CHALLENGES FOR ECONOMIC POLICY[1]

Address by Mr Glenn Stevens, Governor, to The Anika Foundation Luncheon Supported by Australian Business Economists and Macquarie Bank, Sydney, 28 July 2009.

Thank you all for coming today, and thank you to Macquarie Bank for their financial support, and the Australian Business Economists for their logistical support for today's function.

Those of you who were here at last year's Anika Foundation lunch may have noticed that I have selected the same title today.[2] The challenges have changed in nature, but there are no fewer of them. The first part of my remarks will be about the general set of issues confronting policy-makers in key economies. **They are not about Australia, unless specifically noted**. I will devote time to Australia-specific issues in the second part.

Global Challenges

A year ago, the international financial crisis was unfolding, but had not, at that point, spun out of control. The global economy had reached the peak of a long, strong upswing, which had stretched capacity and seen a wide range of raw materials and energy prices reach very high levels. Strange as it may now seem in light of subsequent events, a wave of concern about inflation swept financial markets in the middle of last year.

Many countries were grappling with the lift in oil prices, which were reaching their peak last July. That was starting to reduce growth but also push up the general level of consumer prices in the advanced countries. In many emerging economies, strong growth had pushed up inflation significantly, even apart from food and energy prices.

Australia was experiencing high inflation too, a result of the expansionary impact of a once-in-fifty-years terms-of-trade rise in an economy already close to full employment. We were also being affected by the dampening forces of the financial events, though by less than countries whose banks were closely involved in the problem lending areas.

Since then, inflation rates have trended down in most countries. One thing that helped this was that the rapid final lift in oil prices during the first half of 2008 was reversed by the end of the year. Much of the cumulative increase that had occurred over the preceding five years, however, remains in place. Broadly parallel trends can be seen in other resource prices.

1 *I thank Kathryn Ford for assistance in preparing this address.*

2 *The Anika Foundation was established in 2005 to raise funds for the purposes of supporting research into adolescent depression and suicide. For details, see <http://www.anikafoundation.com>.*

All of that suggests a significant structural rise in demand for energy and resources has occurred, as a result of the cumulative growth of the emerging world. This seems more likely to be a feature of the international economy for some time than to go away. If so, it has to be accommodated by the advanced industrial countries that, hitherto, have had access to those resources on favourable terms. Such an accommodation can be made, over time, via responses to higher prices in terms of efficiency gains, structural change in economies and so on. But it is as well to recognise that an adjustment has to be made. This could well remain something of a medium-term challenge for economic policies in the relevant countries.

At a cyclical frequency, the global economic downturn has taken the pressure off prices for goods and services for the time being. Most likely, inflation rates in the developed world will continue to be low for a while. Some observers worry about deflation.

For the past nine months or so, the key imperative has been to stabilise financial systems, and to support demand during a process of deleveraging, so as to halt an incipient downward spiral of falling asset prices, contracting credit, slumping spending, further deflationary pressure on prices, and so on. Probably in some of the most important countries, this support will need to remain in place for a while yet. Once demand is on a self-sustaining path of expansion, the support can be removed.

At a longer frequency, on the other hand, the aggressive, and in places unconventional, policy responses to the contraction in demand are seen by some observers as increasing the risk of inflation. The essential reasons for such concerns boil down to some fairly basic fiscal and monetary notions.

Fiscal deficits are very large in some countries now, and look like remaining so for some years. Public debt is rising quickly in many countries. For the G7 countries, gross public debt will probably exceed 100 per cent of GDP within the next year. Some major central banks have expanded their balance sheets dramatically, purchasing government debt and/or private securities in order to give additional impetus to efforts to support financial systems and aggregate demand.

It is not that the fiscal burdens are unprecedented: there are periods in history in which deficits and debts were this large, or even much larger. They were mostly, however, war-time precedents, and wars have tended to be inflationary for the combatants. Likewise, large-scale expansions of central bank balance sheets have usually been seen as a fairly sure way of debasing the value of a currency.

So at present, we have the unusual situation where some, who look at the prospective deficits and debt burdens, combined with 'unconventional' monetary policy measures, worry about high inflation down the road, even as others worry about the possibility of deflation over a shorter time horizon, as a result of large-scale overcapacity.

