Guy Debelle: Macroeconomics at the Melbourne Institute

Address by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, to the Melbourne Institute 50th Anniversary Conference, Melbourne, 6 December 2012.

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It's a pleasure to be here today to celebrate the 50th Anniversary of the Melbourne Institute. The Institute has performed a pre-eminent role in the economic research and policy advice of the country. My brief today is to focus on its contributions in the area of macroeconomics.

But before I get to that, I will take a detour onto the cricket field. In reading Ross Williams' excellent book on the Institute, it is clear the important position that cricket occupied at the Institute. My association with a sizeable number of the staff members of the Institute, both past and present, is on the cricket field, or to be more precise, on the indoor cricket field.

Now many of you know that a significant number of the Melbourne Institute staff spent their formative years at the National Institute of Labour Studies (NILS) at Flinders University. Indeed, NILS was somewhat of a feeder for the Institute for quite a while.

Back in the mid-80s, being the economic geek that I am, I used to work at NILS during my uni vacations. As a result, I was a member of the highly acclaimed NILS indoor cricket side. Let me run you through some of the key members of the team. I used to open the batting with Robert Leeson, in his pre-Friedman days. Bob and I were renowned for our kamikaze running between the wickets, particularly when we failed to lay bat on ball (which was most of the time). The next pair was one Peter "Dawkie" Dawkins, fresh off the boat from England, and Mark Wooden, recently minted national surf lifesaving ski champion. Our esteemed captain was NILS chief Dick Blandy, renowned for his innovative field placing. Other members of the team were Garry Goddard, now Deputy Under Treasurer in South Australia. Meredith Baker also made the odd cameo appearance. You may be surprised to hear that we were unable to coax the then NILSite, and future Productivity Commissioner and *Australian* Economics Editor, Judith Sloan, onto the pitch.

As you can see, playing on that cricket team was a good leading indicator of employment at the Melbourne Institute, and indeed even a pretty good indicator of actually running the Melbourne Institute. This seamlessly takes me to my main topic today which is the Institute's contribution to macroeconomics.

I will focus on three main areas of contribution by the Institute to the greater good of Australian macroeconomics. The first is indeed leading indicators and business cycle analysis. The second is modelling and forecasting. The third is surveys.

Leading indicators and business cycle analysis

For many years, the Institute has been associated with its series on leading indicators, a summary statistic that aims to predict economic activity. I am not a particularly big fan of leading indicators as a general rule. Personally, I prefer to look at and think about all the components of a leading indicator individually, rather than attempt to summarise the information in one index, particularly given that what matters most at different points in the economic cycle varies through time. (The NILS leading indicator of employment at the Melbourne Institute that I was just talking about probably does a better job of forecasting than the GDP leading indicator.) That said, if one were going to use one leading indicator series in Australia, then it would be the Melbourne Institute's.

As an aside, I was intrigued to learn from reading Ross Williams' book that the Institute was the first body in Australia to publish seasonally adjusted and trend data, some time before the ABS began to do so.

Through the work of Ern Boehm, Don Harding and Adrian Pagan, the Institute has also made a significant contribution to business cycle analysis. Those three gentlemen have generated a number of great papers on the topic of measuring and dating business cycles. They have produced the definitive body of work for the Australian economy. Out of that research has come the most cited dating of Australian business cycles.

Modelling and forecasting

The Melbourne Institute has been synonymous with modelling, particularly during the reign of Peter Dixon. The modelling by Peter Dixon, as well as that done by Peter Brain was, of course, more of the CGE world than the macroeconomic world. Now a critical question is whether those two worlds overlap. I am told by those who can still remember, that a fair bit of time was spent trying to marry the short-term macro forecasting models at the Treasury and the RBA with the CGE model of the Institute. Many conferences were held on the issue. I am not sure the question was ever really answered.

But besides the modelling side of things, the Institute regularly publish an assessment of the Australian economy in the *Australian Economic Review*, as well as discuss the outlook for the economy. I can recall assiduously reading those assessments during my undergrad days in the Eric Russell Room in the Adelaide University Economics Department. At that time, there was little in the way of such assessments emanating from the official sector, this being in the days before quarterly *Statements on Monetary Policy*. There was also little available from the private sector, as economic research in the banking sector was only in its infancy. So the Institute's assessment was an important contribution to the policy discussion in Australia, as well as an important part of the education of a generation of budding macroeconomists.

Surveys

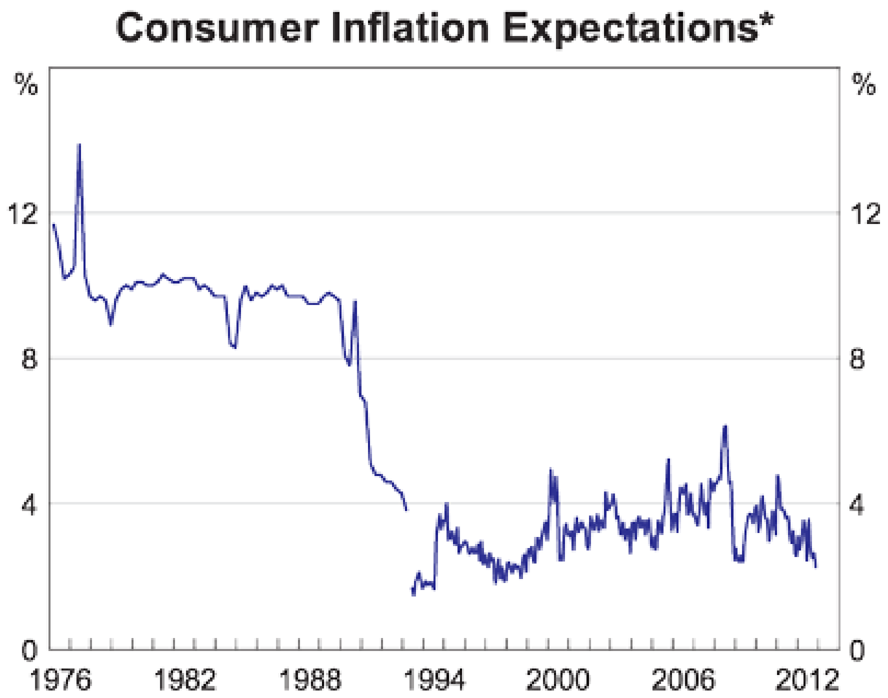
It is in the area of surveys that I think the Melbourne Institute has made its most significant and enduring contribution to the state of Australian macroeconomics. Its name is synonymous with some of the highest profile and longest running surveys in Australia. Much of that contribution can be attributed to the foresight and work of Duncan Ironmonger.

