

I J Macfarlane: Overview of the Australian economy

Opening statement by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Sydney, 31 May 2002.

* * *

Mr Chairman, with the normal timetable interrupted by last November's election, it is slightly over a year since we appeared before this Committee. Since it has been an extremely eventful year, I will have a fair bit of work to do today to fill the gap.

Looking back over the Hansard of the last meeting in May 2001, I see that I was explaining why we had lowered interest rates three times (in February, March and April). At the time of our meeting, I was pretty confident that the Australian economy was on a recovery path after a short housing-induced setback in the second half of 2000, but none of us were sure about what was going to happen in the United States and the rest of the world. External events were seen to be crucial to our fortunes and to the evolution of our monetary policy.

As it turned out, these events unfolded in two distinct phases:

- Over the rest of 2001, the world economy continued to weaken. The United States had a mild recession, with consumer spending holding up and so preventing it from being as deep as earlier ones. On the other hand, the business sector had a pronounced recession judging from the fall in industrial production, business investment and corporate earnings. Most other major countries had negligible growth during the year, so that for the G7 countries as a whole, growth was virtually zero over the year. Even so, it looked for a time that it could have been much worse.

For most of last year, therefore, we were receiving gloomy news on the world economy. After a brief respite in mid-year, bad news began to re-emerge in July-August, so much so that we in Australia eased monetary policy on 5 September. Then the events of 11 September induced a new bout of gloom, and there was a real fear that the world economy would weaken further in 2002 and so experience a prolonged and deep recession. Monetary policy was eased virtually everywhere. In our case, even though our own economy remained in good shape, we eased in anticipation that the weakening prospects for the world economy would eventually flow through to the domestic economy.

- The second phase began in the early months of this year, when it became increasingly clear that our earlier fears about 2002 were not going to be realised. The US economy grew more quickly in the final months of 2001 and the first quarter of 2002 than anyone had expected. In addition, we received better news from non-Japan Asia and Europe. It is now pretty clear that 2002 will be a year of recovery for the world economy, and the IMF is forecasting good growth through the year. The debate is no longer about whether there will be a recovery, but about whether it will be an average or below-average recovery. There is still a good deal of uncertainty about how robust the US recovery will be once the inventory correction has passed, i.e. in the second half of the year. Some of the bubble-type distortions have not been fully unwound so there is still a fair bit of caution around, including in the Federal Reserve Board.

So we are in a world economy with a more comfortable outlook than a year ago, but with still some uncertainties remaining. What of the Australian economy? The story here has been much less exciting, but the results a lot more satisfying.

As you know, GDP grew by 4.1 per cent over 2001, which was the highest among comparable OECD countries. We can now safely claim that the Australian economy has weathered a world recession without itself experiencing one. This is the first time in my experience that such an outcome has occurred, and it must give us confidence in the soundness of our economy. But before getting carried away, we should concede:

- By the standards of earlier world recessions, last year's was a mild and short one, and some observers may be reluctant to classify it as a fully-fledged recession.

- We did not escape scot-free. If you average our growth in 2000 and 2001, it comes out at 3 per cent so we did experience a modest slowing.

As well as good GDP growth, we have experienced quite good employment growth over the past year. It appears that the slowdown in our economic activity resulted in a trough-to-peak rise in unemployment from 6 to 7 per cent, and that half of the rise has already been whittled away so far in 2002. This is extremely good news because it is the first time for three decades that we have been through an international downturn that has resulted in the peak unemployment rate in Australia being lower than its predecessor.

At this point in proceedings, I usually review the previous set of forecasts I gave the Committee and then present a new set for the period ahead. I will continue that tradition, but we should bear in mind there is a full year of new data available to us so there is more to review. Last May, when we had only two of the four quarters of 2000/01 available to us, I said we expected year-on-year GDP growth in that year to be about 2 per cent; in the event, it came in at 1.9 per cent. My forecast for year-on-year GDP growth in 2001/02 was 3 to 3½ per cent, and our current forecast (still with two quarters yet to come) is 3.6 per cent. So, even though there have been big swings in the international outlook in the meantime, the last 18 months seem to have turned out much as we expected (unlike the previous six months where the extent of the housing-induced setback took us largely by surprise).

On the prices front, we still had not seen the GST bulge pass through the system when we met last May. The forecast I presented at the time was that when it had passed through, the rate of inflation measured by the CPI would settle at 2½ per cent. In fact, that was "spot on" for the four quarters to the September quarter of 2001, but by the December quarter inflation had risen to 3.1 per cent, and by the March quarter 2002 it was 2.9 per cent. So, on average, we slightly underestimated the rise in inflation.

For the year ahead, i.e. 2002/03, we are forecasting the economy to continue growing at 3½ to 4 per cent as it completes the eleventh year of its expansion and enters the twelfth. The outlook for inflation over the same period could best be summarised as remaining near the top of our target range, although we expect it to go down slightly for a time, and then to come back up. This was the view expressed in our quarterly *Statement on Monetary Policy* released earlier this month.

