Perspectives from a former central banker

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GDP per capita recession. Productivity slumping. Economy sluggish. Stretched housing affordability. AI advancing. Soaring energy costs.

These are key challenges facing Australia's economy. Who is better placed to speak to these topics than former Reserve Bank of Australia Governor, Glenn Stevens. And speak to them he did, at the opening session of Frontier's conference.

Australia's obsession comes with "self-inflicted wounds"

Footy, cricket, the races?

Australia's obsession is not sport but housing. And housing – affordability, policy, economics – formed a large part of the discussion between Stevens and Frontier Advisors' Senior Consultant Alexandra Veroude, who previously worked with Stevens at the RBA.

While "high house prices relative to income is not uniquely Australian", Stevens admitted it remains a potent question. "How it is that we've come to have among the most expensive housing in the world", given Australia is a "spacious country, with not that big a population"?

Stevens admitted "some of that has to be self-inflicted wounds". He pointed to zoning restrictions and constraints in the construction industry as examples.

Other factors are common among developed economies. Lower interest rates are one such factor. But inelastic supply and supply-side constraints form 'most' of the explanation for Stevens. The former Governor cited analysis he conducted for the then NSW Premier Gladys Berejiklian in 2017 that he thinks generalises to the whole of Australia. Here's a snippet:

The supply side of the housing market is too inelastic. That is, when demand increases, the quantity of housing available is very slow to respond, so that the market clears in the short run, and even the medium run, by prices rising.

Unfortunately, Stevens admitted there are "so many things restraining supply and I think that's still the case." The bottom line? We "need to do more to make supply more flexible." And therein lies the uniquely Australian challenge. Stevens cited research finding that large parts of the US, for instance, live in smaller cities; some of those cities have "very flexible supply sides and much lower costs of housing." But Australians largely prefer to live in big coastal cities, making the vast space available inland largely moot.

DIY fixes to housing affordability

Stevens also briefly talked about the "intergenerational equity" aspect of housing affordability. Housing affordability is a two-sided coin. Higher prices hurt first-home buyers but benefit those whose wealth is tied substantially to their property – or properties. Stevens therefore acknowledged "there are conflicting incentives" that can thwart reform. Governments' policies of helping first-home buyers attain home ownership don't tackle the true problem and can exacerbate existing ones:

For all the focus on first-home buyers – which is a tiny proportion of turnover – governments keep handing them money in order to afford the high prices. The thing that first-home buyers most value would be lower prices.

So those who do own their homes don't look favourably on lower prices. But Stevens urged the audience to approach this issue by thinking intergenerationally. Albeit not an option for many – few rise to lead the nation's central bank – Stevens noted that parents with means, like himself, have DIY tools at their disposal. Stevens has given away some of his wealth to his children early. That bestowment has funded his children's home ownership dreams.

Maybe it's time to give your parents a call.

Energy security

Asked by Veroude whether energy supply is able meet the rising demand spurred by AI, Glenn Stevens demurred, quipping that he would "step into energy policy discussion with great trepidation." But he relented, for the sake of the intrigued audience, packed as it was with delegates stewarding funds on behalf of beneficiaries' long-term needs where energy security is a key concern. More on that in the ESG panel, the summary of which you can read here.

For a country aspiring to retain high living standards while attracting investment to fund and develop the latest technologies – blunter yet – if the country wants to "remain an industrialised [one]", Stevens thinks "it's obvious that ubiquitous and inexpensive energy is a key advantage." And if you "give that away – for whatever reason – you're in for a world of pain".

Stevens expects Australia will face "very tough choices in the coming years" regarding the energy transition and the stated net zero ambitions. Stevens thinks we are not on track to achieve these goals, underestimating both the time and cost required. The "size of the investment to reengineer the economy to make it run in a much less carbon-intensive way" has been greatly underestimated in Stevens' view. The challenge will be exacerbated further by committing the necessary time and money while ensuring reliability.

Productivity

Productivity has been a popular topic in recent years. And not for good reasons. Australia's productivity has stalled and in fact has gone backwards. The March quarter saw GDP per hour worked fall 1% year-on-year.

But Stevens offered nuance that belied the grim headline statistics. First, the former central banker noted that if you disaggregate the data, some Australian sectors are doing fine. Namely the non-farm, non-mining sectors. The productivity woes are largely in the mining industry.

The former RBA governor then singled out the non-market economy, largely dominated by government-provided services. We "can't measure productivity" of this slice of the economy "very well". Yet it makes up a substantial share of GDP due to the "rise of the so-called care economy". For Stevens, the question is twofold: how to best measure productivity in this sector and how big do we want this sector of the economy to be? The challenge is paying for desirable things like aged care, healthcare, and disability care:

The onus is on the market part of the economy to be productive enough to fund what are effectively transfer payments to pay for these things.

