

## **Glenn Stevens: Monetary policy and the regions**

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Foodbowl Unlimited Forum Business luncheon, Shepparton, 20 September 2010.

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Thank you for the invitation to come to Shepparton. No one knew, when the invitation was issued almost a year ago, that you would be battling floodwaters just a couple of weeks prior to today. It is good to see the recovery already well advanced.

In the global economy, recovery from the effects of a different kind of deluge – a man-made one – has been under way for a while. Progress has been quite varied, however, and the outlook is uncertain just now. I will give an update on those matters today.

It also seems a fitting occasion to talk about “monetary policy and the regions”, since a question we are often asked is how we take account of differing economic conditions across the country in the setting of monetary policy. I will offer some perspectives on the issues that arise when we have one policy instrument for a fairly diverse economy. The essential message here is that such diversity matters, but is often not as pronounced as people assume, because all the parts of the economy are ultimately connected. Things that affect one sector tend to have spillover effects elsewhere. Furthermore, economies have a certain capacity to adjust to differing conditions. In Australia this works reasonably well.

### **Current economic conditions**

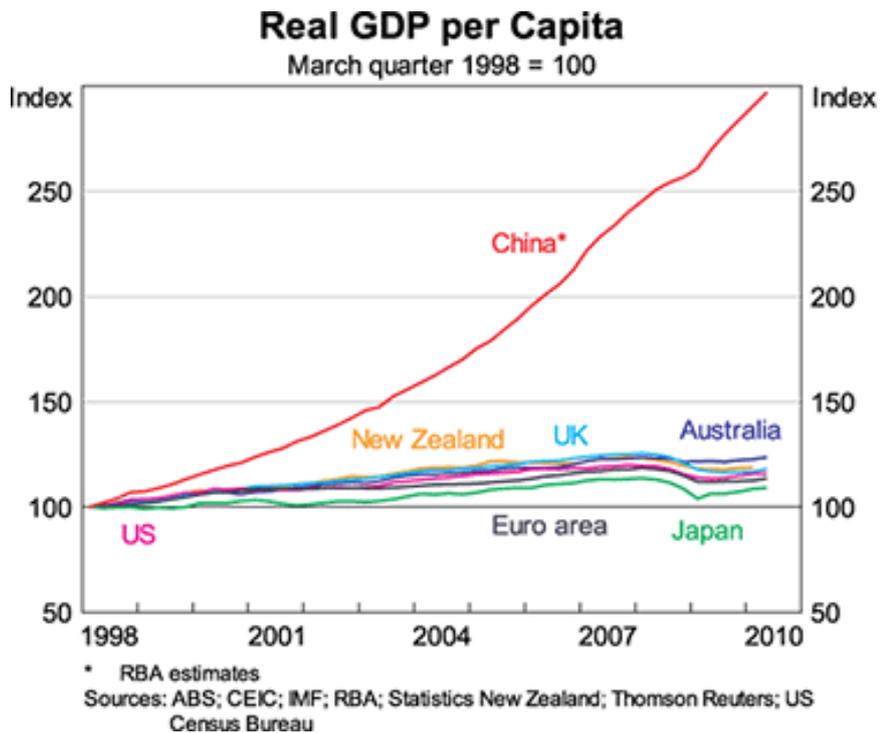
The global economy continues to present a mixed picture. In the Asian region, most countries have well and truly recovered from a downturn that occurred in late 2008 and the first few months of 2009. The main exception is Japan. In the bulk of cases, economies are much closer to their potential output paths now than they were a year ago and policies are moving to less expansionary settings. As a result, over the year ahead the growth in the Asian region is unlikely to be as rapid as over the year to mid 2010, when the “v-shaped” recovery was in full swing. Similar comments could probably be made about Latin America.

In Europe, the German economy has been powering ahead this year, reaping the benefits of many years of attention to containing costs and building productivity. But other continental economies are not as strong, and some are in the grip of a very painful adjustment to a world of constricted private credit and limits to budgetary flexibility. In the United States an expansion has been under way for some time, but seems lately to have been losing a bit of steam and growth has recently not been robust enough to reduce high unemployment.

