Keynote Article

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Macroeconomic policy challenges in the Asian century

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Abstract
This is an edited version of a lecture by economist and former Australian Treasury Secretary (2001–2011) Dr Ken Henry, delivered at a Colloquium in honour of Professor J.W. Nevile, held at the University of New South Wales on 10 October 2012. Taking a practitioner's perspective, the article surveys the management of the Australian economy from the 1970s to the present, with a focus on the reasons Australia escaped the global financial crisis of 2008 and the lessons for macroeconomic policymakers to be drawn from that experience. The author concludes that macroeconomic policy practitioners have to think deeply about microeconomic connections and the potency of different instruments in addressing shocks with different sources. They also have to deal with considerable uncertainty. The global financial crisis demonstrated forcefully that there is no separation between macroeconomics, financial system stability, prudential regulation, micro-level incentive structures and market efficiency.

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Australia, economic stabilisation, global financial crisis, inflation, macroeconomic policy, terms of trade, unemployment

Introduction

When I came to the University of New South Wales (UNSW) at the start of 1976 to enrol in first-year economics and law, Professor Nevile was head of the School of Economics. I did not get to know him until 1979, as a student in his fourth-year honours course in

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growth and capital, which included an introduction to the so-called Cambridge capital controversies. That is where I first heard the Harcourt name. So it is rather special to have been invited by Geoff Harcourt's son, Tim, to deliver a lecture in honour of John. Of course, Tim has made his own name, and I must say that it is very pleasing to see him ensconced at my alma mater.

It was my perception, all those years ago, that John Nevile set the tone for the study of economics at UNSW. It was a tone that valued both academic rigour and real-world relevance. Academic rigour included an appreciation of the importance of formal theoretical models, and an understanding of their normative content, whether explicit or implicit. To this student, economics appeared the most attractive of disciplines: an elegant blending of real-world puzzles, mathematics, philosophy, history and ideas concerned with social progress.

After my fourth year of honours in economics here at UNSW, I suspended for some years, and eventually terminated, my study of law, following one of my economics honours thesis supervisors, the late Richard Manning,[1] to the University of Canterbury in New Zealand, where I taught for some years and where I wrote a PhD in economics under Richard's supervision. Richard Manning was a 'micro man', and under his guidance, I learned a lot of microeconomics. However, that wasn't all. At Canterbury, I got to teach a micro-component in the first-year economics course, honours courses in international trade theory and public finance and a course in intermediate macroeconomics. I also started getting involved, in a modest way, in public debates about the truly abysmal conduct of policy, both micro and macro, in New Zealand.

When I returned to Australia late in 1984, to a position in the Australian Treasury, I came back to macroeconomics – not to macroeconomic theory but its practice. And, of course, I came home to public policy.

Today, I am going to say something about macroeconomic policy challenges in the Asian century. This is an enormous topic but an important one. And I am sure it is one that interests John Nevile. I am going to tackle the topic from a practitioner's perspective: from the perspective of somebody who has had to offer advice to Australian governments on the conduct of Australian macroeconomic policy in the Asian century, and before, and who has also been involved, from time to time, in various official forums around the world, and in debates about the appropriate stance of macroeconomic policy in other places, including the United States, Europe, China and Japan. But first, let me take you back to Australia in 1976, when I came to UNSW.

Australia in the 1970s: rising inflation and unemployment, and rising terms of trade

From 1960 through to early 1971, consumer price inflation averaged a little over 2.5% a year. But between the middle of 1971 and the end of 1975, that jumped to more than 10.5%. And in the last 2.5 years of that period, it averaged 14%, having been as high as 17.5% through the year to the March Quarter 1975. Through 1975, the unemployment rate jumped from about 2% to about 5%.

In the second half of the 1970s, macroeconomists at UNSW, like their colleagues around the world, were focussed on understanding stagflation, exploring various

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expectations-augmented Phillips curves to see if it were possible to resurrect some predictable trade-off between inflation and unemployment.

