Glenn Stevens: Reflections on the global economy and recent economic and financial developments in Australia

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Canberra, 18 December 2013.

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Madam Chair

Members of the Committee

Thank you for the opportunity to meet with you today. I look forward to constructive engagement with you during the 44th Parliament.

As we reach the close of an eventful year, it is perhaps worth reflecting on some key themes, starting with the global economy. At the meeting with the previous Committee early in the year, we noted several developments. Fears of a euro area break-up had abated. The United States economy was gradually recovering, and the slowdown in China had run its course. These outcomes were roughly as expected, though perhaps of greater significance at that time was the fact that various "downside risks" had not materialised. Global growth was running below average, though not disastrously so. It was thought likely to pick up a bit in 2013.

The period since then has been largely more of the same. The euro area economy contracted in the first part of the year, but may be starting to grow again. It still faces immense challenges with its banks and public finances, and some years of uncertainty. But once again the worst fears have not been realised. The United States continues a path of gradual recovery, despite the budget "sequester" and the divisive debate about the debt ceiling. The recovery is more gradual than policymakers there would like but that often is the nature of things after a financial crisis. China is growing at a solid pace, about in line with policymakers' announced intentions, despite concerns it might slow more sharply. Global growth was probably about 3 per cent in 2013, just a little less than in 2012. The pick-up expected has not eventuated as yet, though most forecasters still seem to see reasonable prospects of it occurring next year.

So the past year can perhaps be labelled as: not quite good as hoped for, but not as bad as feared.

Looking ahead, the issue that most people are focusing on is the so-called "tapering" of US monetary policy. What is meant by this is that the Federal Reserve is expected, at some point, to moderate the rate at which it buys securities in the market, which is presently US$85 billion per month, and eventually to stop purchases. We don't know when that process will begin. The Fed has said that it will depend on economic conditions, as obviously it must. Moreover it will only be a step on what is likely to be a fairly long path back towards "normal" monetary policy.

We can be fairly sure, though, that there is ample potential for this shift in direction to reverberate around global markets. That's what usually occurs when the Fed changes course. The anticipation of this has already been a factor affecting markets, including in particular those in some important "emerging market economies", at various points this year. It is sensible to assume that this will be the case over the period ahead, as "tapering" begins and as market participants try to ascertain its extent and pace.

Turning to the Australian economy, in February we felt that growth had moderated somewhat and would be below trend for a while, within a range of 2–3 per cent for 2013. Broadly speaking that is what has occurred. Our most recent *Statement on Monetary Policy*, released in November, put likely GDP growth within that range. The recently released September quarter data don't cause any material change to that view.

This result reflects quite subdued growth in private domestic demand, partly offset by quite strong growth in exports. The very large run-up in mining investment has reached its peak, while non-mining investment remains at a low ebb, and dwelling investment spending is only in the early stages of an upturn. Consumer spending has been rising, but at a below average pace, as people adjust to slower growth in income and look to contain or reduce debt.

Inflation has remained consistent with the 2–3 per cent target. For the year to December, it looks as though the Consumer Price Index will have risen by about 2½ per cent, with underlying inflation perhaps a little below that. Our assessment is that inflation will remain consistent with the target over the next one to two years.

Looking ahead, resource sector investment will decline – gradually at first but more quickly thereafter. It will most likely fall considerably over the next few years. There is therefore scope for other forms of private demand to grow more quickly, the more so as government spending is scheduled to be subdued. Investment in dwellings shows clear signs of a significant increase, and exports of resources will continue to rise strongly. It is likely that capital spending by firms in some sectors outside the resources sector will eventually pick up, but this will take some time yet and it will be against the backdrop of a challenging environment. Consumer demand is likely to grow at a rate close to that of income. Higher wealth and confidence could see the saving rate decline a little, but consumption will not be the same driver of growth that it was before the financial crisis.

