

# SOME ASPECTS OF MONETARY POLICY

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*Talk by the Governor, B. W. Fraser, to Australian Business Economists (ABE), Sydney, 31 March 1993.*

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I have been looking forward to this opportunity to speak to ABE.

For one thing, business economists tend to be practical and pragmatic people who are interested in policies which actually work, rather than theoretical or ideological prescriptions. Perhaps this is because they have to 'sell' their advice to their boards and clients, and bear a measure of responsibility for the quality of that product. In these respects, they are akin to practical central bankers!

With the election settled, now is also an opportune time to revisit some aspects of the Reserve Bank's monetary policy role. Some views of this role became rather foggy in the hothouse political atmosphere of the recent past. Demisting might make the path of monetary policy easier for business economists (and others) to follow in the years ahead.

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## THE ECONOMIC CONTEXT

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First, a few comments on the economy.

At around 11 per cent, unemployment is understandably the main focus of current discussion. The magnitude of that problem reflects the conjunction of unusually strong cyclical and structural forces. After contracting

in 1990/91, the economy has been growing at a modest 2 to 3 per cent, which is not fast enough to reduce unemployment.

The effects of the recession have been compounded by longer-term structural changes in the labour market. To help sustain profits, and to become more competitive, businesses everywhere have been vigorously cutting their costs - and especially their labour costs. This cost cutting, together with associated efforts to raise productivity, has real pluses for the economy longer term, but it involves immediate job losses.

As we get more perspective on the economic history of the late 1980s and early 1990s, we may find that the record is better than it appears from the current perspective, close to the low point in the cycle. Certainly, many structural and attitudinal changes have occurred which augur well for Australia's future prosperity. These include:

- Widespread (and on-going) micro-economic reforms, extending across the public and private sectors, and penetrating the product, capital and labour markets.
- The emergence of a more competitive economy consequent upon Australia's increasing integration with the outside world - import volumes increased from 15 per cent of GDP in 1986 to over 18 per cent in 1992, while export volumes rose from 15 per cent to almost 20 per cent. This increased focus on export markets is no passing fashion, to be dropped when domestic demand picks up: it reflects a

fundamental change of attitude towards exporting, particularly to the fast growing Asian economies.

- Inflation and inflationary expectations have fallen to low levels. The 'headline' rate of 0.3 per cent in the past year is among the lowest in the world, while the underlying rate of around 2 per cent matches that of the traditionally low inflation countries.

In these (and other) ways, the economic structure and mindset of the nation are changing. The benefits of these changes will become more apparent as the recovery accelerates, as will the opportunities they present. As Peter Drucker said recently: 'Whoever exploits structural trends is almost certain to succeed.'

The two main constraints on faster growth at present are slack business investment and the global recession. As a share of GDP, business investment is at its lowest level in decades, depressed by surplus capacity (including empty office space), asset price falls and debt burdens. With time, these negatives will fade and more businesses will start expanding and investing again.

Recoveries traditionally have been primed by higher commodity prices and export demand but that external stimulus has been missing on this occasion. Time, too, will lift that constraint. OECD countries as a bloc are forecast to grow a little faster in 1993 - perhaps by about 2 per cent, compared with around 1<sup>1/2</sup> per cent last year. Faster growth in the United States should offset continuing weakness in Japan and Germany. Fortunately for Australia, the sustained rapid growth of most of the Asian economies (other than Japan) is cushioning the effects of the global recession - these countries now account for about one third of our total exports.

Australia's growth rate should pick up gradually during the course of 1993. It will be aided by the fiscal stimulus now in the pipeline, and by the recent depreciation of the \$A which, in TWI terms, is about 12 per cent below its September 1991 peak. (In real terms, because we have been doing better than our competitors in the inflation stakes, the fall

would be a couple of percentage points more than this.)

I expect the economy to be growing at an annual rate of about 4 per cent by the end of 1993. Growth of at least that order is needed over a sustained period to provide jobs for all those people who want them. Jobless growth is inadequate growth.