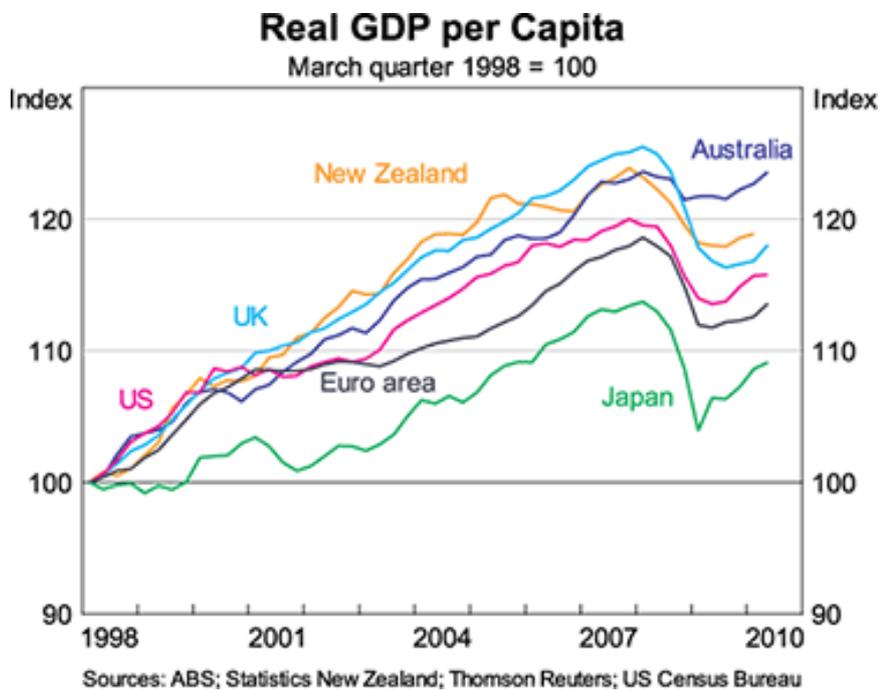
In Australia, growth has been quite solid over the past year, unemployment is relatively low, and inflation has, for the moment, declined. In fact, growth trends have been favourable over several years now in comparison with many other economies.

The charts below, comparing trends in Australia’s real GDP per capita with that of several countries, are illustrative. Of course we cannot match the extent of growth in China – a country where living standards are rapidly increasing in a process of “catch up” to the higher levels of high-income countries (Graph 1). But it is clear that compared with the US or Europe, or Japan, Australia’s per capita output and income has done pretty well over the past several years (Graph 2).

Graph 1



Graph 2



The task ahead, then, is to seek as far as possible to continue a solid trend like this, through various challenges which lie ahead. The future is of course unknowable, and economic forecasts unfortunately are not very reliable. But we have no option but to try to form a view of how things will probably unfold.

We think the global economy will record reasonable growth over the coming year, though not as strong as the past year (a strength that, incidentally, surprised most observers). We think Australia's terms of trade, after reaching a 60-year high in the current quarter, will probably decline a bit, but remain high. We expect that this high level of relative export prices will add to incomes and spending, even as the stimulative effects of earlier low interest rates and budgetary measures continue to unwind. We expect, and indications from businesses are that they do as well, that resource sector investment will rise further – as we experience the largest minerals and energy boom since the late 19th century. Even with continued caution by households, that probably means that overall growth, which has been at about trend over the past year, will increase in 2011 to something above trend. We think that means that the fall in inflation over the past two years won't go much further.

Of course that central forecast could turn out to be wrong. Something could turn up – internationally or at home – that produces some other outcome. We spend a fair bit of time thinking about what such things could be. Possible candidates might be a return to economic contraction in the United States, or a bigger than expected slowdown in China, or the resumption of financial turmoil that abruptly curtails access to capital markets for banks around the world and damages confidence generally. But if downside possibilities do not materialise, the task ahead is likely to be one of managing a fairly robust upswing. Part of that task will, clearly, fall to monetary policy.

