Glenn Stevens: Remarks to Citi's 5th Annual Australian & New Zealand Investment Conference

Remarks by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to Citi's 5th Annual Australian & New Zealand Investment Conference, Sydney, 29 October 2013.

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Welcome to Sydney.

As ever, the times remain "interesting". You will have much to talk about. I will confine myself to some brief remarks, firstly about the global scene, and then about the situation in Australia.

From this distance, the US economy appears to be healing. The "headwinds" from the housing sector are lessening, corporations are in a strong financial position and the labour market is improving, albeit slowly. Much financial repair has been made. The new sources of abundant energy in the US will also act as a growth enhancer. The biggest remaining problems are how to put the US budget onto a sustainable long-run footing, and how to manage the exit from extraordinary monetary policy settings.

In Europe, numerous downside risks that were top of mind a year ago have not, in fact, materialised – which is no small achievement. Moreover, there are signs of a modest cyclical upturn in economic activity. That said, those downside risks still exist and the recovery has been described by ECB President Draghi as weak, uneven, fragile and starting from very low levels.

China, meanwhile, has continued to grow, more or less in line with the objectives of the Chinese authorities. This is more moderate than the double-digit rates China recorded in earlier times. But it is still a robust performance and China is now a big economy whose performance matters for the rest of the world. The key question in China would be whether the "shadow-banking" system, where much of the growth in financial activity has been occurring, can be adequately controlled and kept stable.

The "emerging market" economies have experienced some turbulence. Until May this year, their problem was inward flows of capital, resulting in part from "spillovers" from the extraordinary measures taken by the major countries. This put upward pressure on exchange rates, and made for easier financial conditions, which was conducive to rising credit and asset values. It was also a permissive environment for the continuation of any underlying imbalances or weaknesses. When the Federal Reserve began to lay out the conditions under which it would consider scaling back its extraordinary measures, and the possibility became real that such a scaling back might begin this year, capital markets reacted by scaling back their own purchases of assets in emerging markets. The situation then became much less permissive. Financial conditions for a number of countries tightened, exchange rates started to come under downward pressure, and policymakers were faced with the need to accelerate the crafting of responses.

That pressure was lessened when the Fed did not, in the end, begin the "taper" in September. Since then, stock markets have advanced, long-term interest rates have edged down and the US dollar has weakened. The outflows from emerging markets slowed. Even in the face of the impending deadline for lifting the US debt ceiling, markets experienced a relatively limited amount of disruption (though it is very doubtful that they would have accepted a default event with the same equanimity). There was a distinctly more relaxed tone to the discussions in and around the IMF and G20 meetings in Washington in October than there had been at like meetings earlier in the year.

But it would be a mistake to relax for very long in the face of this delay. Surely the "taper" will come. We should hope it will, since it will signal that the US economy is well established on a recovery track, and it will start to lessen some of the uncomfortable spillover effects unavoidably associated with the present set of policies. For some countries, including Australia, the beginning of a return to something resembling more normal conditions, in at least one major advanced country, would lessen some of the difficulties we face in our own policy choices.

For some other countries, this may see some resumption of the less welcome pressures seen earlier this year. The good news is that we have had a dress rehearsal of what the beginning of tapering will probably look like, so we have a sense of the pressure points, and there is now a window within which to address some of them. It would be wise for policymakers to use that window.

Turning to the Australian economy, we have seen, over the past couple of months, evidence of a lift in sentiment in the business community. A lessening of political uncertainty has no doubt helped this, though we should note that this follows an improving trend in measures of household confidence that began in the second half of last year. That uptrend had a setback in mid 2013, but then resumed.

One force helping household and business confidence has been a positive trend in asset markets. Over the past year, the stock market, as measured by the ASX 200 accumulation index, has returned about 25 per cent.[1] The median price of a dwelling in Australia has risen by about 8 per cent over the past 18 months, reversing a previous decline. Overall, the net worth of Australians has increased by around 15 per cent, or more than $800 billion, since the end of 2011.

It is not yet clear to what extent, or when, these more favourable trends in "confidence" will translate into intentions to spend, invest and employ. The pace of new dwelling construction is starting to respond to higher prices in the established property market, as we need it to. But at this stage, the available information suggests that broader investment intentions in the business community remain subdued. It may be a while yet before we can expect to see conclusive evidence of a change here.

In the interim, some commentators have taken the view that the property market dynamics are worrying. My own view, thus far, has been that *some* rise in housing prices is part of the normal cyclical dynamic, that it improves the incentive to build, and that a price rise reversing an earlier decline probably isn't something to complain about too quickly. Moreover, credit growth, at between 4 and 5 per cent per annum to households, and less than that for business, does not suggest that rising leverage is so far feeding the price rise. Hence it has been a little too early to signal great concern.

There are, however, two caveats. The first is that, notwithstanding the above comment, credit growth may pick up somewhat over the period ahead. So this is an area to which we will, naturally, pay close attention.

Secondly, while overall credit growth remains low at present, borrowing is increasing quite quickly in some pockets. Investor participation in housing in Sydney, in particular, is becoming noticeably stronger. Over the past year, the rate of finance approvals for this purpose has increased by 40 per cent.

We have certainly experienced higher rates of growth of finance than that in the past, and it may be that we are seeing some catch-up from a delayed initial response to fundamentals favouring more investment in housing. Nonetheless, as this activity continues, lenders and borrowers alike would be well advised to take due care. It is very important that strong lending standards remain in place, and that decisions be based on sensible assumptions

[1] This index, by the way, exceeds the 2007 peak, unlike the more widely quoted standard share price index. The difference comes from the fact that the Australian listed company sector has maintained a dividend yield of around 4.5 per cent, on average, since 2007.

about future returns. That's what we need if we are to experience a long and sustainable expansion in housing investment that houses our growing population at acceptable cost, and pays reasonable returns on the capital deployed. That's the sort of outcome we want, as part of the more balanced growth path for the economy we are seeking over the years ahead.

Another part of the balanced growth path would involve an expansion in some of the trade-exposed sectors that have been squeezed by the high exchange rate. The foreign exchange market is perhaps another area in which investors should take care. While the *direction* of the exchange rate's response to some recent events might be understandable, that was from *levels* that were already unusually high. These levels of the exchange rate are not supported by Australia's relative levels of costs and productivity. Moreover, the terms of trade are likely to fall, not rise, from here. So it seems quite likely that at some point in the future the Australian dollar will be materially lower than it is today.

The high exchange rate has also had a significant impact on the Reserve Bank's own balance sheet. It led to a decline in the value of the Bank's foreign assets and hence a diminution in the Bank's capital, to a level well below that judged by the Reserve Bank Board to be prudent. This has been a topic of some interest of late. Our annual reports have made quite clear over several years now that, while this rundown in capital in the face of a very large valuation loss was exactly what such reserves were designed for, we considered it prudent to rebuild the capital at the earliest opportunity. It has been clear that the Bank saw a strong case not to pay a dividend to the Commonwealth during this period, preferring instead to retain earnings, so far as possible, to increase the Bank's capital. That rebuilding could in fact have taken quite a few years, given the low level of earnings.

That is the background to the recent decision by the Treasurer to act to strengthen the Bank's balance sheet, in accordance with a commitment he made prior to the election. The effect of this is that instead of it taking many years to rebuild the capital, it will occur in the current year. This results in a stronger balance sheet on average, and makes it likely that a regular flow of dividends to the Commonwealth can be resumed at a much earlier date than would otherwise have been the case.

With those few remarks, I wish you well in your deliberations at your conference today.

Thank you.