Talk by Governor

Talk by the Governor, B. W. Fraser, to the CEDA symposium entitled 'An Australia That Works: A Vision for the Future', Sydney, 4 August 1993.

'Vision' is not one of my favourite words: it can have surrealist overtones.

But all policy makers and advisers should have – and implicitly do have – a view or vision of their world. Many have at least two: a view of the world as they see it now and another, Walter Mitty-kind-of-view, of how the world would look if policy makers everywhere were as smart as they are. In between lie the 'pragmatic' visions – those that are attainable, that actually work.

The CEDA vision, in my view, falls into the latter category. I could not endorse all its detail, but I share its broad thrust and its major underpinnings. Most Australians would, I think, accept readily a vision of their country characterised, *inter alia*, by:

- rising standards of living, sustained by faster economic and employment growth than we now have, and the low rates of inflation we currently have;
- genuine equal opportunity in all its guises so that, whatever their origins, all Australians receive a 'fair go'; and
- a social and physical environment which reinforces these fundamental tenets.

Substantive differences can be expected to arise over how best to pursue even a shared vision – over the preferred policy mix and its speed of implementation. Too often, self-serving ideology and misrepresentation gets in the way of objective assessments of contemporary economic policy and strategy. This initiative by CEDA, and Mr Argy's clear exposition of the issues, affords a very welcome opportunity to take a fresh look; it deserves to be supported.

Of course, it is not just the decisions of domestic policy makers that determine how many goals we kick. What happens internationally is also very important to a country like Australia. Play in the wider arena has been bogged down over recent years. We see that in, for example, dismal growth rates around the world and in the failure of action to match the rhetoric in the GATT trade negotiations, which keep going into extra time.

The apparent decline in relevance of multilateral bodies like GATT and the IMF highlights the lack of effective institutional arrangements for co-ordinating policies in ways which actively promote a faster growing world economy. The recent breakdown of the EEC's Exchange Rate Mechanism also illustrates the problems of international policy co-ordination, although the broader growth implications of the demise of that mechanism have still to unfold.

For the moment, we rely heavily on meetings of leaders of small groups of major countries. But whether that group is the G3 or the G5 or the G7, recent performances have been unremarkable. I suspect that this is because all the major players are so beset by their own problems that none is able to exercise authoritative leadership – which serves to illustrate the point about getting your own house in order before seeking to reform others.

Australians have to accept the world much as it is. We too, however, need to keep our house in order, both to perform as well as we can whatever the prevailing circumstances, and to respond positively to changes in those circumstances. In retrospect, we can always see how things might have been done differently and better, but policy makers do not have the luxury of reformulations and reruns. In any event, I agree with Fred Argy's comment that:

> 'We achieved much in the 1980s, before the onset of the devastating recession. It showed that we can be a nation of achievers. What we need now is confidence in ourselves and a greater sense of national purpose.'

I believe these things are coming together, albeit slowly, and the benefits will emerge more clearly as the pall of world recession is lifted. Now is not the time for visions of despair or for banal bleatings about 'leadership' every time an inconvenient problem arises. It is the time for everyone to be getting on with things. For the Reserve Bank, this means helping, through banking and monetary policies, to make Australia work better.

Stable Banking

The Bank has specific responsibilities for the banking system, as well as some more general responsibilities for the financial system as a whole. Actual performances in these sectors in Australia in the second half of the 1980s were clearly less than ideal, as they were in a number of other countries which embarked upon rapid financial deregulation.

But whatever the precise reasons for those shortcomings – and it is simplistic and inaccurate to lay the blame for the recession solely at the feet of the banks and monetary policy – the banking system has withstood the tempests reasonably well. The stock of banks' non-performing loans, for example, declined from a peak equivalent to 6 per cent of total assets in March 1992 to 4 per cent in June 1993. At the latter date, the average risk-weighted capital ratio was close to 11 per cent, its highest recorded level and well above the 8 per cent minimum. On average, bank spreads – the difference between what depositors are paid and borrowers are charged – appear to have remained steady over recent years.

As the health of the banking system continues to mend, it can be expected to become more effective in mobilising savings and supporting investment. It can be expected also to become more innovative and responsive to customers' needs. Behind these expectations is the knowledge that the forces necessary for their realisation are already operating. They include:

- a very competitive banking environment, which is compelling improvements in efficiency;
- growing transparency of bank dealings flowing from, for example, greater disclosure requirements and, when it is in place, the Code of Banking Practice (which will promote fair dealing on both sides of the counter); and
- on-going advances in technology, especially in the payments system.

These considerations of competitiveness, efficiency, transparency and innovativeness are lauded in the CEDA study as hallmarks of reform in all markets, not just the market for financial services. They will weigh heavily in the Bank's on-going deliberations on banking/financial sector issues, including attainment of the 'right' balance between freedoms and intrusions in prudential supervision; the future role of banks in mobilising and allocating savings through, for example, superannuation and funds management; and closer relationships with small and medium-sized businesses.

