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Opening Statement to House of Representatives Standing Committee on Economics.

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Glenn Stevens

Governor

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Chair

Members of the Committee

Thank you for the opportunity to meet with you today.

Since the hearing in March, the global economy has continued its expansion at a moderate pace, and Australia's trading partner group has been growing at about its long-run average rate. With the abatement of the adverse winter weather, the US economy recovered in the June quarter and the labour market has continued to strengthen. Growth in **China** has remained close to the target of 7.5 per cent, though **Chinese** residential property prices have declined in recent months. **Chinese** authorities at various levels are responding to these developments with the aim of maintaining stable macroeconomic and monetary conditions.

In Japan, consumption and output grew strongly in the March quarter ahead of the increase in the consumption tax in April, and then contracted sharply in the June quarter. This is a normal pattern surrounding such tax changes, but complicates reading the underlying pace of Japan's economy. Economic growth in the rest of east Asia has continued.

Commodity prices important to Australia have declined this year, as global supply - including from Australia particularly - has increased. The terms of trade have now fallen by about 18 per cent from their extraordinary peak three years ago, but they remain over 50 per cent higher than their twentieth century trend level.

Perhaps the most remarkable feature of the international scene at present is the exceptionally low volatility of financial prices - the lowest observed over the past 25 years for sovereign **bonds**, equities and foreign exchange. Yields on sovereign debt of the major countries are also very low, the lowest on record in some cases. Spreads on investment grade and financial corporate **bonds** have reached multi-year lows and in Europe yields on so-called 'peripheral' sovereign **bonds** have in some cases fallen below previous historic lows.

It is not as though there has been a dearth of geo-political or financial events which might ordinarily trigger more caution among investors. But compensation for risk on financial instruments remains scant.

The reasons for these remarkable trends, including the extent to which they reflect the effects of the exceptional monetary policies being conducted by the major jurisdictions, or other things, could be debated at length. What is clear though is that a combination of forces has resulted in financial conditions remaining remarkably accommodative.

This has been reflected in a decline, at the margin, in interest rates in Australia, even though the Reserve Bank has not changed the cash rate for a year. Australian governments have continued to borrow at or around the lowest rates since Federation. Similarly, funding costs for financial institutions have been declining. This, and an increase in competition to lend in an environment of still fairly moderate credit growth, has contributed to a reduction in the rates on housing and business loans.

Economic growth was, as recorded, clearly above trend in the March quarter. The quarterly result was, to a large extent, driven by a substantial increase in resource exports, as new **mining** capacity came on line and **mining operations** experienced fewer weather disruptions than usual. Data for the June quarter suggest a 'payback' of lower exports, and also a period of more subdued consumer demand. There are relatively few readings for the September quarter as yet, though at least some suggest that there may have been a reasonable start to the quarter. Having printed lower for a few months, the rate of unemployment has recently been recorded at a higher level, though most leading indicators of the labour market seem to have improved a little this year.

Consumer prices rose by 3 per cent over the year to the June quarter, higher than the pace a year earlier. This partly reflects factors such as the increase in the tobacco excise but measures of underlying inflation also increased. A faster pace of increase in prices for tradable goods and services featured, a reflection of the depreciation of the exchange rate since April last year. The rate of inflation for 'non-tradables' has actually declined over the past year, helped by growth of labour costs falling to its lowest rate for many years. There is some evidence that productivity performance may be starting to improve, though this is notoriously difficult to evaluate over periods less than several years.

When we look ahead, a key feature of the outlook, as everyone knows, is that the capital expenditure phase of the '**mining** boom' is winding down, while the export phase is gearing up. The fall-off in investment spending by resources companies has a long way to go yet and will probably accelerate in the coming year. This impending further fall is captivating most of the commentators.

Meanwhile growth in non-**mining** activity has been increasing. A recovery in dwelling investment is well under way, with spending in this area rising by 8 per cent in the year to the March quarter. Forward indicators for non-**mining** business investment suggest a modest improvement over the coming year, though intentions have remained, to date, a bit tentative. Consumer spending, though soft in mid year, could be expected to grow in line with income, or perhaps a little faster, given the rise in household net worth. But it seems unlikely that households will revert to their behaviour of a decade ago, when they were expanding their balance sheets quickly, saving much less of their incomes and increasing their consumption well ahead of the growth in incomes. Public spending is scheduled to remain quite restrained.

