Glenn Stevens: The long run

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Australian Business Economists (ABE) Annual Dinner, Sydney, 24 November 2015.

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Thank you for the opportunity to address you this evening.

You've spent all afternoon talking about the near-term outlook. No doubt there was a lively discussion and some points of debate. I would hazard a guess that most forecasts have the Australian economy continuing to expand at a moderate pace, with inflation low and the rate of unemployment around 6 per cent. The points of debate might be around whether, and when, growth might speed up a bit or slow down; whether inflation would be broadly consistent with the 2–3 per cent target or a bit on the low side; and whether unemployment could start to drift down, or instead, might resume its drift up.

The Reserve Bank released its own views about the outlook a few weeks ago. These left the forecast for growth about where it was before. Over the next couple of years, as the drag from the decline in mining investment starts to lessen (mainly in 2016/17), and the effects of assumed low levels of interest rates and the exchange rate continue to accrue, growth is thought likely to pick up a bit.

A number of data points over recent months suggest that prospects for firmer conditions in the non-mining economy are improving. Business surveys indicate that firms report conditions to be, if anything, above their long-term average in some key sectors. Firms seem to have stepped up their hiring. Job vacancies have been increasing, hours worked have been increasing and employment growth, even before the most recent month's data, had strengthened noticeably over the past year. Labour force participation has risen, and the unemployment rate has been stable. This is supporting income growth as the terms of trade decline works its way through the economy.

The Bank did lower its forecast for inflation a little. This was based on an assessment that the latest reading contained some signal, not just noise. As in the case of many other countries, the effects of a decline in the exchange rate are proving a bit slow to come through. And slow wage growth makes for a low underlying rate of increase in domestic costs. On this basis, the Board concluded that inflation would not be a barrier to further easing of monetary policy, should that be useful to support demand.

But there is little numerical precision that can be attached to these rather qualitative views. For a few years now the Bank has sought to emphasise the idea of the outlook being probabilistic. The "central forecast" is simply the modal point of a distribution of possible outcomes. It is more likely, in our judgement, than any other single outcome, but the likelihood of that particular outcome is in fact not that high at all.[1] We have tried to convey this sense of imprecision by publishing "fan charts" and by putting ranges in tables for forecast variables over horizons longer than a couple of quarters. The point of this is to try to get people to focus less on the central number and more on the set of issues that accompany the forecasts.

It seems that we have not been very successful on that score. There still seems to be inordinate attention paid to changes in the central forecast that are often no more than a couple of tenths of a percentage point. I've debated at times with our staff whether we should leave the central

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[1] If, for example, the 'central' forecast for underlying inflation two quarters ahead is 2 per cent, the statistical likelihood of an outcome of 2 per cent +/– 0.125 per cent, is about 25 per cent, if forecast errors are assumed to be drawn from the same distribution as in the past.

line off the fan charts altogether. The response is that people would simply back it out of the charts. Likewise, the desire I often feel to put wider ranges in the forecasts would probably still result in people just computing the mid-point of the range, ascertaining whether that had moved slightly and offering interpretation of that change.

It's a natural human tendency to focus overly on small changes, perhaps because it allows us to maintain the comfortable illusion that things are predictable and controllable. But this fervent desire for precision is not supported by any demonstrated accuracy of economic forecasts. Its cousin, a hankering for policy fine-tuning, is barely, if at all, better supported by the historical outcomes of economic policymaking.

While small forecast changes get a lot of attention, the far more important question is whether we have recognised and understood the big forces at work. Even if we cannot predict the outcomes with great accuracy, an understanding of these forces ought to help us get policy responses roughly right. And that, in the real world, is probably about as much as we dare hope.

