Glenn Stevens: The path to prosperity

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, at the 2015 Economic and Social Outlook Conference, organized by The Melbourne Institute and *The Australian*, Melbourne, 5 November 2015.

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Thank you for the opportunity to take part in this conference.

The previous occasion on which I spoke at this event was six years ago (to the day, as it happens) in 2009. That conference carried the title "The Road to Recovery". The background was that we had experienced a downturn in the economy at the end of 2008, at a time when the global economy went into a serious recession. For some months thereafter public discussion about the economy contained a good deal of fretting and debate over whether the word "recession" should be used to describe conditions in Australia. I certainly used the term myself.

But by November 2009, it was pretty clear that the recession had been short and shallow, and that we were in fact already on the road to recovery. The issue then was managing the next phase – ensuring that the road to recovery joined the path to prosperity.

At that stage, of course, what has been referred to as "mining boom mark II" still lay ahead. The terms of trade had fallen by close to 20 per cent from their 2008 peak, but had stabilised. They would rise by 40 per cent over the ensuing two years. Resources sector capital spending declined over 2009 but would more than double over the next several years, reaching the highest share of GDP for at least 150 years. These were much bigger increases than we expected at the time.

An unusually long and strong search for yield in global capital markets, driven by ultra-easy monetary policy in the major jurisdictions, was just beginning. By and large this continues today, perhaps more so than we would all have hoped in 2009. The European crisis, which would challenge the very foundations of the European project, was, in late 2009, still to come.

So there were some surprises in store over the ensuing six years.

Nonetheless, some of the features of that next phase and the issues in managing it were reasonably apparent.

It was clear that the remarkable growth of China was a powerful force and that Australia was becoming much more exposed to that growth – which was a good thing, but not without some risks.

It was clear that there would need to be a focus on structural reform.

It was clear that improving housing supply for a growing population and infrastructure for a growing economy generally would be a key theme.

It was clear that there would need to be a significant effort at restoring the state of the budget, so that fiscal expansion would again be possible in the face of a future shock, as it was in 2008 and 2009.

All these things were said at the time.[1]

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[1] See Stevens G (2009) "The Road to Prosperity", Address to the 2009 Economic and Social Outlook Conference Dinner (The Melbourne Institute and *The Australian*), Melbourne, 5 November.

Where are we, then, six years on?

The world economy, despite various threats, has not had a relapse into recession. Even with something of a slowing this year, global growth is still proceeding at a moderate pace.

That said, this growth has taken extraordinary policy settings to achieve and many policymakers and observers find the outcomes disappointing. Most countries around the world would like some more growth. But they can't all get it by just exporting to others and focusing their own demand inwards. And, for a variety of reasons, policymakers are finding the effectiveness of policies aimed at boosting domestic demand more limited than they might have hoped. In some cases the efforts that have been made to foster growth have not been without a degree of risk.

For our part in Australia, we have managed the biggest terms of trade event for more than a century with, so far, some success. History has many examples of such booms that, ultimately, were not successfully managed and which ended badly. It's easy to see how that happens. A gift of higher national income comes our way as a result of the discovery of natural resources or a rise in demand for them. The higher income permeates through the economy and before long even industries and regions not directly exposed to that shock are feeling good. Human nature being what it is, we tend to assume that the good times will continue and we borrow and spend accordingly. Credit growth speeds up, leverage increases, usually inflation increases. And then the terms of trade turn down, at which point the whole process goes into reverse – and a serious downturn ensues.

The current episode is not yet over. But from what we can observe thus far, we can say two things. First, we did not see the same excesses on the upswing as we did in other similar episodes.[2] This has to put us in a better position to manage the inevitable down phase. Second, in the down phase we are still managing to grow. We are probably roughly halfway through the decline in resources sector capital spending now; the headwinds from that source are about as intense now as they are likely to get. We are still growing. It would be good if the growth was a bit stronger, but nonetheless over the past year the non-mining side of the economy has generated respectable growth in employment. The 'rebalancing' is occurring. It isn't as seamless as it would be in an ideal world, but we don't live in such a world.

