Mr Macfarlane comments on monetary policy in Australia

Notes by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, for a talk to Australian Business Economists on 11 November 1999.

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I will say a few words on monetary policy tonight, but they are not intended to be very profound. This is partly because I have recently held forth on the subject in the Chris Higgins Lecture. You will also be aware that we have made a change to monetary policy, issued an accompanying press release, and also issued our regular half-yearly report within the past week or so. With so many public statements in such a short time, we should have got our point of view over to everyone by now. So my comments tonight are not intended to point to any new direction in monetary policy - they are meant only as an elaboration on a couple of points in what we have already said.

We have just been through an exercise in which monetary policy was tightened for the first time in five years. History shows that interest rates have to go up as often as they go down, but although we all know this, Australia has had particular difficulty in handling these rises in the past. Not that the problem has been confined to Australia, many others have had the same experience. Tightenings have tended to be delayed for too long, and when they have finally occurred, they have often been quite abrupt and accompanied by heated political argument. This was certainly the pattern in the 1970s and 1980s, although we made a big step forward in the 1994 tightening as I emphasised in my recent lecture.

On this occasion, I would maintain that the tightening was neither delayed nor abrupt, and it certainly took few people by surprise. But more importantly, the response to it by the economic community and by politicians was extremely civilised. Although some people expressed disagreement, I detected no heat or acrimony in their words. In the political sphere, the comments made by the Government, the Opposition and others showed that we have gone a long way down the path of depoliticising monetary policy. This is a very welcome development, and although there were a number of steps along the path, the most important one was the joint signing of the *Statement on the Conduct of Monetary Policy* in 1996.

Those who disagreed with our decision to tighten tended to point out that there were few signs that the economy was overheating, that inflation was not threatening to exceed the target over the forecast horizon, and that wages growth was not heading up (as in 1994). As a description of the economy, that assessment was essentially correct, and we have no desire to dispute it. But the implication for policy which was drawn from this assessment was not, in our view, correct. In our view, it reflected a rather dated approach to the application of monetary policy.

The traditional view is that you only begin to tighten monetary policy when things have become, or clearly will become, overheated or, in other words, out of control. The tightening in those circumstances is a sign that something has gone wrong and is, in effect, an admission of policy failure. Hence, the ample scope it provides for criticism, particularly in the political arena. The unusual aspect of the recent tightening is that it occurred before things had become, or were about to become, out of control. If it is successful, it will mean that they do not get out of control in the foreseeable future. That is what is meant by the term “pre-emptive”.

But clearly we could not have just picked any period when the economy was performing well and chosen to tighten monetary policy and claimed it was done in order to be pre-emptive. There had to be good reasons why it was now - in the final quarter of 1999 - that we made this decision. Although we have explained this in our *Semi-Annual Statement*, I would like to spell out a couple of aspects of this in the time remaining tonight.

1. The international aspect

Although it is only a year ago, most of us have forgotten how gloomy the prospects seemed in the second half of 1998. This was the time when the Asian problems had spread via Russia and Latin America to Wall Street itself. If you look back at the press release which accompanied our easing of monetary policy in December 1998, you will see it referred to the expectation by official and private forecasters that 1999 would be a worse year than 1998.

As we now know, the world did not turn out that way - 1999 has turned out to be a stronger year than 1998, and both official and private forecasters are now expecting 2000 to be stronger again. I do not wish to quibble with this assessment. I merely wish to record that from about the middle of 1999, markets around the world began to recognise that the accommodative stance of monetary policy by major central banks that had been so appropriate for 1998 and early 1999 was starting to look less appropriate as 1999 progressed and strengthened. This reassessment happened first in the United States and was soon followed in other English-speaking countries and then in Europe.

As usual, the markets were quicker off the mark to raise market interest rates than they needed to be, but they were broadly correct. Since mid-year, we have seen the United States, the United Kingdom, Australia and the ECB tighten monetary policy. I suspect there will be a few more countries to come in the not too distant future.

2. Domestic events

Just as the weakness of the world economy did not come to pass, a similar expectation of weakness in Australia failed to materialise. Real GDP in Australia again grew by over 4% in the 12 months to the June quarter and will probably still be showing a similar rate in the 12 months to the September quarter. This measure may slip for a time as we drop off some of the high quarterly growth rates from our calculations, but we think growth will remain robust over the next 12 months.

Similarly, the quite lengthy period during which inflation was undershooting our target seems to have come to an end. The CPI inflation rate would already be a bit over 2% apart from the Government's reduction in the Health Rebate Levy. Although some of this result has been due to rises in oil prices, measures of underlying or core inflation, which are largely unaffected by oil prices, have also risen by about 2% over the past 12 months.

Thus, the period where the Australian economy was experiencing a contractionary impact from abroad and where the outlook was for weaker growth and sub-2% inflation has now well and truly passed. The monetary policy that was appropriate for that period is no longer appropriate to the new circumstances that we face. That is the main reason behind the tightening of monetary policy we undertook after our November Board Meeting.

