Mr. Macfarlane discusses monetary policy and economic growth in Australia

Talk by the Governor of the Reserve Bank of Australia, Mr. I.J. Macfarlane, to the Australian Institute of Company Directors (Western Australia Division) Winter Dinner held in Perth on 12/8/97.

1. Introduction

It is a pleasure to be in Perth to address the Western Australian Division of the Institute of Company Directors. It is also fitting that I should be talking about economic growth, since Western Australia has set an example to the rest of Australia by its high growth rate in the 1990s. Some would say this is inevitable, given its resource base, but we have seen internationally that the fastest growth does not coincide with the biggest resource endowments. Enterprise and a willingness to embrace change are also vital ingredients, and here Western Australia has also distinguished itself.

In the Reserve Bank we are often drawn into a discussion of economic growth because of claims that we have a “growth ceiling” of 3½ per cent per annum. I do not know where this perceived ceiling came from, and I have on several occasions denied its existence. I will do so again tonight.

It has been suggested to me that one of the reasons for this belief is that I have often highlighted the data contained in Table 1 below, particularly when I have been doing my patriotic duty in

Table 1: OECD GDP Growth Over the Past Six Years
(Average annualised growth)

	Real GDP
Ireland	6.4
Australia	3.5
Norway	3.5
New Zealand	3.4
United States	2.7
United Kingdom	2.4
Canada	2.2
Denmark	2.1
Netherlands	2.0
Austria	1.7
Japan	1.6
Spain	1.5
Finland	1.5
Germany	1.4
Belgium	1.3
France	1.3
Italy	0.9
Sweden	0.9
Switzerland	-0.1

Source: OECD

front of audiences of overseas investors. It shows that over the past six years, that is the period of the current expansion, we have grown at an annual average growth rate of 3.5 per cent. This is very good by the standards of the "high income OECD countries". Only Ireland has done better, and Norway and New Zealand have grown at about the same rate as we have. These are all much smaller countries than we are (their combined GDP is less than Australia's). The other thing that stands out from this table is how well the English-speaking countries have done in the nineties; the six English-speaking countries are in the top seven spots. The 3½ per cent per annum contained in this table is there for international comparisons, not as a yardstick for what we can do this year, next year or the year after. For a start, that six-year average of 3½ per cent contains years like the past 12 months where we have achieved only 2.4 per cent, but there are other periods like the year to September 1994 when we managed 5½ per cent.

2. Economic growth over the cycle

While we do not have a growth target or growth ceiling, we do have an inflation target. This says that inflation should average somewhere between 2 and 3 per cent over the medium term. That is, when we look back, we should see that it has averaged 2 point something per cent, even if we have been over 3 per cent on some occasions and below 2 per cent on others.

This approach is not, as some might think, anti-growth. It is, in fact, pro growth by favouring forward looking management of the business cycle, which will help in achieving a stable platform for long-run growth. The other way of expressing an inflation target is to say that the economy should grow as fast as possible consistent with maintaining low inflation, but no faster. We say no faster because post-war experience in a number of countries has shown us that allowing inflation to rise too much actually harms growth prospects in the longer term. Sustained periods of strong growth have always gone hand in hand with low inflation. Weaker growth occurred in the high inflation era, particularly between the mid-seventies and mid-eighties.

We have also emphasised that it is the length of the expansion that is important. Our last two expansions were cut short by inflationary pressures after about six-and-a-half years. It would probably be possible on this occasion to engineer a short-lived boom, characterised by rising output and falling unemployment, but also by increasing inflation, unrealistically high asset values, inflated paper wealth and financial instability - which is, of course, a recipe for a slump thereafter. Recessions may come for some other reasons, but there is no reason to run a high risk of a self-inflicted one. It is important that we take a longer view in order to achieve a longer expansion. The value of the inflation targeting regime is that it forces us to do precisely that. That is why I am confident that, under our present arrangements, we will be able to do all that can be done to foster a long expansion.

What does this mean for the next couple of years? That is really a matter of forecasting rather than speed limits. With inflation tamed, and with some slack available, we should be quite capable of growing by 3½ per cent, 4 per cent, 4½ per cent (or possibly even faster) over the next couple of years without any significant detrimental effect on inflation. None of these figures is a target; they are simply illustrative of the sorts of numbers we might reasonably expect to see after a period of sub-par growth such as 1996.

