Making Monetary Policy in an Uncertain World

Talk by the Deputy Governor, I.J. Macfarlane, to Monash University Law School Foundation, 27 August 1992.

I want to take the opportunity today to say something about monetary policy over the last few years. At the same time, it is important to view it against the background of some other economic events that have been occurring during this period. For example, we should look outward to the rest of the world, inward to Australian micro and regional economies, and also look at some important structural changes that have been occurring during the latter half of the eighties and into the nineties. Some of the material I will present comes from our Annual Report published last week, but some is new.

The External Environment

(a) The World Business Cycle

No country has eliminated the business cycle. The cycles are less pronounced than before the Second World War, but within the post-war period, there has been no tendency for them to become smaller. There is also still a high correlation between the timing of each country's business cycles, so the world economy, particularly the OECD area, also exhibits a clear business cycle.

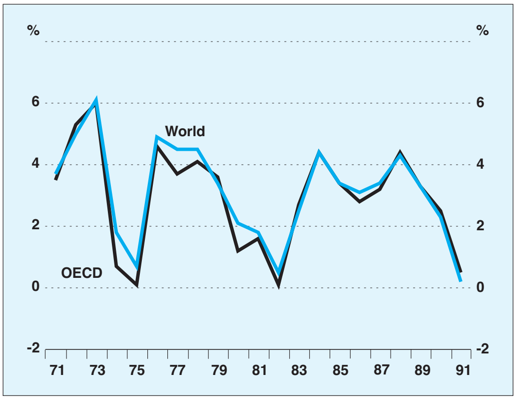
This cycle is familiar to many people and they would have no difficulty in identifying the three world recessions of the last quarter of a century. These occurred in 1974, 1982 and 1991. Not surprisingly, Australia's recessions have followed approximately the same timetable.

Although it is useful to talk of the business cycle as a recurring event, it should not be implied that all cycles or all recessions are the same. While the current world recession has a lot of similarities with its predecessors in the seventies and eighties, it also has some notable differences.

One somewhat surprising similarity this time is the size of the world downturn. We are accustomed to thinking of the present downturn as being mild compared to its predecessors, but this is not so. We still have the earlier forecasts in our mind; they certainly pointed to a relatively mild downturn, but as the numbers have come in, they have been a lot weaker than forecast. Overall, the downturn has been more pronounced than forecast, and of virtually the same severity as previous major downturns (Graph 1).

Growth in the OECD area in 1991 has now been revised down to 0.5 per cent. For the world economy, the IMF estimate that its growth was weaker still; in fact, their figures show 1991 as being weaker than 1975 and 1982. Part of this is due to developments in Eastern Europe and the former Soviet Union,

OUTPUT GROWTH
Annual Per Cent Change



GRAPH 1

where output is estimated to have fallen by 10 per cent in 1991.

Over the last couple of years, the business cycles in individual OECD countries have been relatively unsynchronised. This was widely held to be a stabilising factor which would contribute to a relatively mild downturn. For example, some countries like the US and the other English-speaking countries plus the Scandinavian countries went into recession relatively early in the process, while others, most notably Japan and Germany (and a lot of Continental Europe) continued to grow. This may well have modified the severity of the downturn, but when Germany and Japan enter the contractionary phase, as they now are, it will also make for a much weaker recovery in the world economy. Lack of synchronisation is a mixed blessing; it may have moderated the size of the immediate contraction, but is dragging it out.

A factor which has been important this time around, but not on previous occasions has been the asset price boom and bust. By and large, the countries that went into recession first were the ones that had experienced the largest increases in debt and asset prices – the US, UK, Australia, New Zealand, Canada and the Scandinavian countries. Continental Europe held up best, in part because of its relative lack of financial excesses in the eighties, and also because of the fiscal boost it received from German unification. Table 1 below shows a comparison of the size of the downturn in OECD countries for which we can get timely data, measured by the fall from peak to trough in GDP. Over half of the countries have had a fall, but it is too soon to conclude that this is the final scorecard.

