

## **Philip Lowe: Internal balance, structural change and monetary policy**

Address by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Australian Industry Group 13th Annual Economics Forum, Sydney, 19 March 2013.

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*I would like to thank David Orsmond for valuable assistance in the preparation of this talk.*

It is a pleasure to participate again in the Australian Industry Group's Annual Economics Forum.

This is the fourth time I have participated in this Forum, having spoken in 2010, 2011, 2012 and now 2013. Over this period, the Australian economy has undergone very significant adjustment. My central message today is that, overall, this adjustment has proceeded pretty well, particularly in light of the extraordinary developments that have occurred in the global economy over these years.

This message is not meant to downplay the disruptive and sometimes painful effects of the changes that are taking place. At the Reserve Bank, we have spent much time trying to understand the stresses and strains facing parts of the economy as a result of structural change. But we have also spent time trying to understand the benefits that can come from this change, including an increase in our average living standards and higher productivity.

From an overall perspective, it is important that we do not lose sight of what has been achieved in Australia. We have managed to maintain a fair degree of internal balance during a period in which there has been considerable structural change, a very large shift in world relative prices, a major boom in investment and a financial crisis in many of the North Atlantic economies. Our economic performance has been much better than many other countries and we remain well placed to benefit from the shift of economic weight towards the emerging market economies, particularly those in Asia. While I understand that many companies face challenges, we should not lose sight of this bigger picture – a picture I suspect that many other countries wish they shared.

### **Internal balance and structural change**

I would like to begin this morning by briefly summarising the broad economic outcomes in Australia since I first spoke at this Forum in March 2010.

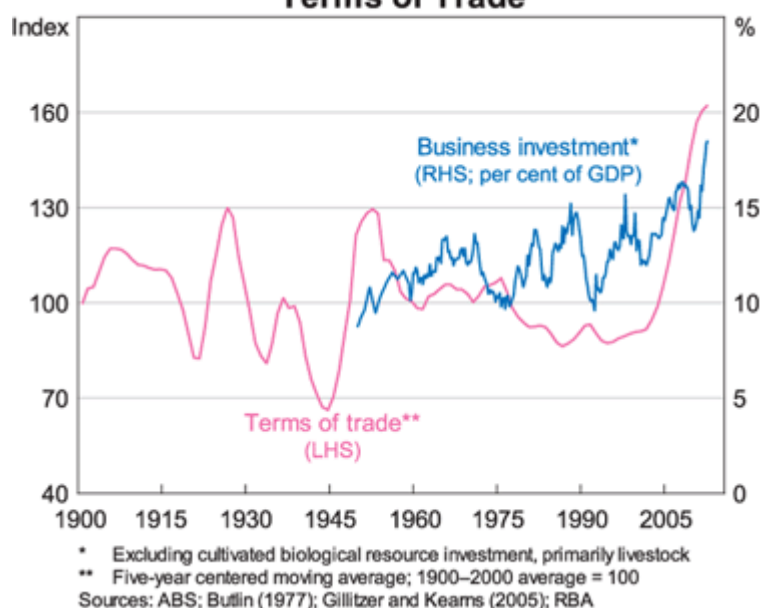
Since that time, output in the Australian economy has increased by 9 per cent. The number of people with jobs has risen by over half a million. The unemployment rate today, at 5.4 per cent, is exactly the same as it was three years ago. And underlying inflation has averaged 2½ per cent over this period, which is the midpoint of the medium-term inflation target.

So over these three years we have seen growth close to trend, a stable and relatively low unemployment rate and inflation at target.

By the standards of most other countries, this represents a very good outcome and a high degree of internal balance. Remarkably, we have achieved this balance despite experiencing the biggest boom in business investment and the largest rise in the terms of trade for over a hundred years (Graph 1). In the past, much smaller investment and terms of trade booms caused outbreaks of inflation and the emergence of other imbalances in the economy. On this occasion this has not happened. The investment boom has not led to a large increase in the current account deficit. There has not been an explosion in credit. Increases in asset prices have generally been contained. And the average level of interest rates has been below the long-term average, despite the very significant additional demand generated by the record levels of investment and the terms of trade.

