Glenn Stevens: The economic outlook

Speech by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the 17th Annual Credit Suisse Asian Investment Conference, Hong Kong, 26 March 2014.

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When I last spoke at this conference two years ago, the United States had just avoided a feared "double-dip" recession. Europe was in the news, with acute concerns over the feedback loop between weak economies, bank asset quality and sovereign finances. China's growth had moderated, and many feared it would decline sharply.

Since then, the world economy has continued its expansion. Growth in global GDP was a bit below trend in 2013, with reasonable prospects of some pick up this year. None of the downside scenarios that have exercised minds over the past couple of years have, as yet, come to pass. That doesn't mean they won't, only that the world economy has been climbing the "wall of worry" for a few years now.

Overall, in 2014 economic global growth is thought likely by major forecasters to be a bit 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 is probably a welcome re-balancing in some respects, after the weakness of the advanced countries in recent years.

The United States continues its recovery led by private demand and over the second half of last year the economy expanded at an annualised rate of just over 3 per cent. With the current agreement over the US Federal budget, one headwind from last year will abate somewhat. Of course there have been effects of the recent severe weather and it will still be a little while yet before US policymakers get a clear reading on the pace of expansion. But there is no obvious reason to expect that the expansion will be de-railed.

The euro area has resumed growth, albeit in a somewhat hesitant fashion and with noticeable differences in performance by country. Some quite pronounced adjustments to cost structures are occurring in some of the so-called "peripheral" countries, as needed under the single currency area arrangement. In Japan, the initial results of the policy measures over the past 18 months have been quite positive, though of course the proposed "third arrow" reforms are yet to be fully delivered.

The much anticipated "tapering" of the US Federal Reserve's monthly asset purchases commenced in December. The initial expectation of tapering in the middle of 2013 caused more market ructions than the event itself. That said, as often occurs when the Fed changes course, investors have taken the opportunity over this period to re-assess their positions and their appetite for risk.

So far, investors have not fled from risk indiscriminately. They have drawn distinctions between alternative classes of investment and the differing outlook across countries. Long-term sovereign yields for the core advanced countries remain low and, with compressed risk spreads, borrowing costs for many private-sector borrowers also remain low.

A few emerging economies have lately come under pressure, with bond yields spiking and exchange rates depreciating. In most of these instances, country-specific issues can be identified as sources of legitimate concern for investors. It is notable that the number of such countries under pressure is smaller than in the middle of last year, because some have made credibility-enhancing policy adjustments in the intervening period.

So far, so good, then for tapering. In my opinion, we should welcome it.

There is a tendency, though, to talk about "normalisation" of monetary policy in major advanced countries as though it is happening in all of them. It isn't: it is really only happening in the United States. Even there it is at a very early stage but the United States is actually on a path that neither the euro area nor Japan is even contemplating yet. In those jurisdictions, so far as I can tell, the discussion is about whether further easing may be in order. In fact were the Bank of Japan (BoJ) to step up its current program of quantitative and qualitative easing, it would soon be adding more cash to the global financial system, in absolute terms, than the Federal Reserve.

Intriguingly, the BoJ's actions attract rather less attention than the Fed's. I am not in a position to opine about whether or not such further easing might occur, but the point is simply that the monetary policy trajectories of the major currency areas could diverge, and increasingly so, over the next couple of years. One interesting question is how fully this possibility is reflected in major exchange rates.

Turning to the Asian region, China's economy grew close to, and in fact a little faster than, the government's target last year. Strong and about equal contributions to growth were made by household consumption and investment. Consumer price inflation continues to be stable.

Recent indicators have shown possible signs of slower growth in the early part of 2014: growth of industrial production slowed; retail sales and passenger vehicle sales moderated; and fixed asset investment growth was a little lower in January and February, though quite stable in year-ended terms. Given that the growth target was more than met last year, and given that the Chinese New Year holiday period makes it more difficult to assess trends in the data, it may be a little too early to draw strong conclusions. Spot prices for steel and iron ore have fallen lately though, on movements to date, seem within the range seen in recent years.

In fact, people may be too inclined to fret over what are still relatively small movements in monthly PMIs, and the like, in China. Sometimes they fret even more than they do over small bumps in the US economic data. The greater concern is the risks involved with the build-up of credit in so-called "shadow banking" over the past five or so years.

To a considerable extent this growth in financial activity surely reflects the natural tendency to avoid the effects of price and quantity constraints imposed on the core banking sector, in an environment of strong demand for credit.

In certain respects, it arguably provides genuine services to the economy. The potential problems, on the other hand, are all too familiar and well understood, at least in a qualitative sense. They include excessive maturity mismatches, where long-term loans are funded essentially by short-term borrowings; less-than-ideal transparency about asset quality; distorted incentives for provincial government entities; assumptions on the part of investors in wealth management products about major bank or government support – and so on.

