Some Thoughts on Current Economic Developments

Talk by Governor, Mr B.W. Fraser, to the Taproom Club, Melbourne, 11 July 1995.

Frankly, I have been at a bit of a loss to know what I might talk to you about today. For one thing, I am unfamiliar with the Taproom Club, although the knowledge that it is comprised exclusively of media people is reason enough to be wary, whatever I might talk about. A brewery also seems to be involved, although there are no real surprises in that. (It presumably explains the name of the Club!)

The fact that I had talked at some length about the Australian economy in London only a month ago added to my predicament. Nothing has occurred in the intervening weeks to alter the overall assessment presented in that talk. Indeed, it would have been remarkable if it had, given that economic circumstances rarely change in fundamental ways from one month to another. Certainly, policy makers must reach their decisions on the basis of longer-term trends, and not seek to adjust policy every time a 'good' or 'bad' figure appears.

Unfortunately, not all commentators and would-be policy makers are capable of taking in this wider panorama. I will give you a few examples, and in the process make some observations on recent developments.

Recent Economic Developments

Since the economy began to recover in mid 1991, real GDP has increased by about 15 per cent. Over the four-year period, this implies an average growth rate of between 3 and 4 per cent. Growth of a similar order is forecast for 1995/96. In other words, so far in this recovery phase we are looking at five years of growth averaging between 3 and 4 per cent – a rate which most commentators would put at the upper limit of Australia's long-run potential.

Discerning listeners among you will know that, even allowing for some 'catch-up', five years of 3 to 4 per cent growth has a different ring to it – and certainly a truer ring – than hollow sounding throwaways, like 'five minutes of sunshine'.

For another illustration of the fixation which many people have with the short term, cast your minds back over the various predictions that have been made about interest rates during the past six months. Some commentators criticised the rise in official interest rates last December – the third increase in the second half of 1994 – but most acknowledged that it was necessary. The common view among the pundits in the early months of 1995, however, was that further

and possibly substantial rises were still to come. These views owed something to the very strong growth shown in the national accounts data for the September quarter.

As signs of slowing in the economy began to appear, expectations in the markets and elsewhere moved from further tightenings to possible easings. Then, about two weeks ago, in the wake of the current account number for May, many commentators swung back to the view that the next move in official interest rates would be up. Now, following the action last week by the Federal Reserve to reduce official interest rates in the US, expectations of interest rate reductions have begun to resurface. Some commentators who were earlier predicting substantial interest rate increases before the end of 1995 are now forecasting reductions.

People are, of course, free to express their views, and to change their views. My point is that policy makers have less freedom in this regard – they must take longer-term views than most people in markets, the media and politics appear able or willing to take. And, as far as possible, they must base their judgments on hard data, rather than wishful thinking. We would be in real trouble – in real 'stop-go' territory – if those responsible for monetary policy decisions allowed themselves to be persuaded to follow even a fraction of the short-term swings in sentiment we see in financial markets (and elsewhere).

It is clear that growth in the Australian economy is slowing down. For the moment, this seems to be occurring broadly as policy makers intended. According to the national accounts, non-farm growth slowed from an annual rate of 7 per cent in the six months to the September quarter, to a more sustainable annual rate of 3 per cent in the six months to the March quarter. Unfortunately, policy cannot slow the economy to some precise, desired growth path and then keep it to that path: the internal dynamics of economies and the lags before policy changes take effect almost guarantee some bumpiness, as distinct from a perfectly smooth ride.

What is not clear at this time is the extent or likely duration of the slowdown which has been occurring. It is possible, for example, that the economy could slow further for a quarter or two. If it did, this need not be a cause for alarm. To the extent that any such pause in growth reflected the working off of excess holdings of stocks, for example, it would be temporary, and not in itself a reason to ease monetary policy.

In London last month, I noted that recent indicators of economic activity in Australia were giving mixed signals, and that there were risks both ways on growth. New information, as it became available, would help to firm up the probabilities attached to these risks. I concluded:

> ' … that there can be no certainty about the timing or direction of the next move in official interest rates in current circumstances. Any change will be dependent on judgments based on the flow of data about trends in activity, capacity utilisation, prices, wages, exchange rates, overseas developments and other factors.'

That remains the situation as I see it.

