STATEMENT TO PARLIAMENTARY COMMITTEE

Opening Remarks by Mr IJ Macfarlane, Governor, in testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Sydney, 18 February 2005. The Bank's Statement on Monetary Policy *was released on 7 February 2005.*

It is a pleasure to be back in front of the Committee after a break of about eight months. As you know, we take these appearances very seriously and appreciate the opportunity it gives us to explain our position to Parliament and to the public. I hope the new Committee will find it as valuable as we do.

Earlier this month we issued our quarterly *Statement on Monetary Policy* which set out pretty clearly how we see the current situation. So instead of going over the same material again, I would like to review the medium-term aspects of economic policy.

As you know, the current economic expansion, which is in its fourteenth year, is the longest expansion we have had since quarterly national accounts statistics were first published in 1959. We had one from 1961 to 1974 that was nearly as long, but it ended up with inflation pushing up into double digits followed by a recession. The following two expansions lasted about eight years each before they came to an end.

In the current expansion, the annual growth rate has averaged 3.7 per cent, but, like all expansions, it has not been completely smooth. For example, the annual growth rate has been as high as 6¼ per cent and as low as 1½ per cent; on two occasions, there has been a quarterly fall in GDP. But overall results have been very favourable: inflation has averaged 2.5 per cent per annum and we have seen the unemployment rate fall from 10.9 per cent to 5.1 per cent. The longevity of the expansion has been due in part to the fact that it has been possible to avoid obvious excesses in the economy. Relatively small changes in policy have prevented the build-up of the type of excess which in the past required a large and determined policy response.

The excesses on previous occasions have been of three main types. The most common was a rise in inflation. The second was an asset-price boom and bust, and the third, particularly in the fixed exchange rate era, was a balance of payments crisis. I would now like to review the current situation in light of the risks posed by these three types of excesses.

The inflation risk is the one that our inflation-targeting monetary policy is specifically designed to control. We feel pretty confident that the type of strong monetary policy response to rising inflation that had been necessary in the past is unlikely to be needed again as long as we are vigilant. While pressures will undoubtedly arise, they should not be as powerful or as widespread as previously. First, the inflation-targeting regime means that the longer inflation has been contained, and the lower are inflationary expectations, the easier it is to keep things that way. Second, there have been important changes in wage-setting arrangements that have meant that pressure in labour markets does not feed as quickly as previously into wage inflation. The main changes have been the decentralisation via enterprise bargaining and the lengthening of contracts out to two or three years. The third influence on inflation has been the increase in competition both at home and from abroad.

But inflationary pressures cannot be completely eliminated and can be expected to make their presence felt as the economy pushes up against capacity constraints. That is something that is happening now, although it is a piecemeal process. There is no economy-wide definite dividing line between a situation of ample capacity and one where growth is limited by capacity constraints. For example, there has clearly been pressure on capacity in the building industry for some years, as anyone attempting to get a house built or renovated will confirm. Over the past year, many parts of the resources and heavy engineering sectors have also been at virtually full capacity, and this has, among other things, limited our export performance. Some parts of the services sector, such as accountancy and other professional services, are also fully stretched. On the other hand, there are other parts of the economy where things are relatively normal. But overall we are hearing more reports of businesses finding difficulty in hiring suitable labour and having to pay more for material inputs. The most obvious signs of this are the increases now being seen in producer prices at all levels and output prices for building and construction. There has not as yet been a big effect on consumer prices, but even so, the rise over the past year has been higher than our earlier forecasts had suggested.

We have not seen evidence of an acceleration in across-the-board wages in the standard statistical series, although there is plenty of evidence from surveys that businesses are finding it more difficult to attract labour and that wage pressures are rising. Of course, there is no reason why the inflationary process has to be triggered by a wage acceleration; it could just as easily start with prices themselves and then move on to wages.

The second risk that I mentioned earlier was a boom and bust in asset prices. I do not think this is a serious risk at the moment, although it was not that long ago that it posed a threat. In 2003, we had both household borrowing and house prices growing at over 20 per cent, and that was on top of several earlier years of strong rises. If 2004 had produced another year of 20 per cent growth, then we would have had the makings of a serious boom and bust situation. As it was, 2004 was a very good year in this respect as borrowing slowed and house prices retreated for most of the year. Growth in borrowing seems to have now settled for the time being at a rate of about 13 per cent per annum, and house prices may have risen in the December quarter of 2004. It is too early yet to know where either borrowing or house prices are headed.