Productivity 'to-do' list a decade overdue

Veroude asked, how can Australia be more productive? The answer is neither new nor arcane:

In the market economy, [it is] competitive markets, efficient allocation of capital, flexible labour market arrangements, flexibility generally… AI is going to be a factor but productivity doesn't come from screwing the worker or governments handing money to you. Where it does come from is from all of us … in our businesses, whatever they may be, everyday coming in and thinking, 'How can we do this a little better than what we were doing yesterday?'

Stevens then told a story about a productivity summit held over a decade ago. Asked by a journalist what can be done to boost productivity, Stevens (in)famously replied, the Productivity Commission "has a long list of things to do; my answer to what we can do about productivity is: go get the list and do them."

'Infamously' because the existence of this list was taken literally and journalists turned to the then chairman of the Productivity Commission Gary Banks to release the list. No such list existed but Banks obliged the interest and created one, outlining his productivity checklist in an address a few months later. However, Stevens told the audience that – in the years since – "by and large, we still haven't done anything on that list."

Forget interest rates when talking about improving living standards

The lack of action on productivity is not only academic. For all the focus on interest rates, it is productivity gains that matter for living standards. In fact, Stevens thinks "interest rates are not the main game". It is "entirely productivity" that's responsible for lifting our way of life. The question on everyone's mind should not be where interest rates are headed but how productivity can be improved.

Asked by Veroude whether AI can be a boon to productivity or whether it is yet another boom-and-bust cycle in the making spurred by animal spirits, Stevens pointed out that Australia would benefit from more animal spirits, not less. "We certainly need animal spirits, another term for that is an appetite for taking measured risk." Stevens thinks Australians are quite risk averse. We want the returns that come from risk taking but we don't want to actually take the risk.

Especially so when compared with Americans, whose appetite for risk leads to strong innovation and the related riches. It is no surprise the bulk of the world's most valuable companies are founded in the US. Stevens observed that US culture is also softer on its billionaires than Australia: "[It's] accepted there that if you take a risk and succeed you might get insanely rich and that's probably OK; it's kind of less OK here." Relatedly, it is this culture of risk-taking and innovation that leads Stevens to believe US exceptionalism will persist despite Trump's trade policies. The "entrepreneurial risk-taking American business ecosystem" will remain alluring and effective.

Reserve currency status of US dollar

Stevens sees that US dollar will remain "pretty dominant but progressively less so over time." If the diversification theme accelerates however, "you could get quite a bit of instability in FX markets." We may have become accustomed to the Aussie dollar not being very variable but "in my ten years as governor, I saw the Aussie dollar as low as 47-48 US cents and as high as 110 cents; it can move a lot," Stevens warned.

And while Stevens wouldn't go as far as predict a crisis of confidence in the US dollar, he reminded the audience that these crises are not hypothetical. They have happened. Stevens cited the late 1960s and early 1970s as an analogue.

Stevens doesn't know the probability of a similar crisis reoccurring but thinks "it's not zero and it is higher now than it was two years ago." And were some of the "fringe Mar-a-Lago Accord-type ideas to gain traction … that could be very damaging and disruptive".

Central bank independence

US Federal Reserve Chair Jerome Powell refuses to cut interest rates in spite of Trump. Is that a fair assessment? It may seem not, but this antagonistic and politicised view of the major central bank is not a fringe idea. As Veroude told Stevens, she heard these views espoused on a popular podcast listened to by tens of thousands each week. The hosts are not the uneducated but highly successful and influential people. Is this public perception of the central bank dangerous? Should people have a greater appreciation for central bank independence?

While "people often expect too much from the Delphic setting of interest rates", Stevens replied, "independence of central banks is very important" as it can be a "fragile flower". Political leaders "always say central bank independence is important and [that they] will honour it but there will come an inconvenient moment when they have to honour it through gritted teeth." The teeth of Treasurer Jim Chalmers may have been likewise gritted over the past year as the Reserve Bank took a cautious approach to cutting rates. But "by and large", Australians think the Reserve Bank will "go about doing its job" and Stevens pointed out the RBA has changed interest rates in both directions near elections. And while he doesn't know him personally, Stevens very much doubts Powell will hold rates steady out of spite. Rather, Powell will hold rates out of justified caution.

Talking shop, Stevens thinks the Federal Reserve is closer to where they want inflation to be but this level is probably not sustainably back to target. "The economy is still quite close to full employment and there won't be fiscal restraint any time soon. The Fed is probably well advised to be careful," said Stevens.

Rounding off his answer, the former governor reiterated the importance of central bank independence:

> *The reason we have central bank independence is not because central banks are always right or because they are so much wiser than everybody else. It's because it's the less bad way of doing things we've found so far and we should preserve that.*

As Churchill may have said, independent central banks are the worst form of monetary policy except for all other forms that have been tried.

Stevens' three risks to monitor

Finally, Stevens left the audience with three risks top of his mind.

- Rising government debt: a persistent long-term risk. The timing of the consequences is hard to predict, but not the inevitability.
- Equity valuations: local and global listed equities are "quite richly priced".
- Private debt: Stevens thinks the sector has potentially become a "crowded trade".