I J Macfarlane: Overview of the Australian economy

Opening statement by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to House of Representatives Standing Committee on Economics, Finance and Public Administration, Brisbane, 8 December 2003.

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Mr Chairman, it is a pleasure to be here today in front of your Committee again, and I am very pleased that we have been able to meet in Brisbane for the first time. As you know, we take these hearings very seriously because they enable Parliament, through its representatives on the Committee, to question the Reserve Bank in depth and in public.

As usual I will make some introductory remarks in which I will focus on three subjects:

- how the situation has changed since the statement I gave to this Committee in June;
- how our forecasts have evolved;
- the background to our monetary policy actions.

1. June and Now

Calendar year 2003 was an unusual one for the world economy. In the first half, prospects for world growth looked doubtful, with the most extreme uncertainty being concentrated in mid-year. If you remember, this is when talk of possible deflation in the United States reached its peak, and the US authorities gave the impression that they needed lower interest rates and a lower US dollar to help them through. In Europe, economic activity was weakening, and Asia received a temporary knock-back from the Severe Acute Respiratory Syndrome (SARS) outbreak. At that time, virtually all the central banks of note - the Federal Reserve Bank of New York (the Fed), the Bank of England, the European Central Bank (ECB), the Bank of Canada, etc. - reduced interest rates, and I indicated to this Committee that if things did not improve, we might also have to do so.

In the event, we did not because we witnessed one of the sharpest turnarounds in economic prospects any of us has seen. While in the June quarter most major countries, including many in Asia, saw declines in Gross Domestic Product (GDP), by the September quarter they were all growing strongly. The weakness we had seen in the June quarter turned out to be a ‘false signal’. In financial markets, bond yields rose sharply, share prices continued to rise, and various prices connected with international trade, such as commodity prices and transport prices, also rose. Talk of deflation ceased and the short-lived bout of monetary easing stopped. Business and consumer confidence indicators around the world rose back to levels consistent with reasonable economic growth.

At the same time as perceptions of the world economy were being raised, the general run of economic indicators in Australia continued to improve, particularly employment, retail sales, construction activity and business and consumer confidence. Prospects for farm production also picked up sharply following widespread rain, even though it was not uniform across the country. Economic conditions here and abroad had returned to something relatively normal and, as a consequence, we judged that we no longer needed such an expansionary setting of monetary policy: interest rates were raised accordingly in November and December.

2. Forecasts

At this point, I will follow my usual practice by discussing the forecasts I gave you at the previous meeting, then adding some new ones for the coming calendar year. When we last met in June, I said that we expected GDP to grow by 3 per cent in real terms over the course of 2003. With three quarters of the year behind us, we now expect that the figure will come in a little higher, at about 3½ per cent. The thing to notice, however, is the big difference between the two halves of the year, with growth in the first half being at an annual rate of 2 per cent, and growth in the second half expected to be at an annual rate of around 5 per cent. The other thing to notice is that growth of domestic demand (Gross National Expenditure - GNE) through 2003, at 5 per cent, is again expected to be well above the figure of 3½ per cent for GDP.

Over the course of 2004, we expect GDP to grow by 4 per cent. The profile of growth, however, is unlikely to be smooth. It would not surprise us if the four-quarter-ended growth rate of GDP reached 4½ per cent in mid 2004 due to the effects of the sharp rise in farm GDP, before returning to 4 per cent by end year. If the world economy continues to surprise on the strong side, as it has in recent months, our GDP growth could be even higher.

On inflation, we said last time that we expected the CPI to increase by 2½ per cent over calendar 2003. We now think it will be a little lower at 2¼ per cent, largely due to the exchange rate being higher than assumed in our earlier forecast. Over the course of 2004, we expect the CPI to increase by 2 per cent, but in mid 2004 it could well be below that because the maximum effects of the higher Australian dollar could be being felt then. As we stated in our quarterly statement, this expectation implies that the profile of inflation will exhibit a shallow U-shape - falling from its present 2½ per cent to below 2 per cent in mid 2004, but then rising back to 2 per cent by end 2004, 2½ per cent by mid 2005, and continuing under upward pressure thereafter. Of course, it is difficult to be precise about these things, especially since future levels of the exchange rate will play a major role. I will say more about this later.

3. Monetary Policy

As I outlined at the start of these remarks, with growth in the world economy getting back to normal, and growth in the Australian economy also getting back to normal, or slightly above it, we could no longer see a justification for Australian interest rates being clearly below normal. That is, the major reason for the two increases in interest rates this quarter is the same as I gave to this Committee 18 months ago in late May 2002 when talking about the tightening then. Another way of putting this is to say that if we had maintained the low level of interest rates we had at the beginning of 2002, there would have been a gradual build-up in inflationary pressures as the growth rates of the world and Australian economies rose through 2003, 2004 and beyond. Interest rates were just too low for an economy that was growing that well. As it turned out, this process of returning interest rates to more normal levels has been a gradual one. Two increases in interest rates were made in mid-2002, then there was a 16-month gap to the next two increases. I have explained in the previous two meetings of this Committee why that long gap occurred.