This move was what the flexible inflation targeting framework suggests should happen. There is some confusion, however, on this point and so it is worth spending some time to clarify it. Some interpretations of the target imply that the Bank is not supposed to contemplate any rise in interest rates until the upper end of the target is threatened. This is equivalent to saying that the most expansionary setting reached during the downward phase of the interest rate cycle should be maintained until such time as a move to a clearly restrictive setting is required, and only then should a move be made. (That virtually guarantees that such moves will be large.) It is as though policy has to operate only with settings of maximum "go", and heavy braking.

This is a reading of the framework we do not share. There is a range of settings of the instrument between "maximum go" and "heavy braking". Most of the time we would expect interest rates to be in that range.

Let us look at two possible situations where monetary policy should be changed:

- The first is when inflation is above the target. In this situation, the inflation targeting framework would say to raise interest rates to a setting which would bring inflation back to the target. But once the higher rates had done their job, they should be gradually reduced to more normal levels. This is what happened in 1996. We did not wait until our forecast had inflation falling below 2% before we started to ease.

- The second is when inflation is below the target. In this case, the framework would call for a setting of interest rates which would, over time, allow inflation to go back up to the target. Once it is clear that such a setting had done its job, the framework calls for it to be replaced by one more likely to keep inflation at the target. The framework does not envisage the policy setting being maintained until something goes wrong.

Now some may object that all this smacks of fine tuning. I agree that we should not delude ourselves that the economy can be precisely controlled so that inflation stays within or close to the band, even when there are no external shocks. The point remains, however, that even if the process is not precise, the instrument does not remain at its most extreme setting once that is no longer needed. As the outlook changes, and as the balance of risks shifts, it is appropriate also for the policy instrument to shift.

3. What about the GST?

Some people have not been convinced by the arguments I have used above. Some still cannot understand why you would tighten unless the economy was overheating, and assume that there must be a hidden agenda. Others are keen to play the old game of trying to find a political dimension to monetary policy. This has led some people to say that the real reason is our fear of the inflationary effects of the GST, but that we are too diplomatic to say so. I am sorry to disappoint the proponents of this view, but that is not the case.

- If the GST was the reason for tightening monetary policy, why have the Fed, the Bank of England and the ECB tightened monetary policy? I am not aware of the forthcoming introduction of a GST in any of these countries.
- Our starting point has always been that the imposition of the GST should not have an effect on wages because wage earners will gain more from the accompanying fall in income tax rates than they will lose from the introduction of the GST. The net effect of the tax changes will be to increase the disposable income of wage earners by more than the increase in their expenditure, as is evidenced by the fact that the package involves a cost to the Budget.
- Monetary policy is based on a view that inflation will be within the target immediately before the GST is introduced and that it will be back within the target a year later. This view, in turn, is based on the assumption that there will be no second round effects due to higher wage outcomes as outlined above. If we started to observe behaviour that indicates that this assumption was not correct, then monetary policy would act upon it. We are not acting at present on the expectation that this assumption will be violated - we are acting in the expectation that it will hold.

4. The need for a long expansion

We have made a point of saying that the recent monetary policy tightening is designed to increase the length of the expansion. Again, this may not be universally accepted, as many people associate tightenings with the end of expansions.

Our position may seem the wrong way round to those who have a more traditional view of monetary policy, but I want to make a few points of clarification:

- First, this is not a new position on our part. We did not wait until we already had the runs on the board before specifying our aim was to have a long expansion. Before I took up this job in early September 1996, I was asked by the Parliamentary Committee why you would tighten in an expansion, and my reply was as follows:

"In the long run, if you want to have a good performance on growth and a good performance on employment, the best thing you can do is to pursue policies that extend the length of the recovery. In the past, we have sometimes had the problem of very strong expansions and a build-up of very big inflationary pressures followed by sharp contractions. In the sharp contraction unemployment goes up very quickly. The way that monetary policy can contribute to a better outcome is not to have a short sharp expansion which generates inflationary pressures, but to have a long slow one. To have a long slow one, it means that you occasionally have to be pre-emptive, at the first signs of things getting out of control you have to squeeze down."

Please excuse the inelegant phrasing - it was an "off the cuff" reply to a question from a Committee member. But at least it shows that we have been consistent on this point since at least mid-1996.

- The second point is that if you have a very long expansion, it seems reasonable to me that it will include a number of phases of monetary policy. It is not as though, in order to get the expansion, you continuously ease monetary policy and then as soon as you tighten it, it brings the expansion to an end and you then experience a recession. It seems far more likely now that a long expansion will include perhaps two or three phases of tightening and easing, as monetary policy seeks to extend the length of the expansion. And, of course, if it is a low inflation expansion, *as it would have to be to in order to be a long one*, the tightenings and easings of monetary policy may then take place over a relatively small range of interest rate settings.

5. Concluding remarks

I was going to conclude by saying a few things about communicating with the public, or what is now known as transparency. But the more I think about this, the more complicated it gets. So the one thought I will conclude with is this. Sometimes it is possible to be reasonably direct when talking to the public, as I believe we have been over the past few weeks. That is because we had a clear view about what needed to be done. But more often than not, you find yourself in a grey area where there is not a strong case to do something, where all incoming data have to be evaluated on their merits and policy options weighed up. In such situations, you cannot give views about the direction of policy - you cannot say more than you honestly believe - and that will often disappoint people looking for a clear guide to future action.