

The Economy and Monetary Policy

Address by Mr Iŷ Macfarlane, Governor, to Economic Society of Australia (Victorian Branch) Luncheon, Melbourne, 10 April 2001.

Introduction

It is a pleasure to be here in Melbourne speaking to the Economic Society again at this very interesting time in the evolution of the world economy, the Australian economy and our monetary policy. With so much happening, I trust you will find what I have to say about our current economic circumstances and monetary policy of interest.

There has certainly been a remarkable change over the past four or five months in virtually everyone's view of the economic outlook. I think the biggest change is at the global level, where forecasts for economic growth in major countries have been lowered. The most important economy, and the one that has been leading this reassessment, is the United States. But Japan has relapsed, and the rest of Asia is also feeling some chill trade winds. The process of monetary policy easing that began in the United States in early January has now spread to Canada, the United Kingdom, New Zealand, Switzerland, Japan, many other Asian economies, and, of course, Australia. The Euro area is the exception. In a medium-term sense, we should

not be surprised that after such a long global expansion, some aspects of the business cycle are reasserting themselves, or that developments in the US economy are playing such a leading role and attracting so much attention.

As always, the evolution of the international business cycle and international financial markets has a major bearing on economic developments in Australia and therefore for Australian monetary policy. But there have been some very unusual developments in Australia which call for explanation, and which also have had implications for our monetary policy. Before returning to the bigger picture, I would like to spend some time on these unusual developments.

Output Developments in Australia

I have frequently said that under the inflation-targeting approach to monetary policy, our aim was to maximise the length of the economic expansion and, as a corollary, to delay and minimise the severity of any downturn. Over the past decade, monetary policy, helped by other policies, has been relatively successful in this endeavour in that the current expansion has been longer than its predecessors in the 1970s and the 1980s. And when I last spoke publicly on this subject

towards the end of last year, I expected this state of affairs to continue. Like virtually everyone else who follows economic developments in Australia, I was surprised and disappointed to learn what the national accounts had to say about our growth performance in the second half of 2000.

The grounds for optimism about our growth prospects, which were shared by most private sector forecasters, have been spelled out on a number of occasions, but let me recap briefly:

- the Australian economy had strong momentum – it had been growing at about 4¹/₂ per cent for a number of years, yet it had not built up any of the imbalances that are common late in an expansion;
- inflation, although rising slightly, was moderate, as was the growth of wages;
- asset prices, although on a rising trend, were not obviously overheated and the balance sheets of the corporate and financial sectors were in good shape;
- a similar situation applied to physical investment, which meant the risk of excess capacity developing was minimal;
- the current account of the balance of payments was being reduced under the influence of rapid export growth;
- the fiscal impact of the various tax measures associated with the introduction of the GST was expansionary by all the conventional measures; and
- although monetary policy had been tightened, the level of real interest rates was not high by historical standards, credit was easily available, and the exchange rate had fallen to a point where it was very competitive.

Of course, there were some worrying signs, but they seemed less significant than the factors listed above. Households in particular had taken on a lot of debt by their past standards, though not by international standards; they were also having to cope with higher oil prices. There were a few rumblings from falls in the US share market which had been going on since March 2000 but, other than that, the mood in the United States was still confident. Business surveys showed

substantial falls in confidence in the second half of 2000, just as they had in 1998, and employment fell for a time, but these things were consistent with a slowdown, not a contraction. There was also the inevitable uncertainty surrounding the GST and the Sydney Olympics.

What Happened and Why?

So the question is: Why was there such a sudden reversal in the second half of the year, particularly the December quarter? Economies as well balanced as the Australian economy was at mid 2000 do not just run out of steam: there has to be a reason, or perhaps several reasons.

I think it is now generally recognised that there was one overwhelming reason for the change in direction. The feature of the national accounts that leaps out is the extraordinary role of house-building in explaining the weakness of GDP. This was surprising in one sense, because house-building only accounts for 5 per cent of the economy. But its decline in the second half of 2000 was so pronounced that it meant that the figure for the total economy showed a decline of 0.4 per cent at an annual rate. If we take out house-building and look at how the other 95 per cent of GDP performed, we see that it rose at an annual rate of over 4 per cent. This is much the same as its rate of growth in the previous year. Now I do not want to suggest that there was no slowing in some other sectors of the economy, but if it was not for the extraordinary behaviour of house-building, the story would be in line with most observers' previous expectations. Similarly, the behaviour of aggregate employment in the second half of 2000 can largely be explained by the construction sector and those parts of manufacturing supplying it.

