Glenn Stevens: Economic conditions and prospects

Speech by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the American Chamber of Commerce (Qld) AmCham iiNet Business Luncheon, Brisbane, 3 April 2014.

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Thank you for the invitation to be in Brisbane again.

Economic conditions in Queensland have been quite varied over recent years. In some ways the forces at work have been in parallel to those in the national economy. On the one hand, the expansion of the mining and gas sectors has driven strong growth in some of the regions. In the past four years, business investment in Queensland rose by 75 per cent, totalling $230 billion over that time and almost $70 billion during 2013 alone. The proportion of national investment occurring in Queensland has been unusually high.

Investment in the mining sector may now have peaked, but the capacity put in place is supporting strong growth in exports. Queensland's coal exports reached record highs over the past year and exports of LNG are expected to commence in late 2014.

On the other hand, more prudent behaviour by households, after an earlier period of fairly free spending and borrowing, has kept demand in the urban areas more restrained.

There was also a marked slowdown in the property sector in the southeast of the state, perhaps more so than in other states, which has been a dampener on economic activity. Part of the story here is that in an earlier environment of fairly easy access to credit, dwelling prices rose too high relative to incomes in some areas. There was also perhaps, in some instances, too much construction of the wrong sort of dwelling. Some people involved in or exposed to the property sector also had too much leverage. When credit conditions tightened and there were not enough buyers, prices fell and construction slowed down significantly. After growing at an annual average pace of 12 per cent between 2002 and the peak in late 2009, dwelling prices in Brisbane fell and remain around 5 per cent below their peak.

About a third fewer dwellings were constructed in the year to September 2013, compared with the peak in 2008. Building approvals have been relatively strong in the resource-exposed regions in recent years, but elsewhere in Queensland approvals for new detached houses are at around half the 2008 level.

This is something that American members of AmCham who are exposed to the US housing sector would have also felt over recent years. The US construction sector, while now established on the path of recovery, is still building only half the number of dwellings it was at the peak in 2006, and in fact is producing at two-thirds of the rate of 20 years ago.

At present there are welcome signs that the Queensland housing sector is now lifting off the bottom. But this has been a long cycle. The price of Brisbane dwellings was historically about 60–65 per cent of those in Sydney. At their peak some years ago they reached about 85 per cent of Sydney levels. Now they are back to about 60–65 per cent of Sydney levels again. The cycle has taken about a decade. That the cycle can be so drawn out is a salient lesson, including for those outside Queensland. Even if a full-blown crisis does not eventuate, as was true of Australia, overdoing it on housing on the way up is usually followed by a fairly extended period of working off the problems.

We have heard much of the effects of severe weather on the US economy over the recent northern winter, with these impacts complicating the task of assessing the strength of the US expansion. Weather events have also been important in Queensland in recent years, and some of them have been very costly. Not so long ago, the problems were those of floods (and indeed some areas of South-east Queensland experienced flooding over the weekend) but at present much of the State is in the grip of drought. Crops have been substantially reduced and the livestock industry will take a number of years to recover from reduced herds. Farm incomes are estimated to be falling to their lowest levels for at least three decades. I don't think this will complicate our task of reading the pace of the national economy as much as in the US case, but these are nonetheless significant effects in regional economies.

Our discussions with tourism operators, on the other hand, suggest that conditions have started to improve, partly as a result of the depreciation of the exchange rate since its peak. Over the year to September 2013, visitor spending in Queensland increased by more than 4 per cent, which is a little higher than its average historically. Tourism operators have also been tailoring their services to suit rapidly growing segments of the market, including the Chinese market, which grew by 25 per cent over the year to September 2013.

Speaking of tourists, there are some rather high-profile visitors coming here later in the year. For a few days in mid November, the city of Brisbane will be the focus of the world, when the leaders of the G20 come to town. I'm not sure, actually, whether you all know what you're in for! But on the weekend of 15–16 November, you can expect the biggest gathering of global leaders ever assembled in Australia to be in your city.

Australia can host this meeting with a strong reputation for economic performance. While you might not know it from the tone of much domestic discussion, most – if not all – of the G20 membership looks at our relative growth, financial stability, banking soundness and public finances with a good deal of admiration. This has given Australia, at the margin, just a little bit of additional credibility in putting forward our agenda.

Just what is that agenda?

In essence, it is about growth. The Australian presidency of the G20 is focused on trying to improve global growth, with a focus on enabling investment, including infrastructure investment, and enacting structural reforms to raise the potential growth of the economies of the G20. At their meeting in Sydney in February, the G20 Finance Ministers and Central Bank Governors agreed to come to future meetings with proposed policies that would have the effect of lifting the level of the G20's collective GDP by a little over 2 per cent by the end of five years.

