

I J Macfarlane: Recent financial and economic developments 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, Sydney, 4 June 2004.

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It is a pleasure for me to be here in front of the Committee once again. As usual, I will start by reviewing the forecasts I gave to the Committee six months ago in Brisbane, then provide you with an update of our current forecasts. I will then move on to discussing the risks to these forecasts, both in the upward and the downward direction.

Last December we thought that GDP growth in calendar 2003 would be about 3½ per cent. We now know that it came in at 3.9 per cent, with the second half of the year being a lot stronger than the first half, but with growth slipping to 3.2 per cent in the four quarters to March 2004. Our forecast for growth through calendar 2004 is now 3¾ per cent. We began to lower our forecast because of weaker-than-expected exports and retail trade and stronger imports. We then raised the forecast following the Budget, but have lowered it again to take on board the March quarter national accounts released two days ago. I must say, however, that I think the market has over-reacted to the March quarter GDP figure. It only lowered our forecast in the mechanical sense that one of the four quarters is now lower than in our previous forecast. It did not materially change our view about the trajectory over the rest of the year, if anything it raised it.

On inflation, we had forecast 2¼ per cent for the CPI increase over calendar 2003 and it came in a bit higher at 2.4 per cent, but has since receded to 2 per cent in the four quarters to March 2004. For calendar 2004, headline inflation will be heavily influenced by movements in oil prices, so it is best to look at underlying inflation. We are still forecasting that underlying measures will be running at about 2 per cent, as we did last time we met. By end 2005, both headline and underlying measures are likely to have moved up to about 2½ per cent. So we still have a shallow saucer-shaped profile for underlying inflation over the next year. Given the recent rise in petrol prices, the headline increase is likely to be higher than the underlying in the short run.

This is a pretty good outlook for growth and inflation, both in absolute terms and, more particularly, relative to how things might have turned out. I would like to illustrate this latter point by referring back to a framework I put before the Committee a year ago when we met in Melbourne. This contained four possible scenarios, which I will recap. The first was:

“a weakening world outlook and an abating of domestic credit and asset market pressures. This would provide a reasonably clear prognosis for monetary policy. In other words, if it were weak internationally, and weak domestically, that would be easy. In the other direction, so too would a combination of a clear strengthening of the world economy and continued domestic buoyancy. That would be easy. A third possible combination, and the most favourable one for Australia, would be a firming world economy and an easing in domestic pressures, resulting in more balanced growth for the Australian economy.

But the combination that would be most damaging to the Australian economy would be if the household sector were to continue putting itself into a more exposed position at the rate it has over the past few years while, at the same time, a further weakening of the world economy was starting to feed through to Australian activity and incomes.”

The last-mentioned of these possible outcomes, and the most unfavourable, was a distinct possibility in the middle of last year, but fortunately it did not come to pass. What occurred instead in the second half of last year was the second-mentioned possibility - a strengthening world economy and a continuation of domestic credit and asset market pressures centred on housing. This was the environment in which we decided twice to raise the cash rate.

What has happened so far this year - although it took some time to clearly identify it - was the third-mentioned possibility - a transition to a set of conditions in line with a firming in the world economy and an easing in domestic pressures. This was the most favourable outcome and the one most likely to result in a more balanced growth for the Australian economy. I outlined this in a speech I

gave to Macquarie University in April and we spelled it out more fully in our quarterly *Statement on Monetary Policy* published last month.

The fact that conditions began to develop along these lines is also the reason why, after two rate rises in late 2003, we have not seen the need for action on monetary policy in any of our Board Meetings this year. In short, we have been comfortable with developments - a lot more so than we were for most of last year. But, as always, there are risks to the outlook, so I will spend the rest of my presentation discussing them.

On the external side, consensus forecasts for the growth of the world economy in 2004 put it well above 4 per cent, with a similar figure for 2005. Certainly, the bulk of the economic data supports this relatively optimistic outlook. We are in the third year of an international expansion, and unless something unforeseen comes along, we should expect the expansion to last for a good few years longer.

This is not the impression you would get by following press reports of financial market developments, where downside risks to the outlook always seem to be easier to identify than upside ones. The risk of a further rise in the oil price is a constant concern, and there is some substance to these apprehensions, but I will say no more on the subject at present as Mr Stevens has already delivered a piece covering it a couple of days ago. A number of others in the market worry that policy tightening in China will be overdone, leading to a collapse of the Chinese economy. I have more confidence in China than that, and welcome the news that the Chinese authorities have been taking steps to rein in excessive investment. More generally, financial markets have had difficulty coming to grips with the fact that the long period of very low world interest rates must come to an end, and that they will have to adjust to an international environment of rising world interest rates over the next few years. Overall, we think these concerns are overdone and we are comfortable working on the assumption that the consensus forecast for a good world recovery is a reasonable one. We should also note that higher oil prices and higher interest rates are a symptom of global strength, not global weakness.