Logically, subject to one or two important assumptions, there must exist a path that avoids both these unpalatable alternatives – deflation and inflation. Finding that path is the challenge for policy-makers around the world over the next several years.

Faced with a large downturn like this, it was the right thing to do to allow budgets to go into deficit. Over time, though, there will obviously need to be fiscal consolidation. This will

be easiest where the fiscal measures taken were temporary: it would be a matter mainly of not repeating the measures. Where more permanent measures were enacted, it will be more of a hard grind to get onto the path of sustainability.

In some countries, moreover, the legacy of the excesses of the earlier part of this decade, and of the steps needed to cope with their subsequent unwinding, is likely to be quite persistent. Some major country governments have assumed, one way or another, a significant part of the obligations associated with earlier poor decisions by lenders and investors. Moreover, the level of potential output in some economies may have taken a step down, which will make the path back to fiscal sustainability more difficult to reach. In the countries concerned, there was no alternative to these actions; inaction would have been more costly. Nonetheless, all of this suggests that, in those countries, constraints on economic policy are likely to last for some time.

The higher debt burdens will limit the extent to which worthwhile structural spending levels can be maintained for other things – like in health, education, urban infrastructure and so on. Moreover, the capacity to respond with fiscal policy to another economic downturn, should there be one, would be much more limited.

Over time, these constraints will tend to become more apparent. Of course they might be disguised for a while under conditions of higher inflation. Indeed, the potential attraction of the 'inflation tax' as a fiscal device is precisely why some worry about inflation, given the size of budget deficits in some countries.

The main safeguard that stands between debt holders and that outcome is the agreed framework for monetary policy, which is, with some differences in detail, in place pretty much everywhere. Its key components are a strong focus on medium-term price stability and sufficient operational independence for central banks to pursue that goal.

This framework will require central banks to remove the exceptional accommodation being supplied at present, in due course. Getting the timing of that right will not be easy. In the major countries, the calibration of even conventional policies has probably been dislodged by the sequence of events, not to mention the almost total lack of comparable history against which to calibrate the unconventional measures.

But while achieving a successful 'exit' will be quite a challenge, the chances will be maximised under the sorts of policy frameworks currently in place in most countries. For a key assumption behind the notion that the ideal path between deflation and inflation can even be found is that inflation expectations remain anchored. Were they to start to drift upwards, policy-makers could be presented with an unenviable situation of gathering inflation and ongoing weakness in real economic activity. Their choices would be very bleak indeed in that world.

So, expectations remain key. It would, therefore, be a mistake to weaken commitments to clearly understood goals for inflation, of either the explicit or implicit type.

Assuming the present set of monetary frameworks remains in place, then, the real constraints will have to be faced squarely. This only reinforces the importance of maximising productivity growth. The households of the Western world are currently feeling that they can no longer consume as they did, in part because the earlier spending is now seen to have been based on an

unrealistic set of assumptions about long-run income and wealth. To that extent, there is no real way around a period of adjustment involving lower consumption for a while.

But the adjustment could nonetheless be eased if a better foundation for optimism about future income could reasonably be established. Productivity is the key to that. In fact it is the only real basis for it.

Of course, finding more productivity is easier said than done. But one key element will be to maintain open and competitive markets for goods and services, since they are most likely to spur the innovation that raises productivity. It is a bit disturbing, in this context, that the World Trade Organization reports a pick-up in trade-restricting decisions by governments in recent times. The challenge for governments is to resist these tendencies. That, of course, is not a new challenge, but it is as important as ever.

Part of the way ahead will, at some point, involve winding back the extensive government guarantees (and in some cases extensive public ownership) of financial institutions around the world. These measures were necessary last October in the extreme uncertainty of the time, and played a critical role in stabilising confidence in the core of the financial system, and re-opening key capital markets. But they are undesirable as a permanent feature of the landscape.