Why did house-building have this extraordinary pattern? I do not think there is anyone who doubts that it was due to the bringing forward of house-building

Table 1: Growth Rates

	Four quarters to Jun 2000	Two quarters to Dec 2000 (annual rate)
GDP	4.9	-0.4
GDP excluding house-building	3.8	4.3

pre 1 July 2000 to beat the GST, and the subsequent dearth of house-building in following quarters. We all knew this transition effect was occurring, and our forecasts showed substantial falls in house-building in the second half of 2000, but not falls big enough to outweigh everything else that was going on in the economy. The size of these falls was truly outside the range of previous recorded experience, and that is always difficult to forecast. Incidentally, similar large shifts in expenditure on housing did not happen in the other countries we had looked at that introduced GST (see Graph 1).

Let me make a disclaimer before I go any further, lest anyone think I am trying to blacken the name of the GST and imply it was all a horrible mistake. I have always thought that a GST is a good thing for the economy, principally because it could take

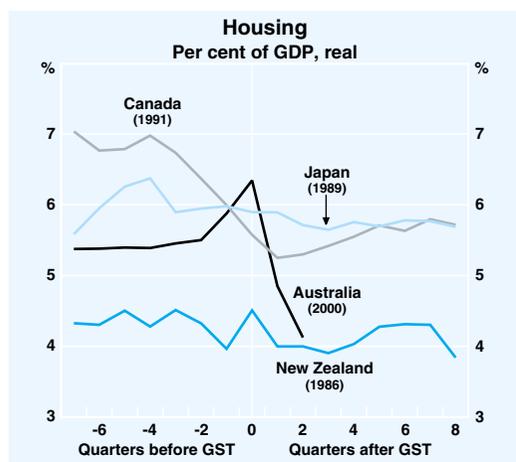
some of the weight off the high marginal tax rates on middle incomes in Australia. I still do support it and note that it will still form an important part of the Australian tax system beyond the next election. My only point is that when making a major reform, such as a tax reform, the transition effects associated with implementing such a large change are nearly always unpredictable and cause short-term dislocation. But that is not a reason not to do them, otherwise we would never get any reform.

Monetary Policy

I will now turn to monetary policy. Since early February, the Reserve Bank has reduced the overnight cash rate by 125 basis points to 5 per cent. A number of people have pointed out that this is an uncharacteristically large reduction over such a relatively short period of time. Why have we seen the need for such a change?

My response revolves around two points. First, even though the outlook for the economy remains positive, the risks on the downside have increased this year. Second, the continuing good inflation performance of the economy provides scope for the Bank to be pro-active in trying to minimise these risks.

Let me begin with the risks. The principal circumstance that has changed in recent months has been international, not domestic. All countries, at about the turn of the year, started to revise down their expectations relatively quickly for the year ahead. The reductions in forecasts for growth were not drastic, but they applied to most countries, and hence to the world economy in aggregate. The reassessment was centred on the United States, with Japan and other parts of Asia prominent. It cannot be denied that the fall in share prices in the United States, which was largely matched by falls in European and Asian exchanges, played a significant role in this reassessment, just as their earlier buoyancy had held up economic activity. As a

Graph 1

result of the reassessment, the year 2001 so far has been one of monetary policy easings around the world, just as its predecessor had been one of monetary policy tightenings.

The reduction in forecasts for world growth is not alarming – for example, the IMF is forecasting growth of 3.4 per cent in 2001, compared with growth of 4.8 per cent in 2000. But forecasts are still probably being revised down and the balance of risks has definitely shifted to worries about a larger downturn. This is seen most clearly in the capital markets, where investors are moving out of equities into bonds, and some banks are becoming more cautious in their lending behaviour. On the other hand, labour markets around the world have so far shown very little deterioration.

The second risk relates to the domestic situation. I have already explained that the major change to our circumstances was that we now needed to factor in the 2.2 percentage point subtraction from GDP that was caused by the fall in housing in the second half of last year. Why should this be important if it has already happened? Indeed, you could make a case to say that if the world economy had continued to grow at the same pace that it did in 2000, the housing effect would have been purely transitory, even if it was much bigger than we or anyone else expected. But the world economy *has* slowed, which makes this reasoning somewhat academic. It is unlikely that such a large contraction in housing, and attendant falls in demand for those industries supplying the housing sector, could occur without some wider ramifications. I pointed out in my testimony to Parliament in December last year that I thought the contraction in housing (even though I did not know how big it was at the time) was the major reason for the fall in business confidence. We saw a similar setback to expectations recently when consumer confidence, which had held at above-average levels until March, fell sharply in the latest survey, which unfortunately was taken a few days after the release of the December accounts and was heavily influenced by the publicity surrounding it.