Graph 1

### Business Investment and the Terms of Trade



There are a number of factors that are important to understanding how domestic or internal balance has been maintained, with generally low interest rates, despite the very large shocks experienced by the Australian economy. This morning, I would like to focus on just two of these.

The first is the flexible exchange rate.

The high levels of investment and commodity prices have been associated with a high value of the Australian dollar. This has clearly caused some difficulties for parts of our economy, including the manufacturing, tourism and education sectors. But from an overall macroeconomic perspective, the appreciation of the exchange rate has played an important stabilising role.

Had we not experienced the sizeable appreciation over recent years, it is highly likely that the economy would have overheated and that we would have had substantially higher inflation and substantially higher interest rates. This would not have been in the interests of the community at large or, I might add, in the interests of the sectors currently being adversely affected by the high exchange rate. It is also worth adding that, in any case, it is unlikely that we would have avoided a substantial real exchange rate appreciation, with it coming through the more costly route of higher inflation.

This, of course, does not mean that, at each and every point in time, the exchange rate is at its ideal rate from a domestic balance perspective. We should not forget that exchange rates are relative prices between two countries' moneys. This means that they are determined both by what is happening domestically and by what is happening abroad. This has been obvious over recent years, with the very accommodative monetary conditions in many of the developed economies tending to put downward pressure on the value of their currencies, including relative to the Australian dollar. As we have said a number of times, the Reserve Bank has responded to this development by lowering the cash rate. It is also worth repeating that this lowering of the cash rate has not been with the direct intention of achieving a lower exchange rate, but rather with the intention of offsetting some of the contractionary effects on the Australian economy of the high value of the Australian dollar.

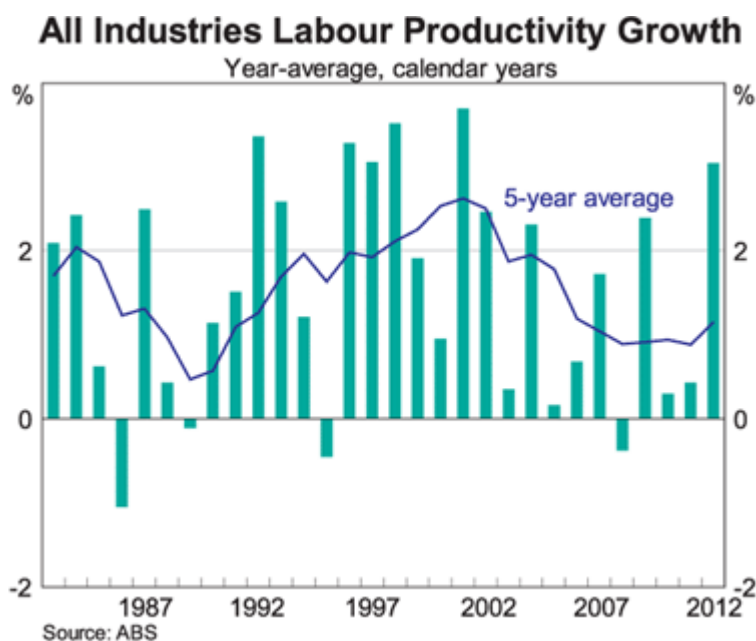
Over recent times, our extensive discussions with Australian businesses confirm that they are adjusting to the high value of the currency. When I spoke at this Forum in 2010 and 2011

my sense was that many businesses were hoping that the high exchange rate was just a temporary development, that it would pass, and that business models wouldn't have to change too much. Today, I have quite a different sense.

Nowadays, there is a greater recognition that the high exchange rate is likely to be quite persistent and firms, including in the manufacturing sector, are adjusting to this. Many are looking to improve their internal processes and address inefficiencies. They are focusing on products where value added is highest and where the quality of the workforce is a strategic advantage. We hear from businesses right across the country that they are looking for improvements and that many are finding them.

