Philip Lowe: Managing two transitions

Speech by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, at the Corporate Finance Forum, Sydney, 18 May 2015.

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Accompanying graphs can be found at the end of the speech.

I would like to thank Kevin Lane for assistance in the preparation of these remarks.

Thank you very much for the invitation to be part of this year's Corporate Finance Forum. It is a pleasure to be here and to be able to address so many of Australia's leading CFOs.

This morning, I would like to talk about two transitions.

The first is a domestic one – that is, the transition in the Australian economy following a period of extraordinarily strong growth in investment in the resources sector combined with record high commodity prices.

The second is a much more international one – and that is what seems to be a transition to a world in which global interest rates are lower, at least for an extended period, than we had previously become used to.

As CFOs, I suspect that you have a keen interest in both of these.

The transition in the Australian economy

So, first, the transition in the Australian economy.

I am sure you are all familiar with the basic story here.

In the middle of the previous decade, global commodity prices rose sharply, largely on the back of strong growth in China. In response, investment in the resources sector in Australia picked up considerably to take advantage of these high prices and Australia's endowment of natural resources, especially iron ore, coal and natural gas. These developments, which were interrupted briefly by the financial crisis of 2008 and 2009, can be seen clearly in this first graph (Graph 1). By 2012, mining investment, as a share of GDP, peaked at its highest level in at least a century.

The good news is that all this investment has considerably expanded Australia's capital stock, and thus our productive capacity. This is now flowing through into higher resource production and exports, and it will continue to do so for many years to come (Graph 2). In 2014, the tonnage of iron ore exported was double that of five years earlier, while the tonnage of coal exported was up 40 per cent over this same period. There has also been growth in LNG exports, although the really big increases still lie ahead of us. All up, growth in resource exports has contributed around 1 percentage point to annual GDP growth over recent years, and this is expected to continue into the foreseeable future, particularly as more LNG projects come on line.

However, the big lift in our capital stock is now drawing to a close and investment in the resources sector is declining towards more normal levels. Last year, it fell by 12 per cent and similar, or larger, falls are expected in both 2015 and 2016. At the same time, the increase in supply made possible by all this investment, both in Australia and elsewhere, has seen the prices of a number of our key exports decline significantly.

Importantly, when investment in the resources sector was at its peak, we avoided the economy overheating as it had in the past when we had much smaller resources booms. This was a significant achievement. In effect, other parts of the economy made way so that we could accommodate the large addition to the capital stock in the resources sector without the overall economy overheating. But now we are in a period of transition to the next phase.

In this new phase, these other parts of the economy could be expected to grow more strongly than they had during the investment boom.

In a perfect world, we might expect that this transition would be a perfectly seamless one – for non-mining activity to pick up at exactly the right time, and by exactly the right magnitude, to perfectly offset the decline in mining investment. In the real world though, things are not so simple, and it is perhaps unrealistic to expect that a transition of this magnitude could be fine-tuned so well as to keep the economy in perfect equilibrium. Over the past three years, GDP growth has averaged around 2½ per cent, and the RBA's latest forecasts, which were released around 10 days ago, have this type of growth continuing for a while yet (Graph 3). While in many other developed economies, growth of 2½ per cent would be viewed fairly favourably, it is below what we have become used to in Australia and it is below what we are capable of. As a result, there has been a build-up of spare capacity in the overall economy.

So, the transition that is taking place is not exactly seamless. However, we should have some confidence that a successful transition can be made, particularly given our flexible market-based economy. Among other things, this transition is being assisted by three developments: the lower exchange rate; restraint in aggregate wage growth; and the stimulatory setting of monetary policy.

In terms of the exchange rate, over the past two years the Australian dollar has depreciated by around 20 per cent on a trade-weighted basis and by around 25 per cent against the US dollar. We are now starting to see signs that this depreciation is boosting activity in various parts of the economy. One of these is tourism, with exports of travel services rising again, as more people visit Australia and spend more money here (Graph 4).[1] Conversely, imports of travel services have declined as more Australians holiday domestically. The lower exchange rate has also improved prospects in a number of other export-oriented industries, including some parts of manufacturing, agriculture and even mining.

The second factor helping with the transition is modest wage growth. Over the past couple of years, aggregate wage growth has slowed noticeably and it is now running at the slowest pace in many years (Graph 5). While this means that average living standards are not increasing at the rate they were during the investment boom, the slower growth in wages is helping to improve the competitiveness of the Australian economy. Lower wage growth, by supporting employment growth, is also helping to share the burden of adjustment across the broader community. In this context, it is notable that for the past nine months, employment growth has been strong enough to keep the unemployment rate broadly steady, even though GDP growth has been below average.

