OPENING STATEMENT TO HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION CANBERRA - 17 FEBRUARY 2006

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Secretary: Stephen Boyd

I.J. Macfarlane
Governor, Reserve Bank of Australia

It is a pleasure to be back here again in front of the Committee, and to be having this hearing in Canberra for the first time in a number of years. I note that the membership of the Committee has changed again, particularly on the Government side. That is something that has happened pretty well continuously in the nearly ten years I have been reporting to it under the current arrangements, but it has not interfered with the Committee's effectiveness.

As you know, we had our February Board Meeting last week and we issued our quarterly *Statement on Monetary Policy* earlier this week. This document spelled out in detail how we see the current situation in the economy, and why the stance of monetary policy is where it is.

This morning I would like to take the opportunity of looking at the broader trends in Australia's economic situation and examining the implications they have for the stance of monetary policy going forward.

I will take as a starting point Australia's current economic expansion. For years I have made the point that progress in winding back economic slack is made not by high growth in any individual year, but by maintaining an expansion over a sustained period. Australia's current expansion began in late 1991 and is now in its fifteenth year. This means that it is already significantly longer than its predecessors in the 1960s, 1970s and 1980s. The expansion has been marked by good growth in GDP, which has averaged 3¾ per cent per annum over this period, one of the best performances in the developed world.

A consequence of the sustained expansion is that the economic slack generated in the last recession has been gradually used up. One indicator of this is the unemployment rate, which has trended down from a peak of 11 per cent in 1993 to be currently just over 5 per cent. Other indicators of the economy's capacity utilisation are also at cyclically high levels. Business surveys report that businesses are operating at close to their highest levels of capacity utilisation since the late 1980s. The surveys

have also been reporting high levels of labour scarcity. For the past year or so, many businesses have been in the unusual position of reporting that scarcity of suitable labour was a bigger constraint on their activities than their traditional concerns about the adequacy of demand or sales.

Given the maturity of the expansion it should not be surprising if the average growth of the economy is now less than it was in the earlier stages. As a general principle, it is easier for an economy to grow quickly when there is a large pool of unused resources to be re-employed, and in Australia's current position in the cycle, that source of growth is now much more limited. So, in the absence of a significant lift in trend productivity growth, we should expect to see annual GDP growth rates mainly in the 2s and 3s, rather than in the 3s and 4s as was typical for most of the expansion. It is not surprising therefore that growth of the economy over the latest year for which data are available was 2.6 per cent, or an annualised rate of 3 per cent for the latest half-year.

Business investment has been a major driver of growth in recent years, expanding by 18 per cent over the past year, and at an average annual rate of 14 per cent over the past three years. The upswing in business investment is being stimulated by high commodity prices and favourable financial conditions. With strong investment growth and an expected improvement in exports, our forecast for the economy overall is that annual GDP growth will pick up modestly during 2006 to about 3¼ per cent. While strong business investment obviously contributes to capacity expansion, the sorts of outcomes envisaged for GDP growth would imply that the economy will continue to operate close to full capacity.

While the overall growth of the economy during the current expansion has been good, there has been concern expressed about its composition. In particular, the growth of the economy over the past few years has been more than fully accounted for by growth in domestic spending, while Australia's export performance has been disappointing. In consequence, Australia's current account deficit has remained high at around 6 per cent of GDP recently, despite a strong international environment and rising commodity prices. Notwithstanding these concerns, it needs to be emphasized that monetary policy cannot be expected to target a particular composition of growth or current account deficit. Any attempt to do so (for example, by running a much tighter policy in order to constrain domestic demand) would be counterproductive and would detract from the Bank's broader macroeconomic goals.

The Global Business Cycle

Australia's economic situation should also be viewed against the backdrop of the global business cycle. In broad terms, business cycles across various countries have tended to move together, at least among countries in the developed world. That is, there has been a reasonably high correlation in the timing of recessions and expansions among developed countries over the past few decades. Most of the advanced countries experienced recessions in the mid 1970s, the early 1980s and the early 1990s, and many did so in 2001. It is relatively unusual for countries in this group to experience what might be termed a "home-grown" recession, that is, a recession not shared by the major industrial countries. Similarly, it is fairly unusual for countries to skip an international recession, though Australia and some other countries have recently done so, as did Japan in the early 1980s. This is not to say that domestic conditions and policies are unimportant. Nevertheless, as a general rule, when the world economy as a whole is in a sustained expansion, there is a good chance that an expansion will also be continuing in an economy such as Australia.