Last week's decision by the Fed to reduce official interest rates by 25 basis points is a relevant 'overseas development', to be taken on board in our on-going assessments. It is a small move, yet it is a good move, to the extent that it helps to 'cushion' the economic slowdown in the US. Any move of that kind, and the similar move by the Japanese authorities on Friday, which was even more pressing, has to be good news for Australia. It does not, however, have any immediate implications for official interest rates in Australia. There is no mechanical linkage between movements in US official interest rates and movements here.

Domestic considerations are very much to the fore in our deliberations on monetary policy. To this time at least, growth in Australia appears to be holding up better than in the US. In the US, retail trade has been flat for much of this year, and employment has been falling over the past three months. Both these indicators have continued to grow strongly in Australia, as have imports. On inflation, while our actual performance over recent years is

better than that of the US, our *outlook* is less secure, given the pressures already in the pipeline from a variety of sources, including the weak exchange rate. These domestic factors argue for holding the line on official interest rates in Australia for the time being.

We also have a large current account problem. That problem is not a primary objective of monetary policy but, in circumstances where the exchange rate is so clearly being driven by concerns about the current account deficit, it has to be factored in.

I have discussed the problem of our current account many times but a couple of points are worth repeating, particularly in the wake of reactions to the figure for May. That was obviously a big figure but it did not warrant the near hysterical reactions it evoked in certain quarters.

Many of those reactions too can be sheeted home to short-termism – to an unwarranted focus on one month's figure. You do not have to be a student of economic statistics to know that monthly figures of the current account deficit (more so than most other indicators) have a lot of 'noise' in them: they can bounce wildly from month to month for a variety of reasons. The Statistician routinely issues public warnings to this effect. He also pointed out last week that, in respect of more than half the monthly figures published over the past decade, 'irregular' factors (as distinct from the trend and seasonal factors) have accounted for 80 per cent or more of the month-to-month movements. Monthly fluctuations, therefore, can hardly be seen as signalling new trends.

In hosing down some of the more extreme reactions to the latest current account number, I do not want to appear to diminish the problem. The current account is the one area of the economy where not a lot of progress has been made over the past decade and a half. That is disappointing. But the need to tackle more vigorously the underlying source of the problem – namely, an insufficiency of national savings – is now widely recognised. And it is now occurring, if a little belatedly.

I have suggested several times that life would be more comfortable for us if the current account deficit were to average around 3 per cent of GDP over a run of years – compared with the average of $4^1/_2$ per cent in the 1980s and 1990s. This would greatly reduce our vulnerability to sometimes fickle changes in sentiment in financial markets. Provided they are followed through appropriately, the measures announced in the last budget to move to surpluses and to raise private savings through increased provisions for superannuation will help to make that 3 per cent a realistic prospect.

In short, I think policy is on the right track so far as the current account problem is concerned, but it will be a long journey. We will have to be patient. We will have to be on guard too to fend off the hawkers of non-existent short-term fixes along the way. And we should not get too excited by monthly numbers, including those which happen to bounce in a favourable way.

Like the recent move by the Fed, the May current account figure has no immediate implications for monetary policy.

What seems somewhat ironic to me is that one event which completely overshadows both the May current account deficit and the Fed's move in terms of its implications for Australia's economic future has passed by with relatively little acknowledgment. I am referring, of course, to Accord VIII.

People in financial markets do not appear to give much thought to the Accord, perhaps because incomes policies do not feature prominently in other countries' economic armouries these days. Or, if they do think about it, they tend to dismiss it as being incompatible with their view of the way 'market' economies should work. Some other commentators seem intent on maintaining the scepticism they have displayed from the outset – notwithstanding that, in the Accord process, Australia has had an incomes policy for more than a decade which actually works. It has contributed, significantly in my view, to sustained moderation in wage increases, and to engineering a more productivity-focussed industrial relations culture, without

Darwinian consequences for the weaker members of the workforce.

As in the past, the growth in wages in the years ahead will have a major bearing on how successful we are in keeping inflation under control. More specifically, it will be critical in helping to keep underlying inflation at 2 to 3 per cent, and in ensuring that any breaches of this objective that might occur are temporary. To my knowledge, Australia is the only country where a union movement has formally committed itself to pursuing wage increases which are consistent with delivering the central bank's inflation objective.

I am afraid that what started out as some brief observations on recent developments has turned out to be rather longer than I had envisaged. It leaves little time to pursue some other aspects which I had planned to explore when I accepted your invitation. In the time remaining, I can give you just an inkling of a couple of these.

