STATEMENT TO PARLIAMENTARY COMMITTEE

Opening Remarks by Mr Glenn Stevens, Governor, to House of Representatives Standing Committee on Economics, Melbourne, 8 September 2008.

Mr Chairman, thank you for the opportunity to meet again with the House Economics Committee.

It might be helpful for our discussion if I begin by reviewing how things stood at the time of our last meeting, and what has changed in the interim.

When the Committee met in April, monetary policy had been tightened in response to very strong growth in demand and a significant pick-up in inflation during 2007. The cash rate had been lifted by 100 basis points and financial intermediaries were facing additional increases in the cost of their funds, which they passed on to borrowers.

This amounted to a significant tightening in financial conditions. That was necessary under the circumstances: if inflation was to decline over time to be consistent with the 2–3 per cent medium-term target, a precondition was to contain demand, which had run too far ahead relative to productive capacity. The fact that inflation picked up noticeably at the end of 2007, with a strong likelihood that we were in for several quarters of faster price rises, only reinforced the need for a credible and prompt response by monetary policy.

In April, there was considerable uncertainty surrounding the outlook given the powerful forces at work pulling in opposite directions. On the one hand, the tightening of financial conditions, including some tightening of credit standards for more risky borrowers, was acting to dampen spending. In addition, developments in the global credit system were a likely dampener for the international and domestic outlooks.

On the other hand, the rise in Australia's terms of trade that was in train was the biggest such event for many years. It was starting to deliver a very large further boost to income and, potentially, to spending.

So while there were signs in April that a slowing in demand had begun, it was unclear what the extent and duration of that slowing would be. But overall, the judgment we had reached at that time, and subsequently spelled out in the May *Statement on Monetary Policy*, was that growth in demand and GDP during 2008 would turn out to be considerably lower than had been recorded for 2007. This forecast was at the lower end of the range of private-sector forecasts made at that time. That in turn led us to believe that pressure would be taken off productive capacity and that inflation would, in time, abate. It was on the basis of that judgment that the

Board held the cash rate steady for six months, even though inflation on both a headline and underlying basis continued to increase in the subsequent two CPI releases.

The picture of moderating demand, at least on the part of households, has continued to emerge. Consumption spending grew modestly in the March quarter, then paused in the June quarter. This came after a very strong run-up in the second half of 2007, when consumption had grown at an annualised pace of almost 5 per cent, well above what was sustainable. Household demand for credit has slowed, and turnover in the market for existing homes and house prices have softened, though spending on the construction of new homes and renovations has thus far continued to rise modestly. Overall, households are at present much more cautious about spending and borrowing, after a number of years in which confidence levels were very high and there had been strong rates of growth in borrowing and spending.

Clearly, tight financial conditions have played an important role in slowing household demand. An additional factor, around the middle of the year, was a surge in global oil prices. Of course oil prices had risen a great deal over several years – from about US$30 per barrel in 2003 to around US$100 per barrel in early 2008. This was a large increase, but it took place over a fairly long period and against a backdrop of strong global growth, and most economies had taken it more or less in their stride. But the surge from US$100 per barrel to nearly US$150 per barrel over a matter of weeks was a very sharp increase from an already high level. Accompanied as it was by forecasts in some quarters that the price could rise much further, this affected both purchasing power and sentiment among households in many countries, including Australia. It also made business conditions more difficult for many firms, and this – together with the effects of the increases in other costs, slowing household demand and tighter credit conditions – has been reflected in the various business surveys over recent months.

Confidence in international credit markets has continued to wax and wane. Following the takeover of Bear Stearns by JPMorgan Chase in mid March, sentiment improved for some weeks. But that improvement, unfortunately, did not last. Concerns about major international financial institutions re-emerged, as asset write-downs and losses related to the problems in structured products based on mortgages continued. A significant tightening of credit standards has ensued in some major countries, due to the need for banks to conserve their own – suddenly scarce – capital resources. The soundness of the two large quasi-public US mortgage agencies, which carry rather little capital, has also come into question, necessitating support from the US Government.

