

I J Macfarlane: Economic growth, inflation and monetary policy in Australia

Opening statement by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Finance and Public Administration, in Wagga Wagga on 1 December 2000.

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I would like to start by endorsing the remarks of the Chairman and saying what a pleasure it is to be in Wagga Wagga for the first hearing to be conducted outside Sydney, Melbourne or Canberra. Like you, Mr Chairman, I think it sets a good precedent for future meetings, even if it does represent a cautious start, given that Wagga Wagga is half-way between Melbourne and Sydney and not that far from Canberra. Perhaps the Committee will be more adventurous in its future choices. I would also like to record our thanks to the Mayor of Wagga Wagga and his colleagues and to Kay Hull (a member of this Committee) for their hospitality earlier this morning.

As usual, I would like to start by reviewing the forecasts I put before the Committee at the previous meeting in Melbourne in May. Starting with *economic growth*, you may recall that the Australian economy grew by about 4½ per cent per annum in 1997, 1998 and 1999, and, as usual, we were expecting a modest slowdown in the year to June 2000. The forecast I put forward for that period was 4 per cent, and the outcome was 4.7 per cent, continuing our tradition of modest underestimates of economic growth.

For the year to June 2001, I said that we had no quibble with the figure of 3¾ per cent contained in the Budget Papers, nor would we quibble with the recent update which puts it at about 4 per cent. It is largely a matter of rounding, and not much should be made of small differences: the figure is meant to suggest again some modest slowing from past growth rates. I would note that the number for GDP growth involves a substantial slowdown in final domestic demand – from about 6 per cent growth to about 3 per cent – which is mostly offset by a further swing in net exports into positive territory and the assumption that the inventory rundown recorded over the past year does not occur again.

On *inflation*, the story is a little more complicated. Last time we met, I said I expected the CPI to rise by 3 per cent in the year to June 2000 – the actual outcome was 3.2 per cent. Not a very big difference, but the first time for quite a while that the outcome was higher than forecast. The reason for this was the higher-than-expected oil prices. When we look ahead, we should make sure our forecast goes beyond June 2001 in order to avoid the “once-off” lift to the price level attributable to the GST. At the last hearing, I suggested that inflation could be in the upper half of the 2 to 3 per cent range once we are well into 2001/2002. Our *Statement on Monetary Policy*, which was released about two weeks ago, forecasts that inflation would be around 3 per cent by that time. This small increase is primarily due to the lower exchange rate now prevailing compared with the middle of the year.

You are probably tired of being reminded that we are still in the longest expansion we have had for three decades, but that fact has to be the starting point for any economic discussion. When we receive the September quarter national accounts in a couple of weeks time, I expect to see them confirm that the expansion has continued unabated into its tenth year. During this period, the growth rate has averaged 4.2 per cent per annum, and most of the annual rates have been between 3 per cent and 5 per cent, with a few outliers above and below this. Over the whole period, inflation has remained low, which, of course, has been a major factor behind the expansion’s longevity. And, in turn, this has contributed to a fall in the unemployment rate of nearly 5 percentage points to 6.3 per cent.

Despite this record, we should not become complacent – we should always be looking ahead to see where the risks to the outlook are likely to come from. Not surprisingly for an economy like ours, which is in reasonable balance, the risks are on both sides. That is, while we are comfortable with our present forecast, there are circumstances which could lead to a stronger economy and hence a speed-up in inflation, and others that could lead to a greater slowdown in economic activity than our current numbers indicate.

I will start with the risks to the inflation outlook. Obviously, the current year has not been an easy one in this respect. In addition to the GST-induced lift in the price level – which was easily foreseeable and appears to have gone according to plan or better – we have experienced two upward “shocks” in the form of the rise in oil prices and the fall in the exchange rate. It is never easy to digest three such events in one year, so we have to be especially vigilant to make sure that any rise in prices is “once-off”, and on-going inflation does not rise to the point where it threatens our medium-term objectives. So far, we seem to be on track to pass this test. The GST caused a smaller rise in the September quarter CPI than expected and, on balance, the data on wages suggest that wages are growing in a way consistent with our inflation target. But there is still some way to go before we can be confident that these temporary factors do not push us off course. If it turned out that the economy was more buoyant than we think, the chances of the shocks feeding into higher on-going inflation would rise.

