Glenn Stevens: Issues in economic policy

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Anika Foundation Luncheon, supported by Australian Business Economists and Macquarie Bank, Sydney, 22 July 2015.

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Thank you for coming out once again to support the Anika Foundation.[1] As a result of your generosity in past years, the Foundation is continuing to expand its activities, as you have heard from earlier presentations.

The very efficient logistics for today were again provided by The Australian Business Economists. I also thank Macquarie Group for its financial support of today's event.

I will organise today's remarks under four headings:

- Negotiating turbulence
- Accepting adjustment
- Maintaining stability
- Securing prosperity.

Negotiating turbulence

Until recently, we were living, at a global level, through a period of remarkably low volatility and skinny pricing for risk. There was bound to be some set of events with the potential to change that.

Once again, some of them have been in Europe. After some months, difficult discussions between the Greek Government and its European partners reached an impasse and Greece was, as a result, unable to make a scheduled repayment to the IMF. The ensuing few weeks, during which the Greek authorities had no choice but to curtail access to the banking system, have been extremely difficult and surely quite damaging for the Greek economy.

There has been progress towards a solution in recent days, though a huge amount of work remains ahead to put the Greek economy, and the whole European project, onto a stable footing.

To date, though, the financial spillovers from the Greek situation have not been large. Spreads to German sovereign yields observed for debt issued by the governments of Spain, Portugal and Italy remain quite contained. At this stage, we do not see a market response that signals serious doubts about the ability of those countries to remain in the euro area. There could be little doubt about the willingness of their European partners and European institutions to support these countries in the event that market conditions took a serious turn for the worse – as they might have done, and still might, had/if "Grexit" occurred. The likely direct economic spillovers to the rest of Europe also seem fairly contained, since Greece is quite a small economy.

Of course, things remain fluid. An unexpected turn of events – of which there have been many over time – could change the assessment above. Broader financial and economic impacts might be longer in coming and harder to predict. There are also important geo-

[1] See www.anikafoundation.com.

strategic elements to the situation, which is one reason why nations outside Europe are taking such an interest. For our part, all we can do is watch and see what eventuates.

Meanwhile, and of arguably greater relevance in our part of the world, China's economy and financial system are going through a period of adjustment and uncertainty.

Recently there have been some quite spectacular developments in the equity market. A rapid run-up in share prices – which more than doubled in the space of a year, far beyond any plausible prospective improvement in company earnings – turned to a slump in mid June to early July. Share prices remain well above their level of a year ago, but the speculative nature of the run-up, and the part played by an increase in leverage, has understandably made everyone a little nervous. The Chinese authorities have acted forcefully with some very wide-ranging interventions to stabilise the situation.

The effect this will have on the Chinese economy is not clear, but may prove to be relatively small. Share prices have stabilised in recent days and authorities have been making financial conditions more accommodative. Households' direct exposure to equity prices is relatively small, notwithstanding their large share of turnover. In addition, the rise in share prices was probably too short-lived for there to have been much in the way of positive wealth effects on spending. Other leveraged entities, such as banks and brokers, have shown little obvious sign of stress resulting from the developments in equity markets.

It seems, on the basis of information available at present, that developments in the Chinese property markets and the broader financial sector are likely to be more important for the outlook. The economy had been showing signs of slowing, of course, in the first part of this year. But policies have been responding to this, and some of the recent economic data suggest they have been having a positive effect.

Lastly on the international front, the likelihood still seems to be that US interest rates will begin to rise before the end of this year. This change, when it comes, will have been very well telegraphed. That being said, long-term yields in the United States and elsewhere are still very low, and risk premia compressed, albeit not so much as they were. Some turbulence may well occur as a result not of the first increase in US rates, but of investors trying to assess how soon subsequent increases might occur. But sooner or later we have to see a start to the process of adjusting these financial prices and I would expect Australian financial markets to be able to take all that in their stride.

Accepting adjustment

The Australian economy has been growing, but at a pace a bit below what we have traditionally thought of as average, as it adjusts to some pretty large changes in circumstances.

The story of the phases of the "mining boom" is well known. Commodity prices rose massively and have since declined (though some prices remain pretty high compared with longer-run history). Investment spending followed suit – first it rose by about 5 to 6 percentage points of GDP, and now it is on its way back down. Finally, shipments of resources picked up, as the new capacity created by the investment became available. As an aside, unlike the situation posited some years ago in the United States, and notwithstanding the growth of services, the physical weight of Australia's GDP has probably increased over the past decade. For iron ore and coal, annual tonnages being shipped from Australian mines have increased by more than half a billion tonnes since 2004.

Growth in domestic demand, in contrast, is fairly subdued. Over the latest year for which we have data (to March 2015), final domestic spending rose by a bit under 1 per cent, as the fall in resources sector capital spending accelerated. Capital spending by other businesses has been weak too, while public demand was roughly unchanged over that year.

