

Statement to Parliamentary Committee

Opening remarks by Mr I.J. Macfarlane, Governor, in testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Canberra, 15 December 1998. The Bank's Semi-Annual Statement on Monetary Policy was released on 9 November 1998.

Thank you, Mr Chairman,

It is a pleasure to be here in front of your Committee again. As you mentioned, the need to make adjustments to the composition of the Committee after the October Federal election means that we are meeting about five weeks later than our normal timetable. Given the uncertainty about the timing of the hearing, and the importance we attach to regular communication with the public about the economy and the Bank's activities, we decided to keep to the regular timetable for releasing our *Semi-Annual Statement on Monetary Policy*, which came out in early November.

So there is a substantial gap between the *Statement* and this hearing. On the whole, we feel that our *Statement* still represents a reasonable summary of our views on events that had taken place over the preceding six months. The world has not changed dramatically since the *Statement* was issued. We have, however, made an adjustment to the stance of monetary policy, following the December Board meeting. This was as a result of our continual process of evaluating

incoming information, and our assessment of the outlook for the year ahead, and the various risks attached to our forecasts. Our judgment was that, even though most of the data coming in were suggesting growth was running ahead of earlier expectations, the likelihood was that growth would decline in 1999. At the same time, the likelihood of overshooting the inflation target was judged to have declined. Hence, we viewed a small further easing of policy as a prudent measure.

The good economic outcomes over the past year will, I suspect, be a recurring feature of our discussion today. It might be helpful, therefore, if I start by reviewing the forecasts I presented seven months ago and making some observations about how recent developments compare with them.

What I said last time could be summarised as:

- GDP would grow by about 3 per cent during 1998;
- the unemployment rate would remain relatively stable;
- we had passed the trough of inflation and it would rise gradually, reaching about 2 per cent by the end of the year; and
- the current account deficit would average about 5¹/₂ per cent of GDP for 1998.

I also said that I thought this combination of events would be a reasonably good result for Australia in view of the difficult external situation we were facing, particularly among

our Asian export markets. In the event, the external situation did not get any better, but Australia's economic performance has exceeded our expectations, and, to the best of my knowledge, the expectations of virtually all forecasters.

It now looks as though GDP growth during 1998 will be about 4 per cent, rather than the 3 per cent that seemed likely in May. A good deal of the additional growth is attributable to stronger outcomes than we had expected in the June and September quarters. The remainder is a result of upward revision to earlier data across most of the recent quarters. Consistent with this stronger than expected growth, the rate of unemployment has continued to edge down, rather than staying flat. Over the past three months it has averaged 7.9 per cent, compared with 8.1 per cent in the first quarter of 1998 and 8.7 per cent in the first quarter of 1997.

On inflation, it seems clear that the trough has passed, and our best guess for the rise in the CPI over the four quarters to December 1998 is, in round figures, still about 2 per cent. But it is also true to say that inflation shows signs of not increasing by as much as historical relationships might have led us to expect, given the fall in the exchange rate. On the current account deficit, it now looks as though it has averaged around 5 per cent of GDP in 1998 rather than the 5½ per cent we expected at the last hearing.

I would summarise the situation as being one where the forecast errors were within the normal ranges that occur with forecasts of this type. The thing we can take some comfort from, however, is that no-one can accuse us of being Pollyannas because in each case the outcome was slightly better than the forecast. Growth has been stronger, the widening in the current account deficit smaller and, at the margin, the rise in inflation slightly smaller than we had expected.

I now propose to make a few general comments about how we are expecting future events to unfold. Over the course of the year before the Asian crisis commenced, that is 1996/97, the economy grew by 4½ per cent. In the first year affected by the Asian crisis –

1997/98 – it grew by 4¼ per cent. Despite starting 1998/99 at a similar pace, we have to accept that we will not be able to continue at this rate. Growth through 1998/99 is more likely to be somewhere between 2½ and 3 per cent. Implicit in this is that the coming quarterly growth rates will be noticeably lower than the ones we experienced over the past year.