It is clear that, despite our best endeavours to explain ourselves, a number of people think that the Bank tightened to cool down the property market. In fact, I have more than once received unsolicited advice that it would be better for us to explain our action in this way because people could more easily identify with it. The overheated property market is something that people can see around them; it is much more concrete than such concepts as inflation-targeting or returning interest rates to normal.

However, such an approach would not be consistent with the truth. For a start, signs of overheating in the housing market were clearly evident through the second half of 2002 and all through 2003, yet the Bank did not change monetary policy. It was only when it became clear that good economic growth had returned both globally and domestically that rates were raised. I have often stressed that monetary policy has to be set taking into account the average of all the parts of the economy, not to what is happening in one sector. Of course, if a sector is overheated, it may push up the average for the economy, and in that way exert a disproportionate influence. It is also true that, historically, borrowing for housing purposes has been one of the more interest-sensitive sectors, and so it may have been more affected than other sectors by the previous low level of interest rates and it may respond more than other sectors to the recent increases. But that does not mean we singled it out.

We have also been accused of setting monetary policy in relation to the Sydney and Melbourne housing markets, and ignoring the rest of the country. This clearly cannot be true in the case of the recent tightenings, as house prices in Sydney and Melbourne are growing less quickly than in other states; in fact, housing prices in some parts of these cities are already falling.

In Australia we have conducted monetary policy by using an inflation-targeting regime for about a decade now. It has been a very successful regime in that it has delivered (along with various other reforms) the longest period of uninterrupted good economic growth in the post war period, at a rate exceeding that of all other significant developed economies. It has concentrated our minds at the Reserve Bank in that we have been very conscious of our need to deliver the results to which we have committed. Over the 10-year period, inflation has averaged 2.4 per cent. By acting early on monetary policy to keep inflation in check, we have avoided large swings in interest rates and thereby allowed the economy to prosper.

As you are aware, our target is a relatively flexible one in that we aim to achieve an *average* rate of somewhere between 2 and 3 per cent. It is that average by which we should be judged, or made accountable. But there are some observers who think that the system should be more prescriptive than this and there should be some strict rule which should determine our actions.

For example, a few people still think we should aim to keep inflation between 2 and 3 per cent at all times. This is a clear misinterpretation of our system because it fails to realise that it is the *average* we are interested in. On a number of occasions, inflation has been above 3 per cent and below 2 per cent. In fact, about 45 per cent of the time it has been outside the 2 to 3 per cent range, and we have not regarded this as a failure of policy.

Since our objective is to achieve an average inflation rate, there are multiple paths for inflation which are consistent with meeting our medium-term objective. We wish to choose the one which best satisfies the other obligations contained in our Act, which I summarise as achieving *sustainable* growth in income and employment. We are not simplistically committed to achieving the minimum possible variability in the inflation rate, or even hitting the target at some fixed period ahead, such as two years.

Another approach sometimes put to us is to say that we should raise interest rates if, and only if, our *forecast* for inflation is above 3 per cent, and lower them if, and only if, it is below 2 per cent. Again, this is a misinterpretation of how the system works. It also ignores the complications and uncertainties involved in economic forecasting. The forecast horizon relevant for policy today is at least two, or even three, years. We can be relatively confident about forecasts for the first half of that horizon, as much of what is going to happen over that period is already set in place. But we can be less confident about the forecasts for the second half. The situation is particularly uncertain when, as is the case at present, the direction of inflation is expected to change during the forecast period.

Since this type of forecast is so hard to make, we, like a number of other central banks, do not wish to lead the public to believe we can do this with much precision. In fact, we tend to appeal to the balance of risks around the central forecast in order to convey our message. In last month's quarterly statement we said that the balance of risks was shifting to the upside, which was meant to indicate that inflation was on an upward trajectory through the course of the second year. We also drew attention to the fact that domestic price pressures were increasing, as shown by the fact that the rate of increase in the prices of 'non-internationally traded goods and services' had increased from 2 per cent to 4 per cent over the past few years. That does not mean that inflation will rise to 4 per cent once the exchange rate effects have worn off, but at least a significant part of the economy will be influenced by this figure.

In summary, I want to assure the Committee that the Bank remains committed to the inflation targeting framework and that the decisions taken over the past 18 months have been fully consistent with that framework. It does not seem plausible to us to argue that the Bank could have been confident of meeting its inflation commitments if interest rates had been held at 30-year lows in the face of the pick up in the international and domestic economies that is currently under way.

Finally, let me end by updating you on a few developments in the payments policy reforms. Since we last met, the challenges brought against the Reserve Bank's reforms to credit card schemes by MasterCard and Visa were dismissed by the Federal Court. Both schemes subsequently appealed, but Visa has withdrawn its appeal. The new interchange fees for Bankcard, MasterCard and Visa came into effect at the end of October, almost halving the fees. The Reserve Bank is monitoring the flow through of this to merchant service fees. The data are still being gathered, but anecdotal evidence suggests that merchants are starting to see a reduction in the merchant service fees they pay to banks.

There have been several developments in other payments streams, and I will be happy to answer questions on those when they arise, but I am aware that I have already taken a fair amount of your time, so I will finish at this point.