The first of these were the surveys of consumers, which were based on the surveys conducted at the University of Michigan. The survey of consumer sentiment has a long-running history back to 1974. I am pleased to note that the Reserve Bank of Australia provided some of the funding for the survey at its inception.

The length of that data series means that for consumers, we have a time series that spans a number of business cycles, something that cannot be said of quite a few other time series, including most business surveys. In addition to the time series information, there is also invaluable cross-sectional information that has proven useful in informing macro policy setting.

Out of the survey of consumers also comes the series on inflation expectations. The behaviour of this time series has long befuddled many macroeconomists, and complicated the life of those inclined to estimate Phillips curves, as I have been known to do in an earlier existence. As you can see from the time series (Graph 1), for a fairly long period of time, one could broadly describe the series as a horizontal line with a structural shift downwards in the early 1990s.

Graph 1



* Expectation of average annual inflation over the next year; a series break occurs in 1993 due to a change in methodology

Source: Melbourne Institute of Applied Economic and Social Research

My colleague at the Reserve Bank, Jacqui Dwyer, spent a lot of time working with Don Harding in the mid-1990s to try to understand the behaviour of this inflation expectations series. From the Bank's point of view, we were in the infancy of inflation targeting, and we were after a clean read on the public's assessment of the credibility of the new policy regime. As a result of that delving by Jacqui and Don, they came up with a number of refinements to the nature of the survey. One of the problems was a round number problem. Respondents tended to answer either 0, 5 or 10. This was probably a reasonable response in the 1970s and 1980s, but didn't really make much sense in the 1990s and beyond. Also, it turns out that people were not that great with percentages and found it hard to distinguish between levels and changes when it came to prices.

As a result of their digging, the survey methodology was updated to better reflect the low inflation environment. Consequently, the time series since the early 1990s is more nuanced and explicable. There is now quite a reasonable cluster of responses at 2 and 3 per cent. This suggests that households accept and understand the overall framework of monetary policy.

Now that the inflation expectations series has been cleaned up, we only need to come up with a decent measure of the output gap and the estimation of Phillips curves would be a breeze!

Don Harding's other contribution in the area of inflation was his work with Stephen Koukoulas (then at Toronto Dominion) in generating the monthly series on inflation. This series is published jointly by the Institute and TD. Australia remains one of only two advanced countries (the other being New Zealand) without an official monthly CPI series. Don and Steve worked on generating a monthly series, including through some innovative use of electronic data.

The final survey that the Melbourne Institute is most associated with is the HILDA survey. This longitudinal study was based on the similar surveys around the world, including the PSID in the United States, and tracks a set of households through time. While much of the information in the survey is more useful for social policy rather than macro policy, there is still a wealth of information in it that has been, and continues to be, of great use to the Bank and Treasury in their macro policy decision making and policy advice. It has enabled an analysis of macro issues to be conducted by aggregating from the micro data in a way that simply wasn't possible before. In the end macro behaviour is, of course, purely the summation of a whole set of micro decisions.

The HILDA survey is very much in the tradition of Ronald Henderson. It is a very rich source of data that can be used to analyse a vast number of socio-economic questions. Others will talk about it more over the course of the day, but it is to the Institute's great credit that it took on the coordination of this important component of understanding the Australian economy.

The Bank funded a wealth module in the HILDA survey in its first round, which has subsequently been incorporated into the survey every four years. Many of my colleagues, particularly in the financial stability area, have made extensive use of the HILDA data in gaining a better understanding of the distribution of household debt in the Australian economy, as well as households' saving patterns. This in turned has enhanced the Bank's understanding of the transmission of monetary policy to the household sector. Quite a sizeable share of the recent research paper output of the Bank's Research Department has involved analysis of the HILDA data.

Finally, one noteworthy contribution to the macro policy debate that doesn't completely fit within my taxonomy is that of Peter Dawkins in injecting the Melbourne Institute squarely into the debate around unemployment with his critical role in the Five Economists Letter in 1998. Peter's very prominent advocacy on this topic built on the foundations laid by Dick Blandy in refocusing the Institute on the labour market.

Conclusion

The Melbourne Institute has reached its half century. While these days the Institute is most associated with its work in the areas of the labour market and social policy, over its 50-year history, the Institute has made a substantial contribution to Australian macroeconomics. In particular, as I have described today, I think its most significant and lasting contribution has been in instituting a number of important surveys, most prominently the consumer sentiment series, the inflation expectations series and, more recently, the HILDA panel data series. These surveys have facilitated a better quality of macroeconomic analysis, through the wealth of data contained in them. In doing so, they have undoubtedly improved the quality of macro policymaking and outcomes, which was one of the founding goals of the Melbourne Institute.

So, on behalf of the macro policymaking community of Australia over the past 50 years, I would like to thank the Melbourne Institute, and particularly the staff, for their contribution. I trust the Institute will be able to convert this half century into a ton!