Glenn Stevens: Challenges for economic policy

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Anika Foundation Luncheon, supported by the Australian Business Economists and Macquarie Bank, Sydney, 16 July 2008.

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Thank you all for coming along again to support the Anika Foundation at the third of these annual lunches. The Foundation is doing great work in supporting research and treatment of adolescent depression.[1] Your being here today will do a lot to help.

Economic policies face no shortage of challenges at present. Internationally, with economic growth slowing in the major developed economies, and the problems in international credit markets still serious, but inflation rates rising in many countries, the task for monetary policies in the old industrialised world is as delicate as any seen in many years. But developing country policy-makers face some big questions too, which are rightly getting more attention. How they respond to those questions will be important for the global economy.

At home, inflation has been too high after a period of very strong demand, but demand is now slowing. At the same time, the Australian economy is experiencing a gain in the terms of trade the like of which we have seldom seen before. So we have plenty of challenges of our own, and in ways that are distinctive when compared with those of the major countries.

I begin with some remarks about the international scene.

International challenges

To date, the US economy has been more resilient than many observers had feared. Real GDP has expanded, albeit very slowly, in the first and probably the second quarters of 2008. Yet the cyclical episode is far from over, as housing activity continues to contract, housing prices fall and the labour market softens. Businesses and households now also have to absorb a recent sharp further increase in energy prices. That rise is made worse by the depreciation of the US dollar (in contrast to the case for Australians, who at least have had the benefit of a high Australian dollar in dampening the rise in oil prices). Credit market conditions are still very difficult in the aftermath of the events of the last year, and pressure remains on key institutions – as shown clearly over the past week.

First quarter GDP growth in the euro area surprised by its strength. The Japanese economy also performed better than some had expected. But the run of other indicators suggests that growth is slowing in those economies.

Meanwhile, CPI inflation has picked up noticeably in most of the major countries. Measures excluding food and energy have thus far remained fairly low. But, compared with last year, there is more concern about inflation prospects. Some of the price rises for Australia's important commodities, for example, signal international pressure on steel prices and non-oil energy costs, and therefore a range of other prices.

Monetary policy in the major industrialised countries taken as a group remains reasonably accommodative. There has, accordingly, been some discussion about how this sits with concerns that inflation might prove to be more persistent than earlier expected. But overall financial conditions are arguably a good deal more restrictive than suggested by policy rates, especially in the United States, where the interest rates paid by many borrowers have not

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[1] For more detail, see http://www.anikafoundation.com.

declined much, if at all, and lenders have toughened their standards considerably. The same is true for the United Kingdom.

The bigger concerns about inflation, in any event, are in the emerging world. These concerns are twofold.

First, food and energy are a bigger part of CPI baskets in these countries than in the developed economies, so the impact there of the rises in commodity prices is larger. For the same reason, the risk of second-round effects must also be higher.

Second, monetary policy has generally been fairly easy in many of these countries, because of the link – explicit or implicit – that they have to the US dollar. In some of the oil-producing Gulf states, where there are explicit dollar pegs, demand growth is very strong and inflation has increased. Around much of Asia, interest rates are below inflation rates, and in several cases even below inflation measured excluding food and energy. That is to say, real interest rates are negative, whereas "natural" real rates are likely to be high, reflecting the potential growth opportunities in Asia.

De facto, many of these countries have had monetary policy settings that have been influenced to a significant extent by US monetary policy, but they themselves are not experiencing US economic conditions. To be sure, slower US growth is affecting trade patterns, but to date growth has remained pretty solid in many cases, helped by firmer exports to places other than the United States and strong domestic demand. Moreover, the financial headwinds being experienced by the United States have not blown to the same extent in Asia.

The danger for the countries in question is quite clear. Inflation outside of food and energy is already rising in many cases and accommodative policy settings heighten the likelihood of it remaining high on a persistent basis.