The other domestic change that influenced our thinking on monetary policy was the lower outlook for inflation. The December quarter CPI followed the pattern set in the September quarter in showing a level of inflation well below our expectation, and implied that our forecasts for inflation would need to be revised downwards.

As I have noted earlier, this gave scope for monetary policy to be eased more quickly than would have been possible on earlier occasions. Over most of the past 30 years, the classic dilemma for monetary policy was that, even when there was a need to ease on domestic activity grounds, there were often still strong inflationary pressures which cautioned against doing so. One of the many benefits of a low-inflation environment is that it restores to monetary policy a degree of freedom that is denied in a high-inflation environment.

With inflation not imposing a constraint, it has been possible for the Bank to respond quickly to the need for a significantly lower *level* of interest rates. That is, we needed a level of real interest rates that was unambiguously expansionary, just as it had been in the period from mid 1997 to end 1999. The actual mechanics of getting from one level to another is a secondary issue. Whether to move by 25 points or 50 points, whether to move between meetings or not, or whether to have a pause or not, are essentially tactical issues related to market perception, rather than fundamental economic ones. It is the medium-term effect of the *level* of real interest rates, not the number or size of individual changes, that matters for the development of the economy. So once we realised that a significantly lower level was required, our aim was to move there as quickly as was practicable, without unduly unsettling markets.

Where Does This Leave Us?

We have traversed a very difficult period. We knew well before we entered it that the

second half of 2000, which included the introduction of the GST and the Olympics, was going to be difficult to forecast. We also knew that, even while we were living through it, it was difficult to assess developments, especially as we had the added complications of rising oil prices and a falling exchange rate. A great range of surprises was possible, but now that the period has passed, we know what the surprise was, and it is now part of history. We also know with reasonable confidence that housing should pick up strongly through the remainder of the year.

Looking at the broader picture, the major influence on our outlook is the world economy and, inevitably, the biggest influence on this will be the US economy. Obviously, there is nothing we can do to influence world economic developments, but what we need to try to do is to foster as much resilience in the Australian economy vis-à-vis the world economy as we can.

For a start, we can move to a stance more supportive of growth, and we have done so over recent months with monetary policy, using the scope to do so provided by good inflation performance.

More fundamentally, we should have some resilience given that, in several respects, we have a better starting point than the United States. We did not have the extent of share price appreciation over the past couple of years that the United States had, and therefore we have not seen the unwinding of this that they have recently experienced. The United States has had an investment boom which has created some excess capacity in some sectors, whereas in Australia there is no such problem. In Australia the current account deficit has been falling, and is back at the low points seen over the past 20 years, whereas in the United States it is at a 20-year high. The Australian dollar is low, and hence supporting economic activity, whereas the US dollar is high, and hence dampening US growth prospects.

This inevitably brings me to the exchange rate. The behaviour of the Australian dollar over the past 15 months has been difficult to explain, and those attempting to do so have

moved from explanation to explanation as developments have changed. There has been no doubt, however, that over the past month much of the fall has been due to the general gloom that accompanied the release of the December quarter accounts, and this should fade as they are put into perspective. Of course, the other explanation has been the strength of the US dollar, which is in itself a bigger puzzle than the Australian dollar. We were told last year that the US dollar strength was due to the strength of the US economy, the high returns from investing in US equities, and the rising interest rates. In 2001, all three of these factors have gone into reverse, yet the US dollar is over 5 per cent higher than at the end of last year. There is not much doubt that a lower US dollar would be better for the United States and the world economy in general.

The fall in the Australian dollar has been, in my view, an overshoot. It is not something I look upon with any comfort. But it is also something which we could not hope to prevent in the short term, short of drastic measures which in our judgement were not in the best interests of the economy, especially given the risks to growth from abroad. At its present level, or even one appreciably higher, the Australian dollar confers a major competitive advantage to Australian producers and has contributed to an exceptional performance by the traded sector. Although exports may not be able to keep up this growth rate over the next 12 months, they should still help to underpin the economy.

Conclusion

To conclude, developments in the world economy obviously pose a risk to economic performance in the near term. Since there is little we can do to change that, we must focus on managing our own affairs in Australia in the best possible fashion. Monetary policy has been eased, in recognition of the changing circumstances, and should prove to have some expansionary influence over the period ahead.

Domestically, the major risk we face is that public confidence over-reacts to the fact that we are not going to be doing as well as we did a year ago, or, somewhat perversely, to the lower exchange rate itself. But, in order to put these things into perspective, we should remember that the large list of positive factors

I gave above still applies – we still have strong export growth, sound balance sheets in the corporate and financial sectors, asset markets which are not overheated, no over-capacity in physical investment, low inflation and macroeconomic policies that are exerting an expansionary influence on the economy. ✕