There were other enquiries of macroeconomic interest going on. Between early 1971 and early 1974, the terms-of-trade had increased by more than 27%. Bob Gregory's influential article[2] on the possible consequences of such a boom for non-traded goods and services production was published during my first year here at UNSW.

And there were academics here who were, in those days, thinking about big changes to the regulatory structure of the Australian financial system, including regulations affecting the cross-border flows of capital and, of course, the management of the exchange rate. Professor John Hewson, who, in 1978, taught me third-year honours in macroeconomics, including a lot about targets and instruments, was involved heavily in that work.

By the time I had returned to Australia from New Zealand, the consequences of a rising terms-of-trade looked like something sane people would only dream about. By mid 1984, the terms-of-trade had more than fully re-traced their steps, being 6% below even their early 1971 level. And they went on to fall by a further 16% over the following two-and-a-bit years.

Recently, though, we have had reason to focus, again, on the macroeconomic consequences of an elevated terms-of-trade. The 1974 peak that had aroused such academic interest in my undergraduate days here at UNSW was surpassed in mid-2006. And the terms-of-trade have marched on further since, climbing a staggering 40% above that 1974 peak. But unlike the mid-1970s, even with a terms-of-trade boom of that order, both unemployment and inflation appear today to be behaving well.

Clearly, quite a few things have changed in the intervening period. Much has been written on these matters, and I don't want to dwell on them for too long today. So I will merely draw attention to those things I consider, from a practitioner's perspective, to have been most important.

Australia from 1983: a period of reform

First, in December 1983, cross-border capital controls were abolished and the currency was floated. Second, because of those changes, it became possible for Australia to operate an independent monetary policy, and the commitment by the Reserve Bank of Australia (RBA), as the economy was emerging from the recession of the early 1990s, to an explicit inflation-targeting regime was an important achievement in Australian macroeconomic policy. And third, while many would still like to see greater flexibility in the Australian labour market, it is considerably more flexible now than it was in the 1970s – especially because of the widespread adoption of enterprise-level bargaining. There are a lot of other policy changes that have also been important in explaining the relatively smooth adjustment of the Australian economy to the recent terms-of-trade boom, including reforms to competition policy, initially through substantial tariff reductions and enhanced financial system regulation. As the terms-of-trade boom unfolded in the pre–global financial crisis (GFC) period, from late 2003 through to mid-2008, the consensus view of Australia's macroeconomic practitioners could have been described as follows.

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First, consumer price stability probably delivers real economic stability. Second, an inflation-targeting regime, implemented by a credible central bank with operational independence from the political government, can deliver consumer price stability.

These core propositions contained no guidance for fiscal policy, other than that it should not get in the way of monetary policy. Most macroeconomists, and perhaps especially those who had witnessed the policy response to the recession of the early 1990s, harboured pragmatic concerns about lags in the implementation of fiscal policy. Others had strong, even ideological, views on the ineffectiveness of fiscal policy, drawing support from arcane theoretical constructs of Ricardian equivalence and others.

While there had been intense interest, in the second half of the 1980s, in the connection between a fiscal deficit and a current account deficit, and – by implication – capital account stability and sustainability, by the mid 1990s the so-called 'consenting adults' perspective was generally held. Some were prepared to accept the consenting adults proposition only if the government sector wasn't contributing to the demand for external financing. However, both camps agreed that, if governments were pursuing balance, even balance on average over the cycle, there was no compelling reason for macroeconomic policy to concern itself with the current account.

Of course, many of those who subscribed to the consenting adults view were also supportive of microeconomic reforms to enhance policy transparency and the efficiency of internal resource allocation. Everybody agreed that a country attracting foreign capital should use it to best advantage.

The 21st century: macroeconomic policy and global imbalances

In the early years of this century, we had some pretty robust debates about these things within the Treasury. Our debates were not motivated so much by a concern with the Australian current account position but rather, with what had been going on in the United States, that is, with an enquiry into the macroeconomic policy importance of the emerging 'global imbalances'.