The weakness in those areas is juxtaposed, as you know, with changing household behaviour. After a lengthy period during which consumer spending growth ran ahead of income growth, and leverage (measured as the ratio of debt to income) almost trebled, households changed course some time ago. To be sure, the rate of saving from current income has declined a little over the past couple of years, which is what is expected at a time of very low interest rates and positive wealth effects resulting from rising asset values. But it remains significantly higher than it was a decade ago. The types of saving rates we see now are more likely to be "normal" than those of a decade ago.

Moreover, while some households (such as first home buyers or, perhaps increasingly the same thing, first home investors) are taking on more leverage, many others are reducing it. They are taking advantage of lower borrowing costs to repay mortgage debt ahead of the schedule in their debt contracts. Despite the lowest interest rates that any current borrower has ever seen, the pace of lending to households remains moderate.

This is not a credit crunch – lenders are willing to lend and competition to do so is strong. Indeed, the prudential supervisor has been minded recently to issue some timely warnings about the need to maintain sound lending standards. Rather, the story is that households are being more prudent about debt and are holding more liquid assets. One measure of this is the size of "offset account" balances – bank deposits held to offset mortgage debt. These now amount to about $90 billion. When the housing credit data are adjusted for the increase in offset account balances, the rate of growth over the past year is put at about 6 per cent, as opposed to over 7 per cent as published.

This may mean that the effect of easy monetary policy is to be somewhat lessened, at least for a time. Taking a medium-term perspective, though, the general strengthening of the balance sheet among many formerly more-indebted households has to be seen as a good thing.

In the interim, the somewhat more restrained attitude to debt and spending by households, combined with a similar attitude by the government sector, has meant that there has not been quite enough domestic demand to achieve full employment, in the face of the fall in business investment. That is why we have felt that, on balance, a somewhat lower exchange rate was likely to be a part of the necessary adjustment. That adjustment seems to be occurring, with relatively little disruption, and is having an expansionary effect. Growth in services trade for example is picking up. The "net export contribution" of services trade over the past year, of around ½ percentage point of GDP, is about the same as the contribution from iron ore exports over that period.

It is worth noting that business conditions as measured in surveys have tended to improve overall, outside the mining sector, over the past year or so. At the same time, the state of the labour market, while still somewhat subdued, appears to be better than we had expected three or six months ago. Employment growth has picked up noticeably, and hours worked have also increased. The rate of unemployment is unchanged from a year ago, whereas we had been thinking it might be a little higher than this by now, since growth in real GDP has been, according to the available statistics, below trend.

Candidate explanations for this better-than-expected set of labour market outcomes include the following:

- Perhaps there is statistical noise in the labour force data or maybe future observations or revisions will paint a different picture. It is worth noting here that recent information on Australian population growth suggests that the absolute growth of employment will be revised down somewhat, though this should not significantly affect labour market ratios like the unemployment rate or the employment-to-population ratio.
- Perhaps output growth has been higher than the GDP data suggest, in which case upward revisions to those data would probably occur over time.

- Perhaps below-trend output growth and trend employment growth can be reconciled in the form of the slower-than-expected growth of wages.
- Perhaps trend output growth is lower than the 3 per cent or 3¼ per cent we have assumed for many years. That is, perhaps the growth we have seen is in fact closer to trend growth than we thought.

Some or all of the above possibilities may be at work. Time will tell which ones, but a few observations may be worthwhile at this point.

First, the economy is making the adjustments required, even if it is a bit slower than we would ideally have liked.

Second, if the slow growth of wages has in fact been a significant saver of jobs, that would appear to indicate a degree of labour market flexibility in operation.

Third, to the extent that the data are hinting that our assumptions about trend growth may need to be revisited, that will be worth some discussion. It need not be the case that per capita growth would be any lower, if the lower growth simply reflects slower population growth. So there may be few implications for living standards as measured by income per head. But if there are assumptions about absolute growth rates embedded in business or fiscal strategies, or retirement income plans, they would need to be re-examined.

I suspect this will turn out to be an important discussion: what is Australia's potential economic growth rate, per head, and why? And what do we want it to be? And, of course, what do we need to do to achieve our desired outcome? I return to that theme – securing prosperity – shortly.

But first, a few words about stability.

Maintaining stability

One of the features of much regular discussion of macroeconomic policy, and monetary policy in particular, is that people tend to adopt a rather short time-frame. Everyone watches high-frequency data and adjusts expectations about what policy should or will do accordingly. Policymakers are expected to respond to events and to deviations of economic performance from what had been anticipated. The number of surveys and obscure indicators seen as conveying information has continued to grow, as has the number of commentators to talk about them.

To some extent this is perhaps a natural outworking of richer, more complex societies possessing more information and analytical resources, the 24/7 operation of financial markets and a competitive media searching for content. And to a point, it is perfectly reasonable to expect policy to be adjusted in response to relevant information about how things in the economy are tracking relative to policy objectives.

The risk, however, is that this process can lead to a mindset in which policymakers end up responding to quite short-term phenomena, using instruments that take quite some time to have their full effect, including effects that might actually turn out to be adverse. This is relevant to our situation. A period of somewhat disappointing, even if hardly disastrous, economic growth outcomes, and inflation that has been well contained, has seen interest rates decline to very low levels. The question of whether they might be reduced further remains, as I have said before, on the table.