The third factor assisting with the transition is the low level of interest rates. The effects are perhaps clearest in residential construction which increased by 8 per cent in 2014. And with building approvals continuing at very high levels over recent months, particularly for apartments, we can look forward to further increases in construction activity over the months ahead (Graph 6).

Low interest rates are also helping to boost household consumption. They are doing this by improving the aggregate cash flow of the household sector and boosting household wealth. However, as I have spoken about previously, the overall effect on consumption is probably smaller, or at least slower, than it was in the past.[2] This is because high debt levels mean that households are less inclined than they once were to respond to low interest rates by borrowing to increase their spending. Notwithstanding this, there is still a spending response

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[1] Some of this rise is also related to a pick-up in education-related travel following changes to arrangements for student visas since 2012.

[2] See Lowe P (2015), "Low Inflation in a World of Monetary Stimulus", Speech to the Goldman Sachs Annual Global Macro Economic Conference, Sydney, 5 March.

to low interest rates and household consumption rose by nearly 3 per cent in 2014. This is slower growth than in the period from the mid-1990s to the mid 2000s, but it is faster than current growth in real household income.

The part of the transition that is taking place more slowly than we had earlier expected is the lift in business investment outside the resources sector. As a share of GDP, non-mining business investment remains just above the levels reached in the recession of the early 1990s (Graph 7). For a few years now, each time we have updated our forecasts, we have pushed out the timing of the recovery in this part of the economy. The latest update was no different. Many businesses tell us that while conditions are okay at the moment, they are not sufficiently strong for them to lift their investment plans. Many feel uncertain about the future and so are waiting until there is a sustained pick-up in demand before committing to new capital expenditure.

There is no single factor driving this tendency to wait and a similar story seems to be playing out in many other advanced economies. Around the world, many businesses seem concerned about the prospects for consumer demand given high levels of debt and the ageing of the population. There is also uncertainty about what type of capital investment is appropriate in a world where new information technologies are reshaping business models. Many firms also see globalisation of markets as a challenge, especially where increased competition has reduced market power.

Overall then, a lift in non-mining investment remains the critical ingredient to stronger growth in the overall economy and to a successful transition. Many of the preconditions for this to occur are in place, although a sustained lift still seems some way off. I will return to this issue in a few moments.

The transition in global interest rates

But I would now like to turn to the second transition that I mentioned at the outset – that is, to a world in which global interest rates are lower than we had previously become used to.

Perhaps the best way to see this is with a couple of graphs. The first shows the average policy rate set by the US Federal Reserve, the European Central Bank and the Bank of Japan (Graph 8). With all three central banks setting their policy rate at, or very close to, zero, the average global policy rate is the lowest on record. The next graph shows the yields on 10-year government bonds in the United States, Germany and Japan (Graph 9). Again, in all three cases these rates are at extraordinarily low levels, even after the increases over recent weeks.

These very low rates mean that savers investing in risk-free assets earn negative real rates of return. They also mean that the time value of money is negative. And they mean that there is no compensation for postponing consumption to tomorrow.

So, how do we find ourselves in this remarkable situation?

The proximate cause is the decisions taken by world's major central banks to set their policy rates at these historically low levels and to buy unprecedented amounts of assets from the private sector. But central banks do not act in a vacuum. They respond to the world in which they find themselves. And, that world is one in which there is an elevated desire to save relative to the desire to invest. And when the appetite for saving is high and few people want to use those savings to invest in new assets, the return to saving is, unfortunately, inevitably low.

We should all hope that this period of extraordinarily low interest rates does not persist for too much longer: that, over time, confidence lifts and once again businesses compete strongly for the world's available pool of savings to fund investment in productive assets. Once this happens, higher returns will again be offered to savers. My own view is that there is a reasonable prospect that, in time, this will indeed take place and that some normalisation of interest rates will occur.

But it also seems plausible that the average return on savings, at least for a protracted period, will be lower than it had been previously. The population in many countries is ageing, aggregate household indebtedness is high and many of the service industries that are growing relatively quickly are not particularly intensive in physical capital. Taken together, these trends might be expected to boost the desire to save relative to invest and thus lead to a structurally lower level of global interest rates than otherwise.

Of course, we can't be sure that things will play out like this. Many other factors influence global saving and investment decisions, including what happens in the populous developing countries in Asia. But what we do know is that even if the current low level of interest rates is entirely cyclical – and has no structural element at all – it is proving to be highly persistent indeed.

As CFOs, I suspect that for many of you this is complicating your job and posing new questions and challenges.

In this context, I would like to touch briefly on three issues.