Let me be clear what this means. The goal is that the level of real GDP in the G20 is 2 per cent (actually a little over 2 per cent) higher by the end of five years. That could be achieved by lifting the rate of growth by 0.4 per cent per year in each year, or by a little more than that in the out years if the reforms take longer to have their effect, which they probably would. It doesn't mean growth is 2 percentage points higher in each year (*that* would be a very big effect indeed).

Just in case you think this doesn't sound like such a big deal, let's contemplate the magnitudes. Were the 2 per cent aspiration to be achieved, it would mean something of the order of US$2 trillion of additional output in the world economy, something like 15 million extra jobs spread around the G20 countries, and hundreds of billions of dollars of additional revenue for governments. It's serious money.

Let's also be clear what this doesn't mean. This goal is not to be achieved by clever programs of cheap money devised by central banks. Nor is it to be the result of fiscal adventurism. We are trying to shift the conversation away from the "growth versus austerity" framing of recent years, which is ultimately a rather sterile discussion. No-one has ever achieved growth simply by austerity, but equally the approach of simply ignoring the gaping hole in public finances in many countries has reached the limits of its credibility. We need a refocused conversation, around doing things that spur growth potential, which would mean, among other things, that the accommodative policies of central banks could get more traction.

These things are, however, demanding. There is something of a tendency for governments, when asked to outline their growth plans, to list the things that they already want to do for political reasons, and then to claim that they will help growth. Some of those things may well help growth, but in fact many of the things that are needed to spur growth seem not to make it onto such lists. Things that boost competition in markets, that genuinely free up trade, that reform the governance and financing of infrastructure projects (and the pricing of use of infrastructure), that put retirement income streams on a sustainable footing, that re-align incentives, that allow exchange rates to be more market determined, that encourage labour market mobility and participation, that enhance human capital, and that minimise distortions from tax – many of these often don't make in onto "to do lists" in the way that perhaps they should.

So there is some hard thinking to do. Time will tell whether the countries of the G20 will rise to the challenge. But if not now, when?

These issues are very real ones for Australia. For we face considerable challenges. In saying this, I am not referring to the short-run ones, to do with the "handover" from mining to non-mining investment, as difficult a challenge as that is at present.

By now the proverbial pet shop residents are all talking about this: where will the growth come from after the mining investment boom ends? I suspect that plenty of the people who never thought the mining boom would do much to boost growth are among those asking the question of what will replace it as a source of growth.

I've spoken about this a good deal in other speeches, so I will not repeat the detail today. If we manage to absorb the upward phase of the biggest terms of trade boom in more than a century without overheating, and the downward phase without a slump, that would be a major achievement. We have, by and large, managed the first part and there are some promising early signs that things may turn out not too badly in the second. But early signs are just that: early. It is far too soon to think about counting any chickens yet. Let's also be clear that the capacity to fine-tune these outcomes is very limited.

Most importantly, for today's discussion, even if we do manage this episode as successfully as we might dare hope, major long-run challenges will remain. These are the things I want to highlight today, two of them in particular.

First, fiscal sustainability. The debate here has, I would have to say, been overly- focused on budget outcomes in particular years. The real issues are medium-term ones. Put simply, there are things we want to do as a society, and have voted for, that are not fully funded by taxes over the medium term, as is starting to become clear in the lead up to the May budget. Here I refer to the very important speech given last evening by my colleague, Treasury Secretary, Martin Parkinson.[1] Our situation is not dire by the standards of other countries but neither are the issues trivial. A conversation needs to be had about this.

Second, demographics. More people will be moving into retirement, and fewer people entering the workforce, over the years ahead.

Our regular discussion doesn't pay much attention to this. It's understandable that with very public announcements of job losses – albeit many of them several years into the future – people become worried about jobs. They ask: where will future jobs come from?

There are two things to say. One is they will come from areas we don't see yet. In the middle of 1991, at the low point of the last serious recession, people were very pessimistic about future employment prospects. The rate of unemployment was in double digits.

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[1] Parkinson M (2014), "Fiscal Sustainability & Living Standards – The Decade Ahead", Speech at The Sydney Institute, Sydney, 2 April http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2014/Fiscal_sustainability.

But today, over 20 years later, there are nearly 4 million more jobs in the economy than there were then. The rate of unemployment, even though it has gone up recently, is just slightly more than half what it was at its peak in the 1990s.

It's worth noting that none of those additional net jobs came from manufacturing.[2] The manufacturing sector in fact shed about 100,000 jobs over that 20-year period. But other sectors increased their employment. Mining employment tripled and that alone more than offsets the reduction in manufacturing, without taking into account the growth in construction, health care and a number of other services sectors where the number of jobs has roughly doubled. As of today, even with some recent weakness, there are more jobs in the economy than ever before.

