

Mr. Macfarlane reports on monetary policy and financial stability in the Australian Economy Opening statement by the Governor of the Reserve Bank of Australia, Mr. Ian Macfarlane, to the House of Representatives Standing Committee on Financial Institutions and Public Administration in Melbourne on 7/5/98 (slightly abridged).

1. Introduction

Mr Chairman,

It is a pleasure to be here in front of your Committee for the third time under the new arrangements set out in the *Statement on the Conduct of Monetary Policy*. I hope this meeting will be as successful as its predecessors in helping to lift the level of understanding of monetary policy, financial stability, the Australian economy and, of course, the region more generally. I also hope you have found our *Semi-Annual Statement on Monetary Policy* a useful source of information and a reasonably clear statement of our views.

It is especially pleasing that we are meeting here in Melbourne for the first time. If you remember, Mr. Chairman, the attempt to do so last November was foiled by a clash with Melbourne Cup week and the attendant shortage of hotel rooms. Fortunately, the Victorian Government has not been able to put on a sporting extravaganza to foil our plans this time.

2. Review of last time

As on the previous occasion, I would like to start today by recognising that accountability includes being accountable for what was said last time. I will do this by reviewing how the past six months have turned out against the background of what I told the Committee we were expecting last November. At that time, I summarised our expectations by saying that I thought 1997 would prove to be a good year for economic growth, with GDP growing by about 4 per cent, that inflation would remain below 2 per cent for a while, but with a tendency to pick up as we went through 1998, and that there was a good chance that unemployment would decline. I said very little about the current account and balance of payments, as the outlook for Asia was still very unclear.

We had only two quarters' data on economic growth in 1997 at the time of our previous meeting - now we have all four. The ABS records that GDP grew by 3.6 per cent over the four quarters, and non-farm GDP by 3.8 per cent, slightly less than the 4 per cent that I was expecting. I do not think there is any point in making much of this small difference.

The other reason that I would not make much of this small difference is that the outcome for the labour market turned out to be a bit better than we expected. The average unemployment rate in the first half of 1997 was 8¾ per cent. When we met in November, the most recent figure we had was 8.6 per cent. The run of numbers we have received over the past few months have been either 8.2 per cent or 8.1 per cent. So if you look across the past 12 months, I think you could see a reduction in the unemployment rate of ½ per cent or so. So over the course of 1997 a combination of good growth and moderate outcomes on wages made some inroads into our unemployment rate.

On inflation, I have little to add to what I said last time. Underlying inflation has been 1½ per cent over the past 12 months. We are still expecting that it will rise over the next 12 months, largely because falling import prices, which were pushing inflation down, have given way to increasing import prices. In fact, the fall in the exchange rate has meant that wholesale import prices have risen by 7.7 per cent over the past 12 months, and import prices made their first positive contribution at the retail level to the CPI in the March quarter after seven quarters when they

detracted from it. These changes are not alarming, but they do tend to suggest that we have passed the low point in the inflation cycle.

So I feel reasonably comfortable with our earlier assessment, except in one respect - last time we met, the full extent of the Asian slowdown was still uncertain. In fact, it is quite interesting that as recently as six months ago, most discussions treated the ASEAN Four as being the known extent of the Asian slowdown. We did not know at that stage, although the possibility was flagged, that Korea would join them, that Indonesia would deteriorate significantly further, and that Japan would suffer a relapse into recession. When we take these developments into account, it is clear that a bigger external contractionary effect now has to be factored in. I will return to this subject in more detail later.

3. Prospects for 1998

(a) General

So much for 1997 - what about 1998? In the absence of the external shock from Asia, 1998 was shaping up to be, if anything, a stronger year than 1997. There was nothing in the internal dynamic of the economy which was pointing to a slowdown, and we had every reason to expect growth of 4 per cent plus. That will no longer be the case, and we are now looking at growth through 1998 of something more of the order of 3 per cent. This would probably mean that after a year in which the unemployment rate came down, we might be looking at a year in which it flattens out.

I have already mentioned the outlook for inflation when I reviewed the previous year's results. Broadly speaking, we think that the trough in the inflation rate has passed, it is moving back again into the 2-3 per cent range, but it is not doing so in an alarming way. We expect it to be in that range by the end of this year, and it probably will rise a bit during next year.