The first is the challenge that low interest rates pose to anyone who is seeking to fund future liabilities. Low interest rates mean that the present discounted value of these liabilities is higher than it once was. In turn, this means that more assets are needed to cover these liabilities. For anyone managing a long-tail insurance business or a defined benefit pension scheme, this is a major challenge. It is also a challenge for retirees and those planning for retirement.

The second issue is the effect of low interest rates on asset prices. Just as low interest rates increase the value of future liabilities, they increase the value of a given stream of future revenue from any asset. The result is higher asset prices. Another way of looking at this is that faced with low returns on risk-free assets, investors have sought other assets, and in so doing they have pushed up the prices of these assets. A good example of this is commercial property, where investors have been attracted by the relatively high yields, pushing prices up even though rents are declining (Graph 10).

A rise in asset prices is, of course, part of the monetary transmission mechanism. But developments here need to be watched very carefully. History is littered with examples of unsustainable asset price rises emerging on the back of perfectly justifiable increases in prices. In a number of cases, this has ended badly, especially if there is leverage involved. Also, we should not lose sight of the fact that interest rates and the returns generated from assets are ultimately linked to one another. So, interest rates may be structurally lower in part because the stream of future income generated from assets is also lower than in the past. This would have obvious implications for the sustainable level of many asset prices.

The third issue is the effect of low interest rates on firms' investment decisions and hurdle rates of return. In today's environment, it seems that many investors have, reluctantly, come to accept that they will earn lower yields on their *existing* assets. An open question though is whether the same acceptance of lower returns is flowing through to firms' decisions about the creation of *new* assets – that is, their own investment plans.

The international evidence is that the hurdle rates of return that firms use for new investment are quite sticky and that they are not very responsive to movements in interest rates.[3] There is less evidence of this issue in Australia, but a recent survey of CFOs by Deloitte hints at the

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3 For example, see Sharpe S and Gustavo Suarez (2013), "Do CFOs Think Investment is Sensitive to Interest Rates?", FEDS Notes, 26 September. Available at <http://www.federalreserve.gov/econresdata/notes/feds-notes/2013/do-cfos-think-investment-is-sensitive-to-interest-rates-20130926.html>.

same conclusion. The survey results suggest that hurdle rates of return on new investment are typically above 10 per cent and sometimes considerably so (Graph 11). The results also suggest that the average margin between the hurdle rate of return and the weighted-average cost of capital is about 3 percentage points. As part of the survey, firms were also asked how often they changed the hurdle rate, with the most frequent answer being “very rarely”. These findings are very similar to those reached through the Bank’s own extensive business liaison program.

One issue that this raises is what is the appropriate hurdle rate of return in a world of persistently low interest rates? Each CFO will no doubt have a different answer to this, but in a world of persistently low interest rates, it may well turn out that the average answer is – or should be – lower than it used to be.

Recently, in a number of countries there has been a tendency for firms to return funds to shareholders. These firms are effectively saying to their shareholders, “here, you manage the money, as we do not have investment opportunities that satisfy our internal rate of return.” In many cases, shareholders have welcomed this, seeing it as a disciplined approach to capital management. The difficulty is that if the majority of firms act in this way, shareholders in aggregate get left holding the cash. And, on that cash, they earn very low rates of return – almost certainly lower than the rate of return that would, on average, be earned if that cash were invested by businesses in real assets. This is really just another way of saying that if the appetite for investment is low, savers, in the end, will get low returns on their savings.

So, as I said, this world of low interest rates is creating many challenges for you as CFOs – whether you are a CFO needing to fund future liabilities, a CFO valuing and managing assets or a CFO determining the appropriate hurdle rate of return for your firm’s investment decisions.

This world is also creating challenges for managing the first transition that I spoke about – that in the Australian economy.

The large monetary expansion abroad and low interest rates of the major central banks have meant that the value of the Australian dollar has been higher than would otherwise have been the case. In this context, it is difficult to escape the conclusion that a further depreciation of the Australian dollar would be helpful in the transition of the Australian economy.

