Statement to Parliamentary Committee

Opening remarks by the Governor, Mr I.J. Macfarlane, in testimony to the House of Representatives Standing Committee on Financial Institutions and Public Administration, 6 November 1997. The accompanying Semi-Annual Statement on Monetary Policy was released in conjunction with the Governor's appearance before the Committee.

Thank you, Mr Chairman. It is a pleasure to be here in front of your Committee for the second time under the new arrangements set out in the *Statement on the Conduct of Monetary Policy*. On the basis of the first hearing, we think the new arrangements are working very well. On that occasion, we received some very penetrating and constructive questioning from Committee members, and there seemed to be quite a lot of public interest in the proceedings.

The main reason for these hearings is to improve the accountability of the Reserve Bank, both directly to Parliament, and via the press coverage to the public more generally. In the spirit of increased accountability, I should, I suppose, be accountable for what I said to this Committee at the previous hearing, as well as for what I am going to say today.

I covered a number of subjects at the previous hearing which I thought were important for an understanding of how the economy was going to perform over coming years. I also mentioned a couple of outcomes we expected for 1997. It is those which will probably be of the most immediate interest. I said that, after a sluggish 1996 where GDP had grown at about 3 per cent – at one point, it got to not much more than 2 per cent on a 12-months-ended basis, we should expect it to pick up to about 4 per cent in 1997. I also said that I expected inflation to stay at the bottom of the 2–3 per cent range, with the possibility that it could go a little lower for a while.

Now I think I could be excused for wanting to walk away from earlier forecasts as a result of the current turmoil in Asian and world financial markets. While I intend to say quite a lot about those events later on, I do not propose to invoke that excuse at this stage, because they have not had any effect on the economy to date. They have affected financial markets, but not the economy yet.

Instead, I want to start by saying that the baseline we have to work from, i.e. the growth of the economy in the first three quarters of 1997, has been at least as good as I was pointing to in May, if not a little better.

- We now have the GDP growth rates for the first two quarters of 1997, which show the economy grew at an annual rate of nearly 4 per cent during that time. And we have further monthly figures for the September quarter which are somewhat stronger than those recorded during the first half of the year. This is true for the major monthly indicators such as retail

trade, imports and exports. It is also true for the labour market, especially for vacancies, and to some extent also for employment. There is also evidence from the business surveys that confidence is picking up, but these surveys were generally compiled before the Asian headlines of a fortnight ago.

- On inflation, the outlook changed a little. New figures brought underlying inflation below 2 per cent, and our on-going assessment caused us to lower our forecasts. As a result, we have had two further easings of monetary policy – one in May and one in July. An important reason for the lower inflation forecasts was the better outlook for wages. You may recall that shortly after the previous hearing in May we received revised figures on earnings from the ABS that suggested not only that they were lower in the quarter in question – the March quarter of 1997 – but that an upward trend had been revised away. This better picture was confirmed again in the June quarter figures, but the picture has been muddied somewhat by the recent September quarter figures which show an unexpectedly strong rise.

On balance, therefore, we at the Bank judged that the information becoming available over the past six months was tending to confirm this relatively benign view of the future – GDP growth of about 4 per cent (enough for some further reduction in unemployment from the 8.8 per cent we had at the time of the last hearing) and inflation a little below 2 per cent (enough to justify the May and July easings in monetary policy).

The picture was not all rosy – the slower output growth of 1996 was still making its presence felt in the form of sluggish employment growth in the first half of 1997, there were some doubts about the strength of investment, and the effects of El Niño were around the corner. But economies nearly always present a mixed picture, and this mixture was a lot better than most. In addition, financial conditions had become clearly easier than in May. The overnight cash rate had come down from 6 per cent to 5 per cent as a result of the two easings of monetary policy, and yields on 10-year bonds were down from 7¾ per cent to 6 per cent. The exchange rate against the US dollar has come down from 77.7 US cents to 70.3 US cents; against the trade-weighted index, it has come down from 60.2 to 57.0.

I come now to the point where I should say a few things about what has been happening in Asia and the rest of the world. I will do my best to be specific, but you should bear in mind that the ground is constantly changing.