But there is also a danger for the global economy. The bulk of the growth in demand for energy and natural resources is coming from the emerging world. Continuation of such expansionary policy settings in emerging countries, apart from continuing the recent tendency to overheating in those countries, would presumably foster ongoing rapid growth in demand for natural resources. That would continue to hold up CPI inflation everywhere, but also weaken growth in many industrialised countries. Policy-makers in many of the advanced countries, already facing a short-term relationship between growth and inflation that has turned much less favourable, could face some very difficult choices in framing their responses to the circumstances they face individually.

What is needed is for emerging countries to adjust their policies according to *their* circumstances. Without that, we risk a new manifestation of the "global imbalances", in which too much of the burden of controlling inflation would be placed on the major advanced countries, where growth is already slowing.

Put another way, this is in some respects a problem of international policy co-ordination. Global monetary policy has been too easy in recent years and that is why we have seen such a major run-up in a wide range of industrial commodity prices. Any individual country might wish to treat those increases as exogenous, but they cannot be exogenous for the world as a whole if they are driven mainly by demand, which by and large they have been to date. So, as a number of commentators have been saying recently, global monetary conditions need to be tighter. But the adjustments needed really should take place more in the emerging world than in the United States or Europe or Japan.

It is odd that, in such a circumstance, inflation targeting should be attracting some of the criticisms that have recently been seen, because were it used more widely it would tend to alleviate this co-ordination problem. Imagine a world in which all countries of significance had been following a medium-term, flexible target for CPI inflation, coupled with appropriate exchange rate settings. Most of them would have been tightening policy in a measured fashion in response to rises in headline inflation over the past couple of years. The result

would surely have been that resource and energy prices, and CPI inflation everywhere, would now be lower than they are. Even now, the current situation could be handled quite well by widespread use of a flexible inflation-targeting approach.

Regardless of the precise details of any particular framework, though, what is most important is for broadly good macroeconomic policy to be followed. At the moment, surely that involves emerging market countries playing their part in balancing global demand and supply, by responding to their own circumstances, so as to avoid prolonged and costly inflation. Compared with past episodes, this part is a larger one now – and that is surely a portent for the future.

This is not an original observation – a number of commentators have made these same points over recent months. And policy-makers in a number of emerging countries are now adjusting policy settings in the required direction. In fact, the list of developing countries that have recently tightened monetary policy is now growing quite long, and includes some of the big ones – like China, India, Brazil and Indonesia. Perhaps more tightening will follow. Inevitably, growth will slow in the regions concerned as a result. But a period of more moderate growth would be a better outcome than either allowing inflation to go unchecked or expecting the major economies to do all the heavy lifting.

Challenges for Australia

These international challenges are considerable and, like all other countries in an inter-dependent world, Australia has a significant interest in how they are met. We have, in the meantime, pretty significant challenges of our own that we must meet.

Even before the price rises for oil and other commodities seen this year, Australia had experienced a significant pick-up in inflation, in the mature phase of a long period of economic expansion. The rise in inflation in 2007 and into the early part of this year was not confined to food and energy, even though higher energy costs certainly were at work. Nor could it be put down mainly to "imported inflation". In fact, the evidence is that a wide range of prices picked up speed. Acceleration in the group of prices generally classified as "non-traded" was quite pronounced. The background environment was one in which demand in Australia – which grew by over 5½ per cent in 2007 – outstripped, by a significant margin, any plausible estimate of growth in potential supply.

There certainly were international forces at work, but the key one was the expansionary effect of the rise in the terms of trade. It is perhaps worth spending a few minutes on the basic analytics of this issue.

For the "average" industrial country that imports much of its energy and raw materials, a persistent rise in commodity prices is a negative shock to aggregate supply. This will reduce output and push up prices. Since the higher resource prices are paid to suppliers elsewhere in the world, this also acts somewhat like a tax on spending, hence aggregate demand falls. So while CPI inflation is likely to rise initially, the net effect of these forces on the ongoing rate of inflation in the medium term is unclear, though the effect on output will be unambiguously negative. In this "average" industrial country case, monetary policy may need to be tightened to control medium-term inflation, or it may not. Much will depend on inflation expectations.