Right now the big forces include:

- for Australia, the closing chapters of a very large and long-running terms of trade event, with all that means in terms of economic adjustment. This coincides with a household sector no longer being in a position to play a major role in leading growth by significantly increasing its leverage, because it had already done that in the past;
- a global economy growing but only moderately, affected by considerable structural change and facing legacy effects of debt, arising from a previous period of over-confidence and under-appreciation of risk;
- a disinflationary or deflationary environment for the production of goods and commodities, and even some services, accompanied by unusually low rates of wages growth;
- extremely low returns on safe financial assets, as central bank actions have removed a significant proportion of these assets from the market, and have encouraged investors to accept interest rate risk on the remainder by providing "guidance", leading to:
- high and rising valuations on existing fixed assets, including dwellings, around the world, but not so much, thus far, in the way of new capital formation by most existing businesses in the "real" economy.

To this list of "conventional" forces we might add:

- the "disruption" of the increasing application of digital technology, which may mean, among other things, that growth in sales, capital formation and returns to capital are happening in entities and activities we don't measure very well – or at all.

Many of these sorts of forces are low-frequency in their nature. Most of the ups and downs in the time series from month to month, or even year to year, on which we all expend so much energy are just temporary fluctuations around these longer-run trends.

If numerical forecasts can't be very dependable, are we – the economics community – much good at predicting these long-run forces? If we look back a decade, to the sorts of things that occupied much attention, the evidence is mixed.

By the middle of last decade, we had certainly noticed the change in household borrowing and spending behaviour, understood that it was important and wondered how long it could continue, and what might cause it to alter course again. In that respect, we were at least looking in one of the right places.

People had also sensed that the emergence of China was starting to have important implications for Australia and the global economy. That said, the strength and duration of the

"China boom" tended to be under-estimated. In forecasts made over a succession of years, people routinely tended to expect that the strong growth then being observed in China would slow. Likewise, through most of the period in which Australia's terms of trade were rising, forecasters routinely tended to call a near-term peak followed by a decline - and were wrong in most years.[2] Even those resource companies that would eventually make massive investments on the back of the rise in commodity prices were initially sceptical. Now, as this period of exceptional, and not well forecast, Chinese growth has ended and we face less spectacular outcomes, a few have been surprised on the downside.

A decade ago, everyone was celebrating the "great moderation" – that period of reduced macroeconomic volatility, good average growth and low inflation. This was regarded as a success of macroeconomic policy. It was also thought that the development of modern financial tools, with fairly light regulation, had helped us to understand, unbundle and disperse risk around the system. To be fair, there were some voices questioning compressed risk spreads, leverage and so on. Some worried about the complex interactions between the various players and how the system would cope in a stressed environment. Some wondered whether apparent stability would lead people to take on leverage to the point where it would threaten that very stability.[3] A few presciently placed financial bets against the prevailing trend. But, overall, very few foresaw either the severity of the crisis that would unfold or the longevity of its adverse economic effects.

If we look at what featured in most discussions about risks to global growth at the time, we find that the so-called "global imbalances" were prominent. It was not uncommon to hear people worry that markets would at some point decline to "fund" the US current account deficit, leading to a crash in the US dollar.

Yet it wasn't the global imbalances that caused a crisis. It was the implosion of complex financial products, against the backdrop of excessive leverage, that ushered in the crisis. It was the drying up of dollar funding liquidity in the financial systems of several major countries that propagated it. The onset of the crisis saw a shortage of dollars in the market, not a glut. And the "global imbalances" continue today, though they have diminished in size.

A decade ago, Japan was experiencing deflation, "ZIRP" – zero interest rate policy – and "QE" – quantitative easing. People offered various analyses of this; many opined that it should not be that hard for the central bank to return to inflation, by sufficiently aggressive action. Thoughtful people pondered the difficulties Japanese policymakers confronted and hoped never to find themselves in that situation.

Ten years on, policy interest rates have been effectively zero in the United States, the United Kingdom and Europe for quite a long time. They are still zero in Japan. "Quantitative Easing" by one name or another has become more widespread. Central bank balance sheets in these cases are a multiple of their sizes in the mid 2000s. I recall few, if any, who a decade ago saw that outcome as having a significant probability.