The first thing I would like to say is that in the long run I am still very optimistic about Asian growth prospects. These countries still retain a set of characteristics that are conducive to long-run growth:

- they can still achieve rapid productivity growth through technology transfer, i.e. they have started from a long way behind and have a fair way to go;
- they are oriented towards international trade;
- they have high savings rates and high investment and a relatively small government sector;
- they have generally sound fiscal and monetary policies – although they have got some way to go in terms of the soundness of their banking and financial sectors; and
- they have great respect for, and devote considerable effort to, education.

I do not see the end of the Asian miracle, partly because I do not think it ever was a miracle; it was just the application of some tried and tested rules of good economic policy. It is still fortunate for our long-run prosperity that we have strong links to Asia.

Having declared my optimism about the long run, I should now turn to the short run. Clearly, there are going to be difficulties here, in particular among four ASEAN countries – Thailand, Malaysia, Indonesia and the Philippines. From the moment the Thai baht was floated on 2 July, attention quickly broadened to encompass these four. Their currencies have fallen sharply, as have their stock markets and property prices. These countries are battening down the hatches – in

two cases with the help of the IMF – to sort out their problems. The principal problem, it is now apparent, concerns how to handle the fall of previously over-inflated asset prices, undisciplined lending by local banks and foreigners, and some very opaque inter-relationships between business and government which have obscured the true financial position of a lot of companies and banks. There also appears to have been over-investment in some areas. Property played its usual major role, but on this occasion there were also more contemporary avenues, particularly electronics and semi-conductors, where there is clear over-capacity and intense competition among these countries (and with Korea and Taiwan). Of course, these problems have been around for years – they did not just start on 2 July.

A part of this adjustment must inevitably involve a sharp curtailment of growth in the short run and a contraction of credit. Imports will fall, and so the effects will be spread to other countries. The good news for Australia is that these four countries account for only 10 per cent of Australia's exports. If the difficulties remain confined to these four countries, the effect on Australia's exports, and hence our growth, would be modest.

The rest of Asia is, in fact, a lot more important to Australia. Japan – our largest market – has been limping along at an average annual growth rate of about 1 per cent now for about five years. Our exports to Japan have virtually not increased at all during that period. The other big Asian markets for Australia are Korea, China, Taiwan and Hong Kong. These are collectively much more important than the ASEAN four. Of course, some of the underlying problems that afflict the ASEAN four also apply, although more modestly, to some of these countries. For a time, it looked as though the ASEAN problems would spill over to these in a big way, but that seems less likely now, although we should not speak too soon. Even so, we should build in the assumption of some slowing in aggregate for these countries.

To judge the effects on Australia, we should, in principle, have a view on how each country will fare in regard to economic growth, imports and the health of their banking systems (and we should look outside Asia, which I will do later). It is never easy and some sure bets turn out to be wrong. For example, virtually everyone thought the simultaneous share market crash of 1987 and associated company failures would presage at least a slowdown, if not a recession. In the event, 1988 turned out to be a boom year for the OECD economy and for Australia.

Let us hope we can be a little closer to the mark this time. Most analysis to date has consisted of a relatively mechanical application of lower growth and lower imports among the ASEAN four to lower Australian exports and lower Australian GDP growth. The orders of magnitudes are quite small and the most commonly cited figure for GDP growth in Australia is a reduction of about a quarter of a percentage point. According to press reports, the OECD has recently suggested figures of 0.3 per cent for Australia in 1997 and 0.4 per cent in 1998. Quite how they got an effect on 1997, which we are already 80 per cent through, I do not know, but, as I said, I am only relying on newspaper reports. These sorts of figures can become considerably larger if we also bring in lower growth rates for Korea, China, etc., but we are getting into the realms of speculation if we do so.

The only guide that we have is that this will not be the first time that it has happened. In 1984 and 1985 we saw a big drop in Asian currencies and a big drop in their growth rates. It had the predicted effect and our exports to Asia for a time were quite weak. Again, last year – in calendar 1996 – there was zero growth of imports in the ASEAN four, and our exports to them slowed. I think we will have to put up with a period of weakness again. Frustrating as this instability may be, it seems to be an inevitable part of an open competitive economic system which is the only type capable of achieving strong growth in the long run.

So far I have only talked about Asia, but the outcome for the world economy will depend on more than Asia. We have to bring in two bigger regions – North America and Europe.

North America (mainly the United States but also including Canada and Mexico) is growing quite strongly. The recent disturbances in financial markets which were imported into North America from Asia do not seem to have had a lasting impact. If anything, their main effect seems to have been to hose down some overheated asset markets slightly, and hence to reduce the likelihood of an imminent tightening of US monetary policy. Such a tightening in the next six months cannot be ruled out, however.

