

I J Macfarlane: Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration

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, Melbourne, on 22 May 2000.

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It is a pleasure to be here in Melbourne again for our regular half-yearly appearance before the Committee. I know we met in March and touched upon monetary policy, but that meeting was mainly about Reform of the International Financial System. On this occasion, we will no doubt have a lot more time to spend on monetary policy.

I would now like to start this meeting in the traditional way by reviewing the forecasts I gave to the Committee last November, and then outlining our current views on likely developments over the year ahead.

Last November, with half a year's data available, I said that we expected GDP growth through 1999 to be 3½%. In the event, it was 4.3%, which continued our record of expecting a modest slowdown that did not arrive. I also said that we expected growth to be 4% in the year to June 2000, and on present indications this still looks likely, even though the rate may well dip below 4% in the year to March. Of course, it will be more difficult than usual to read the true trends this year, with expenditure being shifted between quarters because of the GST, and the boost from the Olympics.

Most monthly indicators of economic activity point to a slowing so far in 2000. However, it is too early to know whether this merely represents the slowdown in domestic demand that we have all been waiting for, and we have had built into our forecasts for some time, or whether it represents something bigger - a significant slowing in GDP growth. Our judgment is that we are seeing mainly the former, namely a change in composition of GDP growth. In other words, the slowing in private domestic demand, which is undoubtedly occurring, will be largely offset by the boost that we are getting from net exports and will soon get from fiscal policy.

While we expect some slowdown in GDP in the sense that we do not expect to repeat the 4½% average that we achieved in 1997, 1998 and 1999, we still see quite solid growth ahead. We have no quibble with the sort of figures that were contained in the Budget Papers showing growth in GDP of 3¾% over 2000/01. Such an outcome would be quite a remarkable achievement compared with the record of the past three decades, but I will return to that subject later.

On inflation, in November we forecast that the CPI would rise by 2% in the year to December 1999 and by 2¾% in the year to June 2000. We got closer to the mark in these forecasts - the outcome for the year to December 1999 was a little lower, at 1.8%, and we now think that the figure for the year to June 2000 will be a little higher, at 3%. Some of the increase in the CPI is due to temporary factors, so that the 3% for the CPI corresponds to about 2½% for underlying inflation. Thus we have finished the period when inflation was below the bottom of our band - a period that lasted longer than any of us expected - and we have moved back to where the CPI is near the top of our band, but partly due to some temporary factors.

Where to from now? This will be particularly hard to judge, given that for at least a year the year-ended figure for the CPI will be obscured by the once-off lift due to the GST, and then the effects of the abolition of wholesale sales tax.

At present, we feel that the most likely outcome for inflation once all the dust has settled - i.e. once we are well into 2001/02 - is that it will be in the 2-3% target range, probably in the upper half. As usual, there is a large margin of uncertainty attached to that forecast, but the adjustments to monetary policy

which have been made over the past six months give us more confidence that inflation should be contained.

I would now like to move away from the short term and turn to the medium term. Most developments in monetary policy can only be understood fully in this context although, by necessity, most commentary concerns short periods such as month to month, in line with our Board Meeting, or even shorter, such as day to day, reflecting deadlines of the daily press.

I will start by restating the logic of the inflation-targeting framework, which is the underpinning of our whole medium-term approach. We have an inflation target that says inflation should average somewhere between 2 and 3% in the medium to long run. We accept that at times it will be outside this range, but if we think this is going to happen more than briefly it calls for adjustments to monetary policy which will return inflation to the target and then keep it there.

We have based our monetary policy on this framework not because we only care about inflation, but because we think it will give us the best result for the whole economy in the long run. In particular, if applied sensibly, it will enable the economy's average growth rate to reflect its potential growth rate and therefore deliver the maximum sustainable increase in employment and living standards.

We have already seen nine years of expansion with growth averaging over 4%, a considerably longer expansion than we were able to achieve in the 1970s and 1980s. And there is every prospect that the expansion will continue for a good deal longer. For the first time in my working life, Australia in the 1990s has come near the top of the decade growth rates among developed countries. We grew faster than the United States, and only Ireland, among developed countries, recorded faster growth.

This growth occurred at a time when our inflation rate averaged about 2¼%, a good deal lower than in earlier decades, and comparable with international standards. There was also less variability from year to year in growth than in earlier expansions, although some variability is inevitable: we have had annual growth rates at over 5% and at less than 3% during this expansion, yet its fundamental momentum has remained intact. I think the system has proved itself to be a very good one, and I am confident that it is the best way to ensure that monetary policy makes sense in the medium term.

