents in the private and public sectors for organisations adopting similar processes in such circumstances. In the Bank's view, this represented a proper, independent and rigorous process. That was the intention.

The Freehills report was highly critical of NPA's practices, which were in need of major reform. It also concluded, based on the material then available, that there was no evidence of a breach of Australian law. That assessment was provided in good faith, and relied on in good faith. It was not proposed by Freehills or anyone else at that time that, having been through a process that concluded there was no evidence of a breach of the law, the next step should be to approach the police. When the Australian Federal Police (AFP) were called in 2009 by the Chairman of Securency regarding the allegations made about Securency at that time, the 2007 NPA matters were all disclosed to the AFP in a timely way. The Freehills report and audit reports were provided to the AFP when requested. There was no attempt to hide any information.

It has been claimed by some that the written statement by the NPA manager contained clear evidence of corrupt behaviour. In 2007, two senior legal practitioners from a leading law firm, who received this material directly from the author as part of their review and interviewed the author and others, did not view it that way in coming to their conclusion that there was no evidence of a breach of the law. Even if it were ultimately to be concluded at some later time, with the benefit of hindsight, that the report reached an incorrect conclusion, it is completely without foundation to suggest that this process – seeking information, conducting audits, having an independent legal review, implementing the recommendations from the review and the audits, and relying on the independent advice received – represented an attempt at a "cover up" by anyone in the Reserve Bank.

I turn now to Securency. The RBA Board asked Securency for its policies on agents in 2006 and the company put in place additional and stronger policies and procedures. Following the audit at NPA in 2007, the Securency Board requested a similar audit and terminated one of its agents (which it shared with NPA). That audit found that, unlike NPA, Securency had a "good and robust process" in place in relation to overseas agent contracts and payments. A follow-up audit was conducted in 2008, which made the same finding.

It is for this reason that the Securency Board, and the Reserve Bank, had no reason at that time to discontinue the use of agents, as had occurred at NPA. With those audits having returned those findings, the Reserve Bank was completely surprised by the allegations that were published in the middle of 2009. We now know, including from a report conducted by KPMG for the Securency Board later in 2009, that critical information regarding the use of agents was withheld from the audit teams and the Securency Board in 2007 and 2008.

Finally, I turn to the question of the provision of materials to this Committee. Currently, there are a number of court orders in place that place restrictions on the documents that the Bank is permitted to disclose. The non-publication orders have been made as a result of applications by the individuals facing criminal charges and are designed to protect their right to a fair trial before an impartial jury. Further non-publication orders have been sought and obtained by the Department of Foreign Affairs and Trade (DFAT) and the AFP.

Among the material subject to such orders is the statement of the NPA manager. I received legal advice in relation to whether I could table the statement. The advice was that I could not.

The Reserve Bank is, however, committed to transparency with this Committee and with the community. To that end we are compiling a folder of the documents the Bank has in relation to these matters, with the intention of tabling it for the Committee at the earliest opportunity. This will include relevant excerpts from minutes of meetings of the Reserve Bank Board, the NPA Board and the Reserve Bank's Audit Committee in the 2006–2007 period, papers prepared for the NPA Board on the use of agents, the audit reports on the use of agents in NPA and Securency, the statement by the NPA manager referred to above along with associated documents, the terms of reference for the Freehills review, the Freehills review itself, and the report to the NPA Board by its sub-committee that examined the issue. We are taking steps to seek the permission of the Court to allow the Bank to table those materials subject to orders.

To the extent that I can shed further light today, while still respecting the legal processes, I am of course more than willing to do so.

My colleagues and I are here to respond to your questions.