### **The objectives of monetary policy**

What then are the objectives of monetary policy? Put simply, our job is to preserve the value of money over time and to try, so far as possible, to keep the economy near its full employment potential. Over the long run, these are mutually reinforcing goals, not conflicting ones. For the past 17 years the way we have pursued these goals has been to operate a medium-term target for CPI inflation of 2–3 per cent, on average. The “on average” specification allows us to accept short-term fluctuations in inflation – as long as they *are* only short-term – and so avoid the risk of attempting to over-control inflation and in the process de-stabilising the economy. But the specification still requires us to limit inflation in the medium term. Over the 17-year period, CPI inflation has averaged 2.5 per cent (excluding the one-time impact of the GST in 2000), and the economy generally has exhibited more stability, with real GDP mostly a little closer to trend than it had been in the preceding couple of decades.

### **How does monetary policy work?**

The Reserve Bank has very effective control over one interest rate – namely the rate that applies when one financial institution lends cash overnight to another (hence the label the “cash rate”). This rate has a major impact – though not to the exclusion of other forces – on a range of short-term market rates. Since the bulk of financing activity in Australia is contracted on variable interest rates, that are axiomatically affected by changes in short-term rates, the rates paid by borrowers are usually closely affected by cash rate decisions – though other factors can impinge as well from time to time. Through this device the Bank can affect the relative incentives for saving versus borrowing, and so have an impact on spending on goods and services and on financial and “real” assets. Because the relative rates of return on Australian assets compared with foreign assets are altered when we change interest rates here, the exchange rate also moves in response to monetary policy changes (although most of the time it is moving in response to a host of other factors as well).

Often, the expectation of what will happen to the cash rate in the future is just as important as, or even more important than, the level of the cash rate today. For this reason what the Bank says – or what people think we have said – can be very influential on markets and

behaviour. It is for this reason that central bankers are usually so guarded in public comments.

### **The effects of monetary policy in a diverse economy**

It is obvious even from the above highly condensed description that monetary policy will affect different groups in different ways. For a start, changing interest rates shifts the distribution of income between savers and borrowers. The larger the size of one's balance sheet – either assets or debt – the more likely one is to be affected by a change in rates of interest. Someone with no debt and no savings will probably feel little impact – if they feel anything at all – of a change in interest rates, at least directly.

In addition, we only have one set of interest rates for the whole Australian economy; we do not have different interest rates for certain regions or industries. We set policy for the average Australian conditions. A given region or industry may not fully feel the strength or weakness in the overall economy to which the Bank is responding with monetary policy. In fact no region or industry may be having exactly the “average” experience. It is this phenomenon that people presumably have in mind when they refer to monetary policy being a “blunt instrument”.

The issue is that it is not possible to have different monetary policies by region or by industry within the country, at least not while we are all using one currency and funds are free to flow around. Either each area that wanted its own interest rate would also have to have its own currency, or there would need to be a draconian set of regulations to prevent savings in one region flowing to another to be loaned out – a sort of local and regional equivalent to the pervasive capital controls which once existed on international capital movements. Quite possibly both of the above might be needed for a comprehensive tailoring of interest rates to each set of local conditions. Obviously that is unlikely to be practical.

Moreover there would be costs for a region having its own currency. It would have to establish its own Reserve Bank for a start, and would have to accept additional transactions costs for cross-border transactions with other regions, which would probably inhibit trade and investment flows with other regions in its own country. Very small currency areas have also often got into trouble over the years. These are reasons why many very small countries often peg their currency to that of a larger neighbour or simply adopt that currency outright. Perceived gains from being part of a larger monetary union have continued to attract small European countries to the euro, even though the membership conditions are fairly demanding, as we have recently seen.

There is a field of economics that thinks about this set of issues. Apart from the obvious criteria like language, culture and political unity, a suitable case for a single currency is thought to be stronger when:

- the forces (“shocks”) that affect a group of regions or countries are fairly similar and the way in which the regional economies respond is similar;
- there is a lot of trade between the regions (as there usually is within a single country);
- factors of production (labour and capital) flow fairly easily between the regions in response to differences in conditions; and/or
- when other means for responding to differences in experience (particularly fiscal transfers) are available.

That framework suggests several questions we might ask for Australia and its regions:

- How different are the shocks by region?
- How flexibly does the economy respond to such differences?

- What other policy mechanisms are at work to respond?
- And finally, how different, ultimately, are the experiences after these responses have occurred?

### **Differences across the country**

It is worth observing that not all “shocks” that hit the economy have markedly different effects by region or industry. Some of them are fairly widespread in their effect.