While outright deflation is still comparatively rare, inflation being a bit too low relative to announced objectives seems to be not uncommon. It is difficult to avoid the conclusion that, in practice, it is more difficult than the textbook says it should be for a central bank (by itself) to create inflation, when other powerful forces are at work. For economists and policymakers

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2 See Health, A (2015) 'The Terms of Trade: Outlook and Implications', Address to the Resources and Energy Workshop hosted by the Department of Industry, Innovation and Science, Canberra, 20 November.

3 On these points, see for example Geithner, T (2006), 'Hedge Funds and Derivatives and Their Implications for the Financial System', Remarks at the Distinguished Lecture 2006, Hong Kong, 15 September (available at <https://www.newyorkfed.org/newsevents/speeches/2006/gei060914.html>) and Stevens, G (2006), 'Risks and the Financial System', Remarks in response to Distinguished Lecture by Mr Timothy Geithner, Hong Kong, 15 September.

trained from the 1960s to the 1990s, when the task was always to stop inflation rising and/or to get it down, this is a remarkable outcome.

One area in which good long-term thinking was being done a decade ago was population ageing. Australian work in this field foreshadowed adverse long-run trends in the fiscal balance. And we can find GDP growth projections from Intergenerational Reports from a decade ago that put average growth between 2010/11 and 2015/16 at 2¾ per cent, noticeably below the growth rates being observed at the time this projection was made. That was not a bad "forecast", actually: the outcome is likely to be about 2½ per cent. This is despite the fact that the people who made this estimate obviously could not have had any knowledge of many of the non-demographic forces that would be at work over the relevant years.

One can't help but observe that, in common discussion about the economic outlook, we too often ignore the influence of demography. But it may be that demographic forces are a common factor behind some of the most important "big force" developments.

It seems likely that the characteristics of the "baby boom" cohort – its relative size and different propensities from those of other generations – have affected saving and investment choices, housing markets, asset values, leverage and so on through time. Further effects no doubt will occur (not necessarily in the same direction).[4]

What then might be some of the "big forces" at work over the next decade?

Perhaps unwisely, I shall chance my arm at some ideas. In so doing, I am comforted by the very low likelihood that I shall have to return to a future ABE forecasting conference to explain why these prognostications were wrong!

It is not very controversial to suggest that China will grow more slowly on average than in the past decade, but it will still be a big deal given its overall size *and* the extent of transition required in its growth strategy. China's financial weight will be increasingly apparent in markets. Those days, like in late August this year, when US and global markets are roiled by some event in China, will probably become more common. The growth transition towards services will have implications not just for the value of resource shipments from Australia, but for the Asian regional manufacturing chain.

But China's demographics are not favourable. To be sure, the continuing process of urbanisation means that the labour available for manufacturing or services production may grow for a while. But, overall, China's total working-age population will be shrinking over the years ahead. Contrast this with India, another large country, but with vastly different demographics. India's population of working age will exceed China's within a decade and continue to grow.[5] So India should become much more prominent in our conversation about the global economy and our own. Are we intellectually prepared for that?

The United States will still be a very large economy and, perhaps more important, still a leading source of innovation and dynamism. It will probably retain its current position of global leadership in international economic governance, though much depends on how two political establishments – the US's and China's - behave, including towards each other.

There are no prizes for guessing that the share of services in most economies will continue to increase. Health and aged care are obvious areas for expansion – another effect of demographics. It may be that jobs will be "robotised". But on the other hand, in the long run we

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[4] See, for example, Kulish, M, K Smith and C Kent (2006), 'Ageing, Retirement and Savings: A General Equilibrium Analysis', RBA Research Discussion Paper 2006-06.

[5] The UN projects India's total population to surpass China's in seven years and the working-age population to surpass China's in 2025. The UN projects India's working-age population to increase by 250 million by 2040, to 1.11 billion (compared with 866 million in China).

may need that to some extent. Demographic factors suggest strongly that, all other things equal, the problem isn't going to be a shortage of jobs, but instead a shortage of workers.

