Still Interesting Times

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It is very good to be with you this morning.

In the process of deciding a title for this address, I recalled that three years ago I was talking in public addresses about the times being interesting, perhaps a little too interesting. That still seems to be the case, hence the title.

As you know, yesterday the Reserve Bank Board met here in Perth. The Board reviewed the international and local information to hand since its last meeting, and decided once again to leave the cash rate unchanged.

The reasons for that decision were given in the statement released following the meeting. More information on the nature of the discussion and considerations the Board took into account will be published in the minutes of the meeting, two weeks from yesterday. I do not want to dampen any of your undoubted eager anticipation for what may be contained in those minutes. What I will do is say a little more about the sequence of decisions the Board has taken over recent months.

To do that in appropriate context, it is worthwhile first recounting the framework for monetary policy that has been in operation since the early 1990s and that continues to guide the decisions of the Board. So I will say something about that. Then I will describe how the flow of recent events, viewed through that framework, has had a bearing on decisions.

The Framework for Monetary Policy

The framework for monetary policy is a medium-term, flexible inflation target. It seeks to achieve a rate of increase in the Consumer Price Index of between 2 and 3 per cent, on average, over time. This arrangement has a fair bit of history now. The Reserve Bank began to articulate it in the early 1990s and it has been formally agreed between successive Treasurers and Governors, in published statements, beginning in 1996.[1] The 'on average' specification allows the Bank to take account of the fact that it cannot finetune inflation over short periods, and of the obligation to promote, insofar as monetary policy can, full employment, which is another of the Bank's charter obligations. Having a numerical goal takes account of the importance of inflation expectations, and seeks to provide an anchoring point for them – which is a critical function of any monetary policy regime. It also provides a focal point and a measuring stick for monetary policy decisions, which recognises that, in the end, monetary policy is really about the value of money.

We arrived at this framework after a long search – the 'search for stability' set out in detail by Ian Macfarlane in his ABC Boyer Lectures in 2006.[2] The current framework is not necessarily the end of history. But it has worked well for a period not far short of two decades now, with no obviously superior framework on offer.

Sometimes people ask whether a higher target for inflation might not be better, particularly when inflation is looking like it will rise and the Bank is running a setting of monetary policy designed to

1 The first such statement was between Treasurer Costello and Ian Macfarlane in August 1996. We are now up to the fifth incarnation of this agreement. See <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

2 Macfarlane I (2006), *The Search for Stability*, Boyer Lectures 2006, ABC Books, Sydney.

resist that. The answer ultimately hinges on how prepared we would be to accept the things that would go with higher inflation. Higher average interest rates would be among them – there is no reason that savers, any more than wage earners, would be prepared simply to accept an erosion of their financial position. That is why countries with higher inflation generally have higher nominal interest rates. Moreover, whatever structural challenges the economy faces would still have to be faced at higher inflation rates. Higher inflation wouldn't make those issues go away, nor make them any easier to cope with (as we know from our own history when inflation was high and structural change still had to occur). We would simply waste more real resources as everyone sought to protect themselves from the higher inflation.

In supporting the decision process that puts this framework into practice, the Bank carries out a great deal of detailed statistical work, tracking several thousand individual data series. It conducts extensive liaison with businesses and other organisations, usually speaking in detail to as many as 100 contacts each month. It produces voluminous published analysis of these data.

The objective of these efforts is, at its heart, fairly simple. We are trying to form an assessment about the course of overall demand in the economy and how it is travelling in relation to the economy's supply potential. That assessment in turn informs a judgement as to whether inflation pressure in the economy is likely to increase, decrease or stay about the same, and how the likely outcomes compare with the announced objective. That judgement then informs a decision as to whether monetary policy needs to restrain demand, to support it or to be 'neutral'. Of course other factors that affect prices – like exchange rate changes, changes in the price of oil, and so on – have to be taken into account as well.

Note that the economy's supply potential is a key element in the above framework. This is not a directly observable thing: there is no time series labelled 'potential supply'. Assumptions have to be made about the availability of productive factors – labour and capital – and about the productivity with which these factors can be used. This is why the current productivity discussion is so important. Incidentally, the desire for more productivity is *not* a call for working harder. Australians already work pretty long hours by international standards. Productivity per hour, which is what counts, is not improved by adding more hours, but by finding ways of making the hours that are already being contributed more effective.

The Board's decision each month, and the reasoning behind it, are communicated to the public. These statements are among the most closely scrutinised documents in the country. I am often awed by the layers of hidden meaning that people are able to detect in them. But the main purpose of these statements, and of all the other communication we do, is simply to try to make the Bank's assessment of the outlook and its actions as understandable as possible to the many people who need to make long-term decisions, including households and businesses. Of course, events and new information often change the outlook, as we have seen recently.

