

# Opening Statement to House of Representatives Standing Committee on Economics



RESERVE BANK OF AUSTRALIA

**Glenn Stevens**

Governor

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In the six months since the August hearing, economic and financial conditions abroad have generally improved. We can see three key sets of developments.

First, the threat perceived in the middle of last year of extreme financial instability arising in the euro area – and, in the eyes of some, possible disintegration of the euro – has abated. This followed various important steps taken by European policymakers. Interest rates faced by some of the key sovereigns which were under acute pressure have declined markedly, and funding conditions for many European banks have improved to the point where some of the central bank funding that had been supplied has been repaid. These countries, and Europe generally, still face immense challenges and it is, as usual, important to stress that sentiment remains vulnerable to setbacks. But a truly disastrous outcome was, once again, avoided.

Second, the United States has continued its gradual recovery and has avoided the worst of the so-called ‘fiscal cliff’. Some of the headwinds for the US economy are subsiding – the housing market seems to have turned, for example. There are still some key decision points in the fiscal area ahead, but if they can be satisfactorily managed, the US has as good a chance of delivering an upside surprise as a downside one over the period ahead.

Third, the slowdown in China’s economy has come to an end. The medium-term outlook for China is for a less hectic pace of growth than we saw on average over the past decade, and with more attention paid to the various risks – financial and environmental included – associated with that growth. Having said that, the greater absolute size of the Chinese economy now means that even less hectic growth is still of global significance and of importance to Australia.

Conditions have improved in international financial markets as the perceived probability of very bad events occurring has declined and as major central banks have maintained highly accommodative policies. Share prices have risen around the world, with global indexes up by about 20 per cent from the lows in June last year. Borrowing conditions in capital markets for creditworthy borrowers internationally remain extraordinarily favourable. For investors, conversely, returns on ‘low risk’ assets are very low and the ‘search for yield’ has intensified.

World GDP growth is thought to have been about 3¼ per cent in 2012 – a little below average. Forecasts for 2013 are for something a bit higher than that, with a further pick-up in 2014. Those seem reasonable guesses at this point in time. Risks now seem less tilted to the downside than they were.

Australia's terms of trade have declined by about 17 per cent since their exceptional peak in the middle of 2011. We are assuming they will fall further over the next couple of years. Even with that, however, they will probably be more than 50 per cent above their twentieth century average over that period. This amounts to an external environment for Australia that, while not without some challenges, is still broadly positive.

Turning to the Australian economy, the information we have at present suggests that growth was close to trend over 2012 as a whole. There was, though, some softening around the middle of the year, and sentiment among many businesses, including some that had seen important positive spillovers from the mining boom, became less optimistic. Associated with this, the labour market softened in the second half of the year, with job vacancies declining, employment growth slowing, and unemployment increasing somewhat. Labour force participation also declined.

Looking ahead, it appears that the peak in the level of resource sector investment is now close. It is a very high peak, but we do not think that there will be a rapid decline in the near term after the peak. However, it seems pretty clear that this type of investment will not be *adding* to demand for much longer. Investment spending by businesses in other sectors has thus far remained somewhat subdued in comparison. There are good reasons to expect it will strengthen in due course, but the available indicators at present do not suggest that is going to happen in the very near term. We will get another reading on the investment outlook next week. The outlook for public spending is being constrained as a result of the budgetary restraint being pursued by governments. It is also noteworthy that in several sectors of the economy a combination of factors is putting pressure on business models, and firms have been responding with an emphasis on lifting productivity and paring back costs. This process, while unavoidable, doubtless feeds into measures of sentiment.

Sentiment of households, in contrast, has improved. Despite continual commentary that households are very cautious, actual measures of confidence have in fact shown an upward trend since the middle of last year and are currently a bit above longer-run average levels. Admittedly, households do not feel the same ebullience they did for some years prior to the financial crisis in the major countries. But that degree of confidence, with its associated patterns of saving and increasing leverage, was unusual, and is not likely to recur.