The overall growth rate of the economy is the sum of these various forces, and is also affected by factors not confined to the **mining** sector or even to Australia. Forecasting is an imprecise art at the best of times. At present, given the size of the **mining** boom, the extent of the shift in global relative prices over the past years, and the very unusual global economic and financial environment in which we still find ourselves, forecasts are likely to be even less reliable.

With that caveat, my guess is that over the year ahead the growth of real GDP will be around 2-3 per cent: close to trend, but probably a bit below it in the near term. Further ahead there are some reasons to think that growth could speed up somewhat and be a bit above trend. This outlook would mean that it will be a while before we see sustained reductions in the rate of unemployment.

Conditional on the usual set of assumptions about **oil** prices, the exchange rate and so on, inflation should be consistent with the 2-3 per cent target over the horizon relevant for monetary policy. The depreciation of the exchange rate last year is likely to continue to contribute to higher prices for tradable items for a while yet. But domestic inflation is likely to remain contained given how slowly labour costs have been rising. The removal of the price on carbon will lower inflation temporarily over the coming year.

To say that growth is close to trend, but probably a bit below in the near term, will be disappointing to many people. And that is with very accommodative monetary policy - with the cash rate held at its lowest in 50 years for a year now and widely expected to be held at or close to these levels for some time yet.

The low returns on offer on safe investments in Australia, and the ultra-low returns on such assets internationally, are certainly having an effect by prompting investors to 'search for yield'. Not only are returns on financial instruments low, but yields on the existing stock of physical assets - houses, commercial property, infrastructure assets - are being bid down. Some of that search is of course coming from offshore.

That's a big part of how accommodative monetary policy works. It prompts substitution towards higher-risk assets; it raises asset prices, which increases collateral values and makes credit extension more viable; it improves the cash flows of debtors; and so on. All those things have been happening in Australia. Admittedly, the exchange rate, another channel through which monetary policy usually has an effect, is probably not doing as much as it might usually be expected to do in achieving balanced growth.

But the thing that is most needed now is something monetary policy can't directly cause: more of the sort of 'animal spirits' needed to support an expansion of the stock of existing assets (outside the **mining** sector), not just a re-pricing of existing assets. There are some encouraging signs here. Nonetheless, if reports are to be believed, many businesses remain intent on sustaining a flow of dividends and returning capital to shareholders, and less focused on implementing plans for growth. Any plans for growth that might be in the top drawer remain hostage to uncertainty about the future pace of demand.

That's actually nothing new. It's pretty normal at this point of the cycle. There is always a period in which people can see that many of the conditions for expansion are in place but aren't yet fully confident it will happen. Nor is it confined to Australia. The gap between financial risk taking and 'real economy' risk taking is seen globally at present.

It is reasonable to expect that, at some point, this will change. After all:

not only are funding costs low, but banks want to lend and are competing to do so more actively than they have for some years

net worth per household has risen by about $120,000 over the past two years

the community's monetary assets have risen by around 13 per cent - over $180 **billion** - over the same period

productivity improvement in enterprises will presumably continue, and needs to do so. But there are actually a few runs on the board now

the level of gross investment in some sectors is barely above depreciation rates

the population is growing, meaning there will be more demand for housing, infrastructure and consumer goods and services

the dynamic of proximity to a rising Asia, with all its opportunities, remains.

Business will need to respond to trends that foreshadow sustainable increases in demand and incomes. Not all that response will come from the large established players; a significant proportion will come from smaller and newer players, most of which operate 'below the radar'. The financial capacity to provide credit prudently will help them do so.

At some point, if these responses start to gather pace, the sorts of forecasts we are setting out at the moment will very likely prove to be conservative. The frustrating thing is that no one can say when that will happen, or just what might be the proximate trigger.

In the interim, monetary policy's contribution to this process is to lend support to demand, consistent with its obligations to seek full employment and price stability as set out in the inflation target, and taking due account of financial stability considerations. This has resulted in very low interest rates, and as noted earlier financial conditions in Australia have in fact eased a little over recent times even though the cash rate has not changed.

In reaching its decisions, the Board has been mindful of allowing time for measures already taken to have their effects, and of the very considerable limitations for monetary policy in fine-tuning economic outcomes over short periods. It has also seen some value, in the present circumstances, in maintaining a sense of steadiness and stability.

My colleagues and I await your questions.

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