Ideally, as we grow fast enough to take up existing slack, businesses would lift investment rates further, pushing the capacity constraints further back. If, at the same time, we found that labour market arrangements were able to bring new employees onto payrolls without

generalised pressure on wages, we would be able to sustain faster growth for longer. In other words, by having a longer expansion, we would be able to drive unemployment down further.

How likely is that outcome? It is hard to say. We do not have a doctrinaire view on what can be achieved. We will evaluate the evidence as it comes in. Critical in that evidence is the course of prices. The main test of what is sustainable on the growth front is the inflation test: is the rate of growth compatible with achieving the 2-3 per cent average for inflation, looking forward as best we can over a year or two? If the answer is yes, then that growth is sustainable, at least at that point in time. To repeat: we do *not* have a growth ceiling, beyond which the brakes automatically go on. We have an inflation target, appropriately and flexibly defined, which tells us to tighten when our forecast of inflation has it exceeding the target for any sustained period of time, and to ease when the forecast has inflation sustainably below target. Growth *per se* does not necessarily trigger this response: it is the *inflation* outlook which is important. In thinking about the inflation outlook, of course, we need to ask ourselves whether the growth which is occurring now and that which is in prospect are likely to put pressure on capacity to such an extent that inflation might rise noticeably. But that is a judgement based on a range of factors, not a mechanical response to the breaching of some arbitrary growth threshold.

Another point I would like to make is that at the moment I do not see that monetary policy is placing any constraint on growth. This is as it should be - one of the advantages of an inflation target is that it makes sure monetary policy is eased when the inflation forecast is below the target average. Hence the five easings over the past year. This might help to reassure those people who think that in order to maintain a low average inflation rate, monetary policy has to be kept continuously tight. It does not - monetary policy will be eased as often as it is tightened. Monetary policy has to be no tighter to maintain an average inflation rate of 2½ per cent, than to maintain an average of 5 or 10 per cent. In fact it probably would have to be tighter at the higher figures as it would be fighting against rising inflationary expectations.

Another sign that present monetary policy is not restrictive is to look at the effect it is having on the cost and availability of credit. If this was too expensive, we would not see much being used, but that is not the case at present. All forms of credit - business, housing and personal lending - have been growing at somewhere between 8 and 11 per cent over the past year. This does not suggest that the economy as a whole is finance-constrained, although there will always be some individuals or firms that are.

Another manifestation of this that may have escaped many people is that we now have lower interest rates out to five years than the United States, which is the usual benchmark for international comparisons. Now this is entirely fit and proper, given the different cyclical positions of the two economies and given our lower inflation. But even so, it would have been unthinkable even a few years ago. Financial markets took it for granted that Australia would always be a high interest country relative to the United States. (International investors put Australia in with a group of countries called the “high yielders”.) I am strongly of the view that these lower interest rates are a substantial benefit for Australian businesses.

3. Economic growth in the long run

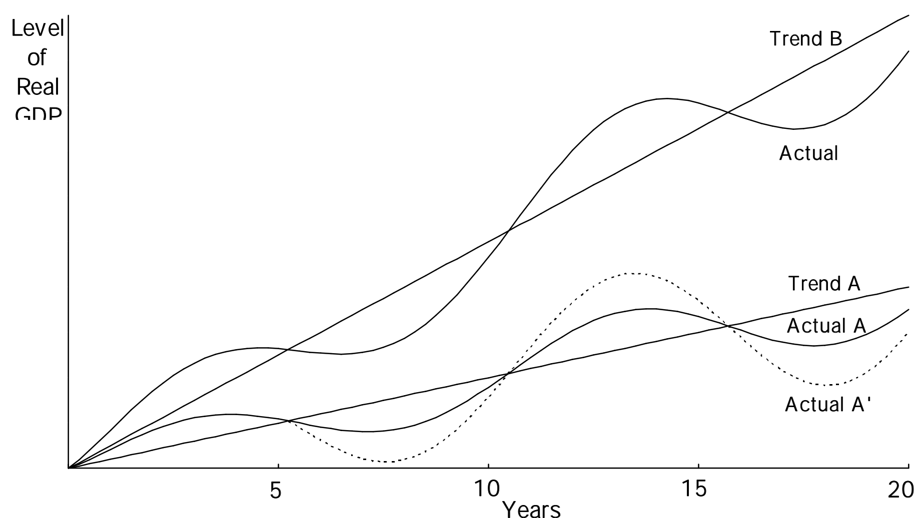
So far, we have been talking about growth over short time horizons such as a couple of years or so. Over this horizon, growth can vary quite a lot, and monetary policy will have some influence on the outcome. While monetary policy’s major long-term influence will be on the rate of inflation, over shorter periods it can have a significant influence on economic

