



RESERVE BANK OF AUSTRALIA

Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration

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Governor

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Mr Chairman, members of the Committee.

Since we last met in Perth, economic conditions in Australia have strengthened. At the same time, financial markets globally have recently become extremely skittish and there has been a very sharp re-assessment of risk and a sudden desire for liquidity.

I will come to the financial market turbulence shortly. Before I do, however, it is worth recounting how the real economy has performed over the past six months. Given the uncertainty being felt in financial markets at present, it is important to keep a clear sense of the economic fundamentals.

According to the national income accounts, growth picked up sharply in the December and March quarters. Over the year to March, real GDP is estimated to have expanded by about 3¾ per cent, despite the impact of the drought. The non-farm economy was reported as having grown by about 4½ per cent, equal to its fastest pace for four years.

Gauging the true extent of acceleration is not straightforward given the inevitable noise in the data over short periods, but a wide range of survey evidence and other indicators also suggest that conditions picked up in the first half of 2007. Domestic spending is rising, with robust rises featured among most of the components. The exception is residential construction, where commencements remain flat at slightly below-average levels. Demand for credit also appears to have firmed, most particularly among businesses. Household finances, like corporate finances, are generally in strong shape.

Demand for Australian exports is rising too. Success in transporting higher volumes of resources has been mixed, varying by location and industry and according to disruptions caused by weather, efforts at adding new capacity, and port and rail delays in some cases. But the trend is upward and tonnages are set to increase over the next several years as capacity comes on line. Agricultural exports will benefit from the improved rainfall in some parts of the country.

Not surprisingly in light of the above, the demand for labour has continued to expand. The recorded rate of unemployment is at its lowest for a generation. Job vacancies are high and surveys suggest that many firms see the difficulty of finding additional labour as among the biggest, or the biggest, impediment to expanding production. As yet, though, the pace of growth in labour costs overall has remained relatively contained.

In thinking about why growth has picked up somewhat more than had been expected, we should not overlook the fact that the global economy has surprised, once again, by its strength. The most recent forecasts for global growth made by the IMF were revised upward only a few weeks ago, with growth now thought likely to be over 5 per cent in 2007, close to the 2006 result. The US economy has slowed but greater strength elsewhere has, to date, more than outweighed the US softening.

Australia's terms of trade have kept rising and stand at a five-decade high. This has added about 1½ per cent of GDP to the annual growth in Australia's national income over the past couple of years, which is quite an expansionary force. Some of the resulting demand spills abroad, but there is also a stimulus to spending on non-tradeable goods and services arising from the income gains being experienced. The rise in property prices in Western Australia is a case in point.

It would be imprudent to assume that this trend will continue indefinitely. Nonetheless, it has already gone considerably further than most observers anticipated. When we lift our gaze beyond the conventional forecasting horizon, the big picture is that the emergence of potentially very large economies like China and India, at such a rapid pace and with such consistency, is unlike anything we have lived through before. We cannot be confident, therefore, that the cyclical experience of the past few decades is necessarily a reliable guide to how things will develop.

In its policy deliberations over several months, the Board has weighed conflicting trends. When we were last before you, we were observing an apparent moderation in inflation. We were, as you know, at that time still of the view that there could be a need to tighten monetary policy further at some stage. But having made three adjustments in 2006, we believed that the improving short-term trend in inflation afforded us time to watch developments.

Information that came in over the ensuing period suggested stronger-than-expected demand in the economy. This meant that the longer-term risk of higher inflation was increasing, not diminishing. Hence, the likelihood that interest rates would need to be increased at some stage was rising.

Moderate price and wage outcomes continued, however, for some months, suggesting that, at least temporarily, the supply side of the economy was managing to respond to stronger demand. It was doubtful that this could continue over an extended period, but taken together, the weight of evidence suggested that the best course for monetary policy was to maintain the existing setting for the time being, but to be ready to tighten should signs of a strengthening of price pressures emerge.

The June quarter CPI data, available for the August meeting, showed some pick-up in inflation. Together with a stronger growth outlook, this information led us to expect a somewhat higher path for inflation over the horizon of the coming one to two years. The judgement we reached was that the risk of unnecessarily damaging growth with a modest rise in interest rates was small, whereas the cost of not responding to a deterioration in the outlook for inflation could well, in the longer term, be substantial. On straightforward macroeconomic grounds, therefore, there was a clear case to make an adjustment to monetary policy.

As our statement on Wednesday of last week set out, the Board considered the recent events in international credit markets in coming to our decision. Here, Mr Chairman, it is worth taking a few moments to set out some history.

For some years now, many long-term observers, market participants and officials have been troubled by very narrow pricing for risk. In other words, it has been easier and cheaper than had been normal in the past for risky borrowers to access funding. Investors were prepared to take more risk in pursuit of returns in a world of low global interest rates.

