

I J Macfarlane: Some recent 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, Melbourne, 12 August 2005.

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I would like to start by saying how pleased I am to be back in Melbourne in these familiar surroundings. Since these half-yearly hearings started in May 1997, this is the sixth time we have appeared in Melbourne, and the seventh time in Victoria – the other time being in Warrnambool in 2002. I hope that the discussions are as fruitful and informative as they have been on the earlier occasions.

On Monday we released our quarterly *Statement on Monetary Policy*, and you will not be surprised to hear that what I have to say today is very similar to it. In fact, what I have to say is also very similar to a speech I gave on 14 June. The past couple of months or so has been a particularly stable period and we have not felt the need to change our views much, if at all. Rather than going over all the recent developments at this time, I will concentrate on a few that I think are important.

The first, as always, is the world economy. It would be possible for someone reading the newspapers to get the impression that the world economy is in a parlous state – rising oil prices, large US current account deficit, China on a knife edge, Japan still stagnating, the US dollar about to plunge, etc. You will be pleased to hear that we are not of that view. In fact, we have for quite a long time been relatively optimistic about the outlook for the world economy.

When looked at region by region, there is good growth nearly everywhere. Obviously, the United States, China, India and East Asia are doing well, but the places we tend to overlook are also doing well – for example, Latin America, the Middle East and the former Soviet Union. Even Africa has picked up, and so has Japan. The only area that continues to disappoint is continental Europe, particularly the big three – Germany, France and Italy.

Oil price increases are a source of concern, but their rise is primarily due to strong world demand, not to supply restriction as was the case in OPEC I and II. They also do not appear to have added to inflation or inflationary expectations, and so have not required a policy response. Much discussion recently has focused on the US current account deficit as a source of risk to the world economy. It has been argued that the United States might encounter difficulty financing its deficit and that this would put downward pressure on the US dollar and upward pressure on world interest rates. In fact, the US current account deficit has been financed relatively easily, and the US dollar has risen over the past year. More importantly, long-term real interest rates around the world have stayed exceptionally low, which indicates a more-than-adequate supply of world savings, rather than a shortage. Although China has been cited as a third source of risk to the global expansion, it continues to power ahead, and the recent changes to its exchange rate regime, although small, will improve its prospects at the margin.

The most reasonable assumption is that the current world expansion, which has been going for almost 3½ years, will continue for a good while yet. Most private forecasts for global economic growth for the rest of this year and the next show above-average rates, although not as strong as in 2004.

The second subject I would like to say a few words about is the interaction between developments in the housing market and household spending and saving. Recent evidence from several countries, including Australia, shows that during periods where house prices are rising rapidly, households tend to react to this by increasing their consumption expenditure faster than their income. They can do this by either reducing discretionary savings, or by borrowing against the equity in their house to finance non-housing expenditure, a process referred to as 'housing equity withdrawal'. This process occurred in Australia, particularly in 2002 and 2003.

Over the past eighteen months, during which Australian house prices on average have not risen, this process seems to have stopped, and so consumption and borrowing have slowed noticeably. In the eighteen months to the December quarter of 2003, real retail trade rose by 10 per cent, whereas in the most recent eighteen months it has risen by 4½ per cent. These developments have not been a concern to us because:

- The pace of growth in domestic demand had been clearly unsustainable, averaging 6 per cent per annum in 2002 and 2003. This needed to be brought back to a more sustainable pace, and this necessarily involved some slowing in consumption.
- Other parts of the economy are still showing good growth, particularly employment and investment. The external sector is also exerting an expansionary influence through higher demand for exports and higher export prices.
- After periods of rapid borrowing and rising interest servicing costs, a period of consolidation is welcome. The corporate sector did this in the early 1990s and is now in excellent shape; the household sector will be in a better position in the long run if it also consolidates its balance sheet.

Nevertheless, we are taking a great interest in the relationship between housing and household spending, as it has been and will probably continue to be an important influence on economic developments. One area where it has been influential has been in explaining the different economic performance of the different states. We have also recently undertaken a survey of a sample of households to study the extent to which they have engaged in mortgage equity withdrawal and to see how the funds were used. We will soon be reporting on the results of that survey.

The third subject I would like to cover is inflation and inflation prospects. This is particularly important given that our monetary policy is based on inflation targeting. That is, we want to ensure that the rate of inflation averages somewhere between 2 and 3 percent. We aim for this – not because inflation is all we care about – but because the maintenance of low inflation is a necessary condition for having a long economic expansion in output and employment.

Over the past two years, inflation in Australia has been restrained by the appreciation of the Australian dollar which took place between mid 2001 and the beginning of 2004. However, there have been a number of influences which have pointed to a rise in inflation further ahead:

- the fact that after a long expansion we were encountering some capacity constraints;
- the rising prices of oil and some other important industrial inputs; and
- the fact that the downward influence on prices from the exchange rate appreciation would eventually fade away.

The likely extent of the upward pressure has been difficult to assess as the signals have varied quite a bit. When I was last before you in February, the signals were quite strong. We had received two quarters of large rises in producer prices at all stages of production and the increase in the CPI in the fourth quarter of 2004 had exceeded everyone's expectations. There was also some evidence that the slowdown in credit had run its course and was picking up again. Shortly after we met last time, the Bank raised the cash rate by 25 basis points.

Since that time we have had more reassuring news on inflation. There is also some evidence that the monetary policy tightening itself may have had a quicker effect than normal. I do not want to make too much of this point, but the saturation coverage of the event in the print and electronic media must have had some dampening effect on expectations, as some surveys have suggested. It would not be surprising if the household sector had become more sensitive to news about interest rates, given the increased debt and debt servicing loads that it is now carrying.

To cut a long story short, the next set of producer and consumer price inflation data that we received was more reassuring. True, it was only one quarter's information and that was not enough to change our numerical forecast of inflation, but it did lead us to conclude in our *May Statement on Monetary Policy* that there was no longer an upward risk to our inflation forecast. The subsequent set of data confirmed a similar picture. With two quarterly sets of more reassuring price data now behind us, we were able in our recently released *August Statement on Monetary Policy* to conclude that the CPI increase will *peak* at 3 per cent per annum in the second half of next year. As was widely noticed, we also refrained from making the point we have been making for the past year or so about it 'being unlikely that there would be no further rises in the course of the expansion'. That does not mean that further rises could not happen; it only means that in our present estimation there is no longer a more than 50 per cent possibility of it happening.

This is a pretty comfortable position in which to be. We are not expecting to change monetary policy in the near term, and when we look further into the future we no longer see a clear probability of it moving in one direction rather than the other. Importantly, this is also the collective view of the market,

as shown by the yield curve and by economists' forecasts. Of course, individuals do not all share this view, but on average that is the collective forecast.

I do not intend to say any more about the economy or monetary policy at this stage, but, of course, am happy to answer any questions that you have on these subjects. I am also happy to answer any questions on the other important area of the Bank's responsibilities, namely financial system stability. Within that general area, the subject that has attracted the most recent attention has been the regulation of the retail payments system by the Bank's Payments System Board. I know that Committee members have met with the various industry participants, including members of the Bank's Payments Policy Department, to discuss the main issues, and, of course, I would be happy to address any questions members have on that subject.