Take the sudden intensification of financial turmoil in September 2008. Confidence slumped and people began to “batten down the hatches” – in just about every industry and every region around the world – more or less simultaneously. Banks became more cautious in lending – most particularly to the property sector, but generally to almost all borrowers – in every country.

Other shocks are more particular. The one most people would think likely to have a differential impact across regions would be the big rise in mining prices and associated build-up in investment that we saw a few years ago, and which has returned over the past year and a half. Since the mineral resources are not found in abundance in every region, some areas would be expected to receive more of a boost than others. For example in Western Australia, mining accounts for a quarter of production; it is only 2 per cent of production in Victoria. So it would seem obvious that the impact of an event that increases the demand for minerals is likely to see, in time, the output of WA given more of a boost than that of Victoria.

But as usual, the picture gets more complicated when we think further. The headquarters of some major mining companies are in Melbourne. Those companies will be putting additional demand on various service providers around the nation – from air travel to consultants, from geologists to manufacturers, and so on. The effects of the engineering and construction build up for some of the minerals investment will be felt in other regions around the country (and indeed also by overseas suppliers). The higher incomes generated from the mineral boom will be felt by employees, shareholders (some of whom are overseas) and by governments (via various taxes). Depending on how these entities respond to these gains in income, there will be subsequent effects on economic activity around the country. It may well still be the case that the effects are most obvious and most pronounced in WA, but there will be substantial spillovers as the economy responds. Incidentally, most data suggest that until quite recently economic activity was growing faster in Victoria than in WA.

So to the second question, how about the mobility of factors of production? A remarkable feature of some of the remote area mining operations is the way the labour operates on a “fly-in, fly-out” basis. Any user of Perth airport can easily attest to this but the “commutes” also occur from the eastern states. More generally, population shifts have long been occurring between the south-eastern states and the resource-rich states. While moving is costly, in most analyses I have seen the mobility of the Australian workforce is pretty good – people shift in response to opportunity. Capital is of course highly mobile, at least at the margin.

As for other policy mechanisms at work, there are substantial fiscal transfers. The “automatic stabilisers” will take more taxes from regions that are doing well, since incomes will be rising relatively quickly, and transfer it to areas doing less well in the form of welfare payments. Governments can also use discretionary spending or other policies as part of this. Moreover there are structures in place that are deliberately designed to lessen systematically the differences in outcomes which might otherwise occur.

Opinions will differ about how effective these have been, and about how effective they should be – as recent political events have probably demonstrated. But the general point is that in a political federation such as Australia, there are various fiscal transfer mechanisms that act to diminish the divergences that might result from differences in initial conditions and exposure

to economic events. This is likely to be less so in an area which is a monetary union but not a political federation. Indeed some economists have long pointed to this as a potential difficulty for the euro area in some sets of circumstances, like the ones that exist in Europe at present. That said, we are seeing, albeit on a somewhat ad hoc basis, more intra-European transfer mechanisms being developed.

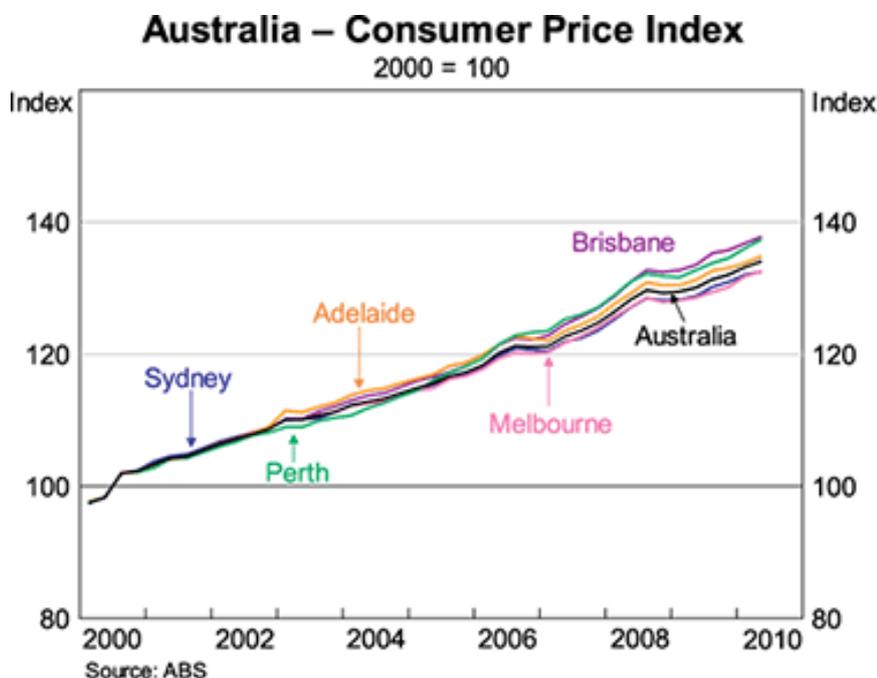
So for Australia, the effects of a “shock”, even if concentrated initially, will tend to be felt more generally across the economy over time. The way the economy works will naturally tend to help this occur, as will various other policy devices. That is what is supposed to happen in a well-functioning, integrated national economy.