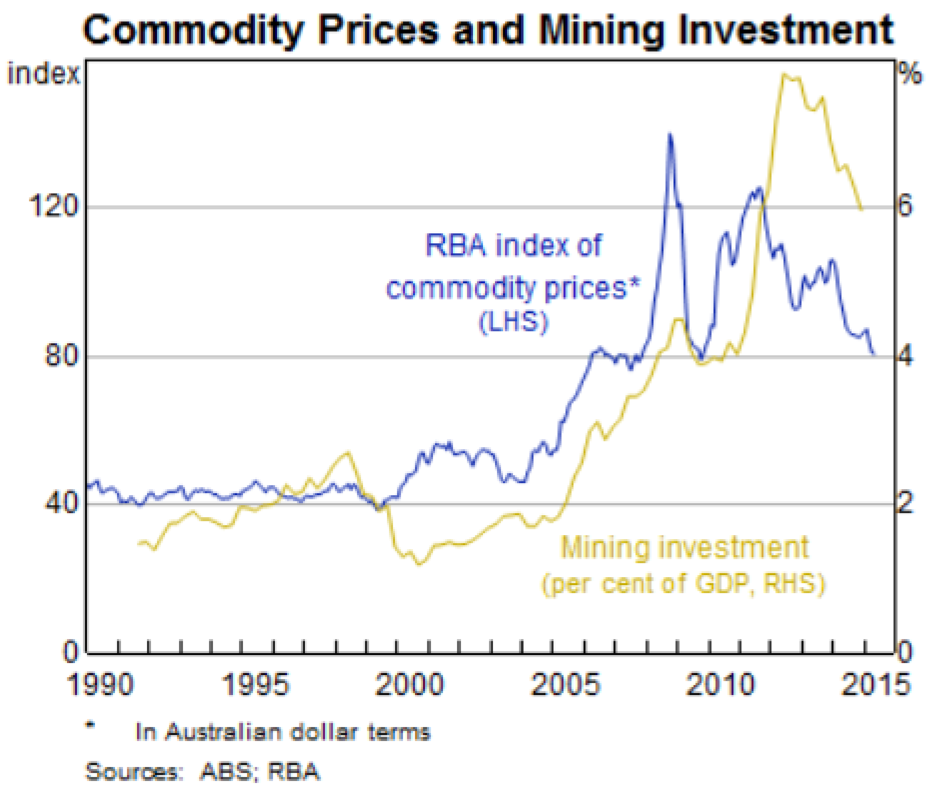
In this challenging global environment, the RBA is seeking to play a constructive role. As I said earlier, low interest rates are supporting spending in the economy. The further reduction in the cash rate earlier this month will provide a bit more support and it will help reinforce some of the recent encouraging signs, particularly in household spending. In time, stronger consumption growth and a continuation of the pick-up in residential construction should lead to a lift in business investment.

It is, however, unlikely to be in Australia’s long-term interests to engineer a consumption boom by encouraging people to borrow large amounts against future income. This is especially so when debt levels are already high and prospects for future income growth are not as positive as they once were. So, there is a fairly fine line to tread here. The RBA’s recent decisions have sought to strike a prudent balance – to help encourage consumption growth and thus business investment, but avoid the type of imbalances that could cause problems later on. We will continue to assess that balance carefully.

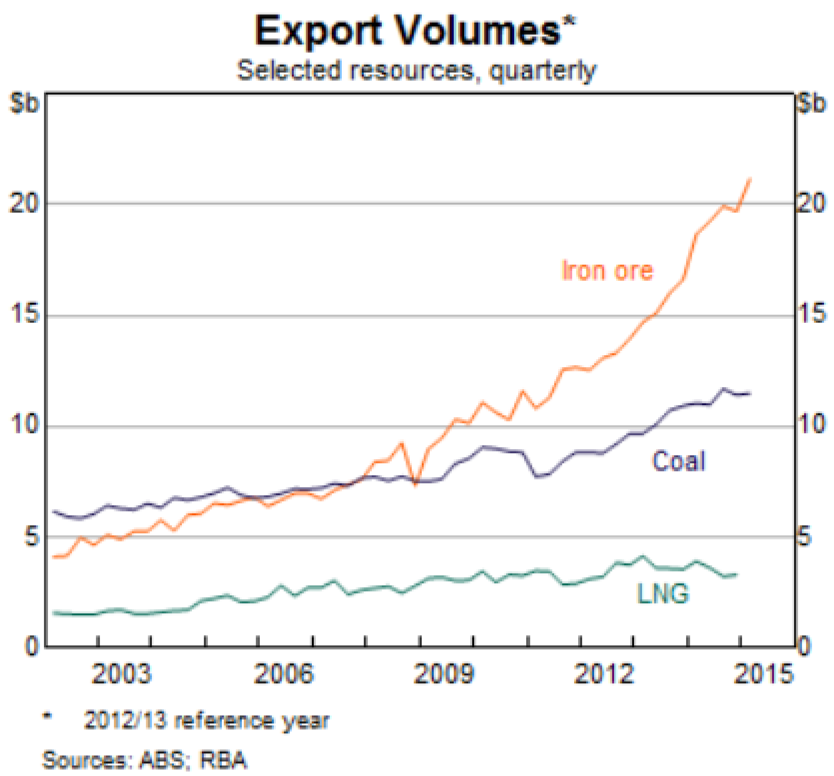
Of course, the more enduring solution to the two issues I have talked about – the transition in the Australian economy and low returns to savers – is an improvement in the underlying investment environment. This is a challenge not just in Australia, but in almost all advanced economies. Unfortunately, there is no magic lever here, but the good news is that the task is not an impossible one!

