STATEMENT TO PARLIAMENTARY COMMITTEE

Opening Remarks by Mr Glenn Stevens, Governor, in testimony to the House of Representatives Standing Committee on Economics, Canberra, 20 February 2009. The Bank's Statement on Monetary Policy *was released on 6 February.*

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

Shortly after the Committee last met, the global financial system took a serious turn for the worse. On 15 September 2008, the American firm Lehman Brothers filed for bankruptcy. It was the biggest actual failure of a major American financial institution for many years. While it had been widely known that Lehmans was under immense pressure, when it came the event was still a shock. It triggered a massive re-appraisal of risk, and ushered in a period of the most intense financial turmoil seen in decades.

The worst of the turmoil was actually fairly short-lived – a matter of weeks. But in that time a number of events occurred that have had a significant bearing on the outlook for the global economy. These included the incipient failure and/or public support of a number of major financial institutions in the United States, the United Kingdom and continental Europe, effective closure of many important capital markets and a worldwide decline in equity values of a quarter, leaving them around 50 per cent lower than their peak.

I believe that the extraordinary actions of governments and central banks in that period – in supporting key institutions, supplying huge quantities of liquidity and offering guarantees on various obligations of banks – helped to stabilise what could have been a catastrophic loss of confidence in the global financial system. This remains a work in progress, and sentiment in financial markets remains fragile. Nonetheless, since October we have seen term spreads in money markets decline (back towards the pre-Lehman, though still elevated, levels). We have seen long-term markets re-open to banks (by virtue of the guarantees), public confidence in the security of the banking system maintained and the exceptional volatility abate somewhat.

Inevitably, however, the turmoil of September and October took a large toll on household and business confidence around the world. Observing those events in real time, people everywhere understandably became much more cautious. We are now seeing the effects. Consumers have pulled back their discretionary spending sharply, are more inclined to save and are looking to repay debt. Businesses have seen the fall in demand, and have responded very quickly to cut production and costs, as well as putting on hold plans for expansion. Nowhere is this more evident than in the automobile sector, where global demand has fallen by around 20 per cent since August and production has declined equally sharply. Global trade has fallen away, driven by these trends in demand and also a significant disruption in trade finance.

For many of the world's largest economies, the contraction in output in the last quarter of 2008 was the sharpest in decades. Nor is the weakness confined to the major economies. Emerging economies around the world, relatively little affected by the problems in the major economies until September, are now suffering the effects of both the weaker demand in the developed world and the shock to domestic demand as their own citizens respond in the same way to the financial turmoil. Many indicators for Asian economies stepped down abruptly in the last few months of 2008. China's economy recorded little GDP growth in the last quarter, and industrial production declined for several months. There are some tentative indications of a turn for the better in China in some of the most recent data, though it is too soon to know yet whether this will continue.

It is all this news that bodies such as the IMF have factored into their growth forecasts for 2009, which put global GDP growth at just half of 1 per cent, which would be a very weak outcome. As recently as October, the forecast was 3 per cent.

Needless to say, this amounts to a very major change in the international environment for Australia. As one metric, our terms of trade, which rose by 65 per cent over five years, look like they will fall by up to 20 per cent during the next year. That would still leave them historically high, and several important commodity prices have stabilised over the past couple of months after steep falls. At these levels, the stronger mining companies will still earn good profits. But the confidence seen in mid 2008 has given way to a much more sober outlook, at least for the near term. Internationally, the availability of risk capital has declined.

Local businesses are anticipating tougher times ahead. Measures of business confidence have diminished sharply. Firms are altering their strategies quite quickly, looking to conserve cash, pay down debt and reduce costs. They are also experiencing tougher credit conditions. Indications are that investment plans, which had been exceptionally strong in the middle of last year, are being quickly curtailed.

Households, for their part, are affected by a significant loss of wealth, especially over the latter part of last year, and are understandably tending to save more and, in many cases, looking to get their debt levels down. That said, measures of consumer confidence and consumer spending in Australia have held up much better than in many other countries over recent months.

Six months ago, our judgment was that Australia was experiencing an economic slowdown that would turn out to be not unlike that of 2001 in magnitude, and that inflation would gradually decline. Absent the events of September and October, that would still have been a reasonable expectation. But the financial turmoil, and the real economic impacts that have flowed from it, altered the balance of risks for the world and Australian economies significantly. The Board quickly came to the judgment that the gradual easing of monetary policy that appeared to be in prospect six months ago should be accelerated. It moved to reduce the cash rate quite aggressively. The total decline of 400 basis points since August – as rapid an easing as any in Australia's history – takes monetary policy to a clearly expansionary setting. The Government has also implemented a major discretionary easing of fiscal policy, and the exchange rate is significantly lower.