I will now talk about risks that the outlook for economic activity could be weaker than we currently envisage. But before doing so, I should remind you that our forecasts already embody a slowing in GDP growth compared with last year, and a more pronounced slowing in domestic demand. So we are not oblivious to the presence of some factors which point to a less buoyant outlook than we have had over recent years.

The first of these risks is the world economy, and the United States in particular. For some time now, most observers have expected lower growth in 2001 than in 2000 for both the world economy and the United States, but there is always the risk that the turnaround could be sharper, particularly if there is a shake-out in asset prices. No-one can be sure that, after such a long expansion, the United States can achieve a soft landing, but at present the odds point to this result.

On the domestic front, the area of weakness that many people point to is in housing construction. There is no doubt that there will be a big contraction here, but we should remember that it was predictable (and has been predicted by virtually all forecasters for some time). We have just gone through a period when activity in the housing sector was really quite frenzied. At its peak in the June quarter, investment in dwellings was at its highest level ever as a percentage of GDP. A lot of activity in the housing sector that would normally have taken place this financial year was brought forward into last financial year in order to get in before the GST, so the cycle in housing is likely to be more pronounced than normal. The rises in interest rates, no doubt, also played a role, but they were small compared to the GST effect.

The third risk that some people have focussed on is business confidence. We have to be careful here because we have over a dozen surveys of business confidence and they do not all show the same results. Even so, it is true to say that business confidence is not as high as it was a year ago and that it has fallen in recent months. I think the recent fall owes a lot to the realisation that the housing and construction sector will be weak, to the fact that a number of businesses have only recently had to face up to the practical implementation of paying the GST, and to rising petrol prices.

What does the foregoing mean for the economy and for monetary policy? Starting with monetary policy, our main message is that it will continue to be conducted according to the medium-term principles contained in our inflation targeting approach. We think this approach has served the economy extremely well, not only in the direct sense that it has maintained low inflation, but in the wider sense that it has provided the preconditions for sustainable growth. We will be looking closely at all the influences on inflation over the coming year – including the demand pressures in the economy, the growth of wages, and the level of the exchange rate – in order to judge how they will collectively influence the outlook. Monetary policy will then be set accordingly.

We will also, of course, be closely watching developments in the real economy, the labour market, financial markets and our exports and imports. There is a wide range of statistics available on an almost daily basis, from the Bureau of Statistics and from other sources, which chart the course of these economic variables. You only have to read the daily press to see how much attention is paid to these statistics. We at the Reserve Bank, of course, follow them in great detail, something we are able to do because we have a good staff and a lot of experience at examining them. But I want to suggest to you that this sort of data gazing, important though it is, is only one aspect of assessing likely developments in the economy and, on its own, can at times give misleading signals. The problem with

statistics is that, as well as containing systematic information, they also contain a fair bit of random variation and sampling error. Sometimes this means that we get a group of strong statistics arriving together or a group of weak ones, which may signify nothing more than the statistical anomalies referred to above. If we rely only on these statistics to form our view of the outlook, we run the risk of regularly swinging from optimism to pessimism and back again, depending on relatively short-term variation in the data.

Obviously, other approaches are needed to augment exclusive reliance on statistical observation and so help to identify the underlying direction of the economy. There are many advocates of approaches such as sophisticated econometric modelling, extensive industry liaison, and examination of leading and lagging indicators or the forecasts embodied in financial prices. All of these have their merits and can provide a broader perspective. But there are two other approaches that I would like to remind you of.

The first is to go back and examine previous expansions and ask what were the imbalances that brought about their demise, and then to see whether those imbalances exist at present. I did this earlier this year in a speech in Melbourne,¹ where I identified a number of domestic imbalances in previous cycles: high inflation, a wage surge, overvalued asset prices, excessive physical investment and excessive credit growth. Not all of these were present towards the end of earlier expansions, but usually two or more were.