Thank you for listening and I would be happy to answer your questions.

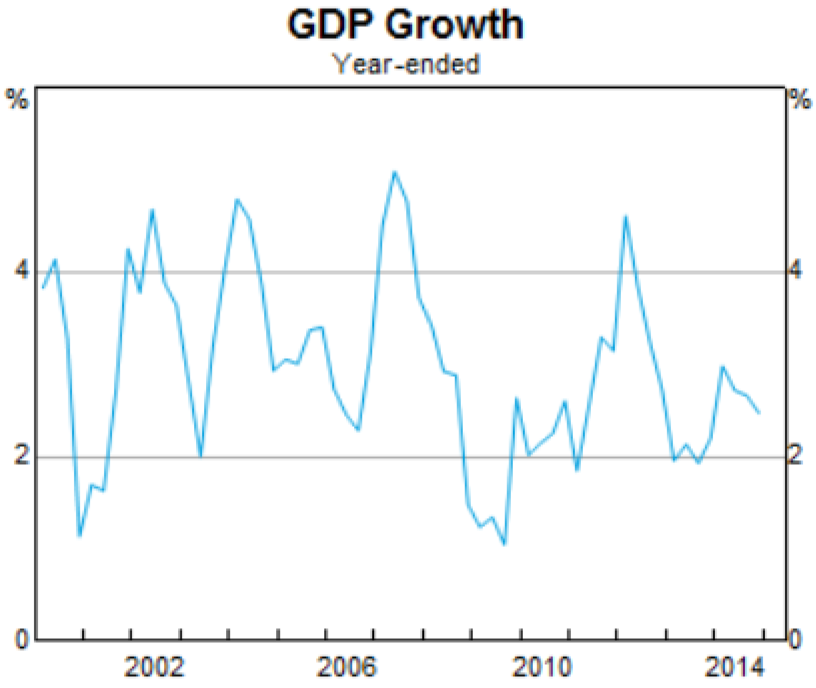
Graph 1



Graph 2

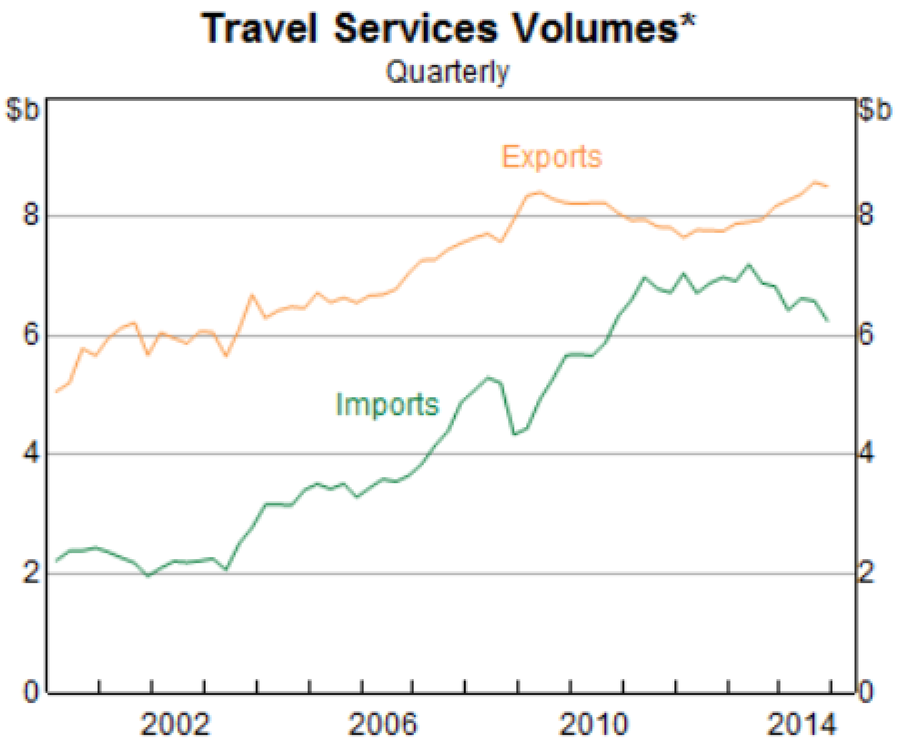


Graph 3



Source: ABS

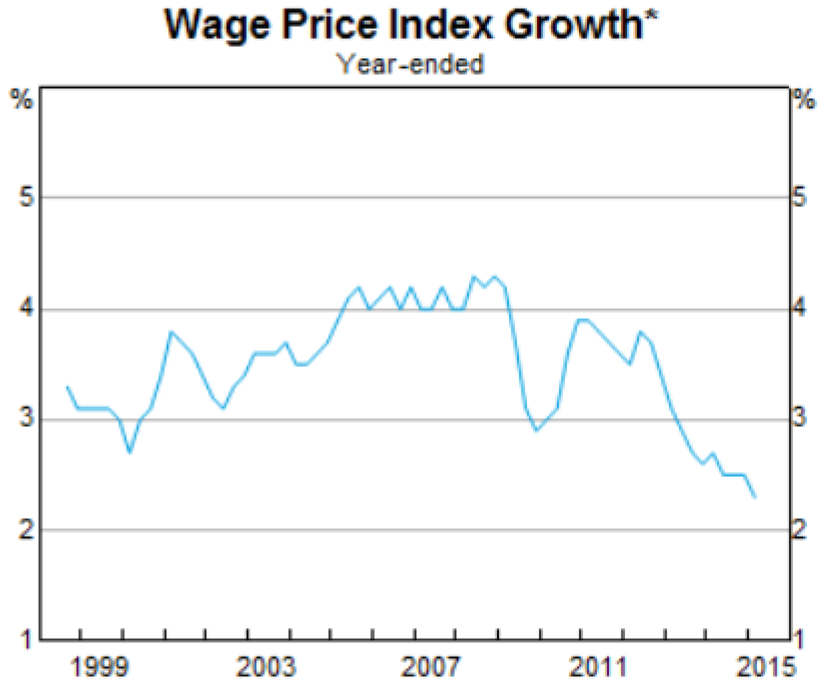
Graph 4



* Reference year is 2012/13

Sources: ABS; RBA

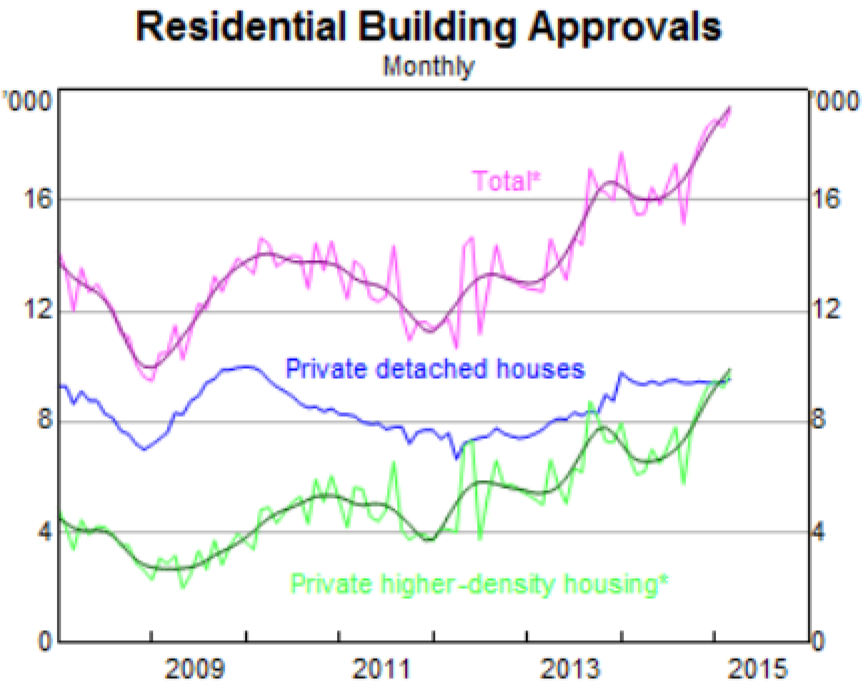