These businesses are emerging as major sources of new jobs and exports and are in the spotlight more than ever before. It is unclear, however, just how significant reported problems in gaining access to bank finance are in impeding the sector's expansion, relative to other factors such as access to equity capital and deficiencies in management and marketing skills. The Small Business Advisory Panel, which has been established by the Reserve Bank and which will hold its first meeting later this month, should help to shed some additional light on this question.

What is clear is that, by and large, the banks have responded positively to the Reserve Bank's calls to the banks not to overlook business borrowers. Since those calls were first made in late 1991, banks' business indicator rates have fallen by at least as much as their housing loan rates. Within the business sector, reductions on average appear to have been spread fairly evenly across large and small customers.

Stable Prices

Perhaps the major long-run contribution a central bank can make to growth is to help to keep inflation low. The CEDA vision rightly emphasises this pre-condition for the delivery of faster, sustained growth.

Today I want to talk not about the cyclical swings in activity and prices – which have implications for monetary policy – but about longer-run trends which are shaped in important ways by the prevailing rate of inflation.

Without being fanatical about it, the Reserve Bank attaches a high priority to keeping inflation under control. I have observed before that we do not have a strong natural anti-inflation constituency in Australia. Partly for that reason, we have to keep harping on the costs of high inflation. These include:

- changes in the distribution of income and wealth. Higher prices across the board cannot really enrich the nation; instead, they generate gains for those able to take advantage of inflation (particularly of asset prices) at the expense of others. Those gains and losses alter income distributions in ways that most people would not vote for if given the choice;
- inefficiencies in economic decision making. Most aspects of our institutional framework – eg for taxes, laws, financial arrangements – assume stable prices. Adjustments can, and are, made to take account of rising prices, but these are costly and incomplete in practice;
- shortening of time horizons. This impedes capital accumulation, which is a key part of raising living standards. The empty office blocks in our cities clearly testify to the inflationary mentality of earlier times, which pushed activity into speculative ventures at the expense of investment in more productive activities.

Ideally, we would like (to pick up Alan Greenspan's definition of practical price stability) to see inflation kept low enough so as not to bias behaviour in these costly ways. Putting numbers on that definition is a matter of judgment. Mr Argy has suggested a range of 2 to 4 per cent. My own view is that if the average rate of underlying inflation could be held to 2 to 3 per cent over time, we would meet our test. That is the standard which countries often seen as benchmarks have achieved – and which we ourselves achieved in the 1950s and 1960s.

Our recent performance, too, is up to this standard. The CPI published last week showed that prices rose by 0.4 per cent in the June quarter and by 1.9 per cent over the past year. This latest reading confirmed the picture of low inflation evident for several years now. Over the three years to June 1993, inflation as measured by the CPI averaged around 2 per cent a year; the last three-year period to show such a low inflation rate was in the early 1960s.

For policy purposes, what we are most interested in is the core or 'underlying' rate of inflation which abstracts from transitory or special influences to better reflect demand and supply conditions in the economy. There is

TABLE 1: SELECTED PRICE AND COST MEASURES
(Percentage change over year to quarter/month shown)

	June 1991	June 1992	Latest	
Consumer Prices				
Consumer Price Index	3.4	1.2	1.9	(June)
Private sector goods and services (net of tobacco taxes)*	3¾	2	1¾	(June)
Treasury underlying measure	4.0	3.2	1.9	(June)
Private consumption deflator	3.8	1.8	2.0	(March)
Producer Prices				
Manufacturing output prices	2.7	1.3	2.1	(May)
House building materials prices	2.7	-0.3	4.0	(May)
Other building materials prices	3.3	-1.0	1.4	(May)
Imported goods prices	-1.9	2.3	9.8	(May)
Broader Measures				
Domestic final demand deflator	2.9	1.5	2.0	(March)
Gross non-farm product deflator	2.5	1.0	0.8	(March)
Nominal Labour Costs				
Award wages	2.5	3.4	0.9	(May)
Private sector ordinary-time earnings	4.3	4.4	0.4	(February)
Unit labour costs	1.8	2.6	1.6	(March)

* Total CPI less fresh fruit and vegetables, fuel, mortgage interest charges, consumer credit charges, public dwelling rents, local government rates and charges, household fuel and light, postal and telephone services, motoring charges, urban transport fares, health services, pharmaceuticals, and education and child care.

no unique measure of this: our approach is to study a wide range of price indicators, and reach a judgment about the trends.

