Managing the Expansion

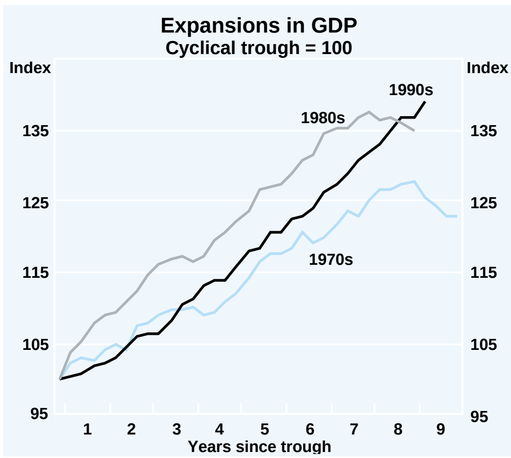
Address by Mr IJ Macfarlane, Governor, to the Economic Society of Australia (Victorian Branch), Melbourne, 11 February 2000.

It is a great pleasure to be here speaking to the Victorian Branch of the Economic Society. I first spoke before the Society in 1986 and have been back a few times since. On each occasion I have appreciated the interest and attention you have afforded me. I hope that what I have to say today will again be of interest to you.

I want to take the opportunity today to expand a little more on the role of monetary policy in managing an economic expansion. This is a subject that I have spoken on in the past, but clearly there is more to be said. On this occasion, I would not only like to restate the Reserve Bank's position, but also deal with some of the views that have been put forward following our recent raising of interest rates.

The current expansion, as you will all probably be aware, has now lasted longer than its predecessors in the 1970s and 1980s, and has also reached a higher level relative to its starting point. This is shown by the accompanying graph, which puts the three expansions on a comparable basis. Another interesting aspect of our current expansion is how similar it is to the much better known expansion in the US economy. While the US expansion has been going for 36 quarters compared to 35 for our own (measured up to the present quarter), our average GDP growth rate of 4.1 per cent is higher than the 3.6 per cent recorded in the US.[1]

Graph 1



While it is satisfying to look back and see how far we have come, it is more useful to look ahead and see what we have to do if we are to continue on this path. For some time now, the task of monetary policy has been just that – to manage the expansion in such a way as to maximise its length. We do not want to repeat the experience of earlier expansions

1. These growth rates are calculated up to the September quarter 1999 – the latest data available for Australia: i.e. for Australia average growth rate from 1991:Q2 to 1999:Q3, for US 1991:Q1 to 1999:Q3.

which ended so unhappily, and therefore we must ask ourselves what it is that we have to do this time to avoid that fate. This is the main subject of my talk today, but before I get into it, I would like to ask your indulgence to detour through the age-old subject of the business cycle.

The Business Cycle

Economists have been analysing the business cycle for a century or more. From time to time after a long expansion, a few feel emboldened enough to suggest that perhaps we have seen the end of the business cycle. This happened in the very early 1970s, and a few people are canvassing the idea now as part of the concept known as the 'new economy' or 'new paradigm'. While there is undoubtedly substance in these ideas, some of you may be disappointed to know that I am not a member of the school that thinks the business cycle has been banished, although I am happy to recognise that increased productivity growth in the 1990s has made the task of macroeconomic management somewhat easier than formerly. The most obvious benefit of this from the monetary policy perspective is that the overall rise in interest rates needed to prevent a potential inflationary situation developing now seems to be a good deal smaller than previously.

There are two main mechanisms that lie behind the business cycle:

1. A business cycle of some sort may be the inevitable result of interactions involved in a *complex dynamic system* such as an economy. We know that cycles are the norm for such natural phenomena as the weather and animal populations, and some tendency in this direction is also probably intrinsic to economic behaviour. The first Nobel Prize in Economics was awarded to Ragnar Frisch for work on how business cycles can be propagated in simple models of the economy, and others such as Samuelson and Hicks expanded on this.[2] More recently, the Real Business Cycle[3] school of economists have taken this in a new direction by regarding all cycles as being a natural result of changes in the supply side of the economy. I do not want to take any of this too literally, but I would agree with one conclusion that comes out of all this work, namely that it is probably unrealistic to expect a dynamic system like a modern economy to expand in a smooth line; its natural progression is probably characterised by some element of cyclicality.
2. A business cycle may be viewed as resulting from policy mistakes. In this view, policy is kept expansionary for too long during the upswing, resulting in the build-up of serious distortions or imbalances – principally inflation. Eventually something has to be done, but in order to eliminate the by then well entrenched imbalances, the degree of tightening required is quite large. As a result, the economy is pushed into recession and unemployment rises sharply. This explanation essentially sees cycles as the result of a *delayed monetary policy reaction* function.

In the popular discussion of economic developments over recent decades, it is the second type of cause – the tendency for monetary policy to contribute to booms and busts – that has been the focus of attention. Fortunately, it is also the type that we have most chance of avoiding if we play our cards right. This would not mean that all cyclical behaviour would be removed, but a significant part of it could be.