The second thing to say is that, cyclical things aside, the more likely problem in the medium-term future won't be one of not enough jobs, but instead, not enough workers. At present the number of new entrants to the labour force after finishing education each year exceeds the number retiring. Ten years from now those numbers could be roughly equal, absent a further rise in labour participation in the older cohorts. The question will be less "where will the jobs come from?" and more "where will the workers come from?" It's true that migration adds to the workforce as well, though migration also adds to the number of people not working and retiring.

So demographic trends point in the direction of a smaller proportion of the population working, and a larger proportion needing support in their later years, even as other demands on the public finances for the provision of social goods increase.

That looks like a pretty uncomfortable combination of trends. How do we reconcile them?

The answer – the only answer – is growth. To some extent we will, hopefully, be able to lessen the problem through higher labour participation, for longer. But most of all we will need higher productivity of those working. That means making the system as flexible as possible and as encouraging as possible to innovation.

That's why the G20 agenda is very pertinent for Australia, notwithstanding that we have enjoyed 20 years of reasonably steady growth. I dare say it is for the United States too. We are not just talking idly about other countries lifting their growth as an intellectual exercise. We are asking how to lift our own trend growth performance.

For Australia, one potential source of productivity improvement lies in the very fact that across a range of sectors the level of US productivity is much higher than our own. There may be various reasons for that, some of which we may be unable to emulate. But it's hard to believe that there are not some, possibly substantial, "catch-up gains" available to us by adopting better practices.

For the United States, it is in some ways harder because generally it is the productivity leader, so "catch-up" is not available. Observers have differing views about the ability of the United States to push up its own productivity growth in future. My own view is that the United States remains an immensely innovative society, which I think is ground for cautious optimism.

In the end, increasing the potential growth of the G20 economies, and our own economy, is a challenge of the first order. The "2 per cent" goal, while subject to uncertainty and based on numerous assumptions and so on, nonetheless will hopefully force us all to confront the right set of questions.

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[2] That doesn't mean there were no new jobs in manufacturing – there undoubtedly were as the sector found things to do that it wasn't doing before, even as things it had been doing became uneconomic and those jobs were lost. I suspect, though I cannot prove, that many of the jobs in manufacturing today did not exist 20 years ago. But in net terms the number of people in manufacturing declined by around 10 per cent since mid 1991.

Before I finish, it is appropriate, particularly given the Financial System Inquiry now under way, to mention the role of finance in supporting growth. The Reserve Bank has made a submission[3] to the Inquiry. It points out that there are a few essential things that we want a financial system to do.

They are to:

- provide a way of exchanging value (i.e. payments services)
- transfer resources between savers and investors (intermediation), with appropriate monitoring
- transfer, price and manage risk
- provide liquidity services.

Over the past couple of centuries, the provision of such services has contributed to the accelerated pace of growth of living standards in the market economies. Recent history has been one of innovation and growth. The development of new products, efficiencies in process, and the use of information technology all held promise. They still do. Unfortunately, and this is stating the obvious, the problems that developed in the international financial system, due to serious shortcomings in key markets and institutions in some of the world's most important economies, have meant that finance has, globally, too often been growth-reducing over the past five years. Moreover, we have to question, in hindsight, the basis of some of the apparently easy growth for a few years before the crisis broke.

The world learned, or rather re-learned, the lesson that finance has its own cycle – of risk-seeking and then risk-aversion; of leverage and de-leveraging; of confidence, then over-confidence followed by fear or even panic. The financial system is capable of providing support for the economy and of helping it absorb shocks. But it is also capable of being a source of shocks itself.

That being so, it is not surprising that, internationally, the focus since 2008 has been one of repair, re-thinking and regulatory reform. It remains a big part of the G20 agenda, with some important milestones to be passed this year.

In Australia, our crisis experience was not as wrenching as for some other places. Our supervisory framework stood up to the test. Our key institutions proved to be robust and generally prudent behavior of our financial institutions stood us in good stead. Nonetheless, there were lessons to be learned, and adjustments to be made, both for supervisors and financial institutions. It is very much in our interests to absorb the lessons, and to make the sensible changes, including those that are part of international standards.

The Inquiry offers the opportunity to distil those lessons, and also to contemplate the future. A financial sector that reliably and efficiently offers the services the community needs – the "handmaid of industry" – is a boon to growth and prosperity, and can play an important role in achieving the growth we want to see.

[3] Available at <http://www.rba.gov.au/publications/submissions/fin-sys-inquiry-201403/index.html>.