There are a few exceptions to the pattern mentioned above, the biggest of which is

Table 1: Real GDP in Selected OECD Countries

	Average Growth Rate 1985-89	Peak to trough movement in GDP
Finland	4.0	-9.5
United Kingdom	3.6	-4.2
New Zealand	0.9	-4.1
Canada	3.5	-3.7
Sweden	2.3	-2.6
Australia	3.8	-2.0
United States	3.0	-2.2
Norway	2.5	-1.2
Switzerland	3.0	-1.1
Germany	2.5	-0.9
Austria	2.7	—
France	3.1	—
Italy	3.2	—
Japan	4.8	—
Netherlands	2.7	—

Japan. It had a huge asset price boom and bust but no recession, although activity has slowed well below the "cruising speed" that had been expected. Asset price falls in Japan, although relatively recent, have been large by world standards. Let us hope that the legendary ability of the Japanese to pull through difficult economic times – as they did in the early eighties, when they were the only OECD country to avoid recession – comes to the fore again this time.

(b) World Inflation

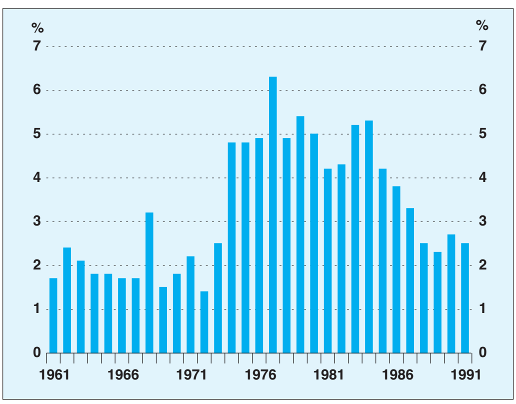
On this occasion the world recession was not preceded by a major inflationary supply shock as 1974 was by OPEC I and 1982 was by OPEC II. If you tried hard, you could perhaps give the Gulf War the same type of role this time, but its effects were much smaller and shorter-lived. As a result of the absence of a substantial supply shock, OECD inflation did not rise by as much during the upswing this time. It rose from about 3 per cent to about $4^3/_4$ per cent. It has since come back to less than 4 per cent, and is definitely trending lower.

There has also recently been a convergence of inflation rates among OECD countries. One simple way of showing this is to calculate the standard deviation of inflation rates for OECD countries for each year (Graph 2). Not surprisingly the international variability of inflation was quite low under the fixed exchange rate regime that was in place up until about 1973. When this broke down into a world of floating exchange rates, each country was free to run its own inflation rate and proceeded to do so. The variability of inflation rates more than doubled in the mid seventies and stayed high until relatively recently.

This convergence in inflation rates has come about largely because the "high inflation" countries have come back into the fold by substantially reducing their core rates of inflation. They have found that running inflation rates noticeably higher than the OECD average – even if still in single digits – is not a viable long-run proposition. On the other hand, the "low inflation" countries have had normal business cycles; inflation went up a bit in the expansion and then returned to where it had formerly been when they entered the recession. It will probably go lower than where it started, but we have not seen it yet.

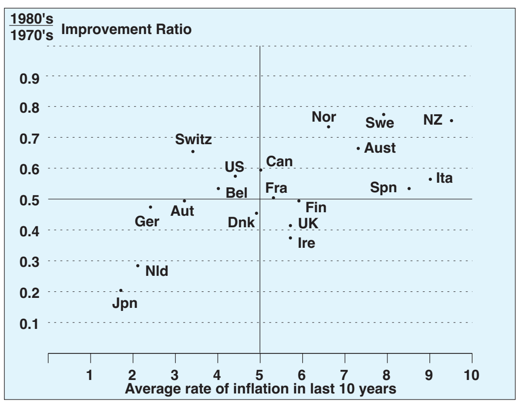
The differing groups of countries are shown in Graph 3. The horizontal axis shows the average rate of inflation over the last ten years. The vertical axis shows the extent to which each country reduced its inflation in the eighties compared with the seventies (a low reading means a big improvement, and a high reading means a smaller improvement). Success in achieving low inflation would show up as a reading near the bottom left hand corner. On the other hand, if only modest improvement was made and inflation was still high by OECD standards, the reading would be near the top right hand corner.