We should also not rule out the risks on the upside. It may turn out to be the case that very low world interest rates were kept in place for too long a period. In this case, we could see greater inflationary pressure than we currently expect. In this scenario, I believe the main result would be a faster rise in world interest rates, as markets reacted to the prospect, and the reality of central banks acting to keep inflation under control.

Turning now to the Australian economy, I want to start by re-emphasising that monetary policy is determined by developments in the economy as a whole, not by developments in any one component. For example, for much of 2002/03, domestic demand was increasing at an exceptionally strong pace, but the external sector was subtracting from growth. Inflation at this time was also above 3 per cent. Even so, we did not use monetary policy to rein in the rapid growth of domestic demand because, for the economy as a whole, growth was not excessive and was not threatening our inflation objective over the medium term, despite being above it in the short run.

While monetary policy is directed at the economy as a whole, it does not mean that we have to direct an equal amount of attention to each of its components. Those parts that are obviously exhibiting a serious imbalance will attract more of our attention than those that are relatively well behaved. This explains why we have spent so much time talking about, and researching, the excessively rapid growth in housing credit and, until recently, house prices. While other economic variables were more important for the overall macro-economic outlook, for example consumption and wage growth, their behaviour was not as clearly aberrant and therefore not in need of such intensive study.

The forecast for GDP growth in 2004 that I presented before is based on the view that domestic demand will slow from its former rapid pace, but at the same time the subtraction from growth due to the external sector will gradually diminish. Consumption has recently slowed a bit, although it continues to be supported by strong employment growth and will benefit from the tax cuts later in the year. Business fixed investment, particularly in building and structures, will add to growth but not to the same extent as in recent years. Residential investment is expected to subtract from growth and government spending will add to it. Overall, expected GDP growth of 3¾ per cent would be a good outcome. At this stage, we are not assuming a significant drought effect over the coming twelve months, but this remains a downward risk, given the dry conditions prevailing in some parts of the country so far this year.

On the inflation front, we do not see a problem over the next twelve months. Beyond that, the picture is of necessity more difficult to quantify. Last time we met we were slightly troubled by the fact that

inflation in the non-traded sector was over 4 per cent, and that if this continued it might imply a medium-term outlook for inflation somewhat above 3 per cent. This is still a risk, but we have taken some comfort from the fact that some of the sectors that were pushing it up - such as house-building and property services - should slow as the pressure comes off the house-building sector. The continued modest growth in average wages to date also gives us some confidence. To the extent that there is an upward risk on inflation in the medium term, it is more likely to come from international developments as the world recovery gathers momentum.

I will conclude by saying a few words about housing credit and house prices. As we said in our quarterly *Statement on Monetary Policy*, "The run-up in credit growth and the associated boom in house prices in recent years presented two implications for the economy: they tended to boost growth in the short term, but carried the risk of a damaging correction if they continued too long." In fact, they represented the one internal imbalance that could have put at risk the continuation of the long economic expansion that has been so beneficial to the Australian community.

It is not surprising, therefore, that we experienced a feeling of relief when data started to emerge this year which suggested the worst of the excesses may be past. First, we saw three monthly reductions in loan approvals starting in November 2003 which amounted to a cumulative fall of 20 per cent. Approvals are now running at about \$12 billion per month instead of \$15 billion at their peak last year. It is still far too early to know whether lending is returning to a sustainable pace - certainly \$12 billion per month is still far too high - but at least some progress has been made. Certainly, the prospect of a return to sustainable rates of growth of credit seems brighter than for several years, and with it the increased likelihood that the run of good economic outcomes of the last decade will continue.

More recently, we received very strong evidence that housing prices have not only slowed their rate of increase, but have fallen in level terms so far this year. This has occurred in most state capital cities, including the two largest, for Australia on average, and for both houses and apartments. As the fall in prices becomes widely known, it should allow potential house purchasers to take their time and not be afraid, as so many were, that they had to rush in and buy for fear of missing their last opportunity. It should enable them to resist the blandishments of the banks, brokers and other commission agents plying them with offers of seemingly generous quantities of credit. It should also reinforce the recent tendency of investors to question their assumptions about easy capital gains. As such, we expect that the housing market will continue to go through a much-needed cooling phase for some time yet.

That is all I wish to say about the economy at this stage, but I will be happy to answer any questions you wish to put to me. I am also conscious that I have been talking on the economy for quite a while and have not left any time to cover the various other areas of the Bank's responsibilities, such as contributing to the soundness of the financial system, ensuring the efficiency of the payments system and issuing Australia's currency. But I am sure these can all be covered during the question and answer session.