A good blend of economic policies is important. Most policies have both short and long-term effects which can pull in different directions. Ideally, policies at this time should address both the short-term cyclical problem of excess capacity *and* enhance the longer-term growth potential of the economy. I want to talk about some of the issues involved here from the perspective of a central banker - whose primary focus is, of course, monetary policy.

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## OBJECTIVES OF MONETARY POLICY

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Like central banks everywhere, the Reserve Bank attaches a high priority to price stability. Our role as guardians of low inflation is important in part because there is no strong, natural lobby for it in Australia. The high inflation rates of earlier years were lamented widely, but our re-entry to the low inflation club has not brought out large numbers of cheering fans.

Hopefully, more support will develop in time as, for example, low inflation is seen to assist businesses to make sound investment decisions in more competitive export sectors; as workers see the creation of new and more sustainable jobs; and as savers come to appreciate that while low inflation means lower interest earnings it also means greater protection of their savings from the insidious tax that high inflation is.

The appropriate degree of price stability to aim for is a matter of judgment. My own view is that if the rate of inflation in *underlying* terms could be held to an average of 2 to 3 per cent over a period of years, that would be a good outcome. Such a rate would be unlikely to

materially affect business and consumer decisions, and it would avoid the unnecessary costs entailed in pursuing a lower rate.

Achieving and maintaining low inflation *does* involve some costs. This is true of most structural changes - including, for example, lower tariffs and increases in competition more generally; wage restraint; and changes in taxes and other fiscal measures.

And it is true of monetary policy, which plays the crucial role of anchoring prices and price expectations in the medium term. Changes in interest rates can have immediate 'announcement' effects, including via the exchange rate, but monetary policy works to reduce inflation mainly through its lagged effect on domestic demand. By increasing the amount of slack in the economy, monetary policy affects the behaviour of price and wage setters and in that way impacts on inflation and inflationary expectations.

It follows from this that monetary policy has implications for activity as well as prices, and that central banks should have regard to both. Most do, although not always as explicitly as in the case of the Reserve Bank of Australia.

Over the past three years, monetary policy has been exercised with an eye to both inflation and activity. Interest rates have been eased progressively on the back of signs that inflation and inflationary expectations were falling, and that activity and employment were slowing. It is true that over this period the signs in respect of both objectives were pointing in the same direction, i.e. in favour of progressive easings. Nonetheless, attention did remain focussed on both objectives: if the concern had been about activity levels only, for example, monetary policy may well have been eased less cautiously.

The exchange rate was not a dominant consideration in monetary policy deliberations during most of this period, although it has assumed more prominence in recent months. Again, this reflects a concern for both objectives: a further sharp depreciation of the \$A, coming on top of the earlier falls, would have posed risks for inflation and, through its effects on general confidence levels, for activity also.

## POLICY FLEXIBILITY AND 'TARGETS'

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In simple terms, monetary policy decisions reflect judgments about how best to sustain reasonable price stability without unreasonably constraining activity. These judgments have regard to the circumstances at the time - the extent to which inflation is out of control, for example, or the jobs situation is deteriorating.

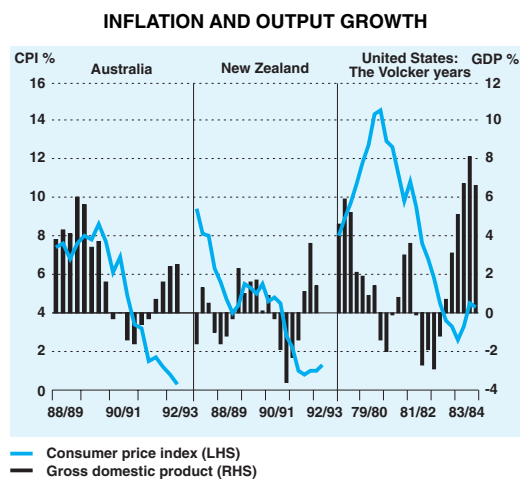
Earlier in the cycle, the task was to steer a course that would deliver lower inflation while minimising the inevitable costs in terms of output and employment. The task now is to hold the gains on inflation while releasing the brake on activity. To assess the extent to which monetary policy is acting as a brake on the economy requires a careful monitoring of a large number of activity and financial indicators.