STANDARD DEVIATION OF OECD INFLATION



GRAPH 2

INFLATION



GRAPH 3

On this basis, the successful countries over the last ten years have been Japan, Netherlands, Germany and Austria. At the other end of the scale, the countries that had least success in reducing inflation were New Zealand, Sweden, Australia and Norway; Italy and Spain also ran high inflation but their improvement was greater.

This comparison is on a decade-by-decade basis, and therefore does not give much weight to recent developments. What we know over the last two years is that each of the "high inflation" countries – New Zealand, Sweden, Australia and Norway – has dramatically reduced its inflation rate. The increase in the CPI over the last twelve months for each country is:

New Zealand	1.0
Sweden	1.8
Australia	1.2
Norway	2.5

They were not the only ones to improve; all the countries, in or near the top right hand quarter of the graph have reduced their inflation rates. Canada is down to 1.3 per cent and Finland to 2.6 per cent. Italy and Spain have also improved to 5.5 per cent and 6.2 per cent respectively; this is still relatively high, but these countries averaged 16 per cent in the seventies and about 9 per cent in the eighties.

The paths by which the relatively high inflation countries have chosen to bring inflation back into line have varied, but monetary policy has played the central role.

- Most countries in Europe have chosen to join the Exchange Rate Mechanism. Monetary policy has been set so as to maintain the value of their currencies within a band against other European currencies, most notably the Deutschemark. This has tended to bring their inflation rates towards the German level. The countries that have been in the mechanism for a considerable time, now find themselves with lower inflation than Germany; those that are more recent additions, such as Spain and Italy are still higher than Germany, but coming down.
- Some countries have decided to shadow the ERM, by maintaining a fixed parity to the ECU. Again this has meant that monetary policy has had to be tight enough to maintain the parity of their currency. Norway and Sweden have chosen this path.
- Some, such as Australia, New Zealand and Canada have run anti-inflationary monetary policies without the exchange rate playing a crucial role. In Australia, incomes policy also played a role.

Economising on Labour for Productivity Improvement

I want to turn to something that has been happening in the economy for a number of years, and which has speeded up over the last two years. I refer to the practice that could be variously termed "labour shedding", "economising on labour", "reducing staffing levels" or in its most favourable form – "productivity improvement". Obviously a lot of this, particularly in terms of the timing, is a result of the recession, but a significant part of it is also structural in nature. It is the result of the country realising that whatever goods and services we produce, we should aim to do so at world best practice. We have talked about the need to do this for ages, and have been acting on it for longer than we realise.

This explicit labour shedding for productivity purposes is very hard to quantify. To do so requires figures on a company-by-company basis, and these are hard to come by. Our attempts to put together estimates have not been sufficiently informative for us to publish. They are based on reports which often do not distinguish between planned reductions and actual ones, they do not specify the time period over which the reductions occurred or are planned to occur, and include both cyclical and structural reductions. Although we cannot quantify it, I don't think there are many who would doubt that it has been occurring. It is well summarised by the business journalist – Alan Kohler, when he said last month

"For three years Australian businesses have been obsessed with cutting costs for two reasons: because sales volumes collapsed as incomes and expenditure fell with recession, and because of the unanimous consensus among opinion leaders in the Government, business and unions that the nation must become more internationally competitive. The Federal Government has been forcing industry to cut costs through lower tariffs, plus whatever other pressures it can bring to bear. The ringing message from Canberra – government and opposition politicians and bureaucrats alike – has been that business must cut costs and become more competitive.

If anything, the additional pressure on company directors from the market place has been even greater. Institutional shareholders have made their views on bloated costs crystal clear in word and action. The stock market has been merciless on companies that did not regularly report continuing reductions in manning levels over the past three years. The chief executives of dozens of leading companies have been pushed aside and replaced by people better able to make the hard decisions."

If I could add a few other pieces to Kohler's account, I would point out that some conservative Australian companies, which have never done it before, are announcing significant programs of staff reductions. It is not only occurring in industries where turnover has fallen; firms in insurance/ superannuation and retail banking, for example, where turnover is still increasing have made significant staff reductions. More importantly, it has also happened in public utilities. These are under no direct pressure to do so because of the recession, but have chosen to do so essentially for productivity purposes. The recent EPAC Report on 38 government business enterprises shows a reduction in staffing levels of 34,000 people over the last two years, even though output increased.