The next question, then, is how different outcomes turn out to be after all these mechanisms have responded to the various impacts. Of course differences will remain at the industry level – ultimately, it looks likely that the mining sector and the areas that supply it will grow, and some other industries will, relatively, get smaller. And at this point, much of the impact of the recent resource price changes is yet to be seen. Nonetheless it is still worth examining just how different key trends have been to date across regions.

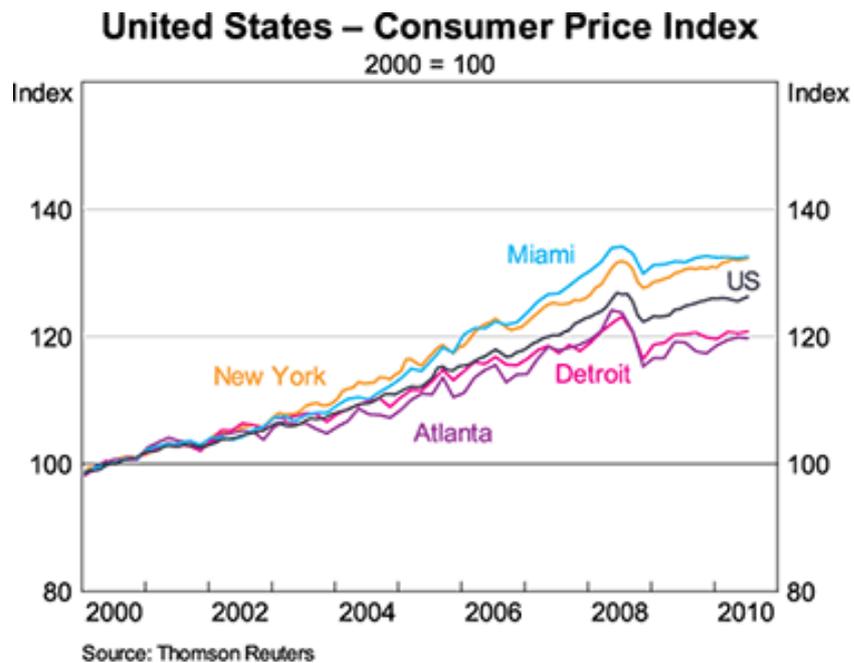
There are various indicators at a state level and even a regional level. These are of varying reliability – sample sizes get pretty small in some cases. Two of the more reliable data sets are likely to be the consumer price index and the unemployment rate. It is these, of course, that people are probably most interested in as well.

The CPI is available only for capital cities. Consumer prices in the capital cities have tracked remarkably closely (Graph 3) – at least as much as in other single currency areas like the United States or the euro area (Graphs 4 and 5).

