

Ian J Macfarlane: Medium-term considerations and the current economic situation in Australia

Opening statement by Mr Ian J Macfarlane, Governor of the Reserve Bank of Australia, to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Sydney, 18 August 2006.

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The present arrangement whereby the Reserve Bank appears before this Committee every six months was put into place by the current Treasurer ten years ago. During that period, I have appeared eighteen times, with two meetings being missed because of clashes with elections. This will be my last appearance, and I have to say I will miss this regular half-yearly event – perhaps I should come and sit in the bleachers at future meetings. I have always thought that it is a very good principle for the central bank to have to report regularly to Parliament, and to be subject to questioning by members. The practice has, I believe, been a valuable form of communication and has contributed to improving monetary policy in Australia.

Since this is my last appearance, I would like to seek the Chairman's indulgence to start by covering some medium-term considerations before proceeding on to the current economic situation. As you are aware, Australia's current economic expansion is now in its fifteenth year. There is a general recognition that this is a good thing and, as a result, there has been a notable increase in the degree of optimism about Australia's economic performance. This is in marked contrast to the general pessimism that prevailed in the 1970s and 1980s and even later, when people were worried that we were falling behind other countries.

After such a long expansion, it should not be surprising to discover that the economy has been experiencing some capacity constraints. But I think a lot of people are disappointed to hear this, and regard it as a bad thing. So I would like to spend a bit of time discussing this issue, which incidentally we first began raising eighteen months ago at the February 2005 meeting of this Committee.

First, being at what is termed 'full capacity' is not a bad thing – it is a good thing. It means, for example, that we have low unemployment and that our incomes are higher than they might otherwise be. What would be a bad thing is if, after fifteen years of growth, we still found ourselves with significant excess capacity (that is, with significant resources of labour and capital that were not being utilised). Economies are meant to operate somewhere around the zone of full capacity, not permanently below it.

Second, there is no sensible alternative monetary policy that would have prevented us from entering the zone of full capacity. The only way monetary policy could have prevented this is if it had kept the economy 'semi-comatose'. That would have meant growing so slowly on average that, even with the passage of fifteen years, it did not use up the excess capacity.

Third, full capacity is not a brick wall that you suddenly hit – approaching it is something that happens in stages. It is a rather patchy process, with some sectors reaching it early and some not at all. That is why I called it the zone of full capacity. Sometimes it is an industry that becomes a bottleneck, sometimes a type of capital equipment and often it is a type of skilled labour. The situation that attracts the most attention is when it is a piece of infrastructure such as a port or a railway. But normally when the Bank talks about capacity, we are not talking about the specific pieces of infrastructure but about the economy's overall availability of labour and capital resources.

It is also worth keeping in mind that it is normal for the capacity of the economy to grow over time. This is because the labour force grows and investment and economic reforms lift output per worker, or productivity. There are limits, however, to how quickly capacity can be raised, though increased investment, as is taking place at present, will boost the rate of increase. But it takes time. In the meantime, it is helpful if demand can slow sufficiently to allow capacity to 'catch up' and perhaps get ahead a little. If this fails to happen, then there is a risk of a generalised pick-up in inflation. Some rises in prices and wages in the areas where bottlenecks exist are unavoidable, but a generalised inflationary process is avoidable. This is why last year I started saying that we should get used to GDP growth with a 2 or a 3 in front of the decimal point, rather than a 3 or a 4 as we had become accustomed to throughout most of the expansion.

In light of what I have just outlined, I would like to review our progress to date. The first thing to note is that over the past two years the economy has slowed from its earlier fast pace of growth. The last time we had GDP growth of over 4 per cent was in the year to June 2004. Since then, the growth rates have had a 2 or a 3 in front of the decimal point. There are a number of indications that growth has picked up again over the past six months, but our forecasts do not have it going back to the four plus rates of a few years ago.

Also, domestic demand has slowed by more than GDP. If you remember it was running at about 6 per cent in 2003/04, but is now growing at about 3½ per cent. More importantly, the composition of domestic demand has changed for the better – the driving force behind demand growth for a long time was consumption spending, but that has now clearly slowed. Two years ago, consumption was growing at more than 6 per cent per annum, but over the past three quarters, it has been growing at slightly less than 3 per cent. There is some evidence to suggest that the slowing in consumption was due, in part, to the fact that household spending was no longer being stimulated by the apparent wealth increases associated with the house price boom. The gradual tightening of monetary policy, which began in 2002, no doubt also played a role.