The United States 'tech wreck' of 2000 had challenged the consensus view that consumer price stability produces real economic stability. Therefore, the core proposition had been modified, to something as follows: Consumer price stability will generally produce real economic stability, though there will be asset price bubbles from time to time. Monetary policy should not target asset prices,[3] but should respond aggressively to 'clean up the mess' when bubbles burst. Fiscal policy should not be used at all, especially because of the risk of it being interpreted as providing implicit guarantees. Thus, monetary policy remains king, and its primary task remains to focus on consumer price stability.

The 'tech wreck' has also challenged the conventional view that 'global imbalances' were not something to worry about. Yet, as the US economy emerged from a remarkably shallow recession in 2001, and the current account again deteriorated, US policymakers appeared to relax almost immediately.

Not everybody was sanguine. In the middle years of that decade, some analysts, including within the International Monetary Fund (IMF), observed that it was difficult to

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explain on fundamentals why, in the first decade of the 21st century, the most advanced economy on earth should also be its biggest borrower.

The complacency, in the years between 2001 and 2008, rested on the consenting adults' perspective – to the extent it rested on anything at all. And almost nobody seemed interested in the qualification on this proposition that I mentioned earlier, namely, the importance of transparency, and the efficiency of capital allocation, in the capital importing country. After all, this capital importing country was the United States, with the most highly developed and sophisticated financial centres in the world. Instead, what looked like global imbalances to some appeared, to others, an agreeable source of cheap finance for all sorts of things, including politically popular sub-prime mortgages. And then we had the GFC.

Why did Australia escape the GFC?

Ironically, when the GFC struck, the United States was one of a very small number of IMF members that had not been subject to a Financial Sector Assessment Program (FSAP) review of the quality of its financial system.

What about Australia? As it had in the face of the other two shocks to the world's financial systems that preceded it – the Asian Financial Crisis of 1997–1998 and the tech wreck and developed world recession of 2000–2001 – the Australia economy once again made a remarkable escape.

The most obvious proximate explanation for that remarkable escape is that Australia avoided a banking crisis. That fact owes quite a deal to the quality of Australian banking regulation, and even more to the timely implementation of various government guarantees of banking sector liabilities – without which the flow of bank intermediated funds to the Australian economy would have dried up. There are other explanations. Many commentators point to Australia's increasing dependence upon the strong Chinese economy, and especially to the impact of strong Chinese growth on Australian mining and mining-related construction activity.

Other commentators point to aggressive monetary policy action. After cutting the official cash rate of interest by 25 basis points on 3 September 2008, the RBA cut again by 100 basis points on 8 October 2008, and by 8 April 2009, it had cut the cash rate by a further 300 basis points – a total cut of 425 basis points in about 7 months.

Still other commentators point to the rapid depreciation of the Australian currency, which, between the beginning of October and the third week of November 2008, lost more than 20% of its value against the US dollar, and depreciated by 18% on a trade-weighted basis.

Only a minority of Australian commentators accepts that our relatively strong performance owes something to the rapid and sizeable fiscal policy adjustment initiated by the Australian Government.

I want to say just a little about the role played by China, the Australian resources sector and the operation of monetary policy and the exchange rate during the GFC. It is important that their roles be understood because all three are likely to play a role in Australia's macroeconomic performance for many years in this Asian century.

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Did mining save the economy from recession? Having doubled over the 5 years to November 2008, employment in the Australian mining sector then fell by 15% in the 6 months to May 2009. If all Australian employers had behaved in the same way as our mining companies, the Australian unemployment rate would have risen from 4.2% in November 2008 to almost 20% within 6 months; instead, in original terms (i.e. not seasonally adjusted), it rose to only 5.8% and peaked at 6% before falling back to around 5%.

Given what was happening globally at the time, the lay-offs in the Australian mining sector are understandable. The financial crisis hit growth hard in the major industrialised economies. The United States' annualised growth fell from 2% to 3% in early 2008 to −4% within about 12 months. For the Euro Area and Japan, the slowdown was even more pronounced.

