Philip Lowe: Opening statement to the House of Representatives Standing Committee on Economics

Opening statement by Mr Philip Lowe, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Sydney, 16 February 2018.

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Chair

Members of the Committee

My colleagues and I welcome these opportunities to explain our thinking on the Australian economy and to answer your questions. We view it as an important part of the accountability process for the Reserve Bank.

Since we last met in August, the improvement in the global economy has continued and forecasts for world growth have been revised up. Rather than just one or two economies doing better, the improvement has been broadly based, with a synchronised upswing taking place. Partly as a result, both international trade and commodity prices have picked up and this is helping the Australian economy.

The stronger economic growth has resulted in unemployment rates falling further. In a number of countries, the unemployment rate is now below conventional estimates of full employment. Inflation has remained low, partly reflecting the fact that wage growth has been quite subdued despite the low unemployment rates. Low inflation has meant low interest rates. And for much of past year, volatility in asset prices was also unusually low.

Over recent times, many investors have been proceeding on the basis that this combination of strong growth, low unemployment, low inflation and low interest rates would persist. Many also expected the low volatility in asset prices to continue. A couple of weeks ago we saw a re-evaluation of some of these assumptions by some investors, with the catalyst being a pick-up in wage growth in the United States. The result has been an increase in bond yields, a decline in equity prices and increased market volatility.

While the exact timing of changes in investors' assumptions is difficult to predict, the fact that some reassessment took place, at some point, is not that surprising. Above-trend growth at a time of low unemployment should be expected to see inflation lift, even if that lift is gradual because of factors that are affecting wage and price pressures globally. To add to the mix, fiscal policy in some countries, most noticeably the United States, is becoming more expansionary. So I expect rising inflation pressures will figure more prominently in discussions of the global economy than they have for some time.

Another important international influence on our economy is what happens in China. Like other economies, China is benefiting from the global upswing. At the same time, there are ongoing efforts to increase the sustainability of China's economic growth, both in terms of its financing and the environment. These efforts are affecting both the structure of finance in the Chinese economy and commodity markets. The Chinese authorities face the difficult challenge of getting the balance right between containing medium-term risks and supporting near-term growth, and we continue to watch developments there closely.

I would now like to turn to the Australian economy. On balance, the news over the summer has generally had a more positive tone than it has had for a while. For some time we had been expecting GDP growth to be a bit stronger in 2018 and 2019 than in the recent past. The recent data have been consistent with this. Over this year and next we expect GDP growth to be a bit above 3 per cent, which is faster than our current estimate of trend growth for the Australian economy. This outlook has not been affected by the recent volatility in the equity market.

The Australian labour market has been noticeably stronger than we were expecting, which is good news. Over the past year, the number of people with a job increased by 400 000, and there has been a marked increase in the participation rate for women. We don't expect a repeat of these very strong outcomes in 2018, but we do expect employment growth to be fast enough to see a further gradual reduction in the unemployment rate. The unemployment rate, though, is likely to remain above conventional estimates of full employment in Australia for some time.

A range of business indicators have also improved since we last met. Business conditions have lifted and so too has the outlook for capital expenditure. It would be an exaggeration to say that animal spirits have fully returned, but the mood has certainly brightened in much of the business community. There are a number of reasons for this, but in parts of the country the lift in mood is being helped by the large infrastructure projects underway. Not only are these projects creating jobs today, but they are building much needed productive capacity for the future.

Against this general backdrop of improving conditions, one uncertainty remains the strength of consumer spending. In the September quarter, spending growth was quite weak, especially for discretionary items. More recently, the retail trade figures have been better and suggest a stronger outcome for the December quarter.

Most households are experiencing only slow growth in their incomes and many expect that this will continue for some time yet. This lowering of expectations about income growth is likely to be affecting spending, especially in an environment of high levels of household debt. A pick-up in income growth, by way of ongoing increases in jobs and stronger wage growth should help here.

We continue to look carefully at household balance sheets. On balance, our assessment is that there has been some containment of the build-up of risk in this area. This is a positive development. Lending standards are stricter than they were previously and there has been a welcome decline in the share of interest-only loans, following measures taken by APRA. Housing credit growth has also slowed a bit, especially to investors. In the property market, prices are no longer rising in Sydney, and have fallen for higher-priced houses. The Melbourne market has also cooled somewhat. Increased supply of housing, changes in the nature and availability of financing, and some reduction in foreign demand have all played a role. While the Reserve Bank does not target housing prices or household debt, it would be a good outcome if we now experienced a run of years in which the rate of growth of housing costs and debt did not outstrip growth in our incomes in the way that they did over the past five years.

In terms of CPI inflation, the picture is pretty much the same as it was when we met six months ago. Inflation, in headline and underlying terms, is still running at a little under 2 per cent. This is higher than the inflation rate a year ago, but inflation does remain low.