Meanwhile the US has seen house prices falling and house construction is at its lowest for many years. The US economy continued to expand in the first half of 2008 due to solid business investment spending, the impact of the fiscal stimulus, and strong export performance, helped by the lower US dollar. In fact, the US was the strongest performing G7 economy in the June quarter, with other major developed countries showing a significant weakening. But most forecasters continue to be fairly cautious about prospects for the US economy in the second half of the year and are now also concerned about the sorts of credit losses that are routinely associated with a period of weak macroeconomic conditions.

Some fairly significant changes of a financial nature are also occurring in Australia. Share prices rose in April and May, but gave back all those gains in subsequent months and at present are down by about 30 per cent since the peak in late 2007. Corporate boards are taking a more cautious approach to debt and there has been a marked reduction in business credit growth. This seems to have been more pronounced in the case of loans to large companies, though growth in credit to smaller enterprises has also slowed. Entities with complex financial structures and/or high leverage have come under pressure and are looking to deleverage their balance sheets.

But overall, what we see in the Australian financial scene is an order of magnitude less troubling than what we see abroad. This, Mr Chairman, is an important point to emphasise. The balance sheets of the bulk of corporate Australia are not over-geared. Australian financial institutions continue to present a contrasting picture to their peers in the US, Europe and the UK. They have adequate access to offshore funding – albeit at higher prices than a year ago. They have tightened credit standards for some borrowers, particularly those associated with property development, and are holding a higher proportion of their balance sheets in liquid form. Some have had to make provisions for unwise exposures that had been accumulated earlier. But even in these cases, capital, asset quality and profitability remain very sound. The money market is functioning more smoothly than it was six months ago, with short-term interbank spreads relative to official interest rates down a little. There are also signs that the securitisation market, which effectively closed late last year, is moving closer to re-opening. In summary, the Australian financial system is weathering the storm well.

Furthermore, while growth in credit to business has slowed quite sharply, and surveys say that business conditions have softened to the weaker side of average, overall profitability remains pretty strong. Businesses still are maintaining high levels of fixed investment spending. Indeed, according to the most recent data released about 10 days ago, firms plan a significant further expansion of investment spending in the year ahead, at a pace as fast as anything seen in a generation. Strength in mining is exceptional, but other areas actually look robust as well. I have spoken in the past of the rise in the terms of trade adding to income and spending power. These actual and intended investments are evidence of that effect. Whether all of the planned investment will come to pass – or whether it is economically feasible for it to come to pass – is a question open to debate. Nonetheless, the strength of those intentions at this stage – a year into the global credit problems, and many months into the more conservative financial environment in Australia – is remarkable. In addition, State governments continue to look to needed infrastructure upgrades. So these areas, on the best available recent evidence, remain likely to be sources of demand growth in the Australian economy in the period ahead.

This highlights again a theme that I have noted before, namely the contrast between household demand and other types of spending. Even with a pretty significant slowing in household spending, total domestic demand in the economy rose at an annualised pace of about 4 per cent in the first half of 2008. This was down from about 5½ per cent during 2007, but is still quite strong. This same picture has been pretty consistent from the liaison the Bank does with its fairly extensive list of contacts, numbering about 1 500, around the country. Those exposed to household spending are finding conditions subdued, while those exposed to the infrastructure and mining build-up are often struggling to keep pace.

Some of that demand has, of course, been supplied from abroad. So at the bottom line, we come to production and capacity utilisation. At this time of the year, with two quarters of national accounts available, growth in the economy is running at a pace slower than last year, and slower than trend. Growth in real GDP in the June quarter slowed, though this was affected by a large decline in farm production because of drought, and which most forecasters expect to be reversed in the coming quarters. Abstracting from those swings, non-farm product rose by 0.5 per cent, down a little from 0.7 per cent in the preceding quarters. There was nothing in those figures to cause us to revise significantly the forecasts we published in the August *Statement on Monetary Policy*.