And the Chinese economy also suffered a large output shock, with gross domestic product (GDP) growth slowing from an extraordinary 15% in early 2007 to only about 7% 2 years later. The Indian economy suffered a large slowdown also.

Chinese industrial production, which is especially important to the Australian mining sector, exhibited considerable weakness. While growing at annual rates of about 20% through 2006 and the early months of 2007, Chinese production of crude steel grew at about half that rate into mid-2008 and then collapsed, falling by 15% through the year to September 2008.

As production volumes fell, so too did raw material prices. During 2008, the US dollar spot prices of iron ore and hard coking coal fell by 70%. Export volumes were also affected. From October to November 2008, Australia's merchandise exports to China fell by almost one-third.

China and the Australian mining sector did not save the Australian economy from recession during the GFC. What about monetary policy and the exchange rate? With most mortgages written on floating rates, there is a rapid flow-through of interest rate movements to a reasonable proportion of Australian households. However, there are lags in transmission to the real economy. In my view, while the lags on the operation of monetary policy have probably shortened over the past decade – especially as the extent of leverage of the Australian household sector has increased – they remain long enough to make it unlikely that the monetary response alone saved the economy from recession in the first half of 2009. While I cannot prove it, my guess is that its most probable positive impact was in supporting consumer confidence. It seems highly implausible that it had any impact on the value of the exchange rate, since most other central banks around the world were also cutting official rates by large amounts.

But the Australian dollar did depreciate, and by a large amount, as I have noted. The most plausible explanation of that is that foreign investors took the view that the Australian economy was going to be more severely affected than its trading partners, including the United States, by the emerging crisis.

Large currency depreciations have been credited with saving the Australian economy from recession on three occasions in the past 15 years. First, the Australian currency depreciated in nominal trade-weighted terms by more than 10% through 1998 as the Asian Financial Crisis unfolded. With no monetary policy response, that depreciation was widely credited with insulating Australia from an economic slowdown. Second, in

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the first 10 months of 2000, the trade-weighted index depreciated by 13.7% as the US economy led much of the developed world into recession. This Australian dollar depreciation, which was argued at the time to be conclusive evidence of Australia's 'old economy' status, was credited subsequently with saving the Australian economy from that particular macroeconomic slowdown.

On this third occasion, we had an even larger depreciation – 18% on a trade-weighted basis through October–November 2008. It seems probable that the currency depreciation helped to insulate the Australian economy from a significant international shock on all three occasions. However, I feel uncomfortable with the proposition that it provides the full explanation in any of them. I do not feel comfortable with the notion that the Australian economy does relatively well in such crises only because everyone thinks it will do relatively badly.

What then about the fiscal expansion? Well, the government and its advisers are in no doubt that without the large fiscal stimulus, and its having been delivered in such a timely fashion, the Australian economy would have suffered a very deep recession.

Yet, the scepticism about the efficacy of the fiscal response is understandable: like many other countries, Australia has a poor history of fiscal activism; indeed, this recent period might be the only instance in Australia's history of a fiscal stimulus having insulated the economy from an external shock that would otherwise have produced a deep domestic recession. That is to say, it could be a unique achievement.

Other things helped. The behaviour of the labour market illustrated how average hours of work can play a shock-absorbing role, suggesting that labour market reforms over many years had built greater macroeconomic resilience. Many employees lost a proportion of their incomes, but the feedback into aggregate demand was weaker than on previous occasions because they did not lose their jobs. It seems likely that this was especially important in Australia avoiding a sharply negative flow-through into the property market.

What has the GFC taught us about the 'consenting adults' proposition?

In the aftermath of the Asian Financial Crisis of 1997–1998, attention focussed on the quality and transparency of policy settings in the crisis-affected economies. The *presumption* was that their current accounts had proved unsustainable because of internal deficiencies. There was an *assumption* that countries with high-quality regulatory systems and strong financial institutions could run current account deficits sustainably. This assumption motivated the IMF's FSAP, to which I referred earlier. We now know that that assumption is false.

