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Boyer Lectures 2006: The Search for Stability. By Ian Macfarlane. ABC Books, 144pp. $22.95

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Banking on dogs that don't bark

This concise book consists of the six Boyer Lectures that the recently retired Governor of the Reserve Bank of Australia, Ian Macfarlane, gave on the ABC at the end of last year. For anybody interested in the recent economic history of Australia this book is excellent – informative, showing good judgement, and very clearly written. Macfarlane does not try to predict the future, though he signposts some problems. He tells the story both of changing philosophies of macroeconomic policy and of Australia's very varied experience. His focus is on Australia's search for economic stability, a story that in 2006 seemed to end in triumph.

His early chapters are on "The Golden Age", "From Golden Age to Stagnation", and " Reform and Deregulation". Here I will jump straight to an episode that many Australians over forty will vividly remember. That is the recession of 1990. It was the recession that, famously, Treasurer Paul Keating said "we had to have". Paul Keating was quite right, though he might have been politically wiser not to have said it. Macfarlane is particularly interesting on this episode, and especially on the boom that preceded it and the long-term effects of the recession.

Because of financial liberalisation, and especially the entry of many foreign banks, there had been a massive lending and borrowing boom beginning in 1985. It reached a peak in 1989. As the journalist Trevor Sykes wrote "Never before in

Australian history had so much money been channelled by so many people incompetent to lend into the hands of so many people incompetent to manage it". Credit extended to the corporate sector grew by an average of 15 per cent a year in the five years to 1989. There was a building boom and a general spending boom leading to a big rise in imports. Interest rates were increased, rising to 18 per cent. Yet the boom continued.

And then, of course, everything inevitably turned around, probably set off by the international recession of 1990. Australia's recession turned out to be no more severe that that of many other OECD countries, but after the wild boom the turn-around certainly was a shock, and Paul Keating got the blame. Various financial institutions failed, as did several entrepreneurs who had been much admired until they could not pay off their debts.

Should interest rates have been raised even more and earlier to moderate or puncture the boom? And should they have been reduced quickly to moderate the recession? These are the big policy questions. It is difficult to get the timing right. Macfarlane discusses all this, and his analysis is very illuminating. It is a real contribution to the study of Australian economic history.

There was a reluctance to reduce interest rates even when the recession became evident. The main reason was a concern with the high current account deficit. Since then we have learnt to live with current account deficits, and this concern was probably excessive. But there was also a desire to get the inflation rate down.

And then inflation indeed fell. It fell much more than expected. That was the favourable effect of the recession. The inflation rate had been over 7 per cent and quickly fell to 2 per cent, which was the inflation rate in major OECD countries. But both the decline in the growth rate and the rise in unemployment were also more than intended and expected.

By 1992 growth had recovered but the inflation rate stayed down. Inflationary expectations had been permanently reduced. Thus there was a favourable permanent effect that resulted from this painful though brief recession. There was no need any more to have high interest rates so as to keep inflation down and to compensate for expectations of future inflation. This episode laid the foundation for the low-inflation low-interest rate prosperity of the last fourteen years, ten of which were the years of the lucky Howard government.

Macfarlane concludes from this episode and also from experiences in other countries, notably the United States, that there are unavoidable costs in the form of a recession to bring inflation down. That is a painful transition process, but after that employment and growth will recover while inflation stays down. The moral is that monetary policy should be used to keep inflation from rising to begin with. Small and timely increases in interest rates designed to keep inflation within a target range can thus prevent the need for an eventual painful transition from accelerating inflation back to low and stable inflation. These views are generally shared now by central bankers and by many, or most, economists working in this field.

There were several reasons for the long non-inflationary expansion from 1992 to 2006, and, indeed, for Australia having a higher growth rate over this period than many other OECD countries. Naturally Macfarlane emphasizes the role of Australian monetary policy, which was actually much the same as in the United States, Britain, Canada, and the Eurozone. But there were a number of other favourable influences on Australia.

In the eighties various reforms had been achieved that made the economy more flexible and probably explained some of the higher growth rate. Major tariff reductions, competition policy, a more flexible financial sector, and a shift away from centralised wage determination must have played a role. These reforms were generally brought about by the Hawke Labor government, but always with the support of the Opposition.

In addition, in recent years Australia and other countries have benefited from world wide low long-term interest rates caused by the high savings of Japan, China, other Asian countries and the oil exporters. Finally, we have benefited, along with other commodity exporters, from the fantastic growth of China.