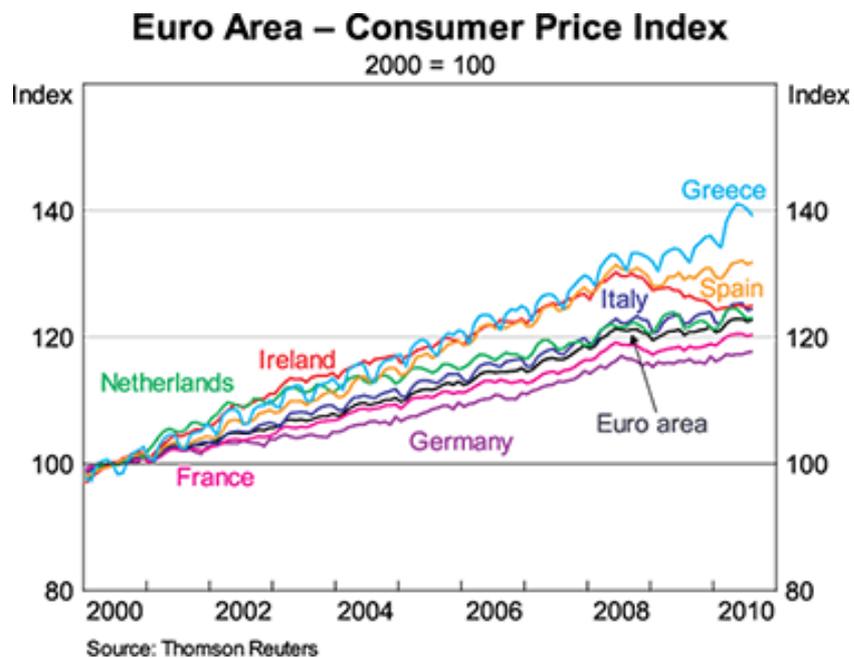
Graph 3



Graph 4



Graph 5

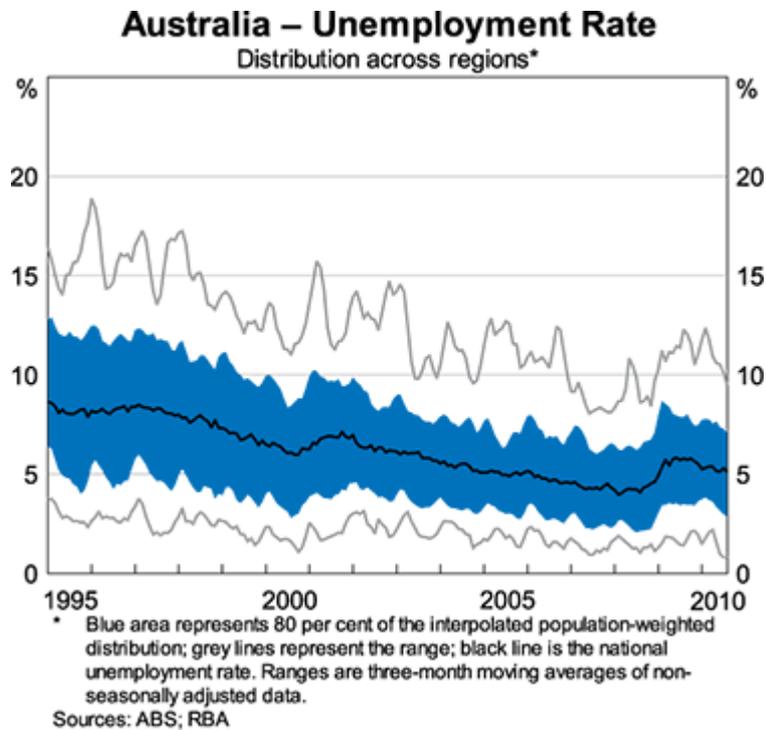


In the case of unemployment rates, a fair bit of disaggregated data is available. Graph 6 below shows the national unemployment rate and the range across the statistical regions measured by the ABS for which there are reasonably reliable continuous time series.<sup>1</sup> If we