Graph 5



* Excluding bonuses

Source: ABS

Graph 6



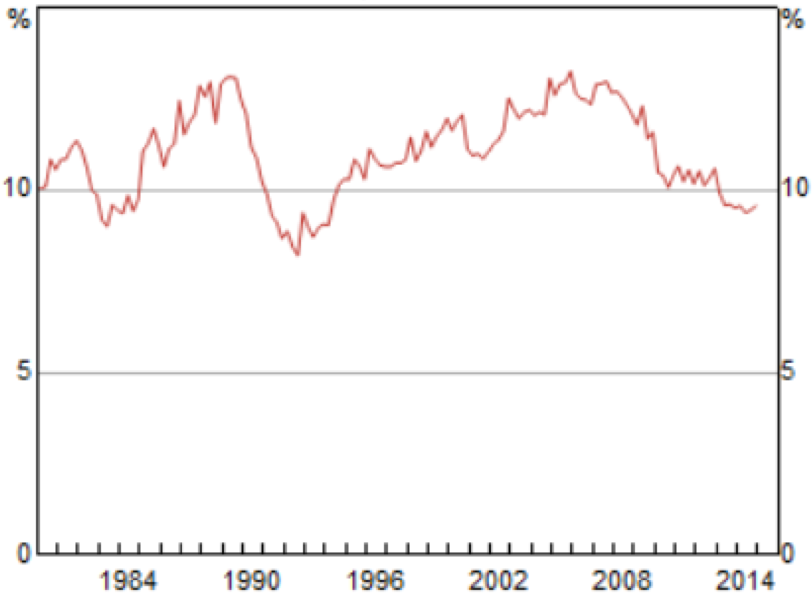
* Smoothed lines are 13-period Henderson trends

Sources: ABS; RBA

Graph 7

Private Non-mining Business Investment*

Nominal, share of GDP

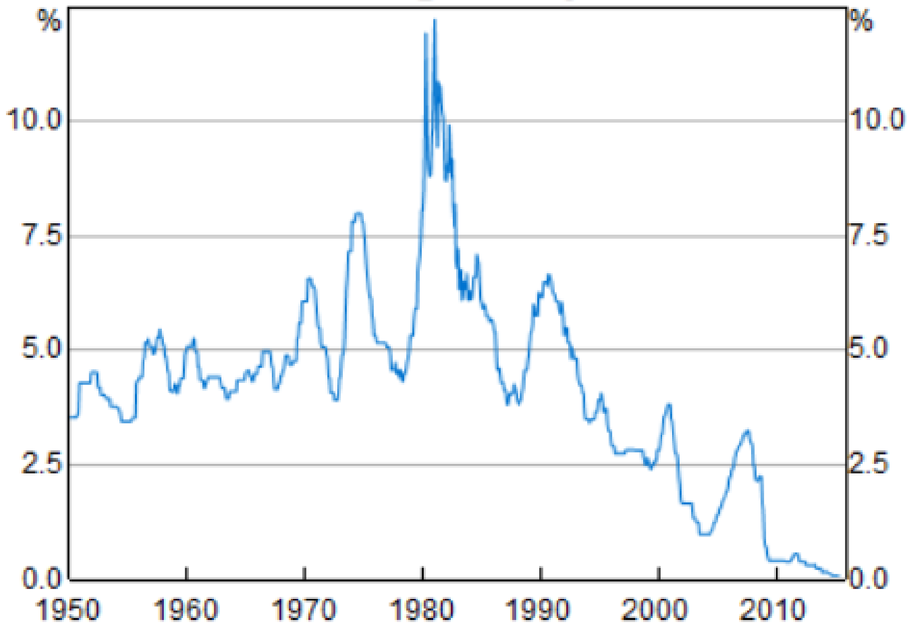