Recent credit events in China have increased focus on the possibility of failure of entities with non-viable business models. There has been a widening of risk spreads for lower quality credits. To some extent this could be seen as a positive development, as a clear-eyed assessment and pricing of underlying economic risks is critical for sound longer-run development in China no less than in any other nation. But of course we cannot know how much further this re-assessment of risk may have to run, nor how disruptive it could turn out to be for the Chinese financial system and the economy.

It is clear that the Chinese authorities are across the issue, and in all likelihood they have the ability and resources to manage the situation. Some reforms have already been implemented, which will help to manage such risks in future, while steps taken to moderate the flows of total social financing seem, so far, to have had some success.

In the meantime, a broader set of other recent reforms represent further incremental steps towards greater financial market liberalisation: the removal of restrictions on most lending rates and some liabilities, with those on deposit rates expected to follow; the recent widening of the renminbi's trading band, as part of the central bank's commitment to let markets play a greater role in the economy; and the introduction of the Shanghai Free Trade Zone with some associated easing of capital account restrictions. These are all welcome moves and are in China's long-run interests.

Around the Asian region generally, at this stage, our sense is that economic growth is continuing at about its trend pace. All countries will be watching closely both developments in China and the impacts on capital flows and risk-pricing as the Fed tapers and other major central banks implement their own chosen policies.

Turning to the Australian economy, I continue to find a fascinating divergence between the views of foreign observers, especially in Asia, many of whom say to me "Australia is doing very well" and the tone of the commentary at home, which is typically a lot more pessimistic. My reading of the actual data is that they suggest that the economy has been doing a bit better than much of our domestic commentary over the past couple of years would have you believe, but not quite as well as many foreign investors seem to have thought.

Australia certainly weathered the financial crisis well, and with a real GDP some 13 per cent larger than it was at the beginning of 2009, compares well with many other advanced countries. It is the case, though, that growth while positive, has been running at a pace a bit below its trend pace for about 18 months now. The rate of unemployment has increased by something like a percentage point over the same period.

Most people are familiar with the fact that there have been very strong conditions in the natural resources sector. The biggest positive terms of trade shock in at least a century drove a mining investment boom of truly epic proportions, and that added a major impetus to demand in the economy. But the terms of trade peaked about two and a half years ago; the capital spending by the resources sector has also now peaked and is expected to decline significantly over the next couple of years.

In the rest of the economy, households have spent most of the past five years behaving more conservatively, or rather more normally, than they did over a long period up to the mid 2000s when they had been in a very expansive mood. Both consumption and residential construction have been soft for a while. I have spoken at length about these trends before and explained why they were to be expected. Nonetheless, many businesses exposed to those sectors, including retailers, builders and banks, have found the going harder. In addition, because the mining boom was associated with a very high exchange rate, other trade exposed sectors have also faced more challenging conditions.

Looking ahead, as the resources sector's capital spending continues to fall, it will be desirable to see some other sources of growth strengthen. One is export volumes for resources, which are already growing strongly, as the additional capacity put in place over recent years becomes utilised. 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. Exports will rise further over the coming year or two, as additional resource projects are completed and, at the margin, some other areas face slightly less of a headwind from the exchange rate.

It is unlikely, though, that a pick-up in resources exports, as important as that will be, will be enough to keep overall growth on the right track. It will be helpful if some of the other areas of domestic demand that have been subdued start to grow faster. For that to occur, households would need to have made progress on their desire to sustain higher saving, and to consolidate debt where needed. Businesses outside of mining would need to have made some progress in containing costs, and raising efficiency. They would also need a bit more confidence about the future than they did before, as a pre-condition to making plans to lift their investment and add to their workforces.

There are some promising signs in this regard. Recent data shows stronger household consumption over the summer. The latest surveys and our own liaison confirm this, and suggest that retailers are more optimistic than they were a year ago. That said, we expect consumption spending to grow in line with income or perhaps a little faster, but not at the pace seen in the years prior to the financial crisis.

We certainly see abundant signs of confidence in the housing market. Dwelling prices have seen a broad-based rise of 10 per cent in the past year and are now about 5 per cent above the previous peak in 2010. Initially this was not associated with very much at all in the way of faster housing credit growth. That has now picked up a little, though it remains far below the rates seen in the 1990s and 2000s. The pick-up is most noticeable for investors, who need to take care with the amount of leverage they take on.

It is clear that dwelling construction activity will rise strongly over the period ahead. Over the past three months, approvals to build private dwellings were at the highest rate for at least three decades. This increase is welcome, certainly at an aggregate level, since on most estimates Australia's additions to the dwelling stock have been running at a rate below population growth over recent years.