Recent Developments

How has the Board evaluated recent developments within the above framework?[3]

Throughout the past year or so, the forecasts that the Bank's staff have provided to the Board have suggested that underlying inflation would probably stop falling and then gradually rise through the three-year forecast period. The backdrop to this view was that the rise in the terms of trade was expansionary for incomes and investment, which would likely see demand growth remain pretty strong even as fiscal stimulus spending unwound.

The exchange rate was working to offset a good deal of this expansionary impact, by restraining some

3 The Deputy Governor recently gave a very good account of this in more detail than I can attempt here today. See Battellino R (2011), 'The RBA's Thinking on the Economy over the Past Year', RBA *Bulletin*, September, pp 89–92. Available at <http://www.rba.gov.au/speeches/2011/sp-dg-230811.html>.

parts of the economy exposed to international trade but not exposed to mining. Nonetheless, given the size of the terms of trade rise, and the fact that the economy started from a position of reasonably low unemployment, it was thought that underlying inflation was more likely to start to go up than to keep falling. On the evidence we have so far, that's what seems to have been happening.

Faced with that outlook, the Board judged that it was appropriate for monetary policy to exert a degree of restraint. As of the end of last year, the Board's view was that it had reached that position. We believed that we were therefore in a position of being able to maintain a steady setting for a while. The post-Board statements I issued each month at successive meetings said that the Board viewed the stance of monetary policy as remaining appropriate for the outlook.

Of course, there are always uncertainties surrounding forecasts, and the Bank's publications have been careful to articulate possible risks that we could identify – including things such as the possibility of a serious worsening of the situation in international financial markets, driven by sovereign debt concerns. Most of these risks do not come to pass, and if they do eventuate they don't necessarily unfold as we had imagined they might. Still, the Bank makes considerable efforts to think about how things could turn out differently to the central forecast.

By the time of the May Board meeting, there was evidence that the pace of underlying inflation had started to pick up. I myself felt that the Board was still well placed to sit still at that time. We had already put in place a response in advance of the expected pick-up in inflation and it is not necessarily always wise to respond to one high (or low) figure. Nonetheless, the updated forecasts carried a fairly clear message: policy would probably need to be tightened further, at some point, if things continued to evolve as expected. The Bank said that – indeed there was no other credible thing we could have said.

In the ensuing months, little has changed about the outlook for resources sector investment. More large projects have been approved and the pipeline of future investment looks very large. On all the available information, resources sector investment will probably rise by another 2 percentage points or more of annual GDP over the next couple of years. Prices for important commodities remain high and the nation's terms of trade are at an all-time high in the current quarter.

At the same time, it has become clearer that precautionary behaviour by households and some firms is exerting restraint on the pace of growth in demand, and that the higher exchange rate is diverting more demand abroad. This is putting pressure on trade-exposed sectors. Moreover, the sense that a higher exchange rate might not just be a temporary phenomenon may be leading to a pick-up in the pace of structural change in the economy.

In net terms, the outlook for the non-resources economy in the near term is weaker than it looked a few months ago, and the recovery of flood-affected mining in Queensland is taking longer than earlier thought. At the same time, looking at financial variables, credit growth has slowed a bit further and asset prices have tended to decline. These factors, along with ongoing evidence that underlying inflation had turned up, were incorporated in the Bank's outlook as published early last month.

Meanwhile, the sense of unease about how Europe will manage its problems has increased over recent months. We also had the anxiety over the US debt ceiling issue, which became acute early in August. Measures of confidence in both economies declined significantly as all this occurred. Equity markets fell as investors shifted to the relative safety of bonds issued by the major countries – even though S&P had announced a downgrade of the US sovereign credit rating.

It is too soon to see much evidence of a concrete impact of these events on the global economy. Any assessment we make at present is highly preliminary.

Moreover, we have no way of knowing what events will transpire in financial markets over the months ahead. There are any number of hurdles in Europe or the United States that could serve as a catalyst for increased anxiety. This state of affairs is likely to persist for the foreseeable future.

With those caveats, a few preliminary observations can be offered on this episode in comparison with what we saw in 2008.

First, the focus is more on sovereign creditworthiness as opposed to the state of private bank balance sheets *per se* (though in Europe of course the two are intertwined). In a proximate sense, that is the direct result of the previous crisis and especially the ensuing period of weak growth that has had a severe impact on government revenues in the affected countries. But, taking a longer-term perspective, some countries, especially in Europe, have had fiscal positions that were quite vulnerable to a shock to confidence for some time now. High debt levels were sustainable while markets thought they were and hence were prepared to offer financing at low interest rates; if people suddenly doubt sustainability and charge high interest rates, that same position becomes much less sustainable. So to no small extent, it is actually a matter of confidence – confidence that there is a sustainable long-run fiscal path, that policymakers know how to get onto it, and that they have the will to do so. In crafting any policy response to near-term economic weakness, this is a key point.

