# THE ROAD TO PROSPERITY

*Address by Mr Glenn Stevens, Governor, to the 2009 Economic and Social Outlook Conference Dinner, The Melbourne Institute and* The Australian, *Melbourne, 5 November 2009.*

When I spoke in April about 'The Road to Recovery', the issue was how to get onto that road.[1] It was clear then that the global financial system had been stabilised by the extraordinary interventions of policy-makers during the December quarter last year. The system was, very gradually, mending. But it was also clear that the major countries had experienced a very sharp contraction in demand in the December and March quarters. It wasn't yet clear, at that time, whether that slump had been arrested – though we now know that it was bottoming out. Reputable observers were talking about the worst global recession since the 1930s. For some of the individual major countries at least, there seemed to be a good deal of evidence for such a view (and there still does).

It was widely anticipated that the Australian economy would be affected by these developments. Even if one was optimistic about the Australian economy in a relative sense, it seemed pretty unlikely that we could escape a significant impact from such an international downturn. To say that we would outperform other countries, while accurate, didn't necessarily reassure people a great deal, because things in a number of those countries seemed to be so bad.

As it turns out, in April we were pretty much at the nadir of sentiment about the Australian economy. Six or seven months later, even most of the optimists are a little surprised, I suspect, at the economy's performance.

So the title of this conference is particularly apt. But the issue before us now is not, in fact, how to get onto the road to recovery: we are already on it. The question, rather, is how to make sure that the road to recovery will connect to the road to prosperity.

To make that connection, I suggest that we need to do two things. First, we need to draw the right lessons from our experience of the past couple of years. There are no doubt many lessons that might be mentioned. I will list just a few that I think are important. Second, we need to apply those lessons in the right way to the challenges that are likely to confront us over the years ahead. I will offer a few observations about some of those.

1 *Available at <http://www.rba.gov.au/Speeches/2009/sp_gov_210409.html>.*

## Lessons from the Crisis

The first lesson is that the business cycle still exists and that financial behaviour matters, sometimes a lot, to how that cycle unfolds. We need to have a broad definition of the term 'business cycle' in mind. There is more than just the cycle in the 'real' economy of GDP, employment, consumer price inflation and so on. These remain important, but it is just as important to recognise the cycles in risk-taking behaviour and finance. Failing to do that is precisely what has got some countries into trouble this time.

For some years we heard talk of the 'great moderation', a reference to a period of unusually low macroeconomic volatility for the major industrial countries from the mid 1980s until the mid 2000s. During this period, the United States had a couple of recessions – in 1990 and 2001 – but they were shallow ones compared with those in the mid 1970s or early 1980s. Inflation in most countries was low and pretty stable. So were interest rates. Australia shared in this experience from about the mid 1990s onwards, with an unusually long expansion.

Compared with the instability of the 1970s and early 1980s, this was a remarkably good period for macroeconomic performance. It was also very positive, for quite some time, for investment returns.

But the problem with this apparently benign environment was that it made things seem just a little too easy. As the period of stability grew longer, so compensation for risk tended to diminish as investors continued their 'search for yield'. In the end that search explored some fairly remote territory, including complex structured products, exotic derivatives and so on. Key sectors of important economies accumulated a considerable degree of leverage along the way – in households, or financial institutions or both.

In other words, as the macroeconomic environment seemed less risky, people changed their behaviour. The macroeconomic stability provided scope, it seems, for some financial trends to run further than they might otherwise have done, and further than they really should have done. Ultimately, this re-introduced risk through another channel: the financial structure of economies changed in a way that was more likely to amplify certain types of shock once they occurred.

The great moderation has ended for many of the world's most advanced economies. They have become re-acquainted with the business cycle, in its most unstable and unpredictable form, where financial shocks and real economic activity become highly, or even dangerously, connected, through balance sheets.

It's an old lesson, but worth re-stating. No country has managed to eliminate the business cycle. No country ever will, because the cycle is driven by human psychology, which finds expression in financial behaviour as well as 'real' behaviour. We are seemingly just made – 'hardwired', as some would put it – in a way that makes us prone to bouts of optimism and pessimism. Occasionally, we are prone to periods of myopic disregard for risk followed, in short order, by an almost complete unwillingness to accept risk.

We could search for perfect policies that will eliminate, or completely offset, these tendencies, but that search would most likely be frustrating, and ultimately, I fear, fruitless. Realistically, what we need are policy frameworks that recognise the cycle – in its inevitability, yet unforecastability – and help us cope with it. They will do that, in large part, by limiting the build-up of excesses in the good times.