Measures of business confidence have improved over the past six months. Businesses seem, so far, to be taking a cautious approach to investment, however: they are waiting for stronger, more persistent signals of improved conditions before committing to significant increases in capital expenditure. That's actually pretty normal in a cyclical upswing. In their hiring decisions there are some early promising signs of improvement, though it is too soon to see much in the way of concrete evidence of stronger gains in employment yet.

So there is encouraging early evidence that the so-called "handover" from mining-led demand growth to broader private demand growth is beginning. Putting all this together, we think economic growth will continue, and may strengthen a little later this year and pick up further during 2015.

It is important to stress that this outlook is, obviously, a balance between the large negative force of declining mining investment and, working the other way, the likely pick up in some other areas of demand helped by very low interest rates, improved confidence and so on, as well as higher resource shipments. The lower exchange rate since last April and the improved economic conditions overseas also help.

Because we are trying to assess the balance between very different forces, however, there is inevitably a very substantial range of uncertainty surrounding this central outlook. That is simply unavoidable. The fact is that no one can say with certainty just how smooth a "handover" will occur. Nor can anyone pretend to be able to fine-tune it.

On inflation, our view is that it will be a little higher than we thought three months ago. This takes account of the most recent data, which was higher than expected, and allows that the result conveyed at least some genuine information. Nonetheless, we think it unlikely that this signifies persistent and serious inflation pressures. Unemployment has been rising, and will probably rise a bit further yet; growth in labour costs have slowed noticeably in response. Indeed, growth of the wage price index is around the lowest in the 15-year history of the measure. Measures of unit labour cost growth are correspondingly quite low. So, absent continually rising profit margins on the part of businesses, we don't see the conditions for persistently higher consumer price inflation, even though tradable goods prices are expected to rise due to the lower exchange rate. Measures of inflation expectations remain well-anchored and are around or below their long-run averages. Our view remains that the outlook for inflation, while a little higher than before, is still consistent with our medium-term target.

Trends in asset prices are an area to watch. In particular, we need to be alert to the possibility that the past year of strong rises in dwelling prices leads people to assume that this is the norm. Were such an assumption to lead to increasing speculative activity, accompanied by a renewed increase in household leverage with all the associated risks to the housing market and the economy more generally, that would be unwelcome. This is a theme discussed in some detail in our latest *Financial Stability Review*, released earlier today. We are watching this closely, and we remind people that house prices can go down as well as up. In fact there have been two episodes where prices fell for a year during the past decade. The Australian Prudential Regulation Authority will also be emphasising with lenders and their boards, as it has been for some time now, the need to maintain high lending standards.

There is, of course, the full panoply of other “risks” that can be identified. As always, the exchange rate is a source of significant uncertainty. Much of Australia’s outlook also depends on developments overseas. Further progress towards the full treatment of banking problems and the return to sustainable fiscal budgets in Europe will be important. With greater certainty in the United States over their fiscal policies and the path of monetary policy, the risks there may now be more on the upside. On the other hand, if some event – like a geo-political shock – led to a wider retreat from risk taking, this could have a significant dampening impact on the global economy. China’s outlook is important for Australia as, for that matter, it is for other countries. China is now the largest or second largest trade partner to most significant economies. Not only the way China manages the current financial issues, but its implementation of structural reforms, so as to maintain robust economic growth in the long run, will have an impact on all of us.

Our monetary policy settings have been unchanged since last August, at what by any standard is a very accommodative level. This is playing its part in supporting sustainable growth in demand, consistent with the inflation target. We have signalled that if the economy evolves in line with the present set of forecasts, a period of stability in interest rates could be expected.

Having said that, let me return to a more global perspective, to make the point that sustainable growth over the long run has to rely on more than just monetary policy. Strong long-run growth won’t be achieved in any country simply by manipulating interest rates (or, for that matter, exchange rates). Monetary policy’s main contribution over the long run is to provide a stable monetary standard. That is a necessary condition for strong growth but it is not a sufficient one. Nor will fiscal expansion serve as more than a temporary boost to growth. Indeed the limits to fiscal activism are surely all too clear in many countries now.

Other conditions need to be right for growth. These include ensuring the environments for competition, innovation and investment, including in human capital, are sound. In those areas, various other government policies must come to the fore.

That is the spirit in which the countries of the G20 recently committed to coming up with measures that could raise the level of world GDP by 2 per cent above what it would otherwise have been, over a horizon of five years. This isn’t to be achieved by a program of cheap money or debt-financed spending. Many of the needed measures are likely to be politically demanding for governments to introduce. But if signing up to the challenge helps to galvanise efforts for the sorts of reforms that need to be made, then it will have been a worthwhile initiative.

Thank you for your attention.