These developments will probably continue to happen for some time. Their short-term unemployment consequences are unfortunate, but they are an essential component of any attempt to solve the nation's medium-term problem of sustainable growth in a competitive world. The alternative of thinking that we could insulate ourselves from the world in order to preserve archaic management and industrial practices was not viable. There is no reason why it should take more Australians to manage a bank or load a ship, than it takes in other countries to do the same thing.

Regional Disparities

Australia has traditionally had relatively small economic disparities among states, compared, for example, with Canada or the United States. In cyclical terms, this has also been the case in the post-war period; recessions and expansions have tended to affect each state reasonably evenly.

On this occasion it has been different. Victoria has had a deeper recession than the rest of Australia, although Tasmania and South Australia have had similar experiences to Victoria. Economic forecasters and policy makers have had to come to grips for the first time with very disparate behaviour among states. This is illustrated in Table 2, which shows the fall in employment in Victoria and

Table 2: Fall in Employment
Peak to trough fall in trend employment

	1982/83	*1990/91*
Victoria	3.7	7.1
Rest of Australia	3.4	2.4

in the rest of Australia. In the recession of 1982, the fall in employment was virtually the same in Victoria as in other states. In the recent recession the fall in employment is nearly three times as large. This means that, in employment terms the recent recession is a good deal deeper than the early eighties' one in Victoria, but somewhat milder for the rest of Australia.

Obviously there are some forces at work on a regional basis that have given us this uneven outcome. I do not propose to speculate on them at this stage, other than to say the uneven outcome could not be the result of nationally operating policies. The tight monetary policy that was necessary in the late 1980s has obviously played a role in the recent contraction in output, but it is only part of the story. The same monetary policy operates in each state, so it cannot explain why employment in one could fall by 7 per cent, while in the others by 2 per cent.

I would also like to come to the defence of another nationally operating policy – namely trade policy. There has been a tendency to blame tariff reductions for the severity of the downturn in Victoria (and South Australia). Our calculations suggest that it is only a very small part of the explanation; the proportion of the workforce in the manufacturing industry in Victoria is 20.5 per cent compared with 15.7 per cent for the rest of Australia. The difference is not large enough to account for the very different labour market outcomes, particularly since the proportionate fall in manufacturing employment was about 11 per cent in both Victoria and the rest of Australia. On the most generous assumptions, it is possible to explain about 0.3 percentage points of the extra 4.7 percentage point fall in Victoria by its larger exposure to the manufacturing sector.

The world is becoming a lot more complicated; we cannot assume that all cycles are the same, or all regions the same. It is human nature to want to put things into convenient and familiar boxes, but the simple explanations often let us down.

Monetary Policy In Australia

This last observation brings me to the role of monetary policy in reducing inflation in Australia. In our Annual Report released last week, and its predecessor in 1991, we pointed out that monetary policy in this cycle had developed a more medium-term anti-inflationary focus than formerly. It is a difficult story to tell because it is about a change in emphasis, rather than the abandonment of one policy approach and the embrace of a totally different one. People who wish to simplify the recent approach to monetary policy fall into two classes;

- Sceptics may still doubt that there has been any change in approach. They may think that monetary policy is still aimed only at smoothing the cycle; on that view, a major fall in inflation must be an accident.
- At the other extreme are those who think the change is so complete that monetary policy has concentrated solely on maximising the reduction in inflation and has become oblivious to any other economic considerations.

I will discuss each of these extreme views in turn, in order to set out where I think the truth lies.

That monetary policy has a clearer anti-inflationary focus, I think there can be no doubt. The Bank has put out numerous articles, speeches and reports highlighting the costs of inflation, and the opportunities available for a return to low inflation. As well, there have been a number of changes in the way in which monetary policy is operated.

(i) It is now more transparent in that when a change in monetary policy is made, it is by a discrete amount and is announced the moment it is made.

(ii) Changes usually follow a Reserve Bank Board meeting. Occasionally, decisions made at the Board meeting are contingent on receipt of data confirming some expected economic outcome, e.g. further good news on inflation. In those cases the change follows the receipt of the data.