The measures which we routinely consider are listed in Table 1. The most important measures are based on the CPI, but adjusted to exclude items such as mortgage interest and consumer credit charges (which are conceptually inappropriate in a measure of inflation for monetary policy purposes), and items subject to temporary influences (such as petrol and fresh fruit and vegetables). Rises in government taxes and charges, which have had a significant impact over the past year, should also be excluded, given that they reflect administrative decisions rather than demand/supply pressures.

After adjustments for such factors, most measures suggest an underlying rate of consumer price inflation of around 2 per cent over the past year. This result is still affected by import price rises flowing from the exchange rate depreciation, although this effect (so far) has been smaller than generally anticipated. Measures of producer prices are more disparate but, overall, are running at generally low rates.

Given that we have had a depreciation in the exchange rate of close to 20 per cent over the past two years, underlying inflation of around 2 per cent is a pretty good performance. The challenge is to maintain this performance.

Looking ahead, the published or 'headline' rate of inflation could rise in the second half of 1993, as the effects of higher import prices continue to come through, albeit slowly. Ideally, inflation in an ongoing sense would remain close to present rates of around 2 per cent: the rises in import prices (and government taxes) have to pass through but, once they have been digested, the measured inflation rate would fall back.

Can we be confident that the effects of higher import prices and government taxes will be a once-off lift in the price level, and not the beginnings of a new spiral?

The key here is whether the initial price rises generate second-round effects, through wage and other cost increases. Such outcomes cannot be ruled out entirely, but the chances of 'quarantining' the effects of the higher import prices and taxes look good. Wage growth, which is perhaps the best test of the strength of our grip on inflation, has been quite restrained, with ordinary-time earnings rising by less than 2 per cent over the past year. Given current levels of unemployment and excess capacity, any second-round effects of import prices and taxes through the wage channel are likely to be fairly muted.

In brief, underlying inflation should remain in a 2 to 3 per cent range over the next year. That was an important consideration behind the decision last Friday to reduce interest rates by a further half per cent.

That decision, incidentally, had little to do directly with the current account statistics. Such statistics are relevant mainly for what they might say about the strength of domestic demand, which bears upon the price outlook, and for the short-term effects they might have on financial markets, which can sometimes be relevant to the timing of policy announcements.

All along, however, the focus of monetary policy has been on domestic price and activity objectives, not the structural balance of payments problem; that problem is not amenable to monetary policy solutions but needs to be (and is being) tackled by the kinds of policies listed for earlier sessions of this conference. Strong international competitiveness is part of the solution but no country has ever depreciated its way to prosperity.

What about the longer term? Here the critical factor is inflationary expectations. I do not mean a narrow economist's definition, but rather the whole way of thinking about inflation in business, government and the community generally. In the 1970s and much of the 1980s this had developed to the point where most people assumed high inflation would continue, and behaved accordingly.

Happily, this mentality has been breaking down over recent years. Our actual performance on inflation has been a big factor, as has the effect of sharp falls in asset prices. The recession and subdued pace of the recovery have reinforced those factors. That, however, is not the whole of the story: the recession in 1982/83 was accompanied by a big fall in inflation, but it had virtually no effect on expectations. That made it harder to maintain low inflation once activity picked up.

This time, expectations have fallen dramatically. A recent NAB survey indicated that nearly 80 per cent of respondents expect inflation to stay below 4 per cent during the rest of the 1990s. In bond markets, yields on 10 year bonds are now at their lowest levels for two decades. The clear public commitment by the authorities (the Government and the Bank) to maintaining low inflation over the medium term appears to have been an important factor in turning around expectations.

That said, the inflationary mentality is not dead. We still hear stories, for example, of companies adopting target rates of return on capital which appear to embody an inflation 'premium' which was part of the 1970s and 1980s, but no longer fits the 1990s. Companies understandably seek to maximise their returns to shareholders, but any failure to properly allow for likely lower rates of future inflation impedes investment, to the detriment of growth in the economy – and perhaps also to the detriment of shareholders' returns.

Some retirees, too, show signs of inflation 'illusion', in that they believe their living standards are now being squeezed as interest rates come down. At least part of this, however, reflects the winding back of inflation, with a corresponding reduction in the inflation premium built into nominal interest rates, which in earlier years was being consumed – ie retirees were effectively running down their real capital, often without realising it.

As the process of adjusting to lower inflation proceeds, the economy should be able to grow faster in a sustainable way. If wage negotiations, for example, were to build in current low expected price increases – of the order of 2 to 3 per cent – that kind of behaviour would clearly produce better national outcomes than if larger increases (not backed by genuine productivity gains) were pursued and granted, only to be followed by a tightening of policy.

Conclusion

Sustained low inflation and stable financial conditions will help to make Australia more competitive. They are important for faster growth but other ingredients also are important. As these come together and businesses marshal the confidence to take advantage of them, we will see a pick-up in investment – and we will be on the way to boosting living standards over the remainder of the 1990s.