The international context is one of more subdued global growth than we expected six months ago. The world economy actually expanded a little faster than we had expected into the early part of 2008, but recent data for a number of countries have been weaker, and we are assuming that weakish performance will continue in the near term. Growth in China has slowed a little, but still looks strong. Some of our other Asian trading partners, though, are facing more difficult circumstances now.

Turning to the outlook for inflation, with pressures going through the system as a result of the rise in raw materials prices and strong demand over the past couple of years, headline inflation figures will remain uncomfortably high for a little while yet. It is expected that annual CPI inflation will reach a peak in the September quarter of about 5 per cent, and be similar in the December quarter. This is higher than expected six months ago. But with international oil prices below their mid-year peaks and signs that the pace of food price increases is abating, it is reasonable to expect that CPI inflation will thereafter start to fall back. With demand growth slower, capacity utilisation, while still high, is tending to decline. Trends such as this usually dampen underlying price pressures over time, and those effects should start to become apparent during 2009 and continue into 2010.

This assessment hinges to no small extent on growth in overall labour costs not picking up further. Relative wages have been shifting, as would be expected given the nature of the forces affecting the economy, but overall the pace of growth in labour costs, to date, has been fairly contained given the tightness of the labour market. With pressure coming off the labour market, an assumption that this behaviour will continue appears to be a reasonable one at this point, but it is a critical one. The outlook also hinges on the expectation that demand growth will remain quite moderate in the near term, so that pressure continues to come off productive capacity. On that basis, Mr Chairman, we believe that prospects for inflation gradually returning to the 2–3 per cent target over the next couple of years are improving.

An outlook like that is, of course, what the Board has been seeking to achieve with monetary policy. As that picture has gradually emerged over the past few months, the question has then arisen as to when the stance of monetary policy should be recalibrated as well. At its August meeting the Board believed, and stated, that conditions were evolving in a way that was increasing the scope to move towards a less restrictive policy setting – one that presses less firmly on the brake. At the September meeting the Board took a step in that direction. The logic of this decision was the same as the one that, some years earlier, had led the Board to begin raising rates from unusually low levels: the setting of policy designed to get the economy to change course probably will not be the right one once the change of course has occurred, and it will need to be adjusted. A further consideration was that conditions recently had actually tightened marginally as a result of rises in lenders' interest rates, which from a macroeconomic point of view was not needed.

Accordingly, the cash rate was reduced by 25 basis points last week. The decision was quite widely anticipated, and less restrictive conditions in the money market had already been in place for about a month before the Board's decision. Since the end of July, key benchmark interest rates have fallen quite noticeably. The rate on 90-day bank bills has fallen by almost 60 basis points, while the 3-year swap rate has fallen by about 80 basis points. Various rates for fixed-rate loans had already declined before the Board's decision, while variable mortgage rates have quickly reflected the decline in the cash rate. The exchange rate has also declined. While some of this change is really a US dollar story rather than an Australian dollar story, our currency has declined somewhat against other currencies and on a trade-weighted basis.

Admittedly, we are probably six months away from seeing clear evidence that inflation has begun to fall, and even then it has to fall quite some distance before it is back to rates consistent with achieving 2–3 per cent on average. A somewhat larger fall in inflation overall is required on this occasion than was the case in either 2001 or 1995, which were the comparable previous episodes, since the peak inflation rate this time is higher. Rather than trying to achieve that larger fall in inflation by pushing it down more quickly, the Board's strategy is to seek a gradual fall, but over a longer period. This carries less risk of a sharp slump in economic activity, though it does require a longer period of restraint on demand. On the other hand, this carries the risk that a long period of high inflation could lead to expectations of inflation rising to the point where it becomes both more difficult and more costly to reduce it.

Monetary policy has to balance these risks, which is why the flexible, medium-term inflation targeting system that we have been operating for 15 years now, and which has enjoyed strong bipartisan support in the Parliament, is so important. That framework will continue to guide the Board's decision making.

My colleagues and I are here to respond to your questions.