STATEMENT TO PARLIAMENTARY COMMITTEE

Opening Remarks by Mr Glenn Stevens, Governor, in testimony to the House of Representatives Standing Committee on Economics, Sydney, 14 August 2009. The Bank's Statement on Monetary Policy *was released on 7 August.*

Mr Chairman,

Thank you for the opportunity to meet once again with the House Economics Committee.

When we last met with you in February, international financial markets were stabilising after the extreme turmoil of September and October 2008. But the fallout of the financial events for demand, production and trade flows in the global economy was only then starting to become apparent in hard data.

Household and business confidence around the world had been severely damaged. Households had sharply pulled back their discretionary spending, were tending to try to save more and were looking to pay down debts. Businesses had responded very quickly to a fall in demand by cutting production and costs, as well as shelving their plans for expansion.

It was already fairly clear by February that the resulting contraction in economic activity in the December quarter was severe in many countries, and that global growth had suffered its biggest setback in decades. Global trade was falling rapidly.

Central banks had eased monetary policy aggressively, including taking short-term interest rates to near zero in several cases, and some were considering or implementing 'unconventional' measures to deliver additional stimulus. Governments were putting in place fiscal stimulus packages.

But these measures would take time to have their effect. In the short term, we worried that the March quarter outcomes for the global economy would be just as bad as occurred in the December quarter. For some months, the news from abroad indeed continued to be very poor and global demand contracted further in the March quarter.

Given the speed of the global deterioration, we believed that it would not be possible to avoid a period of weakness in the Australian economy. We thought that Australia had several advantages – a sound financial system, an absence of the worst of the problems afflicting some other countries, exposure to an emerging China, and scope to use macroeconomic policies to cushion the downturn. The exchange rate had declined, which would also assist in adapting to weak global conditions and lower commodity prices. So we could reasonably have expected to have a smaller downturn than others.

But it is very rare for Australia to escape an international downturn altogether, and it seemed quite unlikely that we could avoid one of this size completely, despite the advantages we had. For confidence here too had suffered a serious setback. This was clear in equity prices, in numerous surveys of sentiment and in the feedback we were receiving directly from firms. Australia was being affected through our trade, financial and business linkages with the rest of the world.

Australia *was* doing better than most countries, as had been anticipated. But for a few months it was not clear how much comfort we should take from that, because the economic news from abroad seemed to be so dire.

As one metric, the IMF's forecasts for global output in 2009 as at last February were for growth of ½ per cent. That was already a marked reduction from a few months earlier. Subsequently they were cut further, and when released in late April showed an expected *contraction* of over 1 per cent, which would be the weakest outcome for at least six decades. Forecasts for Australia were inevitably marked down as well. The time of our May *Statement on Monetary Policy* was when the outlook for the local economy seemed weakest.

In this environment, the possibility that we would need to ease monetary policy further was obviously canvassed. Financial markets expected as much, at one point pricing in a decline in the cash rate to less than 2 per cent. Yet the Board had already aggressively eased monetary policy, delivering the largest reduction in debt-servicing costs to households in modern times. Interest rates were low, or in some cases very low, by historical standards. Substantial fiscal stimulus was also in train. These could be expected to provide significant support for demand. So even as activity abroad continued to contract, the Board had to be mindful of how much action had already been taken in anticipation of serious economic weakness. Those measures would take time to have their full effect. But that lag could not be shortened by increasing the dosage.

Accordingly, while keeping open the option of further easing, the Board kept a fairly steady setting through this period. There was one further small decline in the cash rate in April. Apart from that, official interest rates have been unchanged since we last met, in contrast to the very sharp falls from September through to February.

Where then do we stand at present?

Things abroad hardly look rosy, but they look distinctly better than they did a few months ago. Conditions in international financial markets have continued to improve. There have been occasional reversals, but each time the improving trend has resumed. Extreme risk aversion has abated; spreads have narrowed; capital markets have continued to thaw, though in some overseas cases this has relied heavily on central bank financing activities. Financial institutions in the United States and Europe have recorded better earnings. Global equity markets have risen to be nearly 50 per cent above the lows in early March this year. There has been substantial new issuance of debt and equity. Spot commodity prices have picked up.

In addition, it appears that the really large contractions in major countries' GDP are now behind us and that global output is levelling out. International trade and global industrial production have even recorded small gains over recent months.

Of course there is a long way to go and there are notable differences in economic activity across regions. While the United States and Europe only now seem to be at or near a turning point, there has already been a marked improvement in economic activity in much of east Asia and India. This reflects significant stimulus put in place by governments in Asia, the dynamics of the inventory cycle, the healthier state of their financial systems and, in all likelihood, the inherently better secular growth prospects for these sorts of economies. The improvement has been most pronounced in China, but it is not confined to China. Korea, an important trading partner for Australia, recorded a significant bounce in GDP in the June quarter. There are also some signs that the Japanese economy has begun to grow.

The IMF has recently raised its outlook for world growth in 2010. These forecasts are actually still for pretty lacklustre growth overall. But it is the first time we have seen upward revisions for quite a while.

The Australian economy has been resilient, with economic activity looking stronger than expected a few months ago. Both foreign and local factors have been at work.

Exports have been remarkably strong. For Australia, they grew over the six months to March, whereas for most countries exports fell sharply over that period. Further growth appears to have occurred in the June quarter. This reflects the strength of Chinese resource demand, as well as some other factors. The strength in demand from China has also been associated with the continuation of attractive prices for many commodities. Australia's terms of trade are likely to be around 20 per cent lower than their peak last year. But they are about 45 per cent higher than the average for the two decades up to 2000.