Second, there have been pressures in funding markets for some European banks recently, but at this point not to the same extent as in October 2008. Bank capital levels are improved from three years ago and leverage is reduced. We have not seen significant funding problems for US or UK banks recently; their problems at present seem to relate more to the possible size of legal costs arising from pre-crisis lending standards. Overall, we have not, to this point, seen the widespread withdrawal of willingness to deal with counterparties that we saw in late 2008.

Third, a key feature of this episode is that confidence in the euro is a more prominent issue than was the case three years ago. Those countries at the so-called 'periphery' are paying a high price as they play their part in keeping the euro together. But the ultimate outcome is going to hinge on the willingness of 'core' euro countries to accept socialisation across the euro zone of some of the losses associated with countries in trouble. That is really the issue that is being debated in Europe now.

If there were a major international downturn, an important question would be how policymakers in major countries would respond. The scope for fiscal policy easing in many major countries is hotly debated. Some commentators call for further stimulus, citing faltering recoveries, while others point to medium-term debt paths that look very troubling as a reason for fiscal consolidation. Both have a point. The question in major countries is whether a package combining short-term stimulus with a highly credible medium-term path back to sustainability could be crafted. It certainly does not look easy. As for possible monetary policy responses, most major countries would be quickly into the realm of 'quantitative methods', if they are not there already. It is hard to gauge the effects of those measures.

In Asia and other parts of the emerging world, however, ample policy ammunition is available, both fiscal and monetary, should the authorities have a need to use it. To do so credibly would presumably require confidence that the upward trend in inflation seen over the past couple of years would be likely to turn down. Of course, a significant weakening of the global economy would result in lower commodity prices and generally lower underlying inflation pressures. So far, the decline in major commodity prices has been fairly modest, though enough to help rates of CPI inflation to moderate a little.

In summary, the environment presents no shortage of challenges, though we should not assume that this is necessarily 2008 all over again. It is reasonable to conclude, at this point, that the outlook for global growth is not as strong as it looked three months ago. Forecasters are generally revising down global growth estimates for 2011 and 2012, mainly as a result of weaker outcomes for the major countries.

Turning back to the implications for Australia, periods of sudden increases in anxiety within international financial markets are moments when, if at all possible, it is good to be in a position to be able to maintain steady settings. In the recent few meetings, the Board has judged it prudent to sit still, even though we saw data on prices that were, on their face, concerning. To be in that position of course requires timely decisions to have been made in earlier periods.

Looking ahead, the task for the Board is to assess what bearing recent information, and recent international and local events, will have on the medium-term outlook for demand and inflation. They probably won't have much effect on the large-scale investment plans in the resources sector, but households and firms watching what is happening may continue their precautionary behaviour for longer than otherwise. This would presumably dampen demand somewhat compared with the outlook set out in the *Statement on Monetary Policy* published in early August; it may also condition wage bargaining and price setting. If so, that may act to curtail the upward trend in inflationary pressures that has, up to this point, appeared to be in prospect.

At the same time, significant rises in a range of administered prices are still set to occur over the period ahead. Moreover, unit costs have been rising quite quickly given the fairly poor performance of multi-factor productivity growth over recent years. In fact the experience of the past year, as the Deputy Governor noted recently, is that while growth seems to be turning out weaker than expected at the end of last year, underlying inflation seems to be turning out higher. A key question is whether that is just the vagaries of statistical noise and lags, or whether it is telling us that the combinations of growth and inflation available to us in the short term are less attractive than they seemed a few years ago. If the latter, the spotlight will come back on to supply-side issues.

Conclusion

More than at most times in my professional life, Australia's economy faces a very unusual, and powerful, set of complex forces. Major countries are still coming to terms with the excesses of earlier years and experiencing what many have learned before, which is that after a period of financial distress it is usually a long and difficult recovery. Economic growth has been uneven and patchy, and financial concerns keep recurring, with waves of positive and negative sentiment sweeping global markets. Australians feel the effects of those swings in sentiment.

Meanwhile, the emerging world continues to expand, and it is not all due simply to exports to the rich world, even though the world could still do with some more rebalancing. There is an epochal change occurring, and Australians are also feeling that. It is overwhelmingly positive for us in net terms, even if our tendency to dwell on the downside is more prominently on display at present.

The future is uncertain, but it always is. What we know is that, as we move into that future, whatever it holds, we do so:

- with our terms of trade at a record high;
- with more jobs in the economy than ever before, and with 95 out of every 100 people seeking work in a job;
- with our banks sound, our financial system stable and our sovereign credit respected globally; and
- with the capacity for macroeconomic policy to respond sensibly to events, appropriately guided by well-established frameworks.

We have our problems, but with some good sense and careful judgement we ought to be able to navigate what lies ahead.