Our expectation is that consumer demand will record growth roughly in line with the trend rise in income over the period ahead. Housing investment should strengthen given that several factors are supportive – interest rates are low, housing prices are tending to rise, gross rental yields have increased, population growth remains strong and is even picking up a little. Admittedly, we are as yet very early in this phase. The increased capacity to extract and ship raw materials will see export volumes continue to strengthen, probably quite substantially, over the next couple of years. Some other categories of exports seem to have stopped declining, notwithstanding that the exchange rate remains high.

Putting all that together, while growth was probably about trend in 2012 as a whole, our sense is that the economy has entered 2013 at a pace a little below that. We have been inclined to think that the near-term outlook could be for more of the same, but things are likely to strengthen further out. We are, of course, conscious that forecasts have a considerable margin of error. We have put some emphasis on this point in the way we present our forecasts in recent times.

Stepping back from the numbers, in broad terms, the economy will be adjusting to the peak of the mining boom and some other areas of demand will have room to grow more quickly than they have in recent years. This transition will not necessarily be seamless – these things seldom are – but there are reasonable prospects of it occurring over time. As we go through this period, the pressures to adapt business models, contain costs, increase productivity and innovate will remain. But such adjustments are actually positive for longer-run economic performance.

Inflation is currently consistent with the target. The high exchange rate has lowered prices for tradable goods and services and so helped to hold down measures of inflation over the past couple of years. But some domestic costs have also slowed, in response to softer demand conditions in some areas, even as prices for things such as utilities have risen sharply. The effect of the carbon price on the CPI so far has, as best we can judge, been broadly as expected. Our assessment is that inflation will be consistent with the target over the next one to two years.

Taking account of the evolving outlook for growth and inflation, the Board eased monetary policy further in the last quarter of last year, following up its easing actions in mid year, and earlier actions in the last quarter of 2011. The cash rate has been reduced six times over the past sixteen months, for a total decline of 175 basis points. Allowing for some change in the gap between the cash rate and other rates, lending rates nonetheless have fallen to be not far from their historic lows. The share of household income devoted to interest payments has likewise declined considerably. Indeed housing 'affordability' as conventionally measured, for purchasers, has improved a lot over the past two years.

That represents quite a substantial change in policy settings. It is having an effect. Housing prices have been rising since last May, having declined for a period prior to that. Share prices have also risen quite significantly, and if anything by a little more than in comparable markets overseas. The returns available to savers on safe assets – like bonds and bank deposits – have fallen by enough to prompt Australian savers to consider shifting their portfolios towards other assets. These are channels of monetary policy at work.

At the same time, as we have noted repeatedly, the exchange rate remains somewhat higher than one might have expected given the decline in export prices so far observed. This has been a relevant factor in the setting of interest rates. It is not that interest rates are seeking a particular exchange rate response, but they are being set with a recognition of the exchange rate's effect on the economy.

Overall, there is a good deal of interest rate stimulus in the pipeline. At its meeting earlier this month the Board judged that it was sensible to allow it time to do its work. The Board believed that the inflation outlook, at least as we assess it at present, would provide scope to ease further, should that be necessary to support demand. But for now, the Board decided it was prudent to sit still.

Turning briefly to other areas of the Bank's responsibilities, in June last year the Payments System Board released the Conclusions from its Strategic Review of Innovation in the Payments System. The review identified areas in which innovation in the Australian payments system could be improved through more effective cooperation between stakeholders and regulators. One of the gaps identified in the review was the inability of businesses and consumers to make payments through the banking system that are received immediately, including when the payer and receiver have their accounts with different institutions. The Payments System Board believes that Australia should develop such capability over the medium term, and proposed a target for the payments industry to achieve that goal by the end of 2016. The Board met last week and reviewed an industry proposal for real-time payments that was submitted to the Bank in late 2012. The Board considers that the industry has made good progress and endorsed the proposal in an announcement earlier this week. There are many details to be resolved that will require the Bank and industry to work closely together over the next few years, within a governance framework that gives appropriate voice to the various stakeholders. But we view this as a very positive development and we welcome the industry's commitment to deliver world-class improvements to the payments system by the end of 2016.

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