Domestic demand has likewise held up pretty well, with retail sales posting a solid increase in the first half of the year. Demand for housing credit is up, as are house prices, and purchases of some investment goods by firms rose mid year. Some of this strength is likely to be temporary, the result of fiscal measures that have a finite life. We are assuming, for example, that consumer demand, and first-home buyer demand for finance, will be softer in the second half of the year. Nonetheless, the retreat from the extreme risk aversion of nine months ago, the partial recovery of household net worth and the impact of low interest rates will offer support to private demand over the period ahead.

Survey measures of business confidence have lifted from the very low levels seen at the beginning of the year to be close to their long-run average. Capacity utilisation has stopped its sharp decline. Business credit has been falling, but this has been more than offset by increases in non-intermediated sources of funding, such as equity raisings and corporate bond issuance. Overall business external funding has remained positive, at rates similar to those seen in the 2001 slowdown. For their part, financial institutions remain profitable, even though they are absorbing higher loan impairments.

Business investment has been an area of expected weakness in forecasts for the Australian economy. This is still likely to be true, though recent liaison suggests that some firms may be re-thinking the size of their planned cuts to investment spending. Differences across sectors remain. The commercial property sector, for example, is part way through a difficult period of adjustment to valuation and leverage, even as parts of the mining sector are back to producing at full tilt to supply Chinese demand for resources.

The labour market has seen considerably softer conditions, but there has been little decline in overall employment, and the rise in unemployment, to date, looks smaller than had been feared a few months ago. As several commentators have pointed out, there has been a significant fall in hours worked, as there usually is in downturns. This may be a more reliable gauge of the extent of labour market weakening than employment or unemployment. Compared with some earlier cycles, the reduction in hours has occurred via a reduction in working hours across more people, rather than being concentrated among a group of unemployed. At this point, the fall in hours worked looks larger than what occurred in 2001, but not as large as in 1991.

In fact, that is probably a reasonable characterisation of this downturn in general. On the basis of the information to hand at present, this may well turn out to be one of the shallower recessions Australia has experienced.

Inflation, meanwhile, has been easing. CPI inflation has recorded its lowest outcome in a decade, of 1½ per cent over the year to June. This compares with a peak of 5 per cent in September last year. The size of this decline overstates the real extent of the slowing in prices, just as the peak figure overstated the real extent of inflation. Measures of underlying inflation remain a good deal higher, at around 3¾ per cent over the year, but they too are gradually declining. We believe that decline has further to go, though in the medium term inflation on either a CPI or underlying basis does not look like it will fall as far as we thought a few months ago.

Looking ahead, some of the recent strength in private demand might, as I noted earlier, prove to be temporary. But at the same time, the contribution of public spending to growth in demand is likely to increase over the year ahead. More generally, there has been enough genuine strength in the run of recent indicators, sufficient further improvement in financial conditions and enough recovery in sentiment such that forecasters are starting to lift their numbers for overall growth in both 2009 and 2010.

As always, there are risks.

The global economy could suffer another setback of some kind. The likelihood of that has declined in our view, but the possibility remains.

Perhaps the growth in China's demand will falter. Certainly the pace of China's growth seen in the June quarter, which was extraordinary, cannot continue for long, and may be moderating now. We need to keep an eye out for potential imbalances in China. That said, though, sceptics about the growth of China thus far may have underestimated the determination of the Chinese policy-makers to grow their economy over the medium term. I doubt that determination has lessened.

Some of the pick-up in global industrial output is clearly due to the cessation of inventory run-down, and prospects for final demand will be important in determining the pace of ongoing growth. On that score, the process of balance sheet consolidation for both the private and public sectors in some major countries will probably weigh on growth in demand there for some time. (I am not talking about Australia here.)

On the other hand, performances of both Australia and some of our key trading partners have exceeded expectations in the recent past; that could continue, particularly if rising confidence were to feed further demand, thus increasing income, and so on. That, after all, is the way most recoveries proceed, in cases where there is no strong headwind from financial restructuring.

Moreover, just as the severity and simultaneity of the global downturn was unprecedented, so was the speed and strength of the policy response. Six months ago the possibility of concerted global policy action delivering a surprise on the upside for global growth was noted by some, but it seemed perhaps rather theoretical at that point. It is a bit easier to imagine now.

The forecasts outlined in the recent *Statement on Monetary Policy* give our best assessment of the most likely outcomes for Australia, contingent on these and other factors. Considerable uncertainty inevitably surrounds these numbers. Nonetheless, if things continue to look like they will turn out in that fashion, there will come a time when the exceptional monetary stimulus in place at present will no longer be needed. It will then be appropriate for the Board to do what it has done on past such occasions, namely to start adjusting interest rates back towards normal levels. The timing and pace of those adjustments, if and when they come, will be a matter of careful consideration, taking into account all the relevant factors, including what might be happening with market interest rates.

Mr Chairman, last time we met, I said that there were reasonable grounds to think that the Australian economy would come through this very difficult episode as well placed as any to benefit from renewed expansion. That remains my view. The economy appears to be weathering a very large storm pretty well, and the community's confidence about the future has improved commensurately. No doubt the future will pose its own challenges, but we are well placed to meet them.

My colleagues and I now look forward to your questions.