Australia has some additional dimensions, because it is not the "average" country in this episode. As a commodity *producer,* our terms of trade have risen. Whereas for a net commodity importer a rise in commodity prices acts like a tax paid to foreigners, Australian entities are net receivers of such payments. That impact is expansionary. Just how expansionary depends on the response of the recipients of those income flows, who include local and foreign shareholders, employees and governments. But other things equal, aggregate demand will, compared with the "average" case, be stronger, and it is more likely that there will be a problem of inflation in the non-traded sector. Accordingly, it is likely that

monetary policy in a country like Australia would need to be tighter than in the "average" case.

That is the analytical background. We can then observe that Australia stands out among developed countries in terms both of the extent of the rise in our terms of trade, and the strength of growth of domestic demand over the past few years. It is understandable, then, that pressure on underlying inflation, particularly from domestic sources, has also been somewhat greater. Monetary policy had to respond to that.

The challenge of judging how much response was necessary has been complicated by the global credit turmoil, which has had the effect of pushing up actual borrowing costs relative to the cash rate the Reserve Bank sets. In addition, banks are more careful in their lending (and businesses and households are now more cautious in general than they were six months ago). Overall, as the statements after the past five Board meetings have made clear, the sequence of changes to the cash rate, other adjustments by lenders in response to the rise in term funding costs since mid 2007 and tighter credit standards have combined to produce financial conditions that are tight. They have tightened a bit further in the past month.

The effects of that will be working against the expansionary forces from the terms of trade and the broader pressures on inflation from high resource utilisation. Inevitably, there is a lot of uncertainty about how these opposing forces will net out. But the forecast we released in our May 2008 *Statement on Monetary Policy* was that the net result would be a significant slowing in demand and output growth this year. The evidence is pretty clear that some key components of private demand are now on a slower track. As always with such episodes, the extent of that slowing, and its duration, are uncertain. But to this point, something not unlike what was envisaged in the May outlook appears to be occurring.

Moreover, it looks more likely now than it did a couple of months ago that this more moderate track for demand will continue. If it does, it will, in due course, begin to exert downward pressure on those elements of inflation that had picked up in response to strong demand. That will probably take some time and it may be too soon yet to see much of that influence on the CPI figure due next week. Indeed, on a year-ended basis, CPI inflation might rise further before it starts to come down, particularly given the recent further surge in global oil prices beyond what was assumed in our May projections. By the way, this surge in oil prices does not, in itself, amount to a rise in Australia's terms of trade. As such, it is likely to be exerting some further restraint on non-oil demand, which would, all other things equal, tend to dampen pressure on non-energy-related prices over time. On the information available at present, we still expect inflation to fall back to 3 per cent by mid 2010, and to continue declining gradually thereafter.

We will, of course, conduct a thorough review of the outlook after receiving the next CPI figure, which the Board will have available for the August meeting. The Bank will publish its outlook in the next *Statement on Monetary Policy*, due for release on 11 August. But for today's discussion, I want to use the May projections as the basis for some remarks about the nature of the inflation target.

As you know, since 1993 the Bank has been framing its monetary policy around a medium-term target for inflation of 2-3 per cent, on average, "over the cycle". The Reserve Bank remains committed to achieving that target. Apart from being consistent with the Bank's statutory obligations, it is what has been envisaged in successive formal agreements between two Treasurers and two Governors stretching back now over a dozen years.

This framework has worked well. One of the reasons it has worked well is that it has two essential ingredients. The first is the commitment to the mean inflation rate being at the target. That has been achieved, with medium-term CPI inflation rates averaging close to 2½ per cent. The second ingredient is a sensible approach to variance of inflation around that mean. The framework was designed to have the necessary flexibility to cope with the business cycle, shocks that may occur, the inevitable errors in forecasting and lags in the effects of policy decisions. The framework does not assume that inflation can be fine-tuned

over short periods, nor does it require us to attempt rapidly to correct deviations from the 2-3 per cent range, which have occurred several times over the period since 1993.