(b) Balance of payments

Another part of the economy which in Australia has always been closely watched is the current account of the balance of payments. With domestic demand in Australia growing at or above trend, but with a number of our major export markets declining, it is an arithmetical certainty that the current account has to widen, as it has. This is not a sign of an economic policy failure, and I trust markets will treat it accordingly. A number of people, including myself, have made the point that on this occasion the widening of the current account deficit is not the result of excessive growth in domestic demand, nor is it the result of declining competitiveness because of high Australian inflation, nor is it a counterpart to a large budget deficit. For these reasons, we expect it will not arouse the same excitement as it has in the past, though you can never be sure. At present, our expectation is that the current account deficit in 1998 will be about 5½ per cent of GDP, but if you look at the cyclical behaviour of the current account over the last two decades, you could not rule out it touching 6 per cent for a time.

Imports are probably slowing from their very high growth rate in the second half of last year, but not by much according to the March quarter figures. Over the course of 1998, we still expect them to show their usual behaviour, that is to grow by a few percentage points faster than domestic demand. Exports, on the other hand, cannot hope to keep up last year's pace of 8½ per cent, and a small positive figure is probably what we can expect.

Most of our exports - our rural products and metals and minerals - are sold into worldwide, rather than country-specific, markets. If we cannot sell zinc or copper to Korea, we sell it to another country: the same goes for our rural exports. It means that for two-thirds of our exports,

what we earn is a function of world demand, not of the demand from our specific (largely Asian) trading partners. At the end of the day, the prices for these commodities adjust to clear the market, and that has been happening. The prices of Australian commodity exports have fallen by 9 per cent over the past year when measured in terms of a neutral basket of currencies. At the same time, the Australian dollar has fallen against this neutral basket of currencies, so our commodity prices in Australian dollars - what our exporters actually receive - have gone up slightly. Even for our biggest exports - coal and iron ore - where prices are renegotiated annually, the Australian dollar prices in contracts which commenced in April this year were higher than in the contracts a year earlier. This is an example of the market adjusting - in this case, the foreign exchange market - to shield the export sector (but not the whole economy) from the worst of the Asian downturn.

4. Asia

Having made these points, I do not want to give you the impression that I am downplaying the effects of Asia. To the contrary, the biggest difference between the way we view our immediate future today and the way we viewed it a year ago is clearly the external shock we have received from Asia. While it is true that the Australian business cycle is always affected by the world business cycle, the current Asian crisis is the first significant identifiable external shock we have had for a long time. The last time I can remember something as specific as this was OPEC II in 1979, but that was on a much bigger scale and affected the whole OECD area more evenly. The current Asian crisis is unusual in that Australia has a bigger exposure to it than any other OECD country (other than the two who are actually part of the crisis - Japan and Korea).

We have always been very conscious of Australia's vulnerability to a sharp contraction in Asia. But it has always been our hope, and certainly the guiding principle behind Australia's policy, that the economic problems in Asia could be minimised by prompt action. It was this awareness of possible danger ahead that lay behind Australia's very quick response to the Thai crisis, and the Reserve Bank's willingness to put funds from its balance sheet at the Government's disposal to ensure that Australian participation was not delayed. It also explains why Australia is the only country other than Japan to be a part of all three Asian support packages - those for Thailand, Indonesia and Korea.

Australia has done what it can to help minimise the Asian fallout, but clearly events have turned out worse than we had hoped for. The crisis has spread further than was at first thought likely, it is resulting in larger falls in output and employment in the countries concerned, and finally it has been compounded by the relapse of the biggest Asian economy - Japan - into recession. What started as a currency crisis in Thailand is leading to widespread suffering in a range of Asian countries.

Of course, those countries have some deep-seated economic policy deficiencies - weak banking sectors, too much of what is called "crony capitalism", too much government direction of investment (including implicit underwriting of loans) and insufficient disclosure, poor accounting standards, etc. These deficiencies are common to most countries at earlier stages of development than ours, and they have been around for decades. They did not deter massive capital inflow for most of this decade, and I suppose it must be galling for some of these countries to listen to sermons on their deficiencies delivered by international bankers who, until recently, were happy to ply them with loans. We all have to agree that these countries made policy errors; that is par for the course. Yet I agree with Paul Krugman who, when commenting on the current situation, said: "Yet governments are no more stupid or irresponsible now than they used to be; how come the punishment has become so much more severe?"

These countries have had to make a very rapid adjustment to their external positions to stop their exchange rates from falling below the extremely low levels they reached late in 1997.