In practice, policy making is more complex than this. Inflation and activity are buffeted constantly by 'shocks' which push the economy off track; the indicators often give conflicting signals; and monetary policy operates imprecisely and with lags. Retaining some room to manoeuvre in the implementation of monetary policy is therefore important. One lesson that has been hammered home to me over the years is that policy flexibility is the best defence against shocks of various kinds (including major forecasting errors!). It is a simple lesson but, in economics as in other fields, the simple lessons are often the last to be learned.

Partly for this reason, I am rather wary of inflation targets. A case for targets can be made where inflation is out of control and no credible anti-inflation policy is in place. In those circumstances, a target which the authorities were seen to be totally committed to could help to establish credibility and thereby push down price expectations. Even in these circumstances, however, the evidence suggests that price expectations are shifted more by actions than by words.

To my knowledge, no country has reduced its inflation by incantation, rather than by creating some slack in the economy. My reading of the evidence is that Australia reduced inflation at least as effectively (in terms of the trade-off between inflation and lost output) as countries like New Zealand, which have an inflation target. (I note in passing that inflation was also reduced about as effectively as in the celebrated 'Volcker disinflation' in the United States in 1979-82 - see Graph 1.)

GRAPH 1



An inflation target of the narrow '0 to 2 per cent' variety would, I believe, do us more harm than good. In particular, such targets are apt to bias policy responses to shocks which impinge on prices. Such shocks are probably best absorbed by changes in *both* prices and activity but if the authorities are bound to a narrow inflation target then virtually all of the shock has to impact on activity.

We are often reminded that activity cannot be fine-tuned. Fine-tuning prices is at least as difficult and attempts to do so are likely to adversely affect other macro-economic goals.

## INDEPENDENCE AND ACCOUNTABILITY

Much has been said about Reserve Bank 'independence' over the past few years and,

more recently, about the Bank's 'accountability'.

A high degree of *independence* and insulation from day-to-day political pressures is important for a central bank. It is a way of reducing the risks that monetary policy might be misused for short-term political purposes. That is why central bank independence is an important element of a good macro-economic framework.

Unfortunately, much of the public debate on this issue has been rendered sterile by gladiatorial notions of independence - as something to be displayed like a warrior's shield, raised in constant battle with the government of the day. Nowhere do such romantic notions ring true.

I have said many times that the Reserve Bank does, in fact, have a high degree of independence. We can and do pursue our statutory responsibilities without political interference. But we seek to do this in close consultation with the government - to exercise *independence with consultation*. This accords with the linkages which exist between monetary and other policies, and with the realities of decision making processes in most comparable countries. Co-operation and consultation are not the same as subservience.

As in all joint ventures, success relies on the goodwill of the participants. Should this not be forthcoming, and major disagreements were to develop concerning the conduct of monetary policy, then the dispute resolution procedures outlined in the *Reserve Bank Act* would be activated. Those procedures, however, have never been used. (Indeed, it is ironic that the advocacy over recent years of greater independence for the Reserve Bank - essentially as a means of focussing monetary policy on lower inflation - has coincided with a period when inflation has fallen to its lowest level in a generation, although monetary policy cannot claim all the credit for that.)

Recent talk of greater *accountability* of the Bank is a potentially more fruitful issue for discussion. It at least carries with it the inference that the Bank is independent and has something to be accountable for! Yet it is not always clear what people have in mind when

they talk about accountability, or what is driving suggestions that the Bank should be 'more' accountable.

The Reserve Bank cannot (and does not) expect to have independence without accountability. In simple terms, the *Reserve Bank Act* entrusts the Bank with certain responsibilities and the Bank should be held accountable to the Parliament and the public at large for its actions in pursuit of those responsibilities. The Bank should be required to explain what it is doing and why: such accountability is part and parcel of good governance.

In recognition of the high degree of independence which we have, and have exercised over recent years, we have put a lot more resources into explaining our actions. This is true not only of changes in monetary policy - which have been the subject of public announcements since January 1990 - but also of the Bank's responsibilities for supervision and its other important but less glamorous activities like banking, registry and currency services. Senior bank officers are very accessible and spend a good deal of time talking, publicly and privately, on all aspects of the Bank's operations.