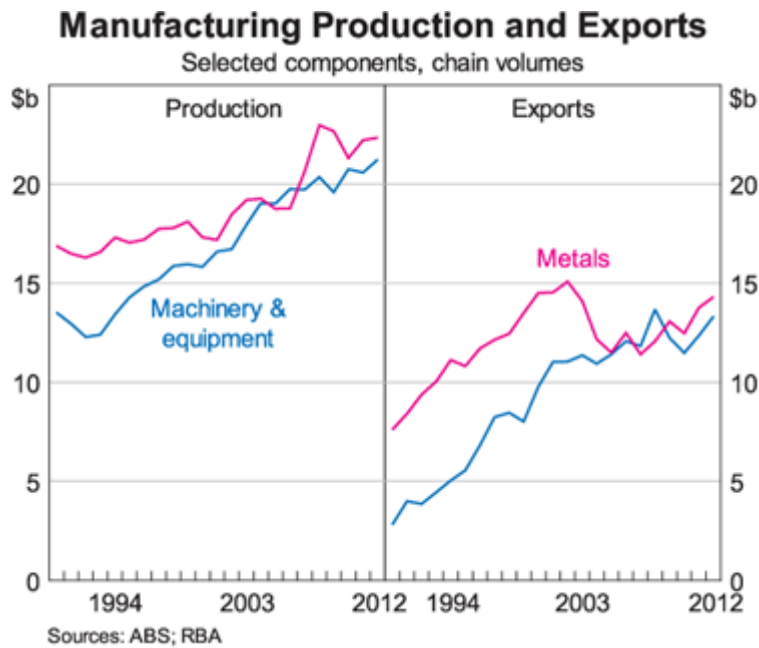
This adjustment in business processes and models is often painful. But the fact that it is occurring is one reason why the Reserve Bank has been tentatively optimistic for some time that productivity growth would pick-up from the low rates experienced over much of the previous decade. We are now seeing some tentative evidence of this in the aggregate productivity data (Graph 2). While these data tend to be volatile from year to year and subject to sizeable revisions, productivity growth in 2012 was better than it has been for quite some time. Of course, we cannot be sure that this will continue, but the structural changes that are now occurring mean that there are reasonable prospects for a sustained lift in productivity growth.

Graph 2



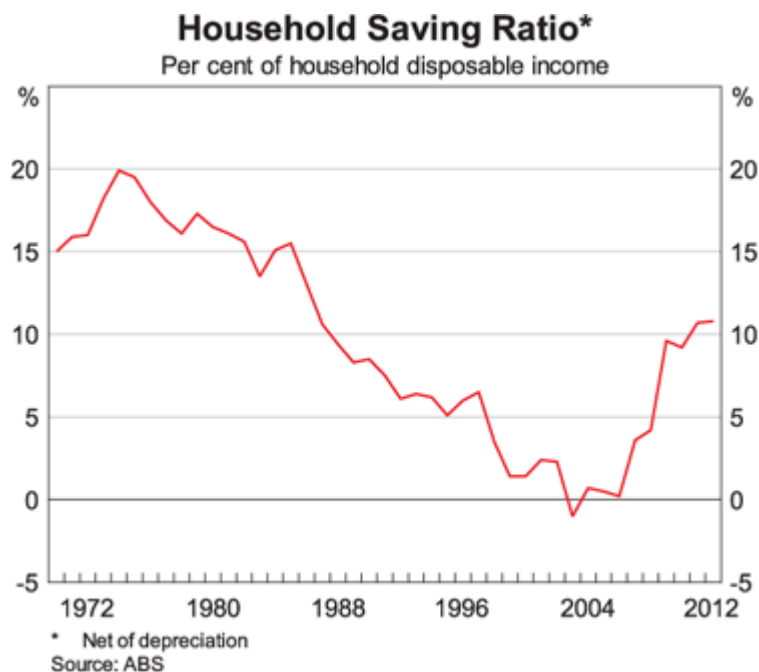
We can also see evidence of adjustment in the detailed industry data, including in the manufacturing sector. While there has been little net growth in either aggregate output or exports from the manufacturing sector for some years, some parts of the industry have done quite well. Output of machinery and equipment and of metals have both trended higher over recent years, and exports of specialised mining-related and other machinery have increased, as have exports in some other categories (Graph 3). Many of these are areas where Australia does have a comparative advantage and where value added is high. It is by focusing on these comparative advantages that we can best build a strong and successful manufacturing sector, while at the same time living with a high exchange rate.