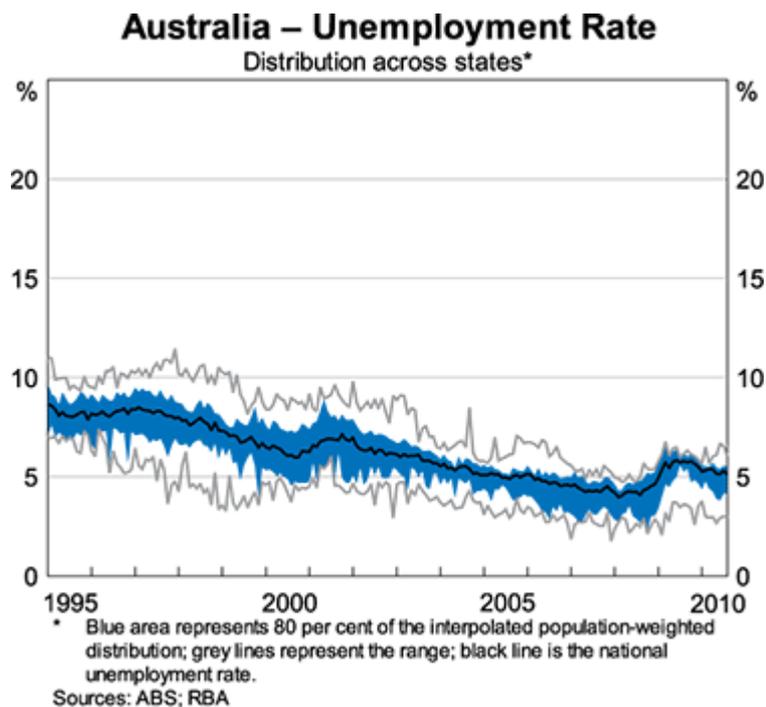
<sup>1</sup> In general, the most disaggregated data available have been used. However, the “Northern, Far West-North Western and Central West” statistical region in NSW has not been disaggregated, as there have been instances in the past when the ABS did not publish data for one of its sub-regions. The number of regions varies with data availability, with two breaks in the series when the number of regions changed. From November 2007, there are 68 statistical regions.

weight these unemployment rates by population, the shaded area is where 80 per cent of the weighted observations lie. Recent rates of unemployment have been between almost zero in the Hunter region (outside of Newcastle) of New South Wales and about 9 per cent in the far north of Queensland. Eighty per cent of the population face unemployment rates between 3 and 7 per cent.