Europe is finally recording some gains after years of disappointingly slow recovery from the early 1990s recession. In fact, European growth has picked up to the point where six European central banks recently tightened monetary policy slightly to head off possible inflationary pressures down the track.

So far, I have talked about Asian and world economic events as though their only effect on Australia was via our exports. Of course, that is only part of the story. The other important part is that we now have to face the possibility of further financial market instability.

For better or for worse, through knowledge or through fear, the international investment community is taking a more sceptical look at things Asian, and that includes all countries in the Asian region, including Australia. That means they have become more risk-averse, and more likely to judge countries and their policies harshly.

We have already seen some of the effects on some Asian countries:

- falling exchange rates;
- falling share prices;
- rising risk margins in interest rates; and
- downgrades by rating agencies.

We are in a better position to handle this financial instability than we have been at any stage in the last 30 years. We formerly had a reputation as a boom-bust economy, and investors used to build in quite a large premium for risk when holding Australian assets. We have come a long way in convincing investors that this is largely a thing of the past. A good example of this is that our bond yields are now virtually the same as US bond yields, whereas five years or 10 years ago it was not uncommon for the gap to be as high as five percentage points; some of this was a risk premium and some of it reflected our higher inflation. Another example is that the Australian dollar used to be one of the most volatile currencies in the world, whereas in the 1990s it has been no more volatile than the major currencies such as the US dollar, the yen or the mark.

Over the past four or five months, this has served us well. While the Australian dollar has gone down a fair amount against the US dollar, it remained relatively steady in trade-weighted terms. It is true that over the last fortnight the Australian dollar has declined in trade-weighted terms, but it has done this in a relatively orderly fashion, and it is not an unreasonable market response given that our export markets have weakened.

This new-found reputation for stability may surprise some people, because there is still a tendency to read so much into the small month-by-month or quarter-by-quarter variations in economic statistics. But if we take a longer sweep, we can see how many of the economic problems that used to concern us have now been eliminated, or are at least under some reasonable sort of control. The headlines are no longer full of stories about the current account deficit or the level of foreign debt. The budget deficit is small. High inflation and its inevitable twin, high interest rates, no longer fill the papers. This does not mean, of course, that we have solved all our economic problems, but we have clearly narrowed them down. This has also tended to concentrate minds on the one that remains – namely, the level of unemployment.

This is a reasonable priority because less progress has been achieved on unemployment than on the other imbalances in the economy that came to the fore in the mid-70s and persisted through the 80s. It is not as though no progress has been made – the

unemployment rate has come down from a peak of 11.2 per cent to its present 8.6 per cent – but it has been disappointing progress. With six years of the expansion now behind us at an average growth rate of 3.6 per cent per annum – the third highest in the OECD area – we could have hoped for more.

I think some further progress can be made over the next year, although we have to accept that it will probably be slow, and monetary policy will only be part of the story – in the long run, only a small part. History suggests this will remain the case.

Australia moved from 2 per cent unemployment to over 10 per cent in the decade from 1973 to 1983. The damage was really done during that period. Despite good output and employment growth in the 1980s expansion, the unemployment rate was back to 11 per cent following the 1990 recession. So in net terms no progress had been made in a decade.

What we want this time is good growth in output and employment, with a difference – we want it to last a lot longer. The six-and-a-half years that the previous two economic expansions lasted was not good enough. Although progress was made in reducing unemployment – particularly in the second one – it was all lost in the ensuing recession.

This time around we must make sure we have a much longer expansion, reducing the likelihood and severity of any future slowdown as much as possible. I do not know how far that will be possible, but the surest way of ameliorating the business cycle in this way is to avoid the imbalances occurring during the later stages of the expansion. The main imbalance in Australia, as elsewhere, has always been the emergence of inflation. The story is never exactly the same – inflation can be accompanied by a wage push, an asset price boom or an external imbalance – but the result has been the same following each of the past three booms.

That is why we need to have a more medium-term focus in our monetary policy and why the inflation target is such a central part of it. The inflation target is not anti-growth; low inflation is not an end in itself, we are interested in sustaining a good inflation performance because we are interested in growth and employment. Keeping inflation in check is the key to longer expansions.