It is also worth noting that during the course of the expansion, we have had one complete cycle in interest rates - rises in 1994, then falls in 1996-98. These played their part in sustaining the expansion. The increase in official interest rates of 125 basis points that has occurred over the past seven months has to be seen in this context. For the present expansion to continue as long as possible, monetary policy has to be adjusted as circumstances change. The economy has been undergoing a shift from a period when inflation had been below the target to one where it was going to be in the target range. Without policy adjustment, there was the prospect that it would, in time, rise above the desired range. Until relatively recently, we were receiving information on economic activity that indicated the economy could even have been accelerating beyond the 4½% growth that had prevailed over the 1997 to 1999 period. From our perspective, the decisions to raise interest rates were relatively straightforward.

The situation is not as straightforward now. Signs of a near-term acceleration in growth have gone. As discussed earlier, there are now signs of slowing domestic demand, some of which may be in response to the tightenings that have already occurred. Other things being equal, this should be helpful in containing inflationary pressures. Other developments, principally the lower exchange rate, will act in an expansionary direction, and potentially put upward pressure on inflation. It will be a difficult time for reading and forecasting the domestic economy, and all this will take place against the backdrop of an international economy dominated by the uncertainty of the unfolding events in the United States.

Markets, as always, will be looking for guidance. The more thoughtful will appreciate the complexity of the situation, the less thoughtful will be expecting to be told the "formula" that we are using. Unfortunately, there is no "formula" other than the guiding principle of the inflation-targeting regime. This means that we will be assessing the outlook for inflation as judged by the factors which form the basis of our forward-looking approach to monetary policy.

Growth in demand and output, and the extent to which that places pressure on the economy's capacity, are clearly important. We judge this by examining all the available monthly and quarterly time series

data on economic activity, including those which give an impression of intangible factors like “confidence”. We monitor trends in commodity prices, wholesale prices, and wages, as well as the CPI and the various measures of underlying inflation derived from it. The wages data may be particularly important in the year ahead, given the difficulties in interpreting price indexes. We have to allow for structural changes - such as the increased competitive pressure in goods markets. This has been an important ingredient in maintaining downward pressure on many prices, and should be helpful in negotiating the introduction of the GST. Inflation expectations are important - since it is the anticipation of price rises that drives many decisions. We need also to consider the financial side of the economy - the expansion of credit, trends in asset markets and the extent of risks which may be building up there.

We then complement this essentially domestic analysis with an appreciation of what is happening in the international environment in which Australian producers and consumers make their decisions. We can not afford to ignore the world price level, world interest rates, or the variable which connects both of them to the Australian economy - the exchange rate. Changes in the price of imports in foreign currency terms can have a large impact on domestic inflation as the OPEC oil price rises of the 1970s showed. The recent oil price increases demonstrate the same principle, on a much smaller scale. Rises in a range of raw materials prices, driven mostly by global trends, are also having an impact on the cost of producing goods in Australia. In the opposite direction, the subdued world price environment of 1997 and 1998 helped contain any inflationary fallout from the lower exchange rate we experienced during the Asian crisis.

Movements in the exchange rate clearly affect inflation and, as such, are an integral part of any inflation-targeting regime. That is why they are frequently mentioned by central banks which operate monetary policy in this way. But there is no mechanical relationship between the level of the most frequently quoted measure of the exchange rate - the rate against the US dollar - and the future domestic price level. For a start, the price effects are better approximated by the trade-weighted index. Second, a temporary movement in the exchange rate may have little or no effect on prices and so some attempt must be made at estimating medium-term developments, or at least market participants’ expectations of medium-term developments. Finally, a change in the exchange rate may have different implications if it primarily represents international views about our economy and policies, or if it is because we are being swept along with other countries in an international adjustment process.

All of these factors are relevant and have to be taken into account with due weight. But that is done under the unifying framework of the inflation-targeting approach to policy. As I have noted above, this approach has delivered tangible benefits. I am convinced that it will continue to do so.

Mr Chairman, it is a difficult time to be making monetary policy. The world environment is changing. Most of these changes are for the better - our region is in recovery, as opposed to the severe recession of two years ago, and global growth is strong. Our terms of trade are improving. Some other changes - in world capital markets, for example - are rather less benign for Australia. Adapting to these changing circumstances presents a challenge.

At such times, it is important to keep our eye on the main goals - to sustain a long expansion, and to address early potential imbalances which could impede the expansion’s continuation. However, we cannot assume that we have a choice of outcomes for the Australian economy, in terms of growth and inflation, which is invariant to what happens in the rest of the world. While we are benefiting from the stronger world growth compared with recent years, we will also be affected by the contractionary effects of the lift in world interest rates. As the forecasts I mentioned in the beginning show, the year ahead will most likely be one of slightly reduced growth, and somewhat higher inflation, compared with the exceptional outcomes of recent years.

But if we can sustain the economic expansion through a tenth and eleventh year, even if its pace moderates for a time, and at the same time keep inflation low, we will have achieved something which has eluded us for three decades. That is a very worthy goal. It is what we aim to do.