RESERVE BANK OF AUSTRALIA

Speech

Remarks to A50 Dinner

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Thank you for the invitation to speak at the A50 Dinner. I would like to offer a particularly warm welcome to those of you who are visiting Australia. The A50 Forum provides a unique opportunity to hear directly from leaders in the worlds of business, politics and Australia's policy institutions. You will find us open and transparent, not only in our assessments of the opportunities that Australia faces, but also the challenges confronting us.

One of the facts that visitors to Australia most frequently remark upon is that Australia has experienced 26 years of economic growth. Over those 26 years we have certainly experienced some slowdowns and periods of rising unemployment, but this long record of economic expansion and stability is not matched elsewhere among the advanced economies. Importantly, it has been accompanied by a long period of stability in our financial system.

These are significant achievements. This is especially so in light of the very large structural changes that have occurred in the global economy since the early 1990s, and the instability we have witnessed elsewhere.

A country doesn't experience these types of outcomes without some good fortune and, importantly, without sensible policy and strong institutions. In Australia, we have had all three.

Partly through sensible and pragmatic policy, the Australian economy has developed the flexibility to adjust to a changing world. An important element of this flexibility is our floating exchange rate. Another is our labour market, which has developed the flexibility to adjust to changes in the economic landscape. A third element is the fact that both monetary and fiscal policy have maintained their ability to adapt to changing circumstances. All these things have helped us adjust to some very large shifts in the economy.

Australia has also benefited from our openness to the world. We are an outward-looking country. Over many decades, our prosperity has been built on our ability to trade in open and competitive markets, to attract investment and ideas from abroad, and to attract talented people to Australia. We have benefited tremendously from an open, inclusive and rules-based international system. We have as much at stake as any other country in the continuation of this system.

Our location on the globe and our mineral and energy resources have both given us a deal of good fortune. In earlier generations, our location was seen as a liability – we were simply too far from the major engines of global growth. Today, though, our location is seen as an asset. We live in the most dynamic region of the global economy and we have capitalised on this with strong trade and personal links with Asia. Over recent times, we have benefited significantly from these links. The most obvious example is the very strong growth in exports of our resources. But increasingly, it is also being seen in the growth of exports of high-quality services, food and manufactured goods to Asia.

Naturally enough, after 26 years of economic expansion people wonder what the future holds. This is an issue that often comes up in discussions with overseas investors. So I would like to use the opportunity of this dinner to address three related questions that we are frequently asked. These questions are:

- What are the next few years likely to hold for the Australian economy?
- What are the challenges facing the Australian economy?
- As other central banks reduce monetary accommodation won't the RBA have to, too?

The Next Few Years

For a while now we have been expecting the Australian economy to grow more strongly in 2018 and 2019 than it did, on average, over recent years. There are a number of reasons for this. We are all but through the decline in mining investment to more normal levels, there is a large pipeline of urban infrastructure work to be done, the global economy is experiencing a solid upswing, commodity prices are up and financial conditions remain accommodative. All this is helping.

The RBA will be releasing our latest economic forecasts tomorrow in the *Statement on Monetary Policy*. These forecasts will be largely unchanged from the previous set of forecasts. The RBA's central scenario remains for the Australian economy to grow at an average rate of a bit above 3 per cent over the next couple of years. This outlook has not been affected by the volatility in the stock market over recent days. Indeed, it is worth keeping in mind that the catalyst for this volatility was a reassessment in financial markets of the implications of strong growth for inflation in the United States. For some time, many investors had been working under the assumptions that unusually low inflation and unusually low volatility in asset prices would persist, even with above-trend growth at a time of low unemployment. A reassessment of these assumptions now appears to be taking place against the backdrop of strong economic conditions globally.

Looking beyond these financial events, the data we have received on the real economy over the summer have been consistent with our assessment that GDP growth will pick up over 2018. Taken together, the recent domestic and global data on the real economy suggest that 2018 has started on a more positive note than did recent years.

Particularly noteworthy has been the labour market, with employment increasing by 3¼ per cent over the past year. This strong performance has been accompanied by a large number of people joining the workforce, so that the participation rate has returned to around the level reached at the peak of the mining investment boom. There have been noticeable increases in the participation rates of both women and older Australians. At the same time, the unemployment rate has declined to around 5½ per cent and a further gradual decline is expected over the next couple of years.