Graph 6

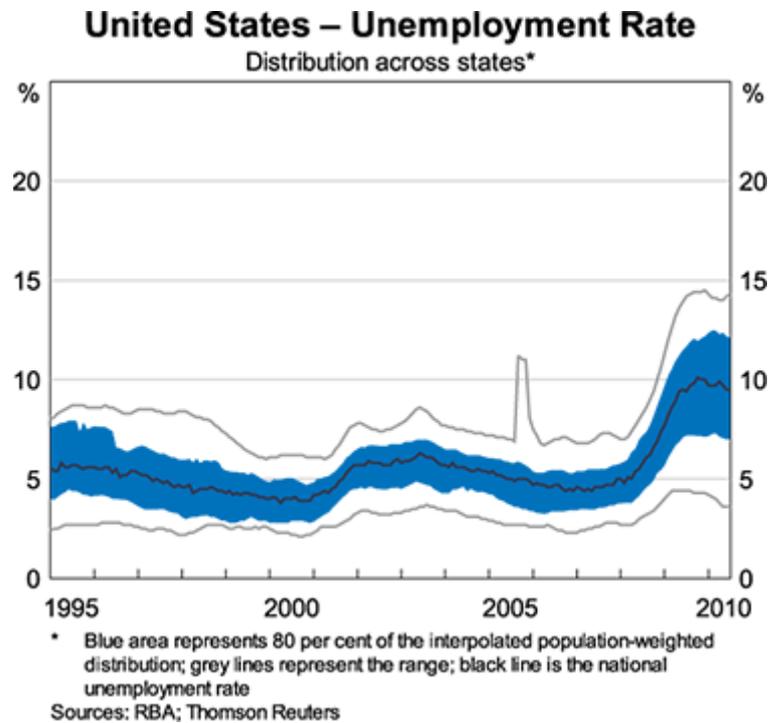


Graph 7

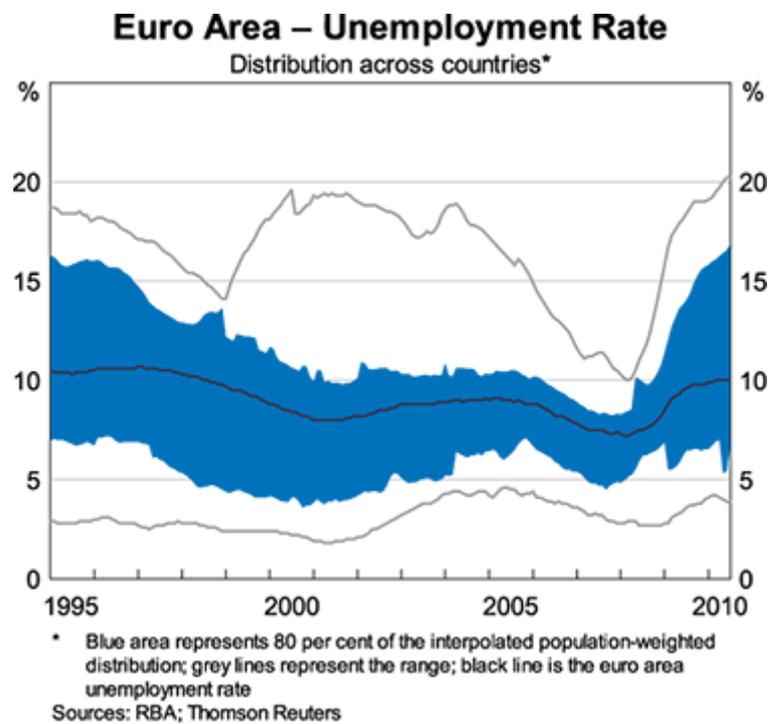


Also shown is the dispersion at a state level (Graph 7), which enables a comparison with the 50 states of the United States, and the 16 countries of the euro area (Graphs 8 and 9).

Graph 8



Graph 9



These comparisons are affected just now by the fact that the US and Europe have had deep recessions and are only in an early stage of recovery, whereas Australia had only a mild downturn and unemployment has been falling for about a year now. As the charts show, dispersion of unemployment rates does tend to have a cyclical dimension.

Nonetheless I think it is reasonable, based on the history shown here, to conclude that, while some events can lead to a divergence in economic conditions across Australia, overall these differences have not been especially large in recent times compared with those seen in other entities with whom we might compare ourselves. That is not to say the differences are unimportant or immaterial to people's lives, nor that they could not get larger. Nonetheless some perspective as to how large they actually have been is useful.

### **How does the reserve bank keep track of different economic performances?**

That having been said, it is important to add that the Reserve Bank makes considerable efforts to look below the level of national data in its pursuit of a full understanding of what is happening on the ground. Over the past decade or so we have put substantial resources into a comprehensive liaison program with firms, industry groups and state and regional government entities. Officers based in every mainland state capital spend much of their time talking to people about what is going on. Every month they talk to up to 100 organisations around the country. I know that some of our staff visited Shepparton last month and some of you may have met them.

The purpose of this is to help us understand what is happening "at the coal face" – the conditions that businesses are actually experiencing and the things that concern them. This helps give a richer and often more timely understanding of what is going on than the higher-level aggregate data alone might provide. Talking to businesses about their plans for the future helps inform our forecasts, and has been especially useful recently for building a profile of conditions in different sectors, such as expected investment in the mining sector over the coming years. This is important for our analysis of capacity in, for instance, the mining sector, which affects how we see commodity prices, the terms of trade, the exchange rate and exports.

### **Conclusion**

As a physically large country, with quite a diverse set of industries, and our largest population centres separated by long distances and even living in different climates, Australia is always likely to see some differences in economic experience by region. What is remarkable, in fact, is that the differences are not, in the end, larger. That they are not is testimony to the degree of flexibility within our national economy that has been built up over time, and to the design of national policies that aim to lessen the more stark differences that might otherwise occur. Those structures have grown up in the context of a system of a national money.

Monetary policy is, by design, appropriately a national policy. In conducting it, the Reserve Bank devotes considerable attention to finding out and understanding what is happening at the regional and industry level. That helps us to maintain an overall set of financial conditions that are appropriate for the national economy. But we know that there will always be some differences in how changes to monetary policy are felt (though it is not always to be assumed that these impacts are necessarily greatest in country areas).

Monetary policy can't make those differences disappear. In the end, however, if monetary policy can help to deliver reasonable macroeconomic stability, that will offer the best chance for any industry, any region, any business or any individual to succeed on their merits. The Reserve Bank, taking account of all the conditions across the various sectors, remains committed to that goal.