Graph 3



I would now like to turn to the second broad factor that has helped maintain domestic balance during the once-in-a-century investment boom. And that is the increase in household saving. Since the mid 2000s, the household sector net saving ratio has risen from around zero to around 10 per cent (Graph 4). In today's money this represents about an additional \$90 billion that is saved, not spent, by households each year.

Graph 4



Now I know that this increase in household savings has not been universally welcomed by the retail sector. It has caused difficulties for some businesses, including those that based their business models on a continuation of the earlier trends. But consider how the economy might have looked over the past few years had households spent an extra \$90 billion each

year. It is likely that there would have been significant overheating. The exchange rate would have been higher. There would have been more borrowing from the rest of the world. And both inflation and interest rates would have been higher. I suggest that these are not developments that would have been warmly welcomed by most in the community.

So, somewhat ironically, two of the factors that have created difficult challenges for many businesses over recent years – the high exchange rate and increased household savings – are the very same factors that have been critical to Australia's good macroeconomic performance. Importantly, these factors have helped Australia to digest a huge investment boom without generating substantial imbalances in the economy. At the same time, these factors have prompted significant structural change which, while difficult, is critical to achieving higher overall productivity and higher living standards.

There is clearly a lot of change going on in the Australian economy at the moment. How you view this change depends critically upon where you stand. However, no matter what one's perspective, we should not lose sight of the fact that maintaining overall macro balance through this period of change has been a significant achievement. And it is an achievement that has benefited the entire community.

### **The contribution of monetary policy**

So far I have discussed structural factors, but monetary policy has also played some role in helping maintain this overall internal balance. In particular, Australia's credible medium-term inflation targeting framework has served us well through this period of change.

It is important though to point out that monetary policy cannot make the various global factors driving our economy go away. Monetary policy cannot, nor should it attempt to, prevent structural change from occurring. What we can do is deal as best we can with the hand that the global economy has dealt us. We can help ensure that aggregate demand and supply remain in broad balance, so that when firms are making employment, investment and production decisions they can do so with reasonable confidence about the health of the overall economy. Importantly, we can ensure that inflation remains low and stable so that uncertainty about the overall level of prices is not added to the list of things that the community has to worry about.

Since November 2011, the Board of the Reserve Bank has lowered the cash rate six times, by a cumulative 1¾ percentage points. These reductions have brought the cash rate down to 3 per cent, which is equal to the lowest level on record. Lending rates have also come down substantially, although a number are still above earlier lows given the general rise in bank funding costs that has occurred since the global financial crisis.