Somewhere or other, returns were eventually bound to disappoint someone. As it turned out, the problems emerged in the US housing sector. Lenders into the so-called 'sub-prime' market attempted to keep the pace of business up as the US housing sector slowed during last year. But they could do this only by lowering lending standards. Before long, arrears began to rise as some borrowers struggled to meet their commitments.

Once this deterioration in underlying asset returns had occurred, those with exposures inevitably began to see losses. Because this type of lending was via securitised structures sold into global capital markets, losses have been coming to light right around the world. In most cases, the losses are embarrassing rather than fatal for the institution concerned. The exceptions have been where particular funds invested mainly or solely in these types of risky assets, and especially where leverage was involved. Several hedge funds have borne large losses, including some in Australia.

All of this created a climate in July and early August in which investors retreated and pricing of risk started to return to levels that could be regarded as more reasonable based on historical experience. A number of capital raisings that had sought to take advantage of the earlier very generous terms were postponed. Volatility in some financial markets increased, share prices declined somewhat and a general sense of heightened uncertainty was evident.

In considering the implications of all this for our decision on monetary policy, there were two questions to ask. The first was whether there was information to suggest that financial developments were likely to make a sufficient difference, over the relevant horizon for policy, to the global economy, and therefore the Australian economy and the inflation outlook, to remove the macroeconomic case for a 25 basis point adjustment to cash rates. On balance, we judged that there was not. Downside risks to the US economy do appear to have increased over recent months, but in other parts of the world the growth outlook has, if anything, been marked higher recently.

The second question was whether a rise of 25 basis points in Australian cash rates would, in itself, be financially destabilising. No credible case could be made for that idea. In fact, it would probably have been more destabilising to expectations not to have carried out a policy adjustment that most people could see was needed.

Accordingly, as you know, monetary policy was tightened last week, taking the cash rate to 6.5 per cent.

Subsequently, towards the end of last week there was a period of stress in some major country money markets. Because the exposures to the mortgage problems in the US are still coming to light, financial institutions are uncertain over the standing of other market participants. Objectively, it is extremely unlikely that the sub-prime mortgage exposures could significantly damage the core banking system in any significant country. The exposures are spread far too widely for that to occur. But precisely because they are spread widely, and because the associated financial structures are opaque, information on who is exposed and by how much is incomplete. Hence people remain wary. At times of uncertainty, market participants naturally get more cautious and want to hang on to cash, rather than lending it in the interbank market.

In such circumstances, central banks typically respond by being prepared to make additional cash available, through purchases of high-quality assets from market participants, in sufficient quantities to keep the cash rate at the level required by monetary policy considerations. Several major central banks made very substantial injections in this way on Thursday and Friday last week in the face of an abrupt shift in cash market conditions. While the likelihood of a significant problem of this sort arising in the Australian money market was low, last Friday the Reserve Bank as part of its normal dealing operations purchased more assets, hence adding more cash to the system, than it otherwise would have done. The intent of this was to ensure that the cash rate remained at the target level set by the Board. The market operated normally and overnight funds were available in the market at 6.50 per cent, exactly as intended, and this has remained the case subsequently. Of course, the Reserve Bank remains ready, as always, to ensure there is adequate liquidity for markets to function normally in the period ahead.

The broader credit market issue is that the losses arising from the US mortgage problems are still being assessed and absorbed. That is producing a degree of uncertainty that is affecting financial markets around the world, leading to tougher borrowing conditions for the moment, and considerable volatility.

The fact that the global economy has been so strong, that core financial institutions after years of strong profits are well

capitalised, and that real sector corporate profitability in most countries is very sound, will be helpful in coping with tougher credit conditions if they persist. Indeed, global growth has of late been sufficiently strong that *some* moderating effect would be welcome.

An adjustment to investor behaviour needed to occur, and was almost certainly overdue. Such adjustments often are not entirely smooth, and are frequently triggered, as in this case, by the realisation that credit terms had been too generous for too long. Sometimes, however, the ensuing retreat can go too far, resulting in a widespread withdrawal from the provision of credit that unnecessarily crimps the pace of economic expansion. We will, therefore, have to continue to watch carefully how this unfolds over the period ahead.

The *Statement on Monetary Policy* released a few days ago contains our most recent assessment of the outlook. It takes account of the change in interest rates as well as the recent flow of data at home and abroad. There are, of course, various assumptions on which the outlook is based, and these parameters could shift over time. The credit market developments add a further degree of uncertainty about the outlook.

Subject to that uncertainty, the picture is one of growth close to trend and the economy remaining close to full employment. Under such circumstances, inflation is likely to be around 3 per cent over the coming year, and near the top of the target zone in the following year. As far as risks to that forecast are concerned, the possibility that the world economy might end up being weaker than assumed, due to a persistence of credit difficulties, is one that everyone will have in mind at present. At the same time, there is also the possibility that ongoing strength of demand in a fully employed economy might leave us with inflation pressure that is harder to manage than expected.

These possibilities, and other things that could come along unexpectedly, will be issues that the Board will have to assess each month. For now, my colleagues and I are here to respond to your questions.

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