Some slowing seems to be inevitable, given the weaker outlook for the world economy. Since we last met in May, most forecasters have revised down expectations. The IMF, to take just one example, has revised down its forecast for world growth in 1998 from 3 per cent to 2 per cent, and for 1999 from 3¾ per cent to 2½ per cent. If these estimates are a reasonable guide, then the external environment will remain difficult, and income from external sources constrained. Of course, domestic demand has been, and remains, much stronger than external demand, and so Australia's expenditure has run ahead of national income over the past year. But that gap cannot be expected to continue to grow at the same pace indefinitely, and so both domestic demand and GDP growth must be expected to come down over coming quarters. With slower growth in the offing, we expect that the unemployment rate will flatten out. Of course, we said that last time; now we are suggesting it will occur at a slightly lower rate of unemployment than we formerly expected.

We expect the four-quarter-ended increase in the CPI to be about 2½ per cent by the end of the financial year – that is, in the short term, we expect inflation performance to be consistent with our target. Of course, any forecast of inflation beyond that period is only as good as its assumption about the future path of the exchange rate.

Given the current tendency towards lower commodity prices, we are assuming some further widening in the current account deficit to about 5½ per cent of GDP in 1998/99. With an annual figure of this size, it would not be surprising to see a quarter or two of it running at over 6 per cent of GDP. I made the same comment in March this year, and again in May at our previous hearing.

I expected that it would have come to pass by now, but it has not. It would not surprise me, however, if it does happen some time in the next year.

This set of outcomes, or something like it, would represent a good performance for an economy in its eighth year of expansion facing a difficult, but not disastrous, external environment. I expect that it would be well received by the domestic and international investment community, though one can never take this for granted. And, of course, if the assumptions we are making about the world economy turn out to be too optimistic, all bets would be off.

I now come to the second part of my testimony in which I attempt to answer the question of why we have done better than most other countries in Asia or the Pacific Rim. In doing so, I am conscious that the story is not yet over, so this is really an interim report. I think a number of factors have been involved and I will list them in no particular order. As we go through them, it will become apparent that they are all intertwined.

First, I think the Asian crisis hit at a time when the Australian economy was in good shape, partly for cyclical reasons. By mid 1997, the economy was growing strongly and inflation was lower than our target. Had we not received a contractionary impulse from the Asian crisis, we may have been facing the need to tighten policy because of a potential overheating. No-one will ever know, but it is a possibility. I am conscious that attributing our performance over the past 18 months to our good starting point is rather superficial because it does not explain why the starting point was so good. But I will come back to that later.

Second, I think we have benefited from the flexibility of our exporters who have switched from the contracting Asian markets into the expanding North American and European ones, and into a number of other markets we do not usually think of as being important to us. The nature of our exports – with so much of them being commodities – has helped, but the efforts of our marketing companies and authorities should not be ignored. Even so, it

has not proved possible to prevent exports from falling, and over the year to the September quarter they fell by 2 per cent in volume.

Third, Australia has benefited from a greatly improved perception of the soundness of its economic policies. The fact that the budget has moved back into surplus – where it should be in the mature phase of an economic expansion – has been important. So has nearly a decade of low inflation. Also important on this occasion has been the recognition that Australia scores well on such factors as its regulation of banks, other financial institutions and stock exchanges, and that its underlying body of commercial law and accounting practice is at or close to world best practice.

Not only have the international capital markets taken a better view of Australia, but we also seem to have more confidence in ourselves. Business and consumer confidence initially fell as the Asian events unfolded, but they did not fall excessively – for the most part they fell from well above average to about average. In the past three months, they have tended to rise moderately again as figures about the economy have confirmed that it has performed better than most expected.

The fourth explanation for why growth has held up is a catch-all one – the economy just seems to be more flexible and adaptable than before. The only clear evidence of this is that productivity – whether labour productivity or total-factor productivity – has increased faster in the 1990s than in earlier decades. For example, total-factor productivity has increased at an average annual rate of 1.7 per cent during the expansion of the 1990s, compared with 0.7 per cent in the 1980s and 1.2 per cent in the 1970s. To me, this suggests that the painful adjustments that have been made over the past decade or so are paying off. By this, I mean the changes that have been made to increase competition in previously sheltered industries. This, of course, includes greater export orientation, but also greater competition in utilities and transport which has reduced costs to other industries. It also includes the downsizing of the public sector which has released resources.