Efforts also are continuing to incorporate additional 'accountability' information in the Bank's Annual Report, which is tabled in the Budget session of Parliament. Since 1991, the opportunity has existed for the House Committee on Banking, Finance and Public Administration to quiz the Bank on issues raised by its Annual Report. That opportunity was taken up last year (on 18 December 1992) but the meeting was attended by only three Committee members (admittedly, there were some competing attractions that day).

It is sometimes suggested that the Governor should be required to appear before appropriate Parliamentary Committees a couple of times a year, in much the same way that the Chairman of the Federal Reserve, for example, is required to appear before Congressional Committees. I have no difficulty with suggestions of that kind, provided they were treated as serious exercises in accountability (as distinct from exercises in

political point-scoring, or lobbying for a particular monetary policy). Indeed, on several occasions over the past few years I would have welcomed such an opportunity to respond to a number of unfounded criticisms levelled at the Bank, sometimes from privileged positions.

We will continue to provide more information about the Bank in statements, speeches and Annual Reports. For me, the main constraint - apart from the confidentiality of some of the information that we collect - is the need to ensure that the Bank's decision making processes are not impaired.

Some important issues are involved here. Many people would no doubt like to know who said what on particular policy issues in Board Room discussions - that is the stuff of conflict so beloved by media commentators in Australia. It can provide good copy for stories on, for example, perceived divisions between the Bank and the Government, and even within the Bank.

But would it improve the decision making process? I think not. It might be seen by some as old-fashioned but, in my view, policy decision making processes usually work best when conducted through private, rather than public, channels. Bank Board members, for example, can - and do - debate policy options, but they should - and do - rally behind the position that is eventually reached by the Board and enunciated by the Chairman. This process is important for efficient decision making and that, in my view, should be the paramount consideration.

It follows that suggestions that the Bank release detailed minutes of its deliberations hold few attractions. I say 'detailed' minutes because the key policy decisions of the Reserve Bank Board are already communicated to the public in press statements in a way that does not occur in, for example, the US (where the directive adopted by the Federal Open Market Committee is released shortly after the next meeting - a lag of about six weeks).

Apart from their potential to fuel 'conflict' stories, and to burn up enormous amounts of energy, the preparation and publication of detailed minutes which reported individual

members' positions would run a real risk of impairing the Bank's decision making. The human temptation would be for Board members to have at least one eye to the public perception of their involvement. It would risk making performers out of participants. Accountability might be enhanced in the sense of being able, retrospectively, to publicly 'nail' or praise particular Board members, but the decision making process would suffer.

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## FISCAL AND OTHER POLICIES

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I mentioned earlier that no path to price stability was costless. These costs, however, could be diminished to the extent that other policies are supportive of monetary policy.

Wages pressures, for example, have been critical influences at times. In the mid-1970s, wage demands fuelled the inflationary process and distorted factor shares. On the other hand, wage restraint in the late 1980s (achieved in part through wage/tax trade-offs) was important in preventing inflation from escalating in the boom conditions of 1988 and 1989.

At this time, wages pose no threat to inflation but the time will come when there is much less slack in the labour market than exists at present. Wages policy would then be called upon to help avoid another round of competing claims for increased shares of the national cake; the success or failure of that policy would have a bearing on the appropriate stance of monetary policy.

What happens to fiscal policy is also relevant in this context. Fiscal policy has been in the headlines recently and I want to take this opportunity to elaborate on some brief comments I made recently.

At times monetary and fiscal policy can reinforce one another, while at other times monetary policy can be called upon to 'offset' or counter-balance fiscal policy. If, for instance, the economy was running close to capacity and fiscal policy was still imparting a stimulus, then

monetary policy - with its eye on inflation - would have to try to offset this.

That is *not* the situation we face in Australia at present. With the economy growing only slowly, and with plenty of slack in evidence, now is not the time to implement a vigorous deficit reduction campaign. But while the present degree of fiscal stimulus might be broadly appropriate, we do need to be able to pull back as the economy recovers.