In short, the outlook for economic growth and inflation is such that the economy no longer needs the boost provided by an expansionary stance of monetary policy. We took the first step towards returning monetary policy to a more neutral setting earlier this month, and, unless unforeseen developments intrude, we should continue the process as we go ahead, while all the time carefully examining incoming data, both from here and abroad, to ensure that developments remain on track. I will return to this theme later in my presentation, but before doing so I should examine the economic outlook in a little more detail.

In looking ahead, we always have to ask ourselves where the balance of risks lies. Another way of expressing this is to ask: what is the main risk for the economy if we did not adjust monetary policy? In our view, the most important risk would be that the expansionary forces in the economy would increase to an excessive degree, bringing with it the likelihood that inflation would rise from its present position at the top of our target range to something in excess of it. In the process, we would also expect other imbalances to emerge which would ultimately bring the current expansion to an end. Of course, we cannot entirely rule out the alternative outcome whereby the economy slows and puts sufficient downward pressure on inflation that it threatens to fall below the bottom of our range, but we would put a low probability on that outcome.

As has been the case now for some time, to the extent we can identify risks on the downside, they come mainly from abroad. Even though the US economy grew quickly in the first quarter of the year, the strength of its recovery is still uncertain, and there are risks to the world economy from the unstable political situations in the Middle East and Indian sub-continent. On the domestic front, the most easily identifiable area of spending that will exert a dampening influence later in the year is likely to be house-building, largely because so many houses will have been built that construction will not be able to continue at its former rate. But overall, barring some unforeseen international event, we find it hard to see serious risks on the downside for the Australian economy. We cannot rule out slightly below-average growth, but we would regard anything significantly more adverse as unlikely.

Instead, conditions are much more conducive to stronger economic growth than last year. The turnaround in the world economy will mean that it will be a positive force for growth over the year ahead rather than a dampening influence. This should be good for exports, investment and confidence

in general. As well, both consumer and business confidence have returned to quite high levels after a couple of setbacks last year. Business investment has been quite restrained over the past couple of years but is about to pick up according to the plans businesses supply to the ABS's Capex Survey. This is not surprising given the relatively healthy profit situation, the high level of business confidence and the expected growth in spending. These more buoyant conditions may also encourage businesses to attempt to rebuild profit margins, which will be a factor underpinning inflation over the next year or so.

Thus, we believe that if monetary policy maintained its present stance for too much longer, there is little risk of a serious slowdown, but a high risk that the economy in time would overheat. This provides the basis for our view that monetary policy should be returned to a more neutral setting. I think there is widespread agreement with this assessment of the situation, but inevitably there will be people who do not agree. One doubt you sometimes see expressed is the fear that any rise in interest rates will "choke off the expansion".

Not surprisingly, we feel that this fear is misplaced. At one level, it amounts to saying that the expansion is so fragile that it can only be continued if monetary policy is kept permanently at an expansionary setting. We also care about continuing the expansion, but feel that the least risky way of doing so is with a more neutral interest rate setting. At another level, the fear may be that we at the Reserve Bank will err on the tight side. Of course, that is possible, but our track record does not support this view. Over the past decade or so, the thing that stands out about our monetary policy is the fast rate of economic growth it has permitted compared with other comparable countries, not any tendency to over-achieve with inflation reduction. Where we differ from some observers is that we are mainly interested in the medium run, i.e. we want to sustain the expansion rather than to maximise its speed over the next year. We have been consistent in this approach for the best part of a decade, and it has served us well.

I would now like to change to a subject that was highlighted by this Committee in its press release announcing today's hearing, namely credit card reform.

The Reserve Bank released its consultation document in December last year. In it, we proposed, subject to further consultation, three major changes to the four party credit card schemes that operate in Australia:

- first, a new and transparent standard for setting the interchange fees on credit card transactions which would lead to a reduction in those fees, and thus in the merchant service fees paid by businesses;
- second, the ending of the prohibition imposed by the card schemes that prevents merchants from passing the cost of accepting credit cards on to cardholders; and
- third, the elimination of the restriction on entry to the credit card schemes that keeps out potential competitors that are not deposit-taking institutions.

After we released our document, we allowed interested parties till mid-March to prepare submissions, and we have been going through those submissions thoroughly with them since then. We want to give each party every opportunity to put their view forward, even if it involves multiple meetings. We are still in this process and, when we have finished, we will release our findings sometime after the end of June.

During this period, we at the Reserve Bank have not engaged in public debate on this subject, even though some of the other participants in the credit card industry have been quite vocal. We see our role during this stage essentially as the umpire adjudicating between the competing views of the financial institutions and card schemes on one side, and the consumers, retailers, billers, etc. on the other side. Of course, our umpire role should not inhibit the Committee from asking any questions it wishes to.