

Statement to Parliamentary Committee

Opening remarks by Mr Iŷ Macfarlane, Governor, in testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Sydney, 29 November 1999. The Bank's Semi-Annual Statement on Monetary Policy was released on 8 November 1999.

It is a pleasure to be here in these dignified surroundings to appear before the Committee again. As you know, we take these hearings very seriously because we regard them as an important channel for Parliament, through its representatives, to question the Reserve Bank in depth. It thus plays an important role in ensuring the Bank's accountability and in the democratic process.

As usual, I would like to make an opening statement, but it will not be comprehensive because we have put out our *Semi-Annual Statement on Monetary Policy* earlier in the month. Its contents are still very current and I will refer to it from time to time during the hearing.

Also following past practice, I would like to start by reviewing what I said to you in June about how we saw the economy developing. There was still a fair bit of uncertainty around at that stage as to the extent of the expected slowdown in GDP growth from the 4¹/₂ per cent plus that had occurred in 1997 and 1998. That is why we had a relatively wide range of projected outcomes from 3 to 4 per cent. The top of that range would

indicate almost no slowdown, while the bottom would probably indicate we were heading still lower and would represent genuine weakness in economic activity.

We think the position is a little clearer now – our forecast for growth through 1999 is 3¹/₂ per cent, and through the financial year 1999/2000 is 4 per cent. A through-the-year growth rate of 4 per cent implies a year-on-year growth rate of 3¹/₂ per cent, the same as the Treasury is forecasting in its mid-year review. Thus, these numbers do show a modest slowdown for the Australian economy, but most of it is behind us. It incorporates the low June quarter figure and reflects weakness in business investment, and particularly a decline in net exports in the first half of 1999. Because the latter is unlikely to be repeated, we expect to see growth of around 4 per cent through the year ahead.

There has been no reason to change our view on inflation. We thought inflation in the year to the December quarter 1999 would be 2 per cent, whether measured by the CPI or some underlying measure. We still think 2 per cent for the CPI and a shade over 2 per cent in underlying terms. When we look out to June 2000, our guess for the CPI is 2³/₄ per cent, with 2¹/₄ per cent for underlying.

On unemployment, we have also not changed our view. When we met last time, the unemployment rate had been averaging 7¹/₂ per cent, and we expected it to edge down over the remainder of the year. This is what it has done,

so that now it has averaged 7.2 per cent over the past three months. We expect that it will go down further so that we will see some numbers less than 7 by June next year.

The balance of payments has also turned out very much as expected. For quite a while, we had been forecasting the quarterly current account deficit to reach 6 per cent of GDP, and it finally did so in the June quarter and will probably remain at about this level through this financial year. It was surprising that the current account did not deteriorate faster and further, given the disparity between our growth rate and that of our trading partners. While the slowness of the deterioration has been a pleasing development, we think that the improvement could be some time in coming.

In summary, we are expecting that the current financial year will be another good one for the economy. Growth will be a little lower than its recent peak, but still good, and inflation should be within the average we aim for. Considering that this is the ninth year of the expansion, such a result would mean that no major imbalances had emerged. The aim, as usual, is to keep the expansion going and to avoid the emergence of problems that would threaten its continuation.

Monetary Policy

This brings me to monetary policy. The most important development here was the tightening immediately after our November Board Meeting when the overnight cash rate was raised from 4.75 per cent to 5 per cent. While I think this adjustment has been quite well received by the community, it is still worth spelling out some aspects which lay behind the decision.

I would like to start by putting it in the international context, not because we have to follow what other countries do, but because there are some international developments that are a common background to all countries. One such development was the

changed perceptions about the world economic outlook in 1999 and 2000. If you remember, 1998 was a weak year for the world economy, largely because of the widespread fallout from the Asian crisis. At the beginning of this year, things looked as though they were getting worse, and most forecasters – public and private – expected 1999 to be weaker than 1998. In the event, it turned out the other way – 1999 has been better than 1998, and 2000 should be better again.