The deterioration in international economic conditions was so rapid that no policy response could prevent a period of near-term weakness in the Australian economy. We are being affected by the global downturn, and cannot realistically expect other than weak conditions in the first part of 2009. But the very large reduction in interest rates, the lower exchange rate and the major fiscal initiatives will work to support demand, increasingly so as the year goes on. Inflation is likely to continue its moderation that began in the December quarter, and to do so faster than expected six months ago.

Compared with the sorts of growth we enjoyed until fairly recently, this is a weak near-term outlook. But if the outcomes we see turn out to be even close to these, Australia will have done well in comparison with most other countries. We have claimed all along that Australia was better positioned than many countries to ride out the international difficulties. Credit standards do seem to have tightened further over recent months and banks are seeing the inevitable increase in bad debts as the economy slows. But our major financial institutions are still in a strong condition, have access to debt and equity markets, are still earning good profits, and are in a position to lend for sound proposals. Our housing sector is not overbuilt; instead there is considerable pent-up demand, and affordability is improving quickly. Most of the corporate sector is not over-geared. Going into this episode, the scope to use macroeconomic stimulus was bigger than for most countries – and that scope is being used. Moreover, our transmission channels are still working: interest rates paid by borrowers have fallen when the cash rate has been reduced. In contrast, mortgage rates in the United Kingdom and the United States did not fall through much of 2008, as margins rose by about as much as the central banks cut their policy rates. Only quite recently have UK and US mortgage rates begun to decline.

So there are reasonable grounds at this stage to think that the Australian economy will come through this very difficult episode – certainly not unscathed, but well placed to benefit from a renewed expansion. Things will be difficult over the next year. But as I have said before, the long-run prospects for Australia have not deteriorated by as much as we may all be feeling just now. China's emergence, for example, has not finished. It has years to run and Australia will benefit from it. We should not lose sight of that or other positives. We can have confidence in our long-run future and in our demonstrated ability to adapt to changing circumstances. If we retain that, there is no reason for any downturn to be a deep one.

The Board is, of course, continually assessing whether the stance of policy is the right one to foster a durable expansion, consistent with the inflation target. A very large easing of policy has been put in place, on the basis of the anticipated effects of the global downturn and more risk-averse behaviour at home. Those effects are yet to be seen in many of the figures, though they are being felt in businesses around the country. The effects of the policy adjustments are only beginning.

So in evaluating the information we receive in the months ahead, our task will be to distinguish between that which confirms the anticipated trends to which we have already responded, and that which tells us something genuinely new about the prospects for demand and prices over the medium term. Our objective, however, remains the same: sustainable growth and low inflation.

Perhaps I should also make one or two comments about payments matters, given the impending changes to arrangements for ATMs. The new arrangements seek to remove several undesirable features of the existing system. In particular, fees paid between banks when their customers use each others' ATMs – 'interchange' fees – are not transparent, and are not clearly related to costs; fees paid by customers using ATMs other than those owned by their own banks – so-called 'foreign' fees – are not always properly disclosed (and in many cases are higher than necessary); the earnings stream for owners of independent ATMs – about half the ATMs in Australia – are limited to the interchange fees paid by banks, which are of course their competitors; and access by new entrants is difficult, potentially limiting competition.

Under the new arrangements, there will be no interchange fees. An ATM owner will be able to charge the customer directly a fee for the use of the machine, but must disclose the fee prior to the transaction. Banks will probably continue to allow fee-free withdrawals by their customers at their own machines, because they expect to cover those costs with the revenue earned across the entire customer relationship. Use of another bank's ATMs will presumably attract a fee by that other bank to cover the costs. But the only cost to a cardholder's bank associated with use of a 'foreign' ATM is the cost of processing the transaction electronically – a matter of no more than 10 cents. Given this, we cannot see any strong case for a 'foreign' fee. Independent ATM owners will charge for the use of their machines, but that will maintain an incentive to grow their network. Otherwise, it is likely that the independents as a source of competition would diminish over time, reducing consumer choice. Access to the system will be governed by a code, which caps the price of connections, so that new competitors cannot be unduly hampered by the incumbent players over-charging to connect.

The essence of the changes is simple. People have always been paying, one way or another, to use ATMs. ATMs do have a cost of operation and somehow that cost has to be covered. Even where no explicit charge is levied, somewhere or other the financial institution is making up that cost. They do not provide services for free.

Now people will know exactly what the price of an ATM transaction is, and they will know it before completing the transaction. There should be no 'foreign' fees of any significance. And competition will be maintained, by allowing the independent ATM owners to remain viable and new competitors to enter more easily. That is, in our judgment, an improvement over the arrangements of the past and is the best way of keeping costs down in the long run.

My colleagues and I now look forward to your questions.