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

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Sydney, 7 March 2014.

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Madam Chair

Members of the Committee

Thank you for the opportunity to meet with you today.

When we met with the Committee just prior to Christmas, I suggested that, taking an international view, 2013 could be described as a year that turned out not to be quite as good as hoped for, but not as bad as feared. Nothing that has occurred in the period since then would change that assessment.

One prominent international event was that, within hours of that hearing, the US Federal Reserve commenced the "tapering" of its monthly asset purchases. This was a possibility we talked about at the time and, although the timing of it wasn't known, it was considered likely that it would begin before long. A further reduction in asset purchases was decided at the Fed's January meeting.

After all the anticipation of this change, the actual announcement of the Fed's decision caused little disruption in markets in December. During January there was more volatility in markets, and a few emerging economies came under pressure, with bond yields spiking and exchange rates declining.

It is important to keep this in perspective. Periods surrounding changes of course by the Fed have often been times when market participants re-assess their positions and their appetite for risk, and this occasion has been no exception. It isn't necessarily the Fed action *per se* that is most important, but rather what it conveys about the overall economic and financial environment. At such times investors sometimes start to focus on risks to which they had hitherto been attaching little significance.

Investors have not, however, fled from risk indiscriminately on this occasion, at least to date. They have drawn distinctions between alternative classes of investment and different countries. Long-term sovereign yields of the core advanced countries have increased a little, but they remain low. With compressed risk spreads, this means that borrowing costs for many private-sector borrowers remain very low. The spreads over German yields for European sovereigns have continued to fall. This suggests that actions by European policymakers have had more influence on European markets than actions by the US authorities. This is as one would expect, but it hasn't always been the case in the past.

Moreover, not all emerging markets are experiencing the same pressure. Some that experienced considerable turbulence in the middle of last year, when tapering was first mooted, have seen less of that recently. This owes something at least to policy responses in those countries in the intervening period. Among those countries that have been under most pressure of late, genuine domestic sources of risk can be observed in most instances. In several cases the market pressure has resulted in policy responses, which were perhaps needed anyway.

In general then, tapering is proceeding, so far, about as well as can be expected.

In the meantime, forecasts for the global economy haven't changed much in recent months. If anything they have inched higher. They suggest that 2014 growth will be higher than in 2013, and at about average pace. More of the growth is coming from the advanced countries, and proportionately not quite so much from the emerging ones. That, too, is

probably a welcome re-balancing in some respects after the weakness of the advanced countries in recent years. Australia's terms of trade have been little changed over the past year, though we still assume they will decline further in the future.

Turning to the Australian economy, for some time our view has been that growth has been running below its trend pace. The national accounts released a couple of days ago don't significantly change that assessment. For the year to the December quarter of 2013, real GDP rose by about 2¾ per cent. This is roughly in line with the forecasts we have had for a while. The drivers of growth are shifting. As we have been saying for some time now, and as confirmed in the recent survey of capital expenditure intentions by firms, the very high level of investment spending by mining companies has turned down, and the decline will accelerate over the coming year. Other areas of demand will provide at least some offset. Export volumes for resources are growing strongly, as the capacity that has been put in place by the high levels of investment comes on line. For example, iron ore shipments have risen by about 85 per cent from their levels of five years ago, to around 1.5 million tonnes per day. They will rise further over the coming year or two.

It is clear that dwelling investment activity will rise strongly over the period ahead. Over the past three months, approvals to build private dwellings numbered almost 50,000. That is an increase of about 27 per cent from the figures of a year earlier, and is the highest three-month total in the 30-year history of this series.

Consumer demand has had a firmer tone over the summer, after a fairly lengthy period of more subdued outcomes. This is evidence in the retail trade and national accounts data and is confirmed in information from the Bank's liaison. Consumer sentiment does still seem a little skittish, though, and while we expect consumption spending to grow in line with income or perhaps a little faster, consumers are unlikely to be the drivers of growth that they were prior to the financial crisis.

Business investment spending outside mining, which has been very low indeed, is bound to pick up at some stage. The signs of improved conditions and confidence that we have observed in some sectors will help, and the early indications of an improvement in capital spending expectations are apparent. Those are, however, quite tentative at this point and firms are looking for recent signs of improved conditions to persist before committing to expanded investment spending. Public final spending is scheduled, according to the announced plans of federal and state governments, to be quite weak.

The expected ongoing effects of very low interest rates and a somewhat lower exchange rate have resulted in a slight lift in forecast growth for the second half of this year and in 2015. This was reflected in our most recent published forecasts released last month. We haven't made any further changes since then.

With growth having been below trend, job vacancies declined, employment growth weakened and unemployment rose in 2013. Some forward indicators have stabilised and then improved a little of late, which is promising. But even with this, and with a slightly better growth outlook, the labour market will probably remain soft for a while yet, given that it lags changes in activity. This has seen the pace of growth of wages decline noticeably.

Turning to consumer price inflation, the recent data show inflation in underlying terms at about 2½ per cent over the course of 2013, and a pace higher than that in the second half of the year. This is a change from the middle of last year, when we were receiving data that were lower than expected.

Part of the increase in inflation is explained by the effect of the depreciation of the exchange rate, which has resulted in increases in prices of traded goods and services. But that does not account for all the result and it is, at least on the surface, something of a puzzle that underlying inflation moved up while growth in labour costs moved down. There may be a re-building of margins in some areas, particularly those where demand conditions have

improved a little from the very weak situation earlier. There may also be an element of noise in the quarterly data.

The view we have taken, pending further evidence, is that there is probably both noise and signal in the result. Hence, our assessment is that inflation is not quite as low as it might have looked six to twelve months ago, but nor is it accelerating to the extent a literal reading of the latest data might suggest. The general situation – 18 months of below-trend growth, a rise in unemployment, a marked slowdown in wages – is not one that would be obviously associated with a sustained rise in price pressures. Our view remains that the outlook for inflation, while a little higher than before, is still consistent with the medium-term target.

Monetary policy is very accommodative. The cash rate has been unchanged since August last year. It and most borrowing rates are at multi-decade lows. The sorts of things that are normally expected to result from low interest rates are increasingly in evidence:

- savers are looking for higher return assets as the yield on safe assets has fallen
- asset prices have risen
- credit growth has picked up somewhat for households, and particularly for investors in housing, where it is running at an annualised pace of close to 9 per cent
- construction of dwellings is set to rise, probably quite strongly
- liaison suggests that lenders are becoming more accommodating to potential business borrowers and few complain about availability of credit
- the exchange rate has depreciated, though it is still high by historical standards.

On the whole, then, accommodative monetary policy is playing its part in supporting sustainable growth in demand, consistent with the inflation target.

Of course, the outlook contains many uncertainties, not least the 'hand over' from mining investment spending to sources of demand outside mining. In some important respects, the basis for such a handover is coming into place, as I have just described. The question then is: will the additional demand likely to be generated outside mining as a result of these trends be just the right amount to offset the large decline in mining investment spending, so keeping the economy near full employment?

No-one can answer that question with great confidence. Moreover, even if it were possible for forecasts to be much more accurate than experience could possibly lead us to hope, it could not be assumed that a shortfall in demand could necessarily be made good in short order by monetary policy. Monetary policy can have a powerful effect on the general environment, but it cannot hope to fine-tune the quarterly or even annual path of aggregate demand.

At the present time we judge monetary policy to be doing the things it can reasonably be expected to do in the circumstances we face. We have signalled the likelihood, if the economy evolves more or less as expected, of a period of stability in the cash rate. As well as the low level of interest rates generally, a sense of stability should be of some help for businesses and households as they form their plans.

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