As our *Semi-Annual Statement* said: ‘This change has led to an increase in both short-term and long-term interest rates in most industrial countries, as markets questioned the continuation of the accommodative monetary stance central banks have generally been following over the past year or two. The upward pressure in interest rates began in the US, the country most advanced in its economic cycle, but quickly spread to other English-speaking countries and, more recently, to Europe’.

The market reaction was a bit quicker than it needed to be, but it was broadly correct. The United States was the first to tighten, followed by the United Kingdom. Our tightening in early November was quickly followed by the European Central Bank, and central banks in Sweden, Canada and New Zealand.

I would now like to turn to the Australian economy, where a similar expectation of weakness in 1999 did not come to pass. Real GDP grew by over 4 per cent in the 12 months to the June quarter (the latest data we have) and will probably still be showing a similar rate in the 12 months to the September quarter. This measure may slip for a time as we drop off some of the high quarterly growth rates from our calculations but, as explained earlier, we think growth will be about 4 per cent in the 12 months to June 2000.

Similarly, the quite lengthy period during which inflation was undershooting our target seems to have come to an end. The CPI inflation rate would already be a bit over 2 per cent apart from the Government’s reduction in the Health Insurance Rebate. Although some of this result has been due to

risers in oil prices, measures of underlying or core inflation, which are largely unaffected by oil prices, have also risen by about 2 per cent over the past 12 months.

Thus, the period where the Australian economy was experiencing a contractionary impact from abroad and where the outlook was for weaker growth and sub-2 per cent inflation has now passed. The monetary policy that was appropriate for that period is no longer appropriate to the new circumstances that we face. That is the reason behind the tightening of monetary policy we undertook after our November Board Meeting.

At the risk of being overly technical, I would like to spell out some aspects of our flexible inflation-targeting regime a little more fully at this stage. In doing so, I want to distinguish between two types of situation: the first is where inflation has been comfortably averaging 2 point something per cent for some time and the economy is performing roughly in line with its potential so there is no obvious upward or downward pressure on the inflation rate. The second is where the starting point is either above or below the range we expect inflation to average.

In the first case, where inflation is where we want it, monetary policy would be set to keep it there. The economy would be in a type of dynamic equilibrium and there would be no need for policy action. We then ask ourselves what are the circumstances under which we would wish to change monetary policy. Would we do it if our forecast for inflation rose from $2\frac{1}{2}$ per cent to $2\frac{3}{4}$ per cent or fell to $2\frac{1}{4}$ per cent? My answer is that we do not worry about small variations in inflation of that magnitude. To trigger a change in policy would require a forecast which had inflation going clearly above 3 per cent or below 2 per cent and likely to stay there for a while. Our flexible inflation-targeting framework does not aim for rigorous fine-tuning, and requires a significant variation in the inflation forecast to trigger monetary policy action.

This brings me to the second type of situation. This is where we start from a position where inflation is above or below our desired target range. In this case, where the

initial situation is one of dynamic disequilibrium, the prescription is a little more complex. Let us look at the situations defined by the two possible starting points.

- The first is when inflation is above the target. In this situation, the inflation-targeting framework would say to raise interest rates to a setting which would bring inflation back to the target. But once the higher rates had done their job, they should be gradually reduced to more normal levels. This is what happened in 1996. We did not wait until our forecast had inflation falling below 2 per cent before we started to ease.
- The second is when inflation is below the target. In this case, the framework would first call for a setting of interest rates which would, over time, allow inflation to go back up to the target. Once it is clear that such a setting had done its job, the framework calls for it to be replaced by one more likely to keep inflation at the target. The framework does not envisage the low interest rate setting being maintained until something goes wrong.

It is this reasoning which lies behind the recent tightening of monetary policy and why we refer to it as pre-emptive. To argue against it on the grounds that we should not act until our inflation forecast clearly exceeded 3 per cent would be to argue for a very 'stop-go' approach to monetary policy. It would be equivalent to saying that the most expansionary setting reached during the downward phase of the interest rate cycle should be maintained until such time as a move to a clearly restrictive setting is required, and only then should a move be made. This would virtually guarantee that such a move would be a large one.

What about the GST?