* Adjusted for second-hand asset transfers between the private and other sectors; excluding cultivated biological resources

Sources: ABS; RBA

Graph 8

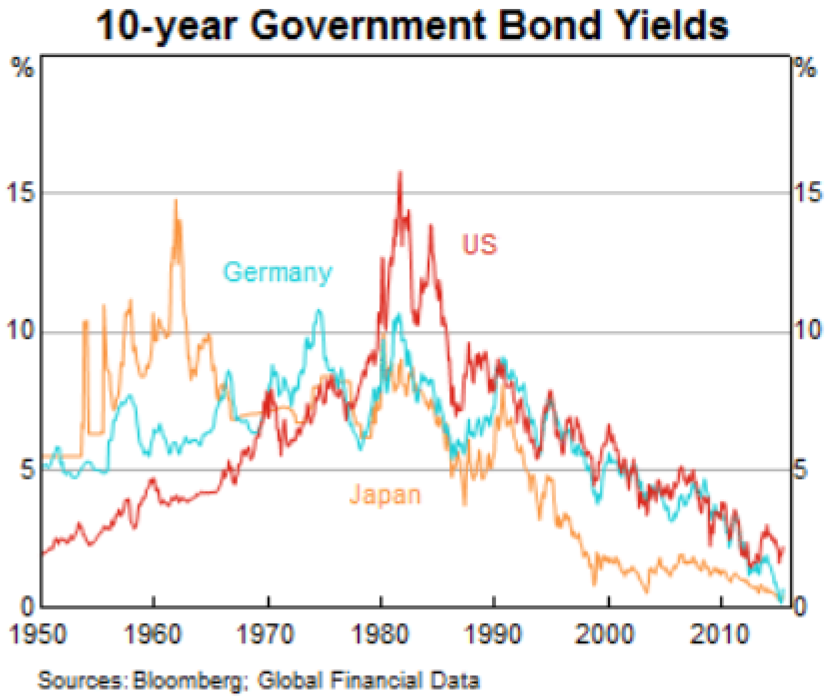
G3 – Average Policy Rate*



* Euro area rate is the Bundesbank discount rate prior to 1997; since April 2013, the Bank of Japan's main operating target has been the money base