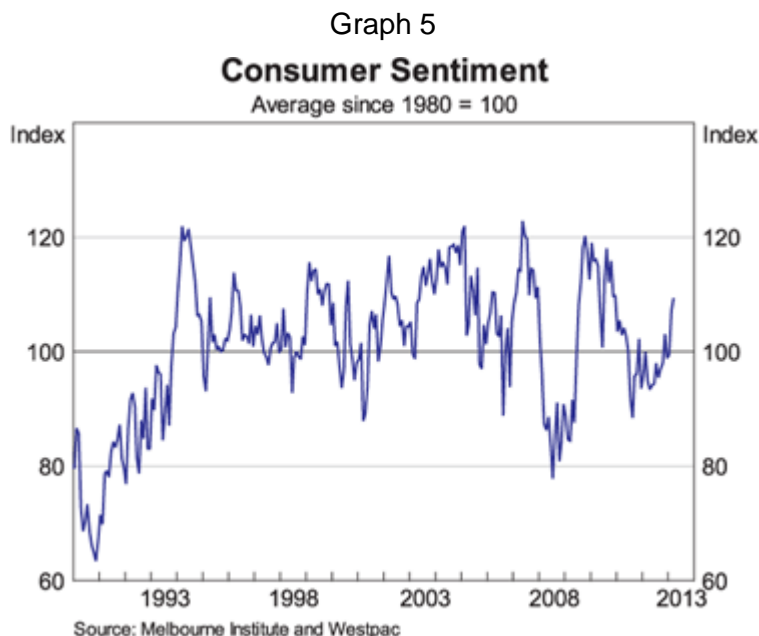
Recently, there has been some discussion as to whether these low rates are actually working. This type of discussion is not surprising given that there are lags between when monetary policy is changed and when the full effect is felt in the economy. It is not a matter of simply changing interest rates today and seeing an immediate response tomorrow. Another complication is that the environment in which interest rates are being adjusted is not the same from one interest rate phase to the next. As a result, the exact way that movements in interest rates are transmitted to the economy can change over time.

All this means that, as always, we need to monitor things very closely. At the moment though, the available evidence does suggest that lower interest rates are doing their work broadly as expected.

In general, the initial responses to a loosening of monetary policy would be expected to include stronger asset prices, improved conditions in the housing market, a lift in consumer confidence and a lower exchange rate.

Much of this does appear to be occurring. Nationwide measures of house prices have increased by around 4 per cent since mid last year, after having declined for around

18 months. Home lending approvals and auction clearance rates have both risen. Equity prices are up over 20 per cent since the middle of last year. And the level of consumer confidence is now well above its long-run average level (Graph 5). Despite what one often hears, households do appear to be feeling better about both their finances as well as Australia's medium-term prospects.



The one notable exception to the expected responses following a substantial easing of monetary policy is that there has been little movement in the exchange rate. However, this reflects the global factors that I talked about earlier, and the Reserve Bank has attempted to calibrate the setting of monetary policy to take account of this.

Now, if the monetary transmission mechanism works broadly as it has in the past, then an improvement in consumer sentiment and higher asset prices should feed through, in time, to higher spending by households. There are some signs, albeit still tentative, that this is beginning to occur. ABS data and the Bank's liaison suggest slightly firmer retail spending over recent months than over the second part of last year, though conditions remain mixed across the industry. There are also signs of a pick-up in the forward indicators for new dwelling construction across many areas of the country. In addition, a number of labour market indicators, after having softened last year, have had a slightly firmer tone of late.

Another critical element in the monetary transmission process is a pick-up in private business investment. This is often the last link in the chain, and typically follows increased confidence and higher spending. Given the nature of the investment boom we are currently experiencing, it is non-mining investment where we are looking for this pick-up to occur. As mining investment inevitably peaks and then gradually declines, a critical question for the outlook is the strength of this expected pick-up in non-mining investment.

We cannot know the answer to this question yet. What we do know is that other parts of the transmission mechanism appear to be working broadly in line with our expectations and that there are some tentative signs of a lift in investment intentions outside the resources sector. The most noteworthy of these was the capital expenditure data published by the ABS a few weeks back, which show that firms expected to increase spending on non-mining construction and on machinery and equipment investment in the next financial year. Whether the increases will be sufficient to offset the expected lower levels of mining investment is something that we will be watching very carefully over the months ahead.

So let me conclude by restating the main message that I started with – that is, that the Australian economy has adjusted pretty well to some very large shocks in the global economy over recent years. We have been able to maintain a high degree of internal balance, while at the same time accommodating significant change in the structure of the economy. Businesses right across the spectrum, including in the manufacturing sector, are adjusting to the new realities. This adjustment is often difficult, but it does hold out the prospect of higher productivity and higher living standards. Monetary policy has played an important supporting role in this adjustment by keeping inflation low and stable and the Reserve Bank of Australia is committed to continuing to play that role.

Thank you.