This flexibility was envisaged from the beginning in our approach to inflation targeting. The Reserve Bank quite deliberately eschewed the narrowly defined targets with "electric fences" that were initially favoured in some other countries and that were at one stage proposed here. We have made use of that flexibility repeatedly, and are doing so again now.

The inflation outlook I have just sketched out would be a pretty long period of divergence from the target. It is important to recall, though, that we have experienced reasonably lengthy deviations before. Annual CPI inflation was below 2 per cent for 10 quarters between the middle of 1997 and the end of 1999.[2] If the May 2008 forecasts turn out to be right, then the current episode would entail nine quarters with year-ended inflation above 3 per cent. If we can achieve something like that outcome, that would still be consistent in every essential respect with the experience under inflation targeting since it began 15 years or so ago.

As always, the challenge is to combine the right degree of flexibility in approach with sufficient confidence that the inflation rate will be on a declining path over time as to keep expectations anchored. This challenge is not trivial on this occasion. We are, of course, fully aware of the possibility that people may fear that this temporary period of high inflation could, in fact, turn out to be persistent. Expectations of high inflation can be self-fulfilling if individuals and businesses behave accordingly.

One possible channel people have mentioned is that of higher wage claims, pursued as a result of the pick-up in CPI inflation, which then add to costs and prices, and so on. But I think it should be stated that while there are some signs of that around the edges, growth in overall wages has thus far remained contained, even though the labour market has clearly been at its tightest for a generation. Relative wages are showing noticeable variation across industries and regions, as would be expected given the events in the economy. But overall growth of wages, as measured by all the formal statistics at least, has to date been pretty well controlled. Furthermore, if the recent signs of moderation in the demand for labour continue, which could be expected if overall demand remains on a slower track, that should help to contain any over-exuberance in wage setting.

So I think that our chances of keeping inflation low over the medium term are good. This outlook does involve a period of significantly slower growth in demand in Australia than we have seen over the period up to the end of 2007. The Bank has been candid about that. But controlling inflation has always involved being prepared to slow demand, for a while, when needed.

Not taking adequate steps to that end would have costs. One is that were we to see inflation become established permanently at higher levels, then over time the whole structure of nominal interest rates would reflect that new reality. The mean interest rate would rise. In that world, the interest rates we see now would not look unusually high. They, or even higher rates, would look pretty common. That is what happened in the 1980s, as a result of the fact that we did not control inflation in the 1970s and early 1980s as well as we should have. Needless to say, it is that world that we are seeking to avoid.

By the same token, there will be a continued pay-off to control of inflation. A stable currency is one of the foundations on which a well-functioning modern economy rests. It is a prerequisite for sustaining growth in living standards. On the interest rate front, moreover, containing and reducing inflation over time will mean that we should be able, at some point, to look back to the current period as one of higher-than-normal interest rates. Interest rates,

[2] CPI inflation excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999-2000.

unlike many other prices in the economy, do not always rise. Provided inflation is successfully controlled, interest rates go up and down around a fairly stable mean.

Conclusion

I have dwelt today on challenges facing macroeconomic policies and particularly monetary policies, both abroad and at home. These challenges look more difficult than they have been for a while.

Of course, the challenges are not limited to monetary policy. There is the question of how resource allocation in the Australian economy should evolve in response to the increases in the prices of minerals in recent years, if these turn out to be persistent. Monetary policy has only a modest role to play there – other policies will be much more important, and they will be tested. There is also the question of how all that adjustment will dovetail with policies towards climate change, which are in the formative stages at present. Those charged with constructing such policies are dealing with hitherto unimagined degrees of uncertainty and the challenges seem to be of an order of magnitude bigger than the ones faced by monetary policy.

It is also important to keep in perspective the very real problems that beset our society in other respects, including adolescent depression and the terrible cost it can extract on young lives, on families and on all of us. Good macroeconomic policies can, we trust, make some difference at the margin by creating a stable environment in which others can carry out the important work to understand and address these real problems. But their work needs to be resourced, which is what the Anika Foundation is all about.

So, once again, thank you for coming here today. Thank you to Macquarie Bank and the ABE for your support of this function, and thank you for your support of the Anika Foundation.