2. R Frisch (1933), 'Propagation Problems and Impulse Problems in Dynamic Economics', in *Economic Essays in Honour of Gustav Cassel*, George Allen and Unwin, London, pp 171–205. JR Hicks (1950), *A Contribution to the Theory of the Trade Cycle*, Clarendon Press, London. PA Samuelson (1948), *Foundations of Economic Analysis*, Harvard University Press, Cambridge.
3. CI Plosser (1989), 'Understanding Real Business Cycles', *Journal of Economic Perspectives*, 3(3), pp 51–77.

The Avoidance of Imbalances

The centrepiece of this approach is to act *before* the imbalances have had time to become entrenched. If you are seriously aiming to maximise the length of the expansion, the tightening of monetary policy comes earlier than if you are mainly interested in a high growth rate for the year ahead and less concerned with the length of the expansion. Of course, this can sometimes make the explanation of monetary policy moves more difficult, because those opposed to the move may be able to claim that there was not sufficient hard evidence of imbalances to justify it.

It is instructive to look back over the past few decades to see how imbalances have built up towards the latter part of economic expansions. No two expansions or their demise have been the same, nor is it the case that a single imbalance was the cause of the problems. In all cases, there were several imbalances whose interaction led to the build-up of an unsustainable situation.

Having said that, however, it must be recognised that the pre-eminent imbalance has been inflation. It is now almost universally acknowledged that the maintenance of low inflation is the *sine qua non* of a sustainable expansion. It was the rise of inflation, in one form or another, which spelled the death knell of our previous expansions.

- In the long expansion which began in the 1960s and ended in 1974, inflation had already risen to 10 per cent by the September quarter of 1973, which was before the effects of OPEC I had been felt. Following the rapid wage escalation of 1974, inflation then peaked at $17^1/_2$ per cent early the following year.
- We had a rather weak expansion in the 1970s, which received a boost from the rises in commodity prices associated with OPEC II in 1979. But by 1981 another wage escalation pushed inflation from a low point of 8 per cent in 1978 to a peak of $12^1/_2$ per cent in 1982.
- In the strong, but shorter-lived, expansion of the 1980s the story was rather different. Although the increases in prices and wages were a good deal higher than we have become accustomed to in the 90s, there was no sudden acceleration in the latter stages of the expansion as there had been in earlier episodes. It was a boom in credit-financed asset prices and the associated speculative activity that did the damage. At some stage the boom was bound to be followed by a bust, whether of its own accord, or as a result of monetary tightening. While asset price inflation is conceptually different to CPI inflation, and is further removed from the ordinary operation of monetary policy, it is nevertheless a classic case of the type of imbalance that can occur in the latter stage of an expansion and lead to its abrupt and painful ending.

There are several other types of imbalances that often accompany the latter stages of an expansion and that can be a warning of danger. One is monetary excess, which is usually manifested as excessive provision of credit, and which often ends up financing speculative activity. I have already mentioned this in relation to the 1980s, when the credit expansion was primarily to business and resulted in the over-leveraging of that sector. It is also possible for the imbalance to show up as over-lending to households, as happened in the UK in the late 1980s.

Another imbalance that can occur is in physical investment. We are accustomed to thinking of investment as a good thing and only ever worrying about it if it is too low. But over-investment can also be a problem at times in that it can lead to the build-up of over-capacity. This in turn can lead to a subsequent dearth of investment, especially if demand has not been as strong as had been expected by those who put the investment in place. Part of the severity of the recent Asian recession, and particularly the Japanese one, is due to the earlier period of over-investment.

Some of that effect also occurred in Australia in the late 1970s/early 1980s during the so-called 'resources boom'.

Looking back over the post-war years, particularly during the fixed exchange rate period, the imbalance that often played the decisive role was the current account of the balance of payments. If it widened markedly, private capital inflow risked being insufficient to cover it, and interest rates would have to be raised to attract more capital and to reduce the demand for imports. This would be a major cause of the subsequent contraction, such as the 'credit squeeze' of 1961. With a floating exchange rate, the current account is a less immediate constraint: it only becomes binding if the market begins to worry about an escalating external debt to GDP ratio, or about the country's capacity to service the debt.

The Current Expansion

This brings me to the current expansion. We have now had two policy tightenings involving a net increase in the overnight cash rate of $^{3}/_{4}$ of a percentage point. The tightenings were pre-emptive in the sense that they occurred before imbalances developed – in other words, before there was clear evidence of the economy generally overheating. As the foregoing discussion makes clear, we regard these tightenings as an essential component of a strategy which is designed to allow this economic expansion to continue for as long as possible, and not be overwhelmed by the usual imbalances that bring an expansion to an end. This approach to monetary policy is not unique to the Reserve Bank of Australia; one can clearly see the same thinking behind the actions of other central banks. They too have been bruised by the failures of the 1970s and 1980s and are determined to do better this time.

While I think this approach is generally well understood, there are obviously some who do not support it. There is nothing like a rise in interest rates to bring out critics of monetary policy who hitherto had been silent. Of course, everyone has a right to express their views, and I have no trouble with the recent debate. I can also see why the public expect explanations from bodies that make important decisions, and we are conscious of the need to meet that requirement. As well as the explanation contained in the media release that accompanied the monetary policy decision, we will be publishing a detailed quarterly report on the economy next week, and I appeared in public before a Parliamentary Committee two days ago. I will also take the opportunity in the remainder of this speech to address these issues.