(iii) Changes are accompanied by a press release spelling out the reasons for the decision. Current and prospective inflation, inflationary expectations and the level of domestic activity are the most frequently quoted variables.

(iv) The pace of reductions in cash rates has been measured and markets have had the opportunity to absorb each change. While the Bank has not been in awe of the market's judgment, it has been conscious that too large a movement could trigger damaging consequences in the foreign exchange and bond markets. We obviously sought to avoid counterproductive reactions which could raise inflation, and conceivably weaken activity at the same time.

The change in focus and in operations has avoided "panic" moves or "about-turns" in monetary policy. The maximum that the bill rate fell in any one month was about 1 percentage point. (In 1982, there were months when it fell by 3 and 4 percentage points.) At no stage was there an attempt to turn all the guns around and focus only on propping up the economy, at the expense of the medium-term objectives. In our view, this would probably have been misguided and risked us ending up with the worst of possible worlds – forfeiting the inflation gains for, at most, a negligible pick-up in activity.

While it is true that the fall in inflation in Australia was greater than forecast by either the authorities or the market, that was also true in other countries where inflation fell sharply, e.g. Canada and New Zealand. It is interesting to ponder why inflation fell so much further in this recession than in its two predecessors. I have already mentioned the role of monetary policy. Two other factors were also extremely important; the effect on inflationary expectations of the widespread fall in asset prices including such household mainstays as houses, boats and cars; and the fact that there was no wage explosion this time so business profits were healthy at the outset of recession.

The other extreme proposition is that monetary policy was only interested in maximising the fall in inflation, regardless of the costs. On this view, the economy would still be moving ahead smoothly, were it not for a misguided application of tight monetary policy. Like its predecessor, I have deliberately set this view up as a caricature, because in answering it, there are several useful points that can be picked up.

(i) The economy was not smoothly moving ahead in the mid and late eighties. It was under some extreme pressures – most notably the debt build-up/asset price boom, and towards the end of the decade, unsustainably strong domestic demand. The tensions were only kept from bursting out by the application of very high real interest rates for most of the decade. It is a mistake to concentrate on the high interest rates of 1989; the whole decade was characterised by high interest rates. Bill and bond rates reached higher levels in 1982 and 1985 than 1989.

(ii) Having seen the experience of other countries in similar circumstances over recent years – some of which subsequently had deeper recessions than Australia – could we have expected to avoid a recession altogether? I think the answer is no, although it is a point that could never be proved. The challenge for policy was to see whether we could come out of it with some permanent improvements in some economic fundamentals.

(iii) While policy was conscious of the need to capitalise on the "once-in-a-decade" opportunity to reduce inflation, it was not operated according to some inflexible rule. For example, the first easings in monetary policy in early 1990 were taken before we had clear evidence that inflation had fallen; the easings were taken on the basis of our forecasts that inflation would come down.

(iv) In nearly all the easings during 1990 and most of 1991, the main danger we faced in terms of public reaction was that we had "gone too far". It may seem surprising today, but if you go back and look at the press at the time, the predominant reaction from financial and economic journalists and the various pundits from financial markets was that the reductions in interest rates were premature, risky, politically motivated etc.

(v) As explained in the previous section, we were not prepared to force the pace too much and end up with a major adverse reaction in financial markets. On the other hand, we were not so cautious as to be afraid to take some calculated risks in this direction. Monetary policy was eased five times before we got any lead from the bond market in the form of falling bond yields; they did not fall significantly until the December quarter of 1990. Similarly, in mid 1991, with the yield curve flat, we did not resile from further easing. A lot of commentary at the time warned against this; an upward sloping yield curve was held to be expansionary and to presage a rise in inflation.

In summary, it could be said that in an open economy with free domestic and international capital markets, the financial markets set a corridor within which monetary policy can act. In the current phase of the cycle, too rapid an easing would risk problems with the currency and adverse reactions in the bond market. Not only would this throw away the opportunity to reduce inflation on a sustainable basis, but the general uncertainty created would be bad for business and consumer confidence, and hence employment and output. On the other hand, had we been rigidly adhering to a policy which involved taking no risks at all of being ahead of the market, we would have achieved a major reduction in inflation, but at a higher cost than the significant one we have already paid.