Countries that issued very generous or even unlimited guarantees of deposits will want to make sure such steps truly were emergency measures, by scaling them back to a more sustainable set of deposit insurance arrangements. Likewise, it would be desirable that guarantees for wholesale raisings in capital markets lapse into disuse as conditions improve. To date, in excess of US$800 billion of government-guaranteed debt has been issued in public markets by banks around the world. An unknown additional sum has been placed into private hands directly.

Taking account of the additional debt governments are issuing for regular fiscal purposes, plus the funding for bank rescue packages, the shape of global capital markets is changing significantly. Government and government-guaranteed debt of one form or another is rapidly increasing globally. This has been accommodated so far because it has, by and large, matched investors' shifting risk preferences. Certainly people will worry, longer term, about increases in long-term interest rates potentially 'crowding out' private borrowers. To date, though, long-term rates remain historically pretty low for public borrowers, despite the prospect of very large debt issuance. They have increased somewhat, but this is best understood as an unwinding of the extreme risk aversion of 2008 and early 2009.

But the longer-term question is whether, even without adverse effects on borrowing costs, we would really want to keep moving in the direction of a world where the bulk of debt is government-issued or government-guaranteed. It seems to me that that could easily be a world in which investors end up being no more discerning about risk and return than the buyers of CDOs a few years ago, and in which banks themselves ultimately rely on the guarantees to an inappropriate or even dangerous extent. More generally, while some countries do need significant regulatory reforms in the financial sector, do we want to throw away the genuine advances of risk management and globalisation of the past generation?

Surely the better world for the decades ahead is one where a global financial system, having been stabilised at a time of crisis by public intervention (at major cost to shareholders and

incumbent managers as well as taxpayers), plays its proper role of capital allocation and risk management. To be sure, it failed to perform as promised in the recent past. But it would be preferable, in my judgment, to work at making the system more effective in doing that job, than to retreat into the financial repression of an earlier state of the world.

Finding a way to combine efficiency and stability in the way we need is a major challenge. The regulatory arbitrages and skewed incentives of the past need to be corrected. The likely pro-cyclicality of the regulatory standards needs moderation. Work is well under way on those fronts. Most importantly, the global policy-making community will have to grapple more effectively with the problem of entities that are 'too big to fail', but potentially 'too big to save', especially where their activities cross national borders. This is probably the most taxing financial regulatory problem of our time.

For their part, banks will need to reduce their reliance on the extended guarantees and stand on their own feet before too much longer. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government-guaranteed bank debt over the past nine months, to step up their efforts to do likewise.

Australian Challenges

Since I have now mentioned the Australian situation, I will go on to talk about challenges for economic policies at home.

The flexibility to use macroeconomic policies, and other measures such as guarantees for deposit-taking institutions, has been used to support demand and maintain confidence, through the period of maximum global economic contraction. To date, because of those actions, earlier sensible management (public and private) and a degree of good fortune, the Australian economy and our financial system have been travelling rather better than those of most of our peers through the crisis and the initial economic aftermath.

Six months ago, my own view was that the biggest risk to the Australian economy was an unwarranted loss of confidence in our medium-term prospects. Late last year, survey after survey pointed to a major battening down of the hatches by businesses across the country. This was quite understandable, and in some respects eminently logical at the level of the individual enterprise. But the risk was that these actions, in bringing on the very weakness that everyone feared, could set off a cycle of further weakening in demand and output.

Now, however, it looks like confidence has recovered some ground. Economic conditions remain very difficult in some sectors. But surveys now suggest that many businesses have found that the worst has not occurred, and are perhaps thinking about their medium-term strategies for the next expansion. They are tending to try to hang on to employees who were recruited and trained at some expense and who will be needed in the future under conditions of stronger demand. Many listed companies are taking the opportunity to raise new equity, strengthening balance sheets. The fact that they can tap the markets for those funds, by the way, says something about the underlying resilience of the system.

Consumer confidence has also recovered a lot of ground. In fact in recent readings it has been at or above long-term averages. This should not be entirely surprising. Households have seen significant gains from the various fiscal packages as well as declining petrol prices. For indebted households, there has been a very large reduction in debt-servicing costs as a result of easier monetary policy. Against that, unemployment has been rising, and a great deal of prominence has been given in public discussion to forecasts that it will rise further, with associated predictions that this will weaken confidence and demand and so on. To date, however, the rise in unemployment has been a little slower than earlier feared, and the effect of the more positive factors for households has, so far, outweighed fears of unemployment.