A country with world's best regulatory settings and financial institutions can still suffer a current account crisis because of events in distant places that cause global financial markets to seize-up. The crisis may be an extreme form of contagion, where all borrowers are assumed to be infected with unacceptable credit risk, or it could be that there is no lender confident of having a balance sheet to support lending to anybody. These are some of the lessons from the GFC.

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Lessons relevant to macroeconomic management

First, monetary policy probably can achieve consumer price stability over time, but there are limits to its ability to do so. Those limits appear to have been reached in several countries around the world. Some shocks pose a bigger challenge for monetary policy than others. Shocks that impair the balance sheets of financial institutions pose the most serious challenge. There would be merit in thinking about the things that might be done to enhance the potency of monetary policy transmission mechanisms in all countries.

Second, consumer price stability in the near-term does not guarantee real economic stability, though it might provide such stability for much of the time, and is worth pursuing for other reasons. Third, while monetary policy probably should not be used to target asset prices, neither can it be relied upon to clean up after asset price bubbles burst. Depending upon the impact on household and bank balance sheets, there may be no monetary policy stance that clears the labour market. This is not a new lesson, of course. One can read about it in J.M. Keynes' *General Theory*.

Fourth, investor psychology is not rational. Thus, the activities of consenting adults are not always rational. And what might look like arbitrage will not necessarily be market stabilising. It could be just the sort of micro-speculation that eventually produces macroeconomic instability.

Fifth, no country can take for granted the financing of its current account position. What appears to be a more or less perfectly elastic supply of funds from abroad can, in the blink of an eye, become perfectly inelastic. Consenting adults can be fickle.

Sixth, there is a risk of consenting adults appearing to have incompatible motives. Thus, when private portfolio equity flows into the United States reversed with the tech wreck of 2000, the hole they left in the US capital account was filled immediately by purchases of US Treasuries by the People's Bank of China (PBOC) and other Asian central banks. A shorthand description of this activity is that the accumulation of the US dollar–denominated reserves underwrote strong Chinese manufacturing exports, and both low prices and a low cost of credit for consumers of those manufactures, especially in the United States. An alternative, though not inconsistent, interpretation is that central banks in Asia have financed, at very low cost, a large proportion of large US fiscal deficits. A third interpretation is that Asian central banks have been buying insurance against the sort of foreign exchange instability that sparked the Asian Financial Crisis. Clear heads will see all of these things as supporting global macroeconomic stability. However, there is a risk of their being misconstrued.

Seventh, it might be useful to find ways of redesigning fiscal arrangements in ways that increase the potency of the automatic stabilisers, thus reducing the size of recognition, decision and implementation lags.

Eighth, given our institutional arrangements, of an independent, non-political, monetary policy agency and a political fiscal policy, monetary policy is likely to be more effective than fiscal policy in taking the edge off unsustainably strong growth. But fiscal policy, not monetary policy, will play the major role in cleaning up the messes generated by asset price volatility. That might involve explicit guarantees, the acquisition of

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various pieces of the financial system infrastructure (an activity that goes beyond normal concepts of fiscal policy) and substantial fiscal stimulus. If moral hazard is a legitimate concern, it is clearly of secondary importance in a crisis.

The resurrection of fiscal policy as the primary instrument for dealing with large macroeconomic shocks, even if those shocks are only due to financial market volatility, is a significant departure from the way we thought about policy assignment during a benign period, early this century, when we were pretty confident that we had, at last, figured it all out.

Thus, while there remains good reason for fiscal policy to have a medium-term anchor, with a transparent connection to net public debt, in this world of very large cross-border flows of financial capital, and the risk of financial sector volatility, fiscal policy will – from time to time – be called on to do a great deal more than respond passively to macroeconomic developments through the operation of the automatic stabilisers. Importantly, fiscal policy will be able to play those roles only if it has the capacity to do so. That capacity rests on public sector balance sheet sustainability and, influenced heavily by that consideration, government fiscal policies retaining credibility with financial markets.