They could not rely on a resumption of capital inflow to stop the problem, so the only feasible way was to return their current accounts to surplus. This has involved very tight policies, a very large fall in domestic demand, and very large falls in imports. For the three countries in IMF programmes, we estimate that imports have already fallen by between 30 and 40 per cent. Even though there has not been enough time to expand exports in line with their improved competitiveness, their current accounts have already moved into surplus. Australia's exports to these countries appear to have already fallen roughly in line with their falling imports. Thus, we have received the effects on our trade flows quite early in the piece. In time, when their exports pick up, we should get some benefit from this even if their domestic demand remains weak.

5. How have we coped?

To date, we have coped quite well, largely because we were in good shape going into it with strong domestic demand and low inflation. This was in part due to the fact that we had taken expansionary monetary policy action between July 1996 and July 1997.

The other way in which we have coped well is that our financial markets have behaved very sensibly. It is true that our exchange rate has depreciated against the US dollar, and against major currencies in general, but this is an understandable market reaction to the deterioration in our international trading environment. Apart from a minor panic in January, the whole process has been very orderly.

The bond market too has performed very well. International and domestic investors have clearly drawn a distinction between Australia and our Asian neighbours, and we have not seen any rise in risk premia on Australian bonds. Indeed, we have improved our position over the period, and Australian borrowers can now borrow in A\$ at or below the same rate as equally creditworthy US borrowers can borrow in US dollars. The Australian share market has also risen over the past six months and, even though it has not performed quite as well as some overseas markets, is higher than its former peak in mid-1997.

What is the implication of Asia for the conduct of monetary policy? The simple answer is that it makes it more difficult. The Australian economy has suffered an external shock - a significant reduction in demand for our exports, which will lead to lower export volumes in some cases and lower export prices in others. This will show up in some combination of lower growth and a widening of the current account of the balance of payments. Because of the fall that has occurred in our exchange rate, it will also show up as higher inflation than otherwise. Even if we had perfect foresight, we cannot adjust policy in a way which would avoid these outcomes altogether.

The best we can hope for is a combination which minimises the longer-run disruption to our economy. Choosing the monetary policy to achieve this is not an easy task. It involves constantly reviewing our position in the light of changes to the economy, and our forecasts of future events. Importantly, it will be heavily influenced by how the Asian situation develops. I repeat that the only reason we are foreseeing any slowdown in growth in 1998 is because of the Asian crisis - there was nothing in the domestic economy that pointed in that direction - in fact, it pointed to higher growth. I suspect that in the future evolution of our policy, Asia will be the major influence.

As you know, the Board of the Reserve Bank met on Tuesday and did not make any change to the setting of monetary policy. There had been some speculation over the preceding month that we might ease, but the majority of observers expected no change. Our on-balance view is the same as the majority of outside observers: that is, we judged that the present setting is the right one. As we see it:

- The present stance of monetary policy provides a low interest rate environment which is working to support, rather than restrain, growth. Credit is readily available, borrowers seem to regard current interest rates as attractive, financial wealth is rising, as is private sector leverage.
- Developments in the exchange rate and interest rates charged by financial intermediaries since the last reduction in the cash rate in July last year have worked to magnify the effects of lower official rates. The exchange rate has come down against major currencies, and competition among banks has reduced interest rates to business and personal borrowers.
- The most likely outcome over the next 12 months at the present policy setting is for inflation to return to its target range and for domestic demand to remain at or above trend growth. With a significant reduction in net exports, GDP will probably grow below its trend rate, but some growth slowdown in the short run is an unavoidable result of the external shock.
- Our measured approach to date has served us well in that it has maintained confidence in Australian financial markets. That, of course, does not rule out further changes in policy, but it does impose a constraint in that it means monetary policy has to be adjusted credibly. We do not wish to jeopardise Australia's current good international standing or revive memories of when Australia was regarded as a "boom and bust" economy. We gain a lot from our current reputation for stability - not only does it reduce our borrowing costs, but we can raise equity more cheaply, and we have become a more attractive place for direct foreign investment.

Of course, we recognise that it would also be a mistake to stick too long to a setting of policy in the name of stability if there were good reasons to move. We have to be conscious of the risks to our current assessment, and constantly review them. The major downside risk which we can see is the possibility that the effect of the Asian and Japanese situations might produce a larger slowing in the Australian economy than our current expectations, perhaps indirectly by slowing growth substantially in other trading partners or by seriously dampening domestic demand through income or confidence effects. Such an outcome is not in our view the most likely one - but it has some probability.