'Digital disruption' will continue. Some of this will be faddish and no great aid to productivity. But other elements will mean fundamental changes to business models. It's already obvious that models that rely on having an information advantage over a customer are struggling as information becomes ubiquitous. Models that can profit by using more information *about* the customer will be advantaged – up to the point at which customers decline to reveal any more about themselves. The issue of trust will be key.

On that note, I suspect the already-considerable resources devoted to IT security will grow further as awareness increases of cyber risk and its consequences. Maybe IT security will need to get as inconvenient as airport security and more costly – a whole new meaning of the term "digital disruption". It remains to be seen whether, at some point, the potential risks of further connectedness might be judged to outweigh the benefits. There are, for example, some organisations sufficiently concerned about cyber risk that they construct a duplicated IT architecture – one connected to the world, the other sealed off. The issue of trust in cyber space may turn out to be every bit as problematic as that of trust in the financial system.

My guess is that global interest rates are still going to be very low for a good part of the decade ahead. Clearly there is a likelihood that the Federal Reserve will raise the fed funds rate next month or, if not then, pretty soon. Once it does, intense speculation will begin about a question much more important than the timing of the first increase, namely the timing of the second (and, by extension, the future path of the funds rate). But it seems likely that the pace of increase will be very gradual. The ECB and the Bank of Japan are a long way from even thinking about higher interest rates; the ECB is openly contemplating further easing. So the average policy rate in major money centres may be very low for quite a while.

In a low interest rate world, the problems of providing retirement incomes will become ever more prominent. The very low level of yields on fixed income assets means that it is very expensive today to purchase a secure stream of future income, which is what someone who is retiring is usually seeking. And there are more of such people, living longer.

The retiree can of course respond to this by holding more of her portfolio in dividend-paying stocks – accepting more risk. She may hope for a dividend stream that is fairly stable from year to year but that tends to grow over time. It certainly seems that many Australian listed corporates feel the pressure from shareholders to deliver that, even some whose earnings are inherently volatile.

Can the corporate sector realistically promise growing dividends over a long period? Not without being prepared to take the risk on investment in new products, processes and markets. How much of that risk an older shareholder base will allow boards and managements of listed entities to take is an important question.

Overall, in a world where a higher proportion of the population wants to be retired and living (even if only in part) off the return on their savings, those returns are likely, all other things equal, to be lower. Part and parcel of the same adjustment may be higher real wages for the smaller proportion of the population that is working. These changes, driven by demographics, may require some adjustment to our collective thinking about what is "normal", not just for rates of return on assets but also for returns to labour.

My final, fairly uncontroversial predictions:

- The business cycle will continue. There will be economic downturns from time to time. If one of those turns out to be a big one, it will be very new experience for quite a lot of Australians. Close to half the workforce has never seen *really* high, nationwide unemployment. A lot of people in business have, I suspect, not seen how tough conditions can become when virtually every industry and region is contracting. That they have not seen this is a good thing – in the sense that it results from the fact that

we have not a really serious downturn for a long time now. But if one comes, it will be a shock.

- A decade from now, I suspect the art of economic forecasting won't have changed much. In my 35 years as a maker, observer and user of forecasts, I think forecasts have improved. Part of that has come from learning more about how economies work. But a lot of it, I suspect, has come from what could be described as improved "now-casting": finding ways of assimilating a host of disparate pieces of information to judge more accurately what the economy has been doing in the very recent past. (That's probably where "big data" potentially has some use.) That provides a better "jumping off" point for the forecast profile, which is important because most revisions to numerical forecasts for annual growth or inflation still seem to come from surprise about the current and most recent previous quarter. When all is said and done, however, it remains the case that "forecasting is hard, especially about the future".[6]
- But, finally, human nature won't change. That means that we, as human beings, will be irresistibly drawn to those who claim to be able to forecast the future, beat the market, and give us the illusion of certainty and control.

So there will continue to be interest in forecasts, and the ABE forecasting conference will, I'm sure, go from strength to strength.

Thank you.

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