Money Matters

One relates to the move towards a so-called 'cashless society'. For most of us, that too is proving to be a long journey. The value of currency notes on issue, for example, has gone on increasing year after year; it has been equivalent to a fairly steady proportion of GDP (around 4 per cent) over the past 30 years. In terms of payments activity, the current pattern, very roughly, is:

- 18 billion cash purchases a year;
- 1 billion cheque payments;
- 0.5 billion direct entry funds transfers; and
- 0.5 billion plastic card purchases.

Clearly, then, we continue to rely heavily on 'cash'. Plastic cards and direct entry systems have been making some inroads but these have been mainly at the expense not of cash but of relatively high-cost cheque services (which are subsidised in part from margins on deposit and loan business).

Driven by computer-chip technology, possible alternatives to conventional currency are now emerging in proposals for the so-called 'electronic purse', in the form of pre-paid, stored-value cards, and smart cards which can be 'recharged' through ATMs, EFTPOS terminals, and so on. Basic stored-value cards – such as Phonecards – have been available for some time but stored-value cards which can be used to purchase a range of different goods and services are new, and they have still to prove themselves in practice to be superior to conventional cash in terms of cost, security and convenience.

Various smart card schemes are being developed and trialled around the world, including in Australia, although their widespread use would seem to be some years away. They raise important issues for retailers, consumers and card issuers. Central bankers also have obvious interests in vital aspects of electronic currency – including the integrity of the issuers, the security and efficiency of the technology, their scope for laundering money, and the ownership of the seigniorage earned on the issue of currency. These and other aspects are being assessed and we will have more to say about them later on.

Finally, a brief word about financial institutions and the problems they sometimes get into. Central banks usually get involved in these problems when they occur, through their role as supervisors of the banks.

Barings, which closed its doors in February, and lost its shareholders about A$1½ billion, was the most recent high profile collapse. The Bank of England explored different avenues for keeping Barings afloat, including support from the Bank itself, but decided against this, apparently on the grounds that the failure of Barings was unlikely to destabilise the broader banking or financial system. An official inquiry into the collapse was initiated almost immediately by the Bank of England and the report of that inquiry is expected to be released in the next couple of weeks.

We will have to await that report for confirmation, but a widely held view is that Barings' problems stemmed primarily from fraud and management failure, rather than something more exotic, like a derivatives

'meltdown'. The derivatives in question were of a relatively straightforward variety.

Supervisors obviously have to do what they can to minimise these kinds of risks. Short of positioning armies of trained staff to look over the shoulders of dealers, and to second guess their decisions, however, there will always be some residual risk. If management cannot control fraud and malpractice, it would seem unreasonable to expect supervisors to be able to do it for them.

Australia has had its share of problems with financial institutions. The shareholders of several banks, including a couple of former State government-owned banks, have paid dearly for their banks' miscalculations and ineptitude. But we have not seen the major bailouts of banks with public funds that have occurred in the US and the Nordic countries – and might yet occur in Japan.

Outside the banks, we have seen the collapse of the Farrow Group of companies, which has spawned a complex set of legal proceedings. The Reserve Bank has been dragged into a number of these proceedings with, in effect, the Victorian Government and various other parties seeking to be compensated by the Reserve Bank if certain claims for damages should go against them.

As you might imagine, we are not particularly happy about any of this. I will not go into details but the main line of argument against the Reserve Bank seems to be that, although the Bank was not responsible for supervising the building societies, it allegedly knew more about them than the responsible supervisor – the Registrar of Building Societies in Victoria – and should have been more forthcoming in conveying that knowledge to the Victorian authorities than we allegedly were.

I think it is all very fanciful but we are obliged to defend our position in the courts. Our latest advice is that the cases could get underway early in 1996, which will be almost six years on from when the Farrow Group collapsed. It is a good bet that the lawyers involved can look forward to a succession of field days, poring over old statements of who said what to whom, uncovering and testing meanings in particular sentences and particular words which even the authors never intended. We have budgetted over $600,000 for the direct legal costs of defending ourselves in these actions in 1995/96. We expect to be successful and, in that event, we might get back about half our direct costs.

I mention this episode not by way of any special pleading on the Bank's part, but as an illustration of a process which, I sense, is being played out in many spheres all over the country. It raises some interesting and difficult questions as to the value added by the process and, more crudely perhaps, about who is making money from it.