Australia's policy frameworks have withstood the test pretty well during this period. Nonetheless, they will need ongoing investment if they are to continue to work well in the future. And even the best policy frameworks will not make the cycle go away.

We need a parallel development in the general public discussion of economic and financial cycles. We might start with a more balanced discourse about recessions. We are still debating whether or not the events of late last year and early this year should be labelled a recession. The fact that we are still debating says something about the episode's severity. Perhaps we should just let the students of business cycles decide what label to apply and focus on the broader issue. If it was a recession, it was the eighth one since World War II. It certainly will not be the last one. Recessions are cyclical events that occur periodically, but not with sufficient regularity to be forecastable as to timing. They will occur in the future. If one's business or personal or policy strategy depends heavily on there not being a cyclical downturn, it is a risky one. The road to prosperity is not a road without cyclical ups and downs.

But the second lesson we ought to draw from recent experience is that while downturns will inevitably occur, we are not helpless to do anything about their severity. We can make a difference. When a downturn came this time to Australia, there were certainly casualties. Risky business strategies (in most cases related to financial structure) were exposed, and those involved sustained losses of income, wealth and reputation. Other firms and individuals suffered much more difficult circumstances too. But on the best reading of all the available information, this appears to have been one of the mildest downturns we have had. Furthermore, it is likely that recovery is already under way. That's the next lesson: when downturns come, we can recover.

Now the relative resilience of the Australian economy in this cycle warrants some discussion. Unless we are prepared to accept it has all been an incredible coincidence, we have to ask why things turned out that way.

It wasn't just that China returned quickly to growth. That certainly was important in sustaining export volumes, and in re-establishing confidence in the outlook for the resources sector, which did wobble for a few months. But China's importance may be greater for future outcomes than recent past ones. Equally important recently were other factors, including the relative strength of the financial sector, the economy's flexibility and the willingness and scope to change macroeconomic policy.

Those things were not accidents. Financial resilience resulted from sensible management by financial institutions themselves, and careful regulation on the part of the prudential supervisor. For the most part, the non-financial corporate sector was also fairly conservatively managed in respect of balance sheets – largely because enough corporate managers and directors today remember a time when that was not so. Moreover, businesses took a far-sighted view about employment decisions. Given the preceding difficulties in securing labour, they found ways of keeping people on payrolls, even if on reduced hours. They clearly had not only the good sense, but also the requisite degree of institutional flexibility, to do that, which must say something about the progress that has been made in labour market arrangements over the past couple of decades.

And finally, long-term investments in prudent fiscal and monetary frameworks paid off. A whole generation of policy-makers painstakingly worked to build credibility by taking decisions with a long-run perspective. The return was in the form of a capacity to respond credibly to the downturn before it gathered much pace. The lesson here, then, is that all those investments were worthwhile.

So I think this episode offers us an opportunity to re-visit our national script about recessions and recoveries, financial behaviour and policy frameworks. Recessions will occur, as they always have. Financial behaviour matters greatly and can, if we are not careful, contribute to instability. In our thinking about the future, we all need to remember that. But if we do, and act with due prudence during the upswings, recessions need not be bad ones and, when they come, we can recover. Signposts to that effect ought to be erected along the road to prosperity.

## Applying the Lessons

The task before us now is to manage a new expansion. Of course, we are still in that period when we cannot be absolutely certain that the expansion will gain full momentum. Every upswing starts with that uncertainty. The conduct of macroeconomic policies in the near term must grapple with that uncertainty, as it always must do.

Even so, it is not too early to think about issues of a medium-term nature. The key question is: having had a fairly shallow downturn, how do we make the upswing long and stable, and relatively free of serious imbalances?

At least part of the answer is that we will need to re-invest in the same policy discipline, and the same careful private-sector management, that paid dividends in the recent episode. That means keeping tested frameworks in place, amended as necessary in the light of experience. It means unwinding temporary measures as appropriate. It means keeping a focus on flexibility. And perhaps most of all, it means resisting the temptation to assume prosperity is easily achieved, or easily managed.

In that spirit, let me offer three observations.

First, we start this upswing with less spare capacity than some previous ones. After a big recession, it usually takes some years for well-above-trend growth in demand to use up the spare capacity created by the recession. This time that process will not take as long. Most measures of capacity utilisation, unemployment and underemployment are much more like what we saw after the slowdown in 2001, than what we saw after the recession in the early 1990s.

This is not a problem. In fact, it is good. It is a goal of macroeconomic policy to try to keep the economy not too far from full employment. And some spare capacity does exist, and will do so for a little while, which is why we think underlying inflation will probably come down a little more in the period ahead. But it does underline the importance of adding to supply, not just to demand, over the medium term, and of maximising the productivity of the factors of production that we have, if we are to have the sort of growth that genuinely brings prosperity.