But in answering that question, it is not quite good enough simply to say that evidence of continuing softness should necessarily result in further cuts in rates, without considering the longer-term risks involved. Monetary policy works partly by prompting risk-taking behaviour. In some ways that is good: in some respects, there has not been enough risk-taking behaviour. But the risk-taking behaviour most responsive to monetary policy is of the financial type. To a point, that is probably a pre-requisite for the "real economy" risk-taking that we most want. But beyond a certain point, it can be dangerous.

Deciding when such a point has been reached is, unavoidably, a highly judgemental process. And that is after the event, let alone beforehand. My judgement would be that policy settings that fostered a return to the sort of upward trend in household leverage we saw up to 2006 would have a high likelihood, some time down the track, of being judged to have gone too far. That is not the case at present, given the current rates of credit growth and so on. But the point is simply that in meeting the challenge of securing growth in the near term, the stability of *future* economic performance can't be dismissed as a consideration. A balance has to be found. I note that the Board's post-meeting statements routinely refer to seeking a stance of policy that will "most effectively foster *sustainable* growth and inflation consistent with the target" (emphasis added). The adjective "sustainable" is used deliberately and financial sustainability is very definitely one of the things we have in mind.

Securing prosperity

The transition in growth is not perfectly smooth, but our economy has, in my judgement, coped remarkably well through a lengthy period of very large shocks in a difficult world. Despite the doom and gloom and fulminations over the airwaves, in newspapers and in cyberspace, business confidence has risen in recent months. One day last week as I was preparing these remarks, newspapers carried stories that personal insolvencies are the lowest for more than a decade. On the same day we could read that income inequality in Australia, as measured in the most detailed survey available, has not, in fact, increased, contrary to the impression so often given. Perhaps we might be allowed to conclude that we have been meeting some of our challenges, thus far, with outcomes that, while not perfect, are not too bad.

So there are reasons to feel more confidence in our future than we often seem to. The question to be asking is how we build on the broadly successful record we have in order to secure prosperity in the future.

In this context, it is likely that questions about potential growth, in per head terms, will become even more prominent. This is partly because of the well-known implications of the lower terms of trade for income per head (i.e. it grows more slowly than output per head). It is partly about demographics, also a well-known issue. Ageing will lower the proportion of people working and hence, other things equal, output and income per head in the country.

We all know these things at an intellectual level. But unless we think our wants, including for publicly provided services, will grow more slowly, which I doubt, the very practical imperative will increasingly be to secure sources of growth. And it is increasingly clear to people that the kind of sustained growth in mind here won't be the result of the manipulation of interest rates or year-to-year government fiscal settings. Demand management policies play an important role, but they have their limitations.

Raising the economy's potential isn't just some esoteric concern for economists, or at least it shouldn't be. Our collective ability to deliver social policy outcomes, to enjoy the benefits of a "good society", or at a more basic level to provide public services and even to defend ourselves, ultimately rests on a productive economy. Many problems, including distributional ones, are easier to deal with if *per capita* incomes are rising steadily, less so if they are stagnant.

Let's be clear that this is not "growth at any price". Wealthy countries tend to have cleaner air, cleaner water, better health and education systems, and more demanding standards for environmental protection, employee safety and leave entitlements. They can afford to devote resources to such things because their business sector is so productive. They tend also to have higher wages – not because they decree wages shall be high but because well-educated, skilled workforces working with a lot of capital and modern technology are more productive. The poorest peoples usually have far less in the way of such things. If we care about wellbeing in the broadest sense, we should care about things that affect potential output per head.

Our citizens certainly care about the results. They don't frame the question as being about per capita real GDP or productivity per hour and they care about more than just "narrow" outcomes for economic statistics. Many would be concerned to reduce our environmental footprint. They would not wish to sacrifice civilising aspects of our society and culture, including many that result from government intervention. But nor will they accept a future in which they are marginalised in the global village because of unwillingness to adapt or to invest, or because of a failure to foster a growth economy.

There is a lot of talk at present about "reform". I would suggest that the case for "reform" needs to be presented as a positive narrative for economic growth. We all know that competitive markets, investment in education, skills and infrastructure, and adaptability, are key parts of that growth narrative.

These reforms matter because of the gains to incomes resulting from better allocative efficiency. But they also, ideally, would support entrepreneurship and innovation – "risk-taking" by another name and of the kind we want. Measuring "entrepreneurship" is not straightforward and various studies have somewhat differing results. At the risk of oversimplifying, one might say that Australians hold our own in the entrepreneurship stakes, but since we don't generally score at the top in such surveys, there must be scope to improve. That too can be part of the growth narrative – the narrative of how we build on the success enjoyed to date and secure an even more prosperous future.

Conclusion

Thank you again for your attention, and for your support of the Anika Foundation. I hope to see you again in another year for a new round of challenges.