Not everyone will be convinced by the arguments I have used above. Some people still cannot understand why you would tighten

unless the economy was overheating, and assume that there must be a hidden agenda. Others are keen to play the old game of trying to find a political dimension to monetary policy. This has led to claims that the real reason is our fear of the inflationary effects of the GST, but that we are too diplomatic to say so. I am sorry to disappoint the proponents of this view, but that is not the case.

- If the GST was the reason for tightening monetary policy, why have the Fed, the Bank of England, the ECB, the Bank of Canada, the Reserve Bank of New Zealand, etc tightened monetary policy? As I have said elsewhere, I am not aware of the forthcoming introduction of a GST in any of these countries.
- Our starting point has always been that the imposition of the GST will affect the level of prices, but not the ongoing inflation rate. This will require that businesses do not engage in opportunistic pricing by raising their prices by more than is warranted by the net impact of the GST and reductions in indirect taxes. If that is the case, the GST should not have an effect on wages because wage-earners will gain more from the accompanying fall in income tax rates than they will lose from the introduction of the GST. The net effect of the tax changes will be to increase the disposable income of wage-earners by more than the increase in their expenditure, as is evidenced by the fact that the package involves a cost to the Budget.
- Monetary policy is based on a view that inflation will be within the target immediately before the GST is introduced and that it will be back within the target a year later. This view, in turn, is based on the assumption that there will be no second round effects due to higher wage outcomes or opportunistic price behaviour as outlined above. If we started to observe behaviour that indicates that this assumption was not correct, then monetary policy would act upon it. We are not acting at present on the expectation that this assumption will be violated – we are acting in the expectation that it will hold.

Y2K and All That

I would now like to make a few comments about Y2K, which is very topical because there are now only 32 days to go to the new century.

When I appeared before the Committee in June, I said that Australian banks, building societies and credit unions were very well prepared for Y2K. They had not completed all their final testing at that stage, but now they have, and everything has been done to make sure that their computer systems will be able to handle the change into the new century. This includes not only all their internal accounting and record-keeping systems, but also their ATM, EFTPOS and credit card systems. As well as making sure their systems are compliant, they have also been sending out very clear messages to their customers about the safety of their deposits. We are very pleased to see this because, as I said in June, the simple fact is that deposits are safe and records are not at risk from Y2K-related problems.

I should also say a few words about my own institution. You will not be surprised to know that we have also put a lot of effort into our own systems to make sure they are Y2K compliant. One of our most important is our electronic direct entry system which handles all of Australia's pension payments. You will be pleased to know that all these payments will be made on time.

I mentioned last time that it is not just a matter of getting the technical side right, but it is also important that we do not run into a problem of public over-reaction. All the indications here are that the vast majority of the public are taking a sensible and calm approach and have not been influenced by alarmist stories or predictions of doom – not that there have been a lot of these anyhow. In our judgment, the Australian media coverage, with only a few exceptions, has been accurate and balanced.

I am often asked by people whether they should take out extra cash to see them over

the New Year period. My advice is generally along the following lines:

- don't take the risk of having too much cash on your person or in your home;
- the safest place for your savings is in the financial institution that they are presently in;
- don't fear that the country will run out of cash – we have printed enough notes to provide for any conceivable demand; and
- remember you are only really dealing with a long weekend – banks, building societies and credit unions will be open on the three days before New Year's Day, which is the Saturday, and will re-open on the Tuesday.

New Year's Eve is going to be rather unusual this year in that a lot of people will not be out enjoying the festivities, but will be at work to make sure that nothing goes wrong. At the Reserve Bank, we will have a team in place,

including myself, and a communications centre to receive up-to-date information from financial institutions on what is happening. This centre will be linked to the Commonwealth Government's National Co-ordination Centre in Canberra and to various international networks that have been established.

Because Australia (and New Zealand) will be the first countries to enter the new millennium, there will be a lot of international attention focussed on us, including a fair bit of live television coverage to other countries about what is happening in Australia. Remember the United States will only be starting its working day on Friday when we cross over into the new millennium. I am confident that Australia will acquit itself well once again in the eyes of the world when the great day comes. ✎