Second, and following on the theme of potential supply, others have noted that the rate of population growth at present is the highest since the 1960s. On one hand, this may help alleviate capacity constraints, insofar as certain types of labour are concerned. On the other hand, immigrants need to house themselves and need access to various goods and services as well. That is, they add to demand as well as to supply. It follows that the demand for additional dwellings, among other things, is likely to remain strong. Corresponding effects will flow on to urban infrastructure requirements and so on. So the question of whether enough is being done to make the supply side of the housing sector more responsive to these demands will remain on the agenda.

Adequate financial resources will of course also be needed. In that regard, the current issue is not the cost of borrowing for end buyers, which remains low, but the availability and terms of credit for developers. Perceptions by lenders of the riskiness of development in some cases are probably overdone just at the moment, given the strength of the underlying fundamentals on the demand side for accommodation. That will probably not be a permanent problem though; the more persistent difficulties look like they may be in the areas of land supply, zoning and approval.

Third, the likely build-up in resources sector investment over the years ahead carries significant implications for the medium-term performance and structure of the economy. Even if a number of the proposed projects do not go ahead, the ratio of mining investment to GDP for Australia, which is already very high, will probably go higher still over the next several years. A sizeable share of the physical input will be sourced from abroad (through imported equipment) but the domestic spend will still be significant. So, other things equal, the investments will be expansionary for the economy.

The financial capital to fund this build-up will mostly come from abroad. That is to say, absent some offsetting changes elsewhere, Australia's current account deficit could be considerably larger for some years than the 4 to 5 per cent of GDP we have seen on average for the past generation, which itself was a good deal bigger than seen in the generation before that. Now of course the current account position we have had turns out, contrary to what most would have expected 25 years ago, to have been manageable and sustainable. A temporarily larger one would probably be so as well, provided it involved a relatively modest amount of currency mismatch, and a rise in investment as opposed to a reduction in saving – and that seems to be the likely shape of things.

In fact a temporarily sizeable current account deficit, if characterised by equity-type capital inflow, may well be optimal, because it would mean that a good deal of the risk of the projects was being shared with foreign investors, and that makes sense. Why would Australians alone take on all the risk of these massive projects? It is probably more sensible to share the risks with global capital markets and global companies. But these trends will take some explaining, not least to foreign and international organisations, many of which have a more traditional view of current account positions.

Our explanation to our own citizens will also be important, and not just about capital flows. Over time, if the resources sector is to grow as a share of the economy, as seems likely, other areas will by definition shrink. This does not necessarily mean that they will shrink in absolute terms, particularly given the population is growing quickly, but certainly their growth prospects would be weaker than in an alternative state of the world in which the resources sector was to remain at its historical size. It follows that adjustment challenges will arise, with industrial and geographical implications. The 'two-speed economy' debate of a few years ago was really only a preview of what we could see if the resources sector build-up goes ahead.

A further implication is that the economy's trade patterns could end up becoming less diversified than they have been in recent years. Such concentration would not be unprecedented and may well be worth accepting if the returns from doing so were high enough, as it appears they might be. But we might also think about how to manage the risks associated with any concentration. The emergence of China and India is a benefit to Australia, but we stand to have a heightened exposure to anything going seriously wrong in those countries. How then to manage an income flow that is higher on average, over a long period, but potentially more volatile? The answer to that question is beyond my brief today but presumably involves thinking about the extent and form of saving by the community.

## Conclusion

As we look forward to a new expansion, Australia has many advantages.

The financial sector remains in pretty good shape. The Government does not own, and has not had to give direct support to, any financial institution. Australia, therefore, will be relatively free of the difficult governance and exit strategy challenges that such support is raising in some countries.

Public finances remain in good shape, with a medium-term path for the budget back towards balance, and without the large debt burdens that will inevitably narrow the options available to governments in other countries. Sensible policy frameworks – both macroeconomic and microeconomic – remain in place, and they have worked. The financial regulatory system is strong and tested.

We remain open for trade and investment, with an exposure to Asia, which still has the most dynamic growth potential in the world over the next several decades. These advantages are already paying dividends. Properly exploited, they will pay many more.

But there is no such thing as effortless, or riskless, prosperity. There is still a business cycle, and we do well to remember that even if we have been spared the worst of the recent downturn. We will need to continue investing in all the things that helped us get through the recent episode. And we will need to accept and manage various changes that will probably confront us over the years ahead.

The road to prosperity will have some bumps, twists and turns. But it is the road to the right destination.