We have for some time been in a period characterised by good economic growth, low inflation and low interest rates. It has been one of the better periods for the Australian economy, especially in light of the turmoil among many of our trading partners. I think there has been a tendency for some observers to think this happy state of affairs could continue indefinitely provided we left it alone. A common theme has been 'don't meddle – just leave it alone', or a related one, 'are you afraid of growth?'.

These views seem to us to be very short-sighted – in essence, they boil down to the view that the best way to manage an expansion is to keep interest rates at their low point for as long as possible, and only raise them when things have gone off-track. We think that if we did this, we would look back in a few years' time and regret it, even though we might have been more popular in the short run.

We also think that this approach fails to recognise just how expansionary the stance of monetary policy was in 1999. In either nominal or real terms, interest rates faced by borrowers were very low, as was shown by their eagerness to borrow.

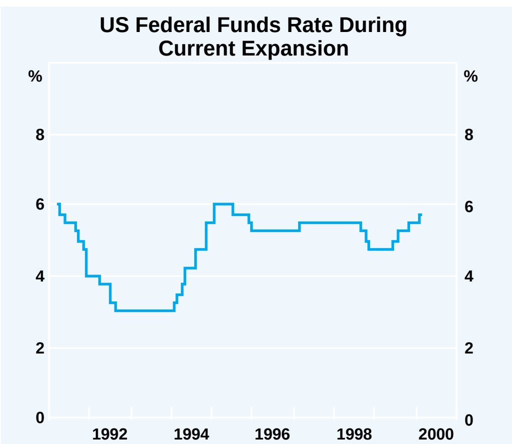
This expansionary stance of monetary policy was designed to combat a specific set of circumstances – weak world economy, expected domestic slowdown, and undershooting of the inflation target. When these circumstances changed, it was only reasonable that monetary policy would also change. We have tried to encapsulate the two changes taken together as a return to 'neutrality' from a position that was clearly expansionary. Of course, there will always be considerable measurement uncertainties about the term neutrality – perhaps we should have referred to a return to the 'neutral zone'. Be that as it may, if you do not have some idea of the concept of neutrality, you run the dual risk of:

- being late by not changing monetary policy until overheating has actually occurred (or, in the opposite direction, until a recession is staring you in the face);
- then being forced into a large and abrupt adjustment to recover the situation.

Both of these outcomes effectively describe a 'boom and bust' monetary policy, which is the approach we set out to avoid.

Another variation of the argument that monetary policy should not have been tightened, or not by as much, is the appeal to US experience. Proponents of this view claim that Chairman Greenspan has been doing the right thing by letting the US expansion run on, and not being deflected by more conventional voices calling for monetary restraint to avoid future inflation. I certainly have no qualms about joining the chorus of praise for Chairman Greenspan's and the Federal Reserve Board's performance during this expansion, but I would like to make two points. First, we should remember that the Australian economy has actually grown faster than the US economy during this expansion. Secondly, the Fed has been prepared to put interest rates up as well as down in its management of the expansion. Interest rates were raised in 1994, again, although by only a small amount, in 1997, and again in a third phase in 1999 and 2000. The US experience argues against a policy of leaving interest rates at their low point for long periods in order to achieve a long expansion.

Graph 2



There is another argument I want to address before concluding. For various reasons, a number of people have been keen to put forward the view that monetary policy was tightened because of the impending GST. Some have done this for partisan political reasons, and others because they are still adhering to the view that monetary policy should only be tightened if general overheating is present. Since it is not present, they assume there must be some ulterior motive that has been hidden and therefore seize on the GST.

I have said on a number of occasions and will say so again today – monetary policy was not tightened because of the GST. The tightening would have happened without the impending GST, just as it has in the United States, the United Kingdom, New Zealand, the Euro Area, Canada, Sweden, etc. We at the Reserve Bank are still operating on the assumption that the GST will affect prices only on a one-for-one basis, and that wages will not be raised to compensate for the GST. The second assumption reflects the fact that reductions in income taxes will more than offset the rise in prices due to the GST. To raise wages as well to cover the GST would be to expect 'double compensation'. There is no economic logic for this and, if it were to occur, it would be an example of the type of imbalance that could threaten the end of the expansion, and therefore threaten the downward trend in unemployment. Wage surges ended two of the past three expansions – it is important that it does not happen again this time. I think good sense will prevail, and that anyone who is encouraging 'double compensation' will think again.

Conclusion

I think we have still got a long way to go in this expansion. It is already longer than its predecessors, and if we as a community are sensible and do not allow short-term thinking to overcome our long-term interests, it could rival in length the expansions of the 1950s and 1960s. As for monetary policy, we think it can play a very important part in achieving that end. Inevitably, there will be those who agree and those who disagree with what we are doing. We think, however, that monetary policy should be judged, not by any particular movement in interest rates, which will always be surrounded by some element of controversy, but by its performance over the whole of the expansion.