I am stating these conclusions from a practitioner's perspective. I am merely observing how I think macroeconomic policymakers will behave in future crises, and why. I appreciate that there would be many macroeconomic theoreticians who accept none of this.

Future considerations for macroeconomic policy practitioners

Looking ahead, there are several developments that should be exercising the minds of macroeconomic policy practitioners. Five issues have a global dimension:

1. Have the conditions been put in place that will produce an unwinding of the global imbalances that have twice proved so destabilising?
2. Closely related to the first question, what will be the implications for global growth of the fiscal consolidation that will have to occur in Europe, the United States, and in other countries? Alternatively, what would be the consequences for global macroeconomic stability of attempts, either in the United States or the Eurozone, to inflate out of unattractive debt dynamics?
3. Again closely related to the first two questions, accepting that, at some point, China will rebalance growth through a lower saving rate, how will that rebalancing affect (a) the level of investment, and hence the trend rate of growth in China, and (b) the global cost of capital, and hence, growth prospects in other parts of the world?
4. What will be the impact on saving and investment balances in the major regions of the world, of the large demographic changes that are affecting several large Asian countries?
5. How can the Euro be deconstructed in a manner least damaging for global finance markets?

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Three issues are closer to home for Australians:

1. In thinking about the Australian economy's greater exposure to commodity price volatility, and especially since the terms of trade appear to have started to decline from peak, do we have the capacity, in monetary policy and fiscal policy, and sufficient labour market flexibility, to secure macroeconomic stability?
2. Now that we know for certain that consenting adults are not always faithful, what should we be doing to protect the Australian economy against capital account volatility?
3. How are we going to finance the infrastructure and public services demands of our fast growing and ageing Australian population?

When I studied economics here in the late 1970s, it was still possible to separate macroeconomic and microeconomic analysis in thinking about the short-run behaviour of the economy, with the growth and capital theories that I was taught by Professor Nevile being one of the few subjects that spanned the two fields. Of course, those boundaries between the 'micro' and the 'macro' were being tested even then, especially by the coincidence of unemployment and inflation. During the subsequent decade, many in the profession made courageous attempts to connect the fields more formally, but those attempts had little impact on practitioners of either discipline.

Today, macroeconomic policy practitioners have to think deeply about microeconomic connections. They have to think deeply, too, about the potency of different instruments in addressing shocks with different sources. And, of course, they have to deal with considerable uncertainty. The GFC demonstrated forcefully that there is no separation between macroeconomics, financial system stability, prudential regulation, micro-level incentive structures and market efficiency. We do not have a unifying theory yet, and I doubt we ever will. But policy practitioners have never had the luxury of waiting for the perfect. The bigger question, therefore, is whether our macroeconomic policy practitioners now know what they need to target, and whether they have the instruments to do so.

Declaration of conflicting interests

The author declares that there are no conflicts of interest.

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Notes

1. My other honours thesis supervisor was Murray Kemp.
2. Gregory RG (1976), 'Some implications of the growth of the mineral sector', *Australian Journal of Agricultural Economics* 20: 71–91.
3. Some took the view that monetary policy should 'lean against' asset price bubbles, but it is still not clear what that might mean.

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Author biography

Ken Henry, as Special Adviser to the Prime Minister of Australia, in 2012, oversaw the development of a White Paper on Australia in the Asian Century. He has worked as a senior adviser to the Keating and Howard Governments and served as an Australian representative to the Organisation for Economic Co-operation and Development (OECD). From April 2001 to 2011, he was Secretary to the Department of Treasury, and ex-officio member of the Board of the Reserve Bank of Australia. From 2008 to 2010, he chaired the panel that produced a comprehensive review of Australia's tax and transfer policies, *Australia's Future Tax System* (2010). In 2007, Dr Henry was made a Companion in the Order of Australia. He was recently appointed Executive Chair of the ANU Institute of Public Policy at the Crawford School of Public Policy, The Australian National University.

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