Monetary policy is contributing to that rebalancing, consistent with its mandate, with a very accommodative stance. It seems likely that an accommodative stance will be appropriate for some time yet. Were a change to monetary policy to be required in the near term, it would almost certainly be an easing, not a tightening. The rate of CPI inflation is clearly no impediment to easing. The housing market may be calming, lessening risks from that source, though by how much and how persistently we cannot yet know.

This is perhaps an opportune moment to offer some observations about the recent change in mortgage interest rates on the part of the major, and some smaller, banks and in particular the question of whether the Reserve Bank should respond to it with a decline in the cash rate.

On some other occasions, the Reserve Bank has moved the cash rate by more than otherwise to take account of changes in the relationship between the cash rate and other interest rates. One such occasion was in May 2012, when the Reserve Bank Board wished to ensure that the economy received a worthwhile stimulus from a policy easing after a period in which lending rates had tended to increase even while the cash rate had been steady. The Board wanted to make sure that financial conditions would move to a clearly easier position than they had been when the cash rate had previously been lowered, five

2 Indeed, Rees and Kulish (2015 RDP) suggest that households behaved as if much of the shock was temporary.

months earlier. So on that occasion the Board decided on a larger than normal reduction in the cash rate.

The question that is relevant for the Reserve Bank Board at present is, first and foremost, whether the recent changes in mortgage rates result in an effective set of financial conditions that is "too tight" for the economy.

In addressing that question, it's worth noting that over the course of 2014 and 2015, effective rates on most loans tended to decline by more than the cash rate, reflecting both declining funding costs and increased competition to lend. For fixed rate mortgages and many business loan rates the fall was quite marked. The average rate on outstanding business loans, for example, fell by over 90 basis points during a period in which the cash rate fell by 50 basis points. Even for floating rate mortgages, rates had fallen a bit more than the cash rate.

The actions of those banks that have lifted mortgage rates over recent weeks reverse a little under half of this year's decline for floating rate mortgages for owner-occupiers and have no effect, at this stage, on the 15 per cent of loans with fixed rates. For investors in housing, these actions and those a month or two earlier reverse the effects of this year's monetary policy easing but, of course, this was the lending that had been growing most quickly. Business loan rates have not risen.

Measuring across the total loan book, the recent actions are the equivalent of roughly half of one 25 basis point monetary policy change. They take back perhaps a quarter of the extent of interest rate easing seen since the start of this year, and a smaller proportion of the total easing in lending costs seen over the past two years. For mortgages, this increase is from the lowest rates that any current borrower will have ever seen. As it is, there are still a number of mortgage products with rates not much above 4 per cent, even a few advertising a "3" before the decimal point.

We also note that a significant proportion of owner occupier households is ahead of schedule on mortgage repayments – in large part because these households did not lower their payments as interest rates fell. Most of these households are unlikely to need to part with extra cash each month as a result of the recent interest rate changes. (Equally, many of these households were probably not boosting spending as interest rates fell, instead allowing their loan principal to fall faster.)

As for the general environment, according to business surveys conditions outside mining have been slowly improving, not deteriorating. So it is not as though the increases in mortgage rates are compounding the effects of a serious deterioration in economic conditions overall.

Could the "shock" value of the rises in mortgage rates itself lead to a significant change in that trend, gentle as it is, of improvement? While such an outcome is perhaps conceivable, given the starting point and all the above considerations, it seems to me a bit of a leap to draw that conclusion.

At this point, then, my preliminary assessment is that the macroeconomic effect of these actions in themselves may not be large. It is one part of a much bigger and evolving landscape. Nonetheless, the Reserve Bank Board will keep this matter, and that broader landscape, under careful review.