activity and employment. If it is too tight, it will unnecessarily constrain them, and if it is too loose, it could set up the conditions for an inflationary boom. The relationship between monetary policy and economic growth is thus essentially a short-term or cyclical one.

But this is not what a lot of people are interested in. They want to know what is Australia's long-term growth potential. Is our potential growth rate relatively low like all the standard OECD countries in Table 1? Is it a bit higher? Or, alternatively could it be as high, or nearly as high, as the newly-industrialising countries of Asia? How could it be raised to a higher figure?

These are all difficult questions to answer, and I shall only attempt a very cursory one. But before I do that, I want to make an important point - whatever our potential growth rate is, monetary policy will have little to do with it compared with other factors. Monetary policy mainly works by affecting aggregate demand in the economy. Fluctuations in demand are the normal (though not exclusive) source of business cycles. In thinking about long run trends, however, it is the *supply* structure - the economy's capacity to produce and how that can be increased - that is crucial.

Perhaps I can take the liberty of illustrating this distinction between short and long run with a stylised diagram. An economy could have an average long-term growth rate as shown in the straight line Trend A. Its actual growth will never be a straight line because of the business cycle, so it is likely to look like the wavy line Actual A. If monetary policy was conducted badly, we could end up with a boom and bust given by the dotted line Actual A[1]. Alternatively, if monetary policy was conducted well, we should expect to have relatively stable conditions, including low inflation; with a bit of luck, we should also get longer lasting expansions and milder recessions. Because a reasonably stable aggregate price level does not prompt the distortions in economic decisions seen with high inflation, trend growth should be a little higher. But while that difference will be worth having, it only adds a little to trend A, and many people would have trouble noticing the difference.



Now, people may be unsatisfied with this outcome and say that they would prefer to be on the faster trend growth line given by Trend B, which is perhaps two or three per cent higher than Trend A. This is a reasonable aspiration, but it cannot be achieved by an adjustment to monetary policy.

What factors then explain long-run growth? In simple terms, it is explained by the growth of the productive factors in the economy - the growth of the labour force, expansion of the capital stock and growth in productivity of both labour and capital. This is why there is such focus on micro-economic policies to raise efficiency, rather than manipulation of the macro-economic instruments, when people talk about long run growth potential. Again, all that monetary policy can do is to minimise the booms and busts around the higher trend. The only way that the economy can move from Trend A to Trend B is by enacting policies that either increase the growth of the productive factors or increase their productivity.

I do not intend to say much about the growth of the labour force, which in the long run is determined by population growth and participation in the workforce. Note, however, that in the short run the economy can grow faster than the labour force constraint would suggest because, if there is enough flexibility, we can move people out of unemployment into employment. The other point that I should register is that I do not think in the long run we will be able to maintain our current low male participation rate. With life expectancy still increasing, we will not be able to continue the luxury of having so many people entering the workforce in their early twenties and leaving in their mid fifties. This is a transitory phase, not a permanent increase in leisure.

In thinking about how to ensure that the capital side of the production potential is expanded sufficiently, it is hard to go past the simple idea that investment has to be funded by saving, and we would probably have more if we increased our domestic saving. Of course it could be funded by more foreign saving, but that path tends to be a more unstable one. I have no new ideas on how to increase our savings other than through the familiar methods of making sure that the government does not reduce national savings through chronic budget deficits and by enacting measures to make sure that a higher proportion of retirement incomes are funded out of private savings.