In looking at the Australian economy at present, it is hard to see evidence of any of these imbalances.

- Underlying inflation is about 2¼ per cent, rising to 3 per cent over the forecast horizon.
- Wages are growing at somewhere between 3 and 4 per cent.
- The share market has risen over the year, but does not seem overvalued compared with many overseas markets. House prices have risen over recent years, but appear to be stabilising at present; rises in commercial property prices have been quite restrained.
- There has been no evidence of over-investment or over-capacity in plant and equipment or construction.
- Credit to households is still growing strongly, but appears to be moderating. Credit growth to businesses has not been unduly strong at any stage in recent years.

Overall, I think it is hard to find signs of the type of imbalances that occurred in the early 1970s, late 1970s/early 1980s and late 1980s which led to such unhappy results. Many people would add the current account of the balance of payments to my list, and point out that in the later stages of previous expansions, fast economic growth led to a widening in the current account deficit. Again, we are different this time in that the buoyant domestic demand growth we have experienced over the past year has been accompanied by a decline in the current account deficit.

Of course, I have only listed domestic factors that give rise to imbalances and imperil the expansion. As I said earlier in my introduction, the world economy plays an equally important role, but we have no control, or even influence, over that. It is possible to construct disaster scenarios for the world economy, and no doubt some will, but I am comfortable sticking with the majority in assuming a modest slowdown in world growth or, in current parlance, a soft landing.

No two economic expansions are the same; each of the previous ones differed, and the present one has its own unique features. As a result, we cannot rely only on cyclical comparisons such as I have just presented, but they are a helpful part of any overall assessment. A second approach, which I think is a useful reality check, is to look at how the present setting of policies is affecting the economy.

¹ "Managing the Expansion", Address to the Economic Society of Australia (Victorian Branch), Melbourne, 11 February 2000.

On monetary policy, there is a tendency for attention to be focussed on changes in interest rates, even when each change is quite small. It is at least as important to look at the *level* of interest rates in nominal and real terms, and ask whether their present setting involves a significant risk that the economy will overheat or contract. As you know, a year ago we thought that the continuation of the then setting of interest rates would risk the former outcome. That is why we moved to our present setting, which we would characterise as being in the neutral zone, i.e. not presenting either of the two risks to any substantial extent. Because it is in this zone, there is no overwhelming case to move it in a particular direction at present. Overall, the main point for present purposes is that you could not claim that the current setting of interest rates is inhibiting the growth of the economy.

Another important influence on the economy which is often put under the heading of monetary policy is the *level* of the exchange rate. I do not wish to spend much time on this subject today because I devoted a whole speech to it less than a month ago.² Suffice to say that I do not think there is anyone who would deny that the current level of the Australian dollar makes our exporting and import-competing industries super-competitive, and hence it is exerting an expansionary influence on the economy.

On fiscal policy, the need to more than compensate consumers for the imposition of the GST ensured that it moved in an expansionary direction between last financial year and the present one. Again, I think we can all agree that, even though the budgetary position will remain in surplus for medium-term purposes, the current stance of fiscal policy is not imposing a contractionary influence on the economy.

Overall, therefore, I conclude that because the economy has not developed the imbalances of the past, it has not been necessary to attempt to remedy them with the sort of counter measures in the fiscal and monetary areas that were often needed in the past. This is another way of saying that we have, in my opinion, avoided the boom-bust cycle in economic policy, and hence have an excellent outlook for the coming year.

I have no further comments to make on the economy at this stage, but will be happy to answer your questions. The only other point I would like to make concerns the economics of banking. In the past, we have often provided to the Committee a paper on some banking subject, such as bank margins or bank fees and charges. On this occasion, there is no special paper, but we have recently finished a major study, in conjunction with the ACCC, on interchange fees in credit and debit card schemes. We will be happy to answer any questions on that study.

² "Recent Influences on the Exchange Rate", Address to CEDA Annual General Meeting Dinner, Melbourne, 9 November 2000.