And there was something else. This was “the dog that did not bark”. There were two recessions that Australia might have had but did not have in that period. The Asian crisis of 1997 and 1998 did indeed reduce demand for Australian exports, but the Australian dollar was allowed to fall greatly while interest rates remained unchanged. Thus the floating exchange rate regime that was established in 1983 by the Hawke government insulated Australia from this external shock. By contrast, New Zealand did have a recession caused by increases in interest rates that were designed to avoid a big fall in the exchange rate.

Then there was another recession that other countries, notably the United States, did have but we did not. That was the recession of 2001 caused by the ending of the US technology-related stock market bubble. This was generally known as the “dot com bubble”. We did not have such a bubble, and no bubble meant also no crash. The US recession was quite moderate owing to the flexible interest rate policy of the US Federal Reserve Board, but it was a recession that we avoided completely.

From Macfarlane’s book the reader will learn that in 1996, when the Howard government took over from the Keating government, there was signed a “Statement on the Conduct of Monetary Policy” whereby the Reserve Bank gained full independence in the conduct of monetary policy. It became free to change interest rates without requiring government approval. Previously the Reserve Bank had to get the approval of the government before changing the interest rate.

Central banks have been independent in the United States and in Germany for many years, and about this time central bank independence was widely adopted internationally. Notably, one of the first acts of the new Blair Labour government in Britain that replaced the conservative Major government in 1997 was to give the Bank of England full independence in determining British monetary policy. Similarly, the European Central Bank established in 1999 is completely independent of the governments of the member countries.

The logic was that it is always politically difficult to raise interest rates, but timely increases in interest rates are necessary to avoid the return of inflation. Politically difficult, but necessary actions are better done by an independent, non-political body. Furthermore, if inflationary expectations – and hence wage increases - are to be kept in check the commitment to cautious monetary policies of an independent central bank is more credible than that of politicians who are usually fixated on the short term. The long periods of low inflation that Australia, Britain and many other countries have enjoyed in recent years are at least partially attributable to central banks being independent.

In the 2004 election campaign the Prime Minister, Mr Howard, had a message for voters with high mortgages that helped him win the election. Under a Labor Government, he said, interest rates would he higher. Implicitly he reminded voters of the contrast between the interest rate of 5-6% per cent or so during the Howard government and interest rates that reached 18% when Paul Keating was Treasurer. But he did not remind them that Australian short-term interest rates are now determined solely by the Reserve Bank, not the government.

Perhaps he might have suggested that a Labor government would abrogate the agreement that gave the Reserve Bank independence. Or was he suggesting that a Labor government would run high budget deficits? When the Bank recently raised interest rates the then Leader of the Opposition made this a point of attack on the government. Clearly, the new regime of central bank independence is not widely understood. The politicians still hold the Commonwealth government responsible for changing interest rates, or at least some politicians find it convenient to pretend to do so. It is also worth reflecting that the low interest rates of recent years which have undoubtedly benefited the Howard government were only made possible by the earlier recession which was at least partly caused by the high interest rates of the “Keating” recession.

The book has a sting in the tail. If one is thinking about the future, the most important chapter is the last. Macfarlane argues that it has become clear how high or increasing inflation can be avoided. Yet there is another task. It is to avoid or minimise the instability caused by asset market booms and busts. These originate in the financial sector, as indeed did the boom and bust in the eighties and in 1990. There is a problem here even when there is no inflation.

Should interest rates be raised to moderate the booms (“prick the bubbles”), and can timely reductions in interest rates moderate recessions resulting from the busts? The solutions are not obvious. Macfarlane is concerned about developments in the capital markets, including the increasing complexity of financial innovations and the build-up of risky positions. Thus, he worries about the threat of major financial instability. To quote: “ I cannot help but feel that the threat from that source is greater than the threat from inflation, deflation, the balance of payments and the other familiar economic variables that we have confronted in Australia in the past “. He has no simple solution for this problem, or at least does not explore possible solutions.

But it is clear that a focus purely on the inflation problem is not sufficient.

This is a very good book. It shows how thinking in central banks not only in Australia but also in other developed countries has evolved. Macfarlane tells an important Australian story. His last chapter clearly signposts the big problems that are likely to arise. The central bank is meant to ensure reasonable stability of the economy. And that is not just as matter of avoiding a resurgence of inflation. Insofar as it is able it should also avoid deep recessions caused by capital market instability and, indeed, by various shocks that might come from outside or inside the economy.