The problem, as we see it, is further down the track. There are two aspects, cyclical and structural.

The *cyclical* concern is that, when business investment does recover and this feeds through to faster growth in spending, capacity constraints will begin to appear, putting pressure on inflation. To help avoid this, the extra fiscal stimulus injected during the slack period should be withdrawn. In part, this will happen automatically through the operation of so-called 'automatic stabilisers': as the economy grows, tax revenues rise and expenditure on unemployment benefits falls. Economic growth can have a powerful effect on the deficit but more than that is likely to be required to wind back the extra discretionary expenditure provided during the downturn.

In addition to this cyclical concern, there is the matter of the *structural* deficit. Structural deficits are not intrinsically inflationary; the US has run a significant structural deficit throughout the 1980s while maintaining a good record on inflation, while the experience of OECD countries generally suggests there is no clear relationship between deficits and inflation.

The concerns about large structural deficits are of three kinds. First, there are arguments about resource allocation - that continuing structural deficits can be justified only if the return on the budget spending is very high and will benefit future generations, who have to foot the bill. Some government expenditures do, no doubt, have very high returns and raise the longer-term production potential of the economy. I simply observe here, however, that the case has not been made to justify continuing structural deficits on this ground.

A second argument against large on-going deficits is that governments can be tempted to resort to the printing presses to finance them and this will push up inflation. This seems to have been a common enough experience in some developing countries, and it was an issue in Australia in the 1970s. Since the mid 1980s, however, budget deficits in Australia have been fully funded by tenders of securities at market determined rates.

The third and substantive concern comes by way of the external sector. Because we are linked with outside capital markets, an on-going structural budget deficit need not 'crowd out' business investment or other desirable domestic expenditures. Instead, the extra expenditure is likely to be reflected in a larger current account deficit. This is not to say that the linkage is one for one: the experience of the 1980s refuted the rigorous version of the 'twin deficits' theory. But there *is* a link between the budget deficit and the external deficit.

The external deficit averaged around 5 per cent of GDP during the 1980s. It is now about 3½ per cent but it could widen again as the economy grows faster. While a significant deficit can be sustained for quite some time (as was demonstrated in the 1980s), sooner or later it has to be wound back if we are to maintain the confidence of international investors.

Whether we like it or not, the reality is that even *perceptions* of large on-going budget deficits and borrowing requirements risk major instability in financial markets, which is in no-one's interests. We have had several reminders over the past year of how such perceptions, which were not always well founded, have destabilised both bond and foreign exchange markets.

Winding back the dependence on foreign savings - which is effectively what the current account deficit reflects - requires an improvement in the nation's savings/investment imbalance. Encouraging private savings (through, for example, more superannuation) is important but it seems inevitable that the major contribution will have to come from the public sector reducing its demands on savings to fund its deficits.

I repeat that the fiscal task is *not* to withdraw immediately the short-term stimulus, but to address the longer-term problem. This requires longer-term solutions and the planning for these needs to start now. As one of the foot soldiers in the late 1980s campaigns, I know that it is, in the words of the Duke of Wellington, a matter of 'hard pounding'. It takes time and, in practice, plans need to be put in place before the pressures emerge. It is, therefore, reassuring to hear the Treasurer reiterate a couple of days ago that planning is underway.

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## CONCLUSION

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Tensions can arise for both monetary and fiscal policy between what they can do to help smooth the cycle, and their longer-term objectives. That is one reason for seeking to co-ordinate these (and other) policies as much as possible.

So far as monetary policy is concerned, various institutional and operational changes have been suggested with the aim of preserving the longer-term objective of price stability in the face of pressing short-term cyclical concerns. We do not believe that narrow targets - whether in the form of a monetary aggregate, the exchange rate, or an inflation number - provide the answer. But nor does ad hoc policy making.

We think we have struck a reasonable mix - a flexible approach which gives a high priority to low inflation over the medium term, while recognising that policy also has to take account of what is happening to jobs and activity in the near term.

Inflation is now running at low levels and the authorities have reiterated their determination to retain those gains as the economy picks up. We believe we have the institutional and operational structure in Australia to back that resolve.