At the same time as consumption and overall demand have been slowing, investment has grown strongly. This is important because investment in plant and equipment and in construction is crucial to the process of increasing the economy's capacity to grow. Over the past three years, the Capex Survey shows that investment has grown by nearly 16 per cent at an annual rate. Much of this has been in the resource sector, but even if we take this out of the figures, the remainder has grown at 12 per cent per annum. Even in manufacturing, which many people assume has floundered, investment has grown at a similar rate, although it has been held up by resource-related activities. In the long run, this strong investment performance increases the economy's supply potential, and hence puts downward pressure on inflation. In the short run, however, it is pushing up the prices of many inputs and wages in the construction and resource sectors.

The capacity constraints caused by shortages of labour are harder to remedy in the short term. Interstate movement of labour can help to provide skilled and unskilled labour to the areas that have greatest shortages, mainly in the resource sector and its supplying industries. At the same time, increased immigration has helped to expand the overall supply of skilled labour. But clearly more has to be done to attract people into the occupations where skill shortages are most acute, and to train them without unnecessary delay. I do not profess to be an expert in this important area and do not want to lecture the Federal and State Governments on this issue, which I know is already absorbing a lot of their attention.

This process of slowing demand and expanding capacity has been going on for several years, but it has not prevented some general upward pressure on producer and consumer prices. This was brought home to the public with the publication of the June quarter CPI. The increase of 4 per cent over the year to the June quarter made headlines, even though many observers were quick to point out that more than half of the June quarter increase was due to petrol and bananas, the latter influence giving the cartoonists of Australia great opportunities for mirth.

They were correct to downplay these two influences which, in all probability, will either reverse or revert to zero in the coming quarters. But there is also a danger in simply taking out the two fastest growing components and looking at the rest of the CPI basket. At the Bank, we tackle the problem of lumpy, and possibly one-off, price movements by looking at various measures of underlying inflation. Our preferred measures show that underlying inflation is running slightly below 3 per cent per annum. This has picked up moderately since the start of the year, after a period when it had been fairly stable at around 2½ per cent.

The Bank's mandate is to keep inflation averaging 2 to 3 per cent over the medium term. This does not mean that it is never to exceed 3 per cent or fall below 2 per cent – it clearly has done both during the inflation targeting period. We need to be confident, however, that it will return to the 2 to 3 per cent range.

Viewing all of the available evidence that has accrued over the six months since we last appeared before this Committee, the Board came to the view that inflation was likely to exceed earlier forecasts and that corrective action was therefore needed. As you know, the cash rate was raised by 25 basis points in May and again by the same amount earlier this month.

In making these decisions, the Board was conscious that the global economy remains very strong, with output expanding at an above-average pace for the fourth year in a row. It also noted that global

inflationary pressures have been rising. This is in part the consequence of the very accommodative monetary policies that the major countries ran over 2003 and 2004. While the English-speaking countries have generally returned interest rates to more normal levels, the continuing low level of interest rates in Asia and Europe means that global interest rates on average remain low. This is continuing to stimulate global economic growth and inflation.

Domestically, there has been a pick-up in the pace of economic growth after a mild slowing in the second half of last year. While the pick-up has not been excessive, the general message from the growth of employment and consumer spending was that the household sector is still in good shape, and has not retreated into its shell as a result of the rises in petrol prices and the May interest rate increase. The fact that borrowing by the household and business sectors had accelerated over the past six months or so confirmed this general picture. But as indicated earlier, the most important consideration was that our forecast of underlying inflation has had to be progressively revised upwards over the past six months.

Before closing and moving on to question time, I would like to thank the Committee again for the work that it has put in during the years I have been appearing before it. Not only has it kept an eye on monetary policy developments, it has also done a valuable job looking at payments system developments. The recent two-day hearing on payments system reform shows how willing the Committee has been to devote time to important issues, and how effective such public inquiries can be.

I will, of course, be willing to answer any questions on the economy, monetary policy, financial system stability or payments system matters that you wish to ask. Alternatively, you may wish to look to the future and address them to the next Governor of the Reserve Bank – Glenn Stevens. I am sure he will be as forthcoming with you as I hope I have been.