# Glenn Stevens: Summary of economic developments during 2015 and outlook for Australia

Opening statement by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Sydney, 12 February 2016.

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Chair

Members of the Committee

Since the Committee's previous meeting in September, we have continued to see evidence that economic activity outside the resources sector has been gradually improving. The pattern observed six months ago whereby business surveys were suggesting improving conditions by and large continued through to the end of the year.

Inevitably, this expansion is not uniform across the country or across industries. Areas that led the growth dynamic a few years ago are on the trailing edge now. Conversely, some that were subdued for a few years are among those leading growth today.

But few, if any, expansions are completely even, either geographically or by industry. Given the nature of the economic events through which we have been living, moreover, it is not surprising that there are differences. The good thing is that there are strong areas to counteract the weak ones.

The available information suggests that real GDP is expanding at pace a bit lower than what we used to think of as normal. Our estimate is that growth over the four quarters of 2015 was about 2½ per cent. This continued expansion has occurred in the face of a very large contraction in capital spending in the mining sector, restrained public final spending and the reduction in national income coming from the declining terms of trade. It has been helped by easy monetary policy and the lower exchange rate.

Notwithstanding below-average GDP growth, the demand for labour increased at an above average pace in 2015. The number of people employed, as measured, increased by well over 2 per cent, participation in the labour force picked up and the rate of unemployment declined, to be below 6 per cent. That is a noticeably better outcome than we expected a year ago.

This poses the obvious question of how, with apparently still somewhat below-trend GDP growth, the rate of unemployment has fallen. And whether the pattern will continue. Of course, it may be that the labour force data overstate the strength. Alternatively they may be telling us something not yet apparent in the GDP estimates. More data may shed light on this question over time.

Part of the reconciliation appears to be that growth has been concentrated somewhat in labour-intensive areas, like certain household and business services.

Another part of the reconciliation probably lies in the very modest pace of growth of labour costs. At any given rate of unemployment, wages growth appears to have been lower than would have been expected based on historical relationships. In fact, at an economy-wide level, unit labour costs – that is, wages per unit of aggregate output – have not risen for four years. This has surely helped employment.

This same phenomenon is also important in understanding the behaviour of inflation, which has been quite low. As measured by the Consumer Price Index, inflation was 1.7 per cent over 2015. This was affected by falling prices for petrol and utilities, the latter in part due to government policy decisions. But even the underlying measures, which remove or down-weight such effects, at around 2 per cent, are low. Price rises for non-tradeable items are at their lowest for many years, and this reflects, among other things, the modest growth of labour costs.

In summary then, the economy is continuing to grow at a modest pace, in the face of considerable adjustment challenges. It has apparently been generating more employment growth and lower unemployment than we expected, while inflation has remained quite low.

Turning then to the rest of the world, there have been some key developments since we last met with the Committee.

In December, the United States Federal Reserve raised its policy interest rate for the first time in 9½ years. The last time the Fed actually started an upward phase in rates was as far back as 2004. The Fed's rationale for this change was that the US economy had sufficient strength that a zero interest rate was no longer needed – and, as such, it is a welcome development. The change had been very well telegraphed and was absorbed by financial markets without any immediate disruption.

That said, US dollar funding costs are important to many financial strategies around the world and when they start to increase, however gradually, investors adjust their positions. This had already been happening in anticipation of the Fed's decision, with funds seeking to lessen their exposures to emerging markets, high-yield debt instruments and so on.

These adjustments continued subsequent to the Fed announcement. For some emerging market economies, facing lower commodity export prices, things have become more challenging.

At the same time, some other major jurisdictions have sought to ease their monetary policies further. Both the European Central Bank and the Bank of Japan have pushed rates on some deposits at the central bank below zero. In other words, policy trajectories among the major jurisdictions are diverging, which creates the potential for market movements, not least in exchange rates.

Meanwhile, the Chinese economy has become more of a concern for many observers. It is not that the actual data on the Chinese economy are all that different from what we had been seeing. They paint a picture of softness in growth – but they were already saying that some time ago. The more recent anxiety is probably best described as greater uncertainty over the intentions of Chinese policymakers and over whether they will be able to carry off the economic transition China needs. This anxiety has been reflected in capital flows.

Commodity prices have generally fallen further over recent months. Most prominent was the further fall in crude oil prices to about US$30 per barrel. While this level of oil prices is not especially low in a longer-run historical context, it is a large decline from prices prevailing in recent years and is bringing considerable adjustment. Oil-producing companies and nations are seeing a decline in their incomes, and yields on debt issued by corporates in the energy sector have increased sharply. Exploration expenditure and investment in new capacity is being rapidly curtailed. Sovereign asset managers for some key oil producers are liquidating some assets to help manage the effects on fiscal positions.

As with most price changes, there are gainers as well as losers. The fall in energy costs is a windfall to energy users and represents a terms of trade gain for countries that are net importers. Importantly, it does not appear to be the case that the fall has predominantly been caused by weak demand for oil. Indications are that oil demand has still been rising, albeit not as quickly as it had been. Supply increases appear to have been more important than demand factors in explaining the large price fall, at least thus far. Hence, we should not interpret the decline in oil prices as uniformly negative. On the contrary, a fall in oil prices resulting from additional supply has usually been seen clearly as a bonus for consumers and many businesses in advanced economies, including Australia.

In financial markets, as investors and traders have sought to make sense of all these conflicting currents, we have seen a period of volatility recently. This has been apparent in equity and bond markets, as well as foreign exchange markets. Equity markets are lower, yields for core sovereign obligations are lower, spreads for lower-rated corporates and emerging market sovereigns are wider. Exchange rates have seen more variability, with currencies for many emerging market countries weaker. The Australian dollar is around the same level now as when we last met with the Committee, though commodity prices are lower.

Looking ahead, forecasters expect a bit less growth in the global economy this year than they did a few months ago. Expectations for Australia’s trading partner group itself are for growth to be a bit below average, little changed from six months ago. Inflationary pressures globally look quite subdued. Global interest rates will still be very low, even if short-term rates move up a bit further in the United States.

For Australia, the adjustment we have been experiencing for a couple of years now will most likely continue. The terms of trade are still falling. The fall in mining investment spending will continue for at least one more year, though it is probably having its most significant effect on the rate of growth now. Other areas of demand are expected to add to growth. The net effect of all this is likely to be continuing expansion at a moderate pace.

One key question will be whether the recent financial turbulence itself will have a material negative effect on aggregate demand – in Australia or abroad. I don’t expect that we will be able to answer that question for a little while yet.

Another question is what the recent unexpected strength in the labour market means for the outlook. If it turns out that the strength is just temporary, then the outlook is still for moderate growth, but no near-term acceleration. If, on the other hand, recent trends were to continue, the income gains coming from higher employment may start to feed into stronger demand growth, which would probably lead in due course to higher levels of investment. Alternatively, if demand growth were to be in areas that require relatively little capital to support the labour employed, then the apparent weakness in capital spending outside mining could be of less concern anyway.

As usual, there are many questions regarding both our current circumstances and the outlook. At its recent meetings, the Reserve Bank Board has kept the stance of policy unchanged, with the cash rate at 2.0 per cent. We will be examining new information over the months ahead as we try to discern the answers to these and other questions. With inflation unlikely to cause a problem by being too high over the next year or two, the statement after the recent meeting indicated that the Board retains the flexibility to ease further, should that be helpful.