The third risk I mentioned was the balance of payments, where the current account deficit is estimated to be 6¾ per cent of GDP. This is not very different to the level reached on a number of occasions over the past two decades, but it is disappointing given that it has occurred against the background of a reasonably buoyant world economy and a strong rise in the terms of trade. Strong domestic demand pushing up imports is part of the story, but the bigger part is the failure of the volume of exports to rise sufficiently to take advantage of the strong world demand. We have recently analysed this at some length, and presented our conclusions in our quarterly *Statement*. I will be happy to talk about this later in more detail. But while the balance of payments result is disappointing, it is not of itself a reason for a monetary policy response.

At this point, I usually look back at the forecasts I gave the Committee last time to see how the outlook has changed. I also make a couple of new forecasts. On economic growth, last year was one of the few examples where the growth rate we now expect will be well below what we had forecast. In the middle of last year we were forecasting 3¾ per cent growth for the year to the December quarter 2004; now we think that when we receive the December quarter national accounts next month, they will show a growth rate of not much more than 2 per cent. How do we explain the difference?

One explanation would emphasise that the national accounts are showing a picture of the economy which is considerably weaker than that shown by most other indicators. For example, employment growth has been booming throughout the twelve months that GDP has apparently been restrained. The lagging nature of the employment/GDP relationship may explain part of this, but not all of it. There is a similar discrepancy in the comparison with high business confidence, high consumer confidence, increasing business profits, booming share market and government tax receipts. It would be tempting to disregard the national accounts entirely and rely instead on the other indicators of economic activity mentioned above. However, I do not intend to do so. While I think there is some tendency for the national accounts to be understating the level of economic activity at the moment, I think that they are right in the sense that they show that growth has slowed somewhat from 2003 to 2004. The next question is to ask why.

This is where capacity constraints enter the picture again. Economic policy in Australia, most notably monetary policy, has allowed domestic demand over recent years to run at a reasonably fast pace. But as can be seen from the numbers below, this has not been translated into an equivalent growth of output as measured by GDP (Table 1).

Table 1: Demand and Output
Four-quarter-ended growth rate

December	Demand	GDP
2001	4.3	4.3
2002	6.7	3.2
2003	5.8	4.3
2004[(a)]	4.3	3.0

(a) Four quarters to September quarter
Source: ABS

The most obvious explanation for this discrepancy is one particular capacity constraint, namely that which has restricted the expansion of our export volumes, particularly resource exports. But it is highly likely that other capacity constraints have also begun to operate. For example, the growth of manufactured and service exports has also slowed and this is partly due to the fact that an increasing proportion of existing capacity is used to supply fast-growing domestic demand. After nearly fourteen years of economic expansion, we do not have the spare capacity we once had.

Looking ahead, we have to recognise this situation. Attempting to maintain demand growth at the rates to which we were accustomed would risk a rise in inflation and would probably not result in an appreciable increase in output growth. Fortunately, demand has already started to slow somewhat and it is getting closer to the growth of output. Despite its growth probably being understated, GDP is also starting to slow under the constraints imposed by capacity limitations. I think we will have to get used to seeing GDP growth rates starting with the numbers 2 or 3 rather than 3 or 4 for a time.

On inflation, our forecast a year ago for underlying inflation in the four quarters to the December quarter 2004 was 1½ per cent. At our June meeting we had raised it to 2 per cent. In the event, it came in at 2¼ per cent, while the headline figure was 2.6 per cent. Some of this was due to the increase in the oil price, but some of it was more general, as indicated by the fact that the December quarter CPI came in above all forecasters' estimates. Overall, the inflation outcome to date is still a good result given the pressures we are now starting to see around us, but looking over a longer period it seems that inflation has now reached a trough and is showing signs of turning up. At earlier stages of production, there has been a noticeable pick-up in prices between the first half of 2004 and the second half (Table 2).

Table 2: Output Prices[(a)]
Annualised percentage change

	First half 2004	Second half 2004
Preliminary	2.5	6.0
Intermediate	1.6	5.1
Final	2.7	4.7

(a) Excluding oil
Source: ABS

Looking ahead, we forecast gradual rises in underlying inflation, with it reaching 2½ per cent by end 2005 and 3 per cent by end 2006. Like all forecasts, they are smoother than reality will probably turn out to be, and they are subject to risks. Our assessment is that the risks are more likely to be on the upside, as we do not see any obvious downside source of risk unless there was a sharp weakening in the world economy, an eventuality on which we would place a low probability.

I suppose you could conclude that this combination of weaker-than-expected GDP growth and higher-than-expected inflation is a disappointing situation. But while less than ideal, the figures I have quoted are still pretty good for this stage of an expansion. Our feeling is that we – that is, policy-makers and the public – will have to realise that there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances that have got us into trouble in the past. ✠