Putting all this together, our expectation is that the below-trend growth in GDP we have seen for a while now will probably continue for a bit longer yet. Over the more medium term, there are good grounds to think that growth can strengthen. Eventually more capital spending will be required in some of those sectors where it is very low at present. The corporate sector in aggregate has high reserves of cash, financial intermediaries and capital markets are willing to lend, and interest rates are low. If the nascent improvement in "confidence" we have seen can be sustained, that will help to achieve better growth. In fact, we could aspire to a period during which growth could be a bit above trend for a while, since spare capacity in the economy has increased a bit over the past eighteen months or so.

Monetary policy has been playing its part to support demand. Because inflation has been consistent with the target, the Board has been quite comfortable in easing policy by a significant amount. The cash rate has been reduced twice more since we last met with the Committee, and by a total of 225 basis points over the past two years. Borrowing rates are at their lowest levels in a long time. The returns to savers for holding safe assets have commensurately declined, and this has clearly prompted substitution towards other assets, including equities and dwellings. The rate of credit growth has remained quite low thus far, though it is now increasing a little, as housing loan approvals have moved up quite noticeably over recent months. Low interest rates are doing the sorts of things we expect them to do. This is the way expansionary monetary policy works.

The exchange rate has also behaved, of late, more as might be expected in such circumstances: that is, it has declined. From about US$1.03 at the February hearing, it has fallen by about 13 per cent. The Bank has described the exchange rate as "uncomfortably high", and suggested that balanced growth in the economy would probably require a lower exchange rate.

The Board has maintained an open mind about whether we may need to lower interest rates further. At this point, however, there are few serious claims that the cost of borrowing per se is holding back growth. On the contrary, monetary policy is supporting higher spending by altering incentives as between spending and saving, and working to create an environment in asset and credit markets that eases the restraints on some sorts of activity.

In the end, though, firms and individuals have to have the confidence to take advantage of that situation. They have to be willing to take a risk – on a new project, a new product, a new market, a new worker. Monetary policy can't force spending to occur.

That is why the conduct of other policies is also important. The myriad things which can make it harder or easier for businesses to innovate, to change their ways of doing things, to avoid unnecessary costs and to be more productive, all matter. No single one is decisive in itself; but collectively, they are crucial. It is hard to escape the feeling that we as a society have tended, for quite a long time now, to go about our decisions on such matters while making the assumption, perhaps without realising it, that solid growth of the economy will simply continue, and that it won't be affected by these other choices of various kinds. We are at a moment now when that assumption has to be questioned.

The path of pro-growth, pro-productivity, confidence-building reforms would mean that the basis for investment and growth in real incomes would improve. That would allow consumption to grow without recourse to excessive borrowing. It would provide a revenue base for governments to provide the services and infrastructure the community needs. And so on.

The alternative path is a much less attractive one.

Before I conclude, a few words on payments and regulatory matters. As I mentioned at the February hearing the Payments System Board has been working to encourage industry to put in place the infrastructure to make real-time payments capability for the community a reality over the next few years. Good progress has been made, though there is a long way to go. An early milestone was reached a few weeks ago when the settlement of direct entry payments, amounting to about $50 billion per day, moved to same-day settlement, as opposed to the previous practice of settling the next day. Quite substantial changes to operational arrangements in the private sector, and in the Reserve Bank itself, were required to achieve this. But it was worth doing because it lowers risk in the system and helps faster access to funds.

On financial regulation, the global effort at building a stronger framework continues. The Financial Stability Board has been clear about the priorities over the coming year, under the headings of implementation of Basel III changes, continuing towards completion of a regime for "too big to fail" financial institutions, making derivatives markets safer and making sure "shadow banking" activities have appropriate oversight. Australia, as chair of the G20 this year, welcomes this prioritisation and has indicated that it supports the FSB as it seeks to achieve concrete results by the time of the Leaders' meeting in Brisbane next November. Australian regulatory authorities continue, meanwhile, carefully to implement internationally agreed reforms, with due regard to local conditions.

With those remarks, Chair, we are here to respond to your questions.