Let me be clear that in making these comments I am not offering an endorsement of the banks' actions. Nor should an assumption that shareholder returns must not decline as a result of the effects of supervisory measures, or any other factor, simply be accepted without question. The "right" rate of return for bank shareholders is, as others have observed, an open question. It is not a constant of the universe.

Returning then to the general theme of "where are we, six years on?", my next observation is that many of the points that were being made at that time remain as relevant today as they were then.

The Australian economy's exposure to China has increased, as was understood then. So China's prospects matter more. The current rate of growth of the Chinese economy is uncertain, as is its future growth rate. Chinese policymakers are attempting a profound transition in the growth model while dealing with some legacy issues (such as a substantial debt build-up) arising from the previous model. It is likely that the marginal steel intensity of China's growth will be lower in future than in the past. Some suggest that Chinese steel consumption, which has fallen this year, may continue to do so. At the same time, the marginal propensity of the Chinese people to consume services is rising noticeably. So the challenge for Australian resource producers to be the most efficient suppliers in a world of slower growth in demand for resources will co-exist with greater opportunities for other firms to offer value added in services.

The challenges of adjusting the responsiveness of our economy and developing its infrastructure, noted six years ago, are still relevant. To say this is not at all a suggestion that nothing has been done in the interim, but the importance of productivity performance for growth in living standards has become progressively clearer as the terms of trade have fallen. The effects of population ageing, moreover, while slow moving, are now occurring. There is perhaps more of an edge in the productivity discussion just lately, as there should be.

On infrastructure, there are some encouraging developments and a degree of expectation is building. Without wanting to dampen the enthusiasm in any way, I simply repeat that the key issue is not funding. The key issues are: governance, appropriate risk sharing and pricing.

The need for medium-term budget repair also remains. Here also progress has been made, and the budget deficit at present still compares favourably with what we see in many other countries. But my sense is that a fair bit of the necessary national conversation about how we pay for all the things we have voted for lies ahead. This doesn't imply a need for radical immediate action, but I suspect it does mean an unusually long period of tight budget discipline on recurrent spending is likely to be required.

Perhaps the main message is that the nature of the path to prosperity doesn't seem much different today from what it was six years ago. Macroeconomic policies can provide a measure of counter-cyclical stabilisation, but they can't serve as a magic bullet to achieve sustained growth in living standards. And with the terms of trade-driven improvements now behind us – and at least partly reversing – productivity is the main game.

Gains in productivity come in part from improvements to the way we do the things we currently do, in part from stopping doing things we are not very good at and doing more of things we are good at. It's understandable that this is often seen as a threatening notion and it is certainly disruptive when adjustment has to happen in a short period. It is unrealistic, though, to think the pressure to adjust will simply go away.

But equally importantly, gains will come from doing completely new things – the provision of new products to meet people's changing desires and needs. These will also, in time, be sources of major employment opportunities. The answer to the question "where will the jobs come from?" is usually: from lots of places we haven't thought of yet.

Many of the jobs in the economy today are in activities that few predicted 25 years ago. Few would have foreseen the vast growth in employment in a range of industries that provide services to both households and businesses. For example, employment associated with computer system design and related services has quadrupled as a share of total employment over the past 25 years. Few would have anticipated the rapid rise in employment related to social media, cloud computing and the creation of apps or other services related to environmental sustainability, to take just a few examples. It will also surely be the case in the future that jobs will come from unexpected places and new occupations will continue to emerge.

The questions then are whether Australian businesses and their workforces have, or can acquire, the necessary capabilities to offer those services and perform those jobs; whether the incentives they face to do so are adequate; whether the public policy framework appropriately encourages risk-taking and entrepreneurship; and so on.

No doubt various aspects of “reform” are needed to ensure the answers to such questions are in the affirmative. As on other occasions when “reform” has been discussed of late, my suggestion would be that such reforms are most likely to succeed – that is, to be implemented in a durable fashion – when the conversation is framed within a narrative about growth. Hopefully your deliberations today will contribute to that narrative.