In addition, the decline in interest rates, together with the additional grants for first-home buyers, has seen a significant pick-up in demand for housing finance. The value of loan approvals has risen by about a third since the low point in the middle of 2008. In contrast to developments in so many other countries, house prices are tending, if anything, to rise, and arrears rates on the bulk of mortgages remain very low by historical and international standards. In fact, across some portfolios arrears rates have declined in recent months.

We cannot claim that Australia has avoided any downturn at all. It appears at this stage, however, that the downturn we are having may turn out not to be one of the more serious ones of the post-War era, in contrast to the experiences of so many other countries. It is becoming more common for Australians to see the glass as half full than as half empty. Put another way, we can much more easily imagine upside risks to the outlook, to balance out the downside ones, than was the case six months ago.

So far, so good. But what challenges lie ahead? And how should we respond to them?

Just as it would have been a mistake nine months ago to write off our long-term economic prospects at the height of the financial turmoil, it would be a mistake now to lapse into the comfortable assumption that easy prosperity will come our way.

The pace of global growth, and the easy availability of credit, seen in the period up to 2007 was not the norm. It is unlikely to be seen again any time soon. The path to economic health for the major countries of the world will still be a difficult one, because the legacy of the crisis will cast a shadow for some time. Major international banks will remain diminished in stature and balance sheet capability, and will be required to devote more capital to their strategies in the future. If global regulators have their way, the world will be characterised by less leverage, and scarcer and more expensive credit, than in the earlier period. We here in Australia have to accept that fact and accommodate it in our thinking.

One thing this presumably means is that the prominence of household demand in driving the expansion from the mid 1990s to the mid 2000s should not be expected to recur in the next upswing. The rise in household leverage, the much lower rate of saving out of current income, and the rise in asset values we saw since the mid 1990s, are far more likely to have been features of a one-time adjustment, albeit a fairly drawn-out one, than of a permanent trend. Moreover the risks associated with those trends going too far are apparent from events in other countries. These risks have been reasonably contained so far in Australia – but it would be prudent not to push our luck here.

A very real challenge in the near term is the following: how to ensure that the ready availability and low cost of housing finance is translated into more dwellings, not just higher prices. Given the circumstances – the economy moving to a position of less than full employment, with labour shortages lessening and reduced pressure on prices for raw material inputs – this ought to be the time when we can add to the dwelling stock without a major run-up in prices. If we fail to do that – if all we end up with is higher prices and not many more dwellings – then it will be very disappointing, indeed quite disturbing. Not only would it confirm that there are serious supply-side impediments to producing one of the things that previous generations of Australians have taken for granted, namely affordable shelter, it would also pose elevated risks of problems of over-leverage and asset price deflation down the track.

Over the medium term, the emergence of China (and other countries such as India) will continue, and will offer opportunities for Australia. Plenty of observers, the RBA among them, have been saying this for years. But China's emergence also presents challenges. If commodity prices do stay at their current relatively high levels on the back of strong emerging world demand, the mineral extraction sector and all those parts of the Australian economy that service it and feel its flow-on effects, will expand. Other sectors will, relatively, contract over time. That is to say, the structural adjustment issues that faced us a year and a half ago, and which have received less attention since then, would resume. These sorts of adjustment in the economy have industrial, geographical and social dimensions.

Moreover, if we are more integrated into China's expansion, we will be similarly more exposed to the consequences of whatever might go wrong in that country. So our understanding of how the Chinese economy works, and of what risks may be accumulating there, will need continual work.

To conclude, challenges abound for policy-makers, for private firms and for individuals. The fact that we have managed to get through the past nine months in reasonable shape ought to give us some quiet confidence in our capacity to meet the current set of 'crisis'-related issues. But many years of careful work is the price of being able to ride out crises and benefit from the ensuing period of growth. We will need to re-invest in all that over the years ahead.

Thank you once again for coming today, and for your support of The Anika Foundation. ✥