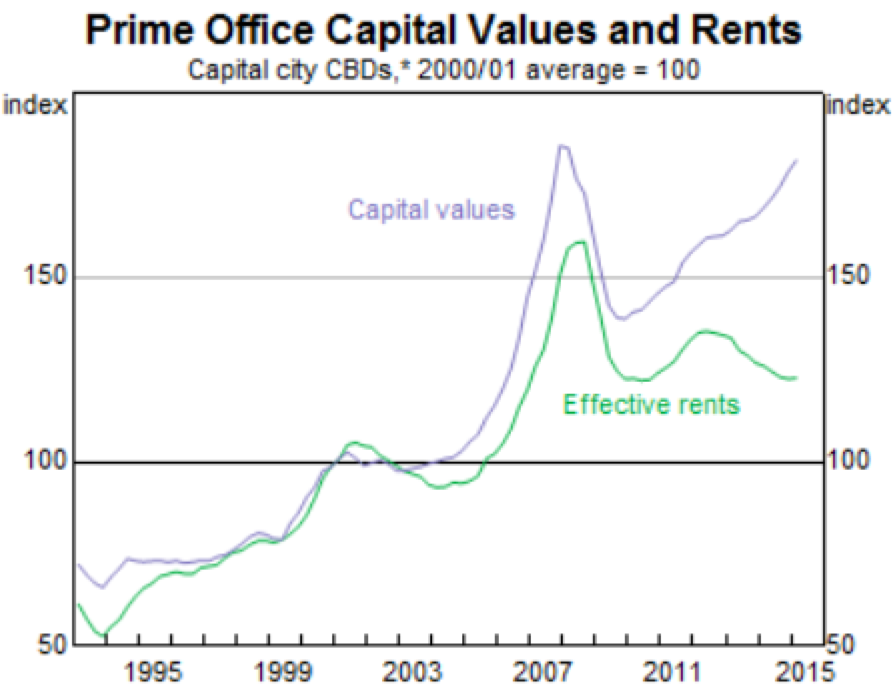
Sources: Global Financial Data; RBA; Thomson Reuters

Graph 9



Sources: Bloomberg; Global Financial Data

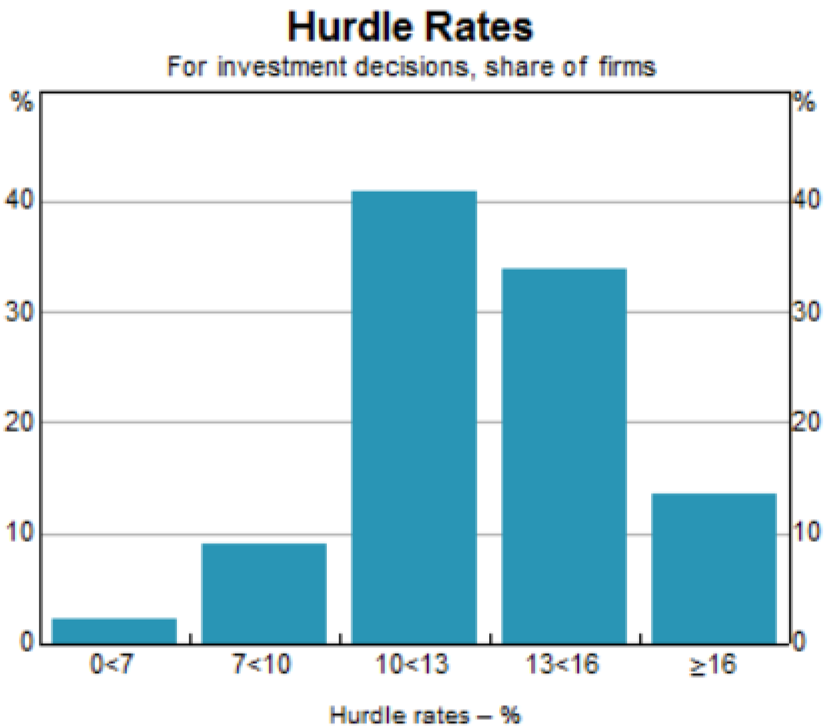
Graph 10



* Excluding Darwin and Hobart

Sources: JLL Research; RBA

Graph 11



Sources: Deloitte CFO Survey; RBA