Business conditions are around their highest level since before the global financial crisis and there has also been an improvement in business confidence. Non-mining business investment has been stronger than we had expected a year ago and the investment outlook has brightened. One ongoing area of uncertainty, though, is consumer spending. Household incomes are growing slowly and debt levels are high. I will return to these issues in a moment.

On the prices front, we continue to experience subdued outcomes, although inflation is higher than it was a year ago. Over 2017, inflation was a bit under 2 per cent, in both headline and underlying terms. Last week's data provided further confirmation of trends we have been witnessing for some time. Increased competition in retailing is contributing to price declines for many consumer durables. And subdued wage increases are contributing to low rates of inflation for a range of market services. The rate of rent inflation also remains low.

The immediate outlook is for a continuation of these broad trends, but for inflation to pick up gradually as the economy and labour market strengthen. We are expecting CPI inflation to be in the 2 to 2½ per cent range over the next couple of years. Underlying inflation, which is less affected by the scheduled increases in tobacco excise, is expected to be a bit lower than CPI inflation.

I would now like to touch on a couple of issues that we are paying close attention to and that could have a significant bearing on the outlook for growth and inflation over the next couple of years.

The first of these is wage growth. Not only are most workers experiencing low wage increases, but following the resources boom some people have moved out of highly paid jobs. The result is that after many years of Australians experiencing strong growth in real incomes, growth in average nominal and real incomes has been much slower over recent times.

The effects of low real wage growth on the economy work in different directions. On the one hand, the restrained growth in labour costs is one of the factors that has boosted employment. But, on the other hand, the slow growth in incomes has weighed on spending, including by making it harder for some households to pay down their debts.

On balance, though, in the current environment, some pick-up in wage growth would be a welcome development. Ideally, this would be on the back of stronger productivity growth. But even if productivity growth were to be around the average of recent years, a faster rate of wage increase should be possible. Indeed, a lift in wage growth is likely to be necessary for inflation to average around the midpoint of the 2–3 per cent medium-term inflation target. Stronger growth in real wages would also boost household incomes and create a stronger sense of shared prosperity.

Our central scenario is for this pick-up in wage growth to occur as the economy strengthens, but to do so only gradually. Through our liaison with business we hear some reports of wage pressures emerging in pockets where labour markets are tight. We expect that over time we will hear more such reports. After all, the laws of supply and demand still work.

I have spoken previously about the factors affecting wages, and they have a global dimension. Globalisation and advances in technology have increased competition, and greater competition means less pricing power. Given the strength and pervasiveness of these forces, it is unlikely that they are going to disappear quickly, so the pick-up in wage growth is likely to be fairly gradual.

A second factor shaping the outlook is the level of household debt. Indeed, the high level of household debt in Australia is remarked upon by international investors almost as often as the fact of 26 years of growth.

A while back we had become quite concerned about some of the trends in household borrowing, including very fast growth in lending to investors and the high share of loans being made that did not require regular repayment of principal. Our concern was not that developments in household balance sheets posed a risk to the stability of the banking system. Rather, it was more that they posed a broader macro stability risk – that is, the day might come, when faced with bad economic news, households feel they have borrowed too much and respond by cutting their spending sharply, damaging the overall economy.

We have worked closely with APRA, including through the Council of Financial Regulators, to address these issues. This work, together with other steps taken by APRA, has helped improve the quality of lending in Australia. In the housing market, there has also been a change. National measures of housing prices are up by only around 3 per cent over the past year, a marked change from the situation a couple of years ago. This change is most pronounced in Sydney, where prices are no longer rising and conditions have also cooled in Melbourne. These changes in the housing market have reduced the incentive to borrow at low interest rates to invest in an asset whose price is increasing quickly.

On balance then, from a macro stability perspective, the situation looks less risky than it was a while ago. We do, however, continue to watch household balance sheets carefully as there are still risks here.

Challenges

I would now like to move to the second question that I get asked frequently. Beyond the short term, what are the challenges facing the Australian economy?

When I spoke at this forum last year I talked about four challenges:

- the need to reinvigorate productivity growth

- finding ways of capitalising on the opportunities in Asia
- providing the infrastructure needed for a growing population and to support productivity
- making sure that our public finances were on the right track and that our tax system was internationally competitive.

This is by no means a complete list; at a minimum, you could add some of the issues I have just spoken about. But it remains a reasonable list and I thought it useful to offer an update.