The most recent data confirmed themes that we have been seeing for some time. Strong competition from new entrants and changes in retailers' business models are putting downward pressure on the prices of consumer durables and groceries. The prices of many of these goods are lower than they were a few years ago. This is good news for consumers, although not for some retailers. We do expect to see some lessening of this downward pressure on prices at some point, although not for a while yet.

The second ongoing theme is higher prices for utilities and tobacco. Both of these have added materially to the CPI over the past year, and further increases are expected.

The third theme is the subdued increase in wages feeding through into subdued price increases, particularly for a range of market services. This, too, is likely to continue for a while yet.

We have discussed on previous occasions the reasons for the subdued wage increases. These include the continuing spare capacity in the economy after the unwinding of the mining investment boom; the heightened sense of competition due to globalisation and technological change; and changes in bargaining arrangements. These factors are still at work, although through our liaison program we hear reports of pockets where the labour market is tight and firms are finding it hard to find workers with the right skills. In some of these areas wages are now rising more quickly than previously, but many firms remain wary of adding to their cost base in the current environment.

Over time, we expect wage growth to pick up as the labour market strengthens further. The pick-up, though, is likely to be gradual. This increase in wage growth and the more general reduction in spare capacity in the economy are expected to contribute to inflation picking up as well. But to continue the theme, this pick-up, too, is expected to be only gradual. This year and next, we expect CPI inflation to be between 2 and 2½ per cent.

As you would be aware, the Reserve Bank Board has held the cash rate at 1½ per cent since August 2016. This represents an accommodative setting of monetary policy, aimed at supporting the economy and employment, and returning inflation towards the mid-point of the medium-term target range. As we have discussed with this Committee on previous occasions, the Board has sought to strike a balance between these benefits of monetary stimulus and the medium-term risks associated with the increase in the already high level of household debt. We have sought to steer a middle course, promoting sustainable growth in the economy.

Over the past year the economy has been moving in the right direction. Progress has been made in reducing unemployment and having inflation return to around the mid-point of the target range. And on the financial side, the build-up of risks in household balance sheets has been contained, although risks there remain.

Over the coming year we expect to make further progress. Our central scenario for the Australian economy is for a further reduction in the unemployment rate and an increase in inflation towards the mid-point of the target range. Of course, this is just the central scenario, and there are other scenarios as well.

But if this is how things play out, at some point it will be appropriate to have less monetary stimulus and for interest rates in Australia to move up, as is already happening in some other countries. In other words, it is more likely that the next move in interest rates will be up, rather than down.

The timing of any future move will depend upon the extent and pace of progress that we make in reducing the unemployment rate and having inflation return to target. As things currently stand, we expect that progress to be steady, but to be only gradual. Given this assessment, the Reserve Bank Board does not see a strong case for a near-term adjustment of monetary policy. We will, of course, keep that judgement under review at future meetings.

Before finishing, I would like to mention a couple of developments on the payments side of the Bank's responsibilities.

The first is the launch this week of the New Payments Platform. This is a major piece of national infrastructure, which will benefit households and businesses. Its development is the result of a very complex collaborative industry effort over many years. This new payment system will allow Australians to make faster, simpler and smarter payments on a 24/7 basis. One element of this is the use of PayIDs instead of having to know BSBs and account numbers for many transactions. A major focus of the development effort has been security and to protect people from fraud. The process for initially registering PayIDs, which is now underway, requires users to verify their identity. The new platform also requires users to confirm the recipient before a payment is completed. We would be happy to discuss further details of the new arrangements during the course of this hearing.

The second development on the payments side is the release yesterday of the design of the new $50 banknote. This new banknote will be issued into circulation from October this year. There are more $50 banknotes in circulation than any other note, so it is a big task. All up, there are 700 million $50s on issue – they are used heavily in transactions as well as being the main ATM banknote.

The new $50 banknote will feature the same world-leading security features as the $5 and $10 banknotes, including the clear top-to-bottom window. It will also have four bumps to help people with impaired vision recognise the note. As with the current $50 banknote, the new one honours two very significant Australians: David Unaipon and Edith Cowan.

While these two Australians came from very different backgrounds, they were both significant pioneers. David Unaipon was Australia's first published Aboriginal author, writing about, in his owns words, Aboriginal 'customs, beliefs and imaginings'. The micro-text on the banknote is an extract from his book, the Legendary Tales of the Australian Aborigines . Edith Cowan was the first female member of an Australian parliament, being elected to the Western Australian Parliament in 1921. I am pleased to be able to say that the new banknote contains text from her first speech to that parliament. We are proud to have these two distinguished Australians on our most widely used banknote.

Thank you. My colleagues and I look forward to answering your questions.