Finally, our labour relations practices and wage-setting machinery now have a degree of flexibility that has surprised the sceptics.

I now come to a fifth factor, which most commentators view as being important – namely, the fact that in response to a contractionary external shock, the Australian dollar was allowed to float down. This is the way the textbooks say the situation should be handled, and is in sharp contrast to the severe domestic squeeze that can result in the cases of countries with fixed or quasi-fixed exchange rates.

The domestic economy has benefited from the lower exchange rate because exporters' incomes have been held up and the incentive to export maintained (while at the same time assisting those industries that are competing against imports). The domestic economy has also benefited because we have not had to put up interest rates in order to maintain our external parity (as in a fixed exchange rate) or to prop up a floating rate that threatened to fall so far that it would have undesirable inflationary consequences. Raising interest rates in response to an external contractionary shock is not something that you normally would want to do, although in extreme circumstances it may become necessary.

I have heard people say that it is a good thing that, unlike some other countries, we were relaxed in the face of a falling exchange rate. I can assure you all that we were never relaxed. Having followed the Australian dollar on virtually a daily basis for 15 years, I know that you can never take it for granted. While the floating rate is the best system we have had, like all asset prices freely determined in unconstrained markets, the Australian dollar is prone to bouts of instability or overshooting. On three occasions – in January, June and August – a downward overshooting threatened and we responded with foreign exchange intervention. On each occasion, stability was re-established, and unlike the experience of the mid 1980s, we did not raise interest rates. But this does not mean that that option was not on the table. It was, and financial markets knew this; as a result, 90-day rates were well above cash rates in both June and August.

Fortunately, things turned out well, and so the option did not have to be used.

Thus the exchange rate was centre stage. The general direction of its movement was performing a very useful function, yet the short-term dynamics were such that it often threatened to go too far. It has been a delicate balancing act, but one with a favourable outcome. Over the past two years, the economy has been able to grow at over 4 per cent per annum without significant upward pressure on inflation (which has averaged 1.6 per cent over the same period). This is better than almost anyone expected.

Another way of approaching the question is to ask why were we at the Reserve Bank able to accept this continuation of high growth and depreciating exchange rate without having to tighten monetary policy (in fact, being able to ease it slightly at the beginning of this month). The answer is that the combination has not to date seriously threatened our inflation target. Why has it turned out this way?

The answer, I think, is that we are beginning to receive the big dividend that low inflation provides.

The economy has gradually adjusted to nearly a decade of low inflation and, although the adjustment is still not complete, the benefits are becoming apparent. Inflationary expectations are much lower and more stable; wage contracts are now often two or three years in duration; loans, including housing mortgages, often have interest rates fixed for long periods; and businesses know that they can no longer automatically pass on any cost increase secure in the knowledge that it would get lost among the multitude of other price increases. This new less volatile environment allows the floating exchange rate to do its job of stabilising the domestic economy in the face of an external shock. It does so by reducing the tendency for the expansionary effects of a falling exchange rate to be dissipated in the form of rising inflation. It also goes without saying that the low inflation environment makes the task of monetary management a lot easier.

I think we can take some satisfaction about how events have turned out over the past

two years, but we should not become complacent. This particular episode, which started as a regional Asian crisis, is far from over. We should not think that we can see the end of it just because it has already been running for 18 months. For a start, the United States has only recently started its slowdown, and uncertainty about the US outlook seems greater at present than for some time. In addition, Japan remains gripped by powerful contractionary forces. That could put continued pressure on commodity prices. Much has been said recently about how Asia has passed the worst of its problems, and on

many measures this is so. But the contractions have been very severe in many cases, and no-one is expecting a quick or strong recovery.

I do not wish to say any more at this stage. You will note that I have dealt exclusively with the domestic economy, but I think that is appropriate since I have spoken so much recently in other places about Asia, the world economy, and international financial markets. My colleagues and I are, of course, happy to answer any questions you may have on the topics I have not covered, or for that matter, on the ones I have. ✕