Improving our productivity remains the key to further improvement in our living standards. Average growth in labour productivity has been a bit higher since the peak in the mining boom than it was in the preceding five years, although capital deepening has been an important part of the story here. Late last year the Productivity Commission provided some guidance about how we might lift our performance with the release of the first of its five-yearly reports – the *Shifting the Dial* report. This is another example of Australian policy institutions tackling important issues through serious and systematic reviews. A central theme of the report is the importance of services and cities. Most Australians now work in the service sector and live in cities, so how we deliver services and how our cities function have a major influence on our future living standards. This is yet another area where we will benefit from a strong innovation mindset.

On building our links with Asia, we continue to see progress. New trade agreements are opening up new opportunities for Australian business in the region and the share of Australia's exports going to Asia continues to rise. Last year, the value of Australia's merchandise exports increased by more than 15 per cent to each of China, Japan, Korea, Taiwan, Indonesia and the Philippines. Exports of resources have been an important part of the story, but it is broader than that, with strong growth in exports of services too. Person to person links also continue to deepen, with half of all international visitors to Australia last year coming from Asia.

On infrastructure, the story is also a positive one. Increased public investment in infrastructure in our largest states is currently providing a boost to the economy and it is also building productive capacity for the future. With our population continuing to grow at a relatively fast rate for an advanced economy – around 1½ per cent a year – this is an area for us to continue to focus on. As we do this, we need to pay close attention to the governance of decisions around project selection, the control of construction costs, usage pricing and the allocation of risk between the public and private sectors. Good governance is important in these areas to support sound decision-making and to retain public trust and confidence in governments' spending plans.

Finally, on the fiscal side, the latest estimates are that things are on track to meet the Australian Government's projection of returning the budget to balance by 2020/21. Australia's record of careful management of public finances meant that when the financial crisis hit a decade ago, fiscal policy was able to play a role stabilising the economy. Ensuring that our public finances are on a sustainable footing is important to ensuring that we have similar flexibility in the future. The issue of how the tax system affects the competitiveness of Australia as a destination for investment is one of ongoing political debate. There have been some cuts in company tax and parliament is considering further changes.

Reduction of Monetary Stimulus Globally

I would now like to turn to the final question that I often get asked: as other central banks raise interest rates, won't the RBA have to, too?

It is understandable that this question is asked. Over time, there is a common element to movements in interest rates around the world. The level of interest rates in all countries is influenced by movements in the neutral global real interest rate. During the financial crisis, the neutral global rate fell and this has had an important influence on the setting of interest rates in all countries, including here in Australia. If we had not lowered our interest rates as global rates fell, the Australian economy would have grown by less and inflation would have been even lower than it turned out to be.

The fact that there is a common element in interest rates, however, does not mean that interest rates need to move in lock-step with one another. Countries with a floating exchange rate, like Australia, still retain considerable flexibility to set interest rates based on their domestic considerations. We did not lower our interest rates to the extraordinarily low levels seen elsewhere after the financial crisis. Our circumstances were different: we didn't have a meltdown in the financial system and we experienced a very large cycle in commodity prices and mining investment.

Just as we did not move in lock-step on the way down, we don't need to do so in the other direction. It's understandable that some other central banks are raising rates. They lowered their rates by more than us and, in a number of countries, the unemployment rate is now below conventional estimates of full employment at a time when above-trend growth is expected.

Our circumstances are a little different. We are still some way from what could be considered full employment and our central scenario for inflation is for it to remain below the midpoint of the medium-term target range for the next couple of years.

We expect, though, to make further progress in reducing unemployment and having inflation return to the midpoint of the target range. If we do make that progress, at some point it will be appropriate for interest rates in Australia to also start moving up. So, given recent developments in Australia and overseas, it is likely that the next move in interest rates in Australia will be up, not down. If this is how things play out, the likely timing will depend upon the extent and pace of the progress that we make. As I have discussed, while we do expect steady progress, that progress is likely to be only gradual. Given this, the Reserve Bank Board does not see a strong case for a near-term adjustment in monetary policy. It will of course keep that judgement under review at future meetings.

I hope that these remarks this evening have helped you understand the Australian economy, our opportunities and some of the challenges we face. I look forward to answering your questions.

Endnotes

[*] I would like to thank Michael Plumb for assistance in the preparation of these remarks.