The really big issue for long-run growth is how we raise productivity. In simple debate, this is often portrayed as producing the same with less people, either by job shedding or by substituting capital for labour. But any business knows that it is not just manning levels which are important. The flexibility of the workforce in using the capital equipment, the skills which they can bring to bear in response to new demands and opportunities, the capacity of the firm to innovate and improve processes in industrial and service applications, the ability to develop and exploit new technology - these are actually more important ingredients in the long run.

Of course, all good firms are trying to do this all the time. In a competitive marketplace, they have to keep up with their competitors or fall by the wayside. In a global marketplace, they increasingly have to move towards international best practice, which itself is always advancing as a result of innovation and adoption of new technology. In the process of matching their competitors, the best firms drive the development of productivity and the rise in living standards.

Not all firms nor all industries will succeed in doing this. Some will thrive and others will fail. Some industries will grow, and some industries that we do not even know about

as yet will emerge. The only thing we know is that there will be continuous change, not just here but in all countries, under the constant pressure of competition, new technologies and globalisation. There is no simple secret to success, but part of the answer must be for both firms and for countries to facilitate change, and to adapt to it, not to resist it. The central issue is that all productivity gains involve change. By their nature they involve producing goods and services in different (and better) ways, or in producing different goods and services. Change is a necessary condition for productivity growth.

These major changes are going to occur in the private sector among both large and small firms. The adjustment task will be difficult, but they must try to seek out the profitable and growing areas. While the role of government will be important, the Government will not be able to do the adjustment for the private sector. I find it hard to believe that the Government would be better than the private sector at picking the growth areas, so I believe that the Government's main contribution should be to remove unnecessary obstacles to change, to provide a high quality infrastructure, to encourage saving and to work at lifting and maintaining quality of education.

I know this is a difficult message to give to a public which is growing tired of change (not all of it economic). But the alternative of stopping change is really not viable. It has always been the case that the firms and societies that have managed to embrace the challenge of change and seize new opportunities, rather than turning their backs, have been the ones that prospered.

It may, of course, be harder for the high income societies like Australia than for the newcomers who feel less attachment to established ideas and who therefore have less to "lose" in embracing change. But we surely have the capacity to adopt change when we see the need. We have to be convinced it is worth it.

The advantages of flexibility have been well demonstrated in the nineties by the superior performance, both in terms of growth and in lower levels of unemployment, of the less regulated English-speaking countries compared to the corporatist European ones.

I am not suggesting we should remove all regulation and rely totally on *laissez faire*. There is clearly a large role for government, but we should always ask whether particular government initiatives are forward looking, or whether they are protecting an existing industry or an existing privilege.

The first requirement of government is to provide as stable a macro-economic environment as it can. The second requirement of government is to provide first class, low cost infrastructure. This stretches from such items as the legal system and accountancy standards through to more tangible items like the education system and the utilities, including electricity, gas, water and telecommunications. The Government, of course, need not be the provider of each of these, but it will always ultimately set the standards. Inevitably, governments will also be called upon to enact policies which affect one industry at the expense of others. My only plea here is that they do it in a way that encourages adjustment, perhaps even compensates losers, but not to do it in a way which resists change.

4. Conclusion

Australia has recorded quite a respectable growth performance by developed country standards during the current upswing. Even our low point in the mid-cycle growth

pause - a bit over 2 per cent - is pretty good compared with many countries' average performances. People are disappointed that more progress has not yet been made on reducing unemployment, but we have made some, and further real progress will be made if we can sustain a long running expansion. As I have noted tonight, I think our current monetary policy framework is serving us well in this regard, by requiring us to take a medium-term view in our policy deliberations and maximising the chances for a long recovery. I hope I have helped to explain our thinking.

When we shift our focus to the economy's long run growth prospects, however, monetary policy should inevitably attract less attention. Price stability is a necessary condition for faster long-term growth, but there are many other policies which have to be got right. That's why it is so hard. If there is a simple message, I think it is that the heart of the long-term growth process is productivity enhancement through innovation, technological change and so on, and that to reap the benefits of those processes, we have to embrace the forces of competition and globalisation, with all the changes and discomforts they bring.