It has sometimes been said that we are too cautious in following this policy. I think that is a little unfair. Of course, we are cautious in that we like to look at a range of information and think carefully before we make a move on monetary policy. But we try to be forward looking and pre-emptive. For example, we did not wait till measured inflation was below 2 per cent before easing – in fact, it was 3.1 per cent when we first eased in July last year.

Similarly, there have been suggestions that the Reserve Bank has a speed limit above which the economy cannot be allowed to grow (the figure usually cited was 3½ per cent). Such a suggestion is, of course, incorrect and I have pointed this out on several occasions. In case there is still any doubt, you only have to look at our behaviour in 1997. As I said earlier, the economy has been growing at 4 per cent per annum so far in 1997, yet it did not stop us easing monetary policy twice this year. If we are getting reasonable news on inflation and our inflation forecasts are in good shape, we have no objection to the economy growing by 4 per cent or 4 per cent plus.

When looking at the whole picture of employment and unemployment, monetary policy is only a small part of the story, and it mainly concerns the cyclical aspect of unemployment. If you look at the really big changes in employment or unemployment over decades, rather than years, monetary policy plays a very small role. The biggest change in employment performance of which I am aware is the contrast between the United States and continental Europe. In the United States, the unemployment rate is back to its sixties level, whereas in Europe it is about five times as high as it was in the sixties. A few European countries have done better than that – including the United Kingdom – but others have done worse.

If you try to explain the superior US employment result by faster economic growth

you get nowhere. Europe has grown as fast as the United States over three decades – it just has not generated jobs. The explanations for the poor European performance on jobs all centre around various types of rigidities, especially in wages and conditions of employment, but also the social security system and the difficulties involved in starting businesses and the subsequent lack of entrepreneurship.

I do not intend to go into this in any depth because it is a huge topic. I only raise it to point out that there is much more to the story than the growth of demand, and the role that monetary policy plays in it. In other words, even if we succeed in having good economic growth and sustaining it for a longer period than in earlier expansions, it will not solve all our unemployment problems. We will make some progress, but it is too optimistic to think that we will be able to emulate the Americans and return to the 1960s level of unemployment through macroeconomic policies alone.

I saw in the paper yesterday someone from ACOSS saying that the big challenge for Australia was to achieve US-style economic growth and low unemployment without US-style inequality and poverty. I think this is a realistic way of looking at it. It shows an awareness of the current trade-off, and I suspect a hope that, with some ingenuity, we might be able to improve on it somewhat. My only quibble is that we already have achieved US growth rates – in fact, exceeded them – it is the US unemployment rate that has eluded us. This is something that people like myself, who studied economics in the sixties, find surprising. In the sixties it was the United States that was always criticised by countries like Australia and most of Europe for their high unemployment. Now the boot is on the other foot.

There is a lot more that I could talk about, but I will confine myself to only one further topic. That is the subject of bank lending and bank margins, particularly bank lending to small business. This is a subject that this Committee has taken a particular interest in. In fact, the first large-scale inter-country study of Australian banks' margins and banks' profitability was undertaken by the Reserve Bank at the request of this Committee in August 1994. We did another study at the Committee's request recently which was published in our October 1997 *Bulletin*. As Committee members also know, the Reserve Bank has been meeting with its Small Business Finance Advisory Panel since 1993 to discuss the provision of finance to that sector. We formed this Panel because we were worried that banks had become excessively risk-averse and were reluctant to lend to small business in the early part of the recovery from the 1990/91 recession.

It has been a slow process, but competitive pressures have been gradually working their way into banks' margins, i.e. the difference between the average rate they earn on their loans and the average rate they pay on their deposits. These margins are now lower than at any time since we have been collecting the statistics, and the biggest fall has occurred over the past two years. Clearly, the entry of mortgage originators into the housing market was a very important development, and it led to the margin on housing lending falling from a level which was high by international standards to one which is about average. We are now beginning to see hotter competition in lending to small and medium-sized businesses. Partly this is a result of the need felt by many banks, particularly the regional ones, to reduce their reliance on the now much less profitable mortgage market. In this sense, it shows how competition slowly works its way through the system. I confess that it has taken longer than I expected, and longer than I hoped, but we are finally getting there.

That brings me to the end of my introductory remarks. We have certainly had a very eventful period in the month leading up to this meeting and we have all been working hard to keep up with events, particularly in the international scene. We are happy to answer any questions you have, and I hope it leads to as good a discussion as we had together last time. ✠