Currently the world economy is expanding strongly. The recovery from the global downturn in 2001 is now well established and, on past experience, the expansion should still have some way to run. While growth to date has been led mainly by the United States and China, there have been encouraging signs over the past year that growth is becoming very broadly based, with conditions improving in Japan as well as in a number of other economies. Assessments of the risks to the global growth outlook have focused mainly on the effects of higher oil prices and on the possibility that the US current account imbalance will have a disruptive effect on the world economy. However, there is little sign that these forces are restricting growth at present. World GDP growth in 2005 is estimated to have been above average, and most observers expect this to continue in 2006.

This growth performance has been accompanied by generally subdued inflation outcomes. One factor behind this was the increased focus on inflation control by central banks around the world, after the high inflation of the 1970s and 1980s. Many central banks have now adopted numerical inflation targets and others have clearly become more focused on inflation control even without adopting explicit targets. At the same time, the importance of structural factors, and particularly the industrialisation of China, should be recognised. The huge pool of low-cost labour that this has brought into play has put sustained downward pressure on a wide range of prices of internationally traded goods.

The Terms of Trade

One consequence of these developments has been a marked upswing in Australia's terms of trade, defined as the ratio of our export to import prices. Currently Australia is benefiting from the largest cumulative increase in our terms of trade since the early 1970s. The main factor driving this has been the rapid growth in global demand for resources, with China in particular contributing strongly. As a result, world prices for a wide range of resource commodities have been increasing sharply.

Over the past three years Australia's terms of trade have increased by around 30 per cent. This is estimated to have added 1½-2 percentage points per annum to the growth in national income over this period, a significant expansionary force for the economy as a whole. The economic effects can be seen in a number of areas including strong growth in business investment, company profits, share prices and imports. Increased export prices also tend to boost government revenues through company taxes and a range of federal and state royalties.

Interest Rates and Financial Markets

Although Australia avoided the recession that engulfed many developed countries at the start of this decade, it was not totally unaffected by world events, and the Bank found it necessary in 2001 to cut the cash rate to 4.25 per cent in a series of steps. While that was a new low for Australian official interest rates – the previous low had been 4.75 per cent in the late 1990s – it was a relatively muted response compared with the very large cuts in interest rates that occurred elsewhere in the world.

In mid 2002, with both domestic and global economic conditions improving, the Bank began the process of restoring official interest rates to more normal levels. It did this in five steps over three years – two in mid 2002, two in late 2003 and one in early 2005 – a more gradual tightening cycle than normal.

At the current level of 5.5 per cent, the cash rate is in line with its average over the low inflation period since 1993. There is therefore a sense that the current level is relatively neutral in terms of its impact on economic activity and inflation. One complication in assessing the level of interest rates, however, is that competition in the financial sector has seen margins between the cash rate and institutions' lending rates narrow over recent years, so the interest rates faced by borrowers are still a little below average.

Australia moved to restore normal interest rates well ahead of other developed economies. All the major countries had reduced interest rates to unprecedented levels in the early part of this decade – 0 per cent in Japan, 1 per cent in the United States and 2 per cent in the euro area – and they maintained this position for a prolonged period. Of the major countries, the United States was the first to raise rates, with the Fed beginning to tighten in mid 2004. The European Central Bank has only just started the process in recent months and the Bank of Japan is not expected to start lifting rates for some time yet. Thus, even though the Fed has now restored the funds rate to a relatively normal level of 4.5 per cent, world policy interest rates on average remain well below normal.

Another unusual aspect of current global interest rates is that long-term rates, which are set by the demand for and supply of funds in capital markets, have remained quite low in the face of rising official interest rates. Although various explanations have been put forward for this unusual behaviour, the most likely cause is an *ex ante* excess supply of savings relative to investment around the world, with Asia accounting for a large part of the excess global savings.

For equity markets, the combination of low interest rates, strong economic growth and low inflation has proved very beneficial, with global share markets rising solidly in each of the past three years. This has been underpinned by strong growth in profits so that, notwithstanding the rise in share prices, P/E ratios have been declining on average.

It is worth noting that the Australian share market has behaved quite differently from the global market over the past decade. It was affected much less than most markets by the tech bubble and the subsequent collapse, and in recent years has been rising faster than average. Along with the Canadian share market, it is the only major market that is currently above earlier peak levels, whereas in Europe and the United States share markets are still about 20 per cent below their early 2000 peaks.

The Australian dollar has remained in a relatively steady range over the past couple of years, at levels that are a little above average against the US dollar and about 10 per cent above average in trade-weighted terms. Some people have found this steadiness puzzling against the background of very strong rises in commodity prices and the terms of trade, as such episodes in the past have been associated with strong rises in the currency. A key to understanding the different behaviour on this occasion is the change in the interest differential with the United States. This has

narrowed appreciably over the past 18 months because the Fed has tightened much more than we have.

Domestic Credit and Debt

In recent years we have given a lot of attention to the growth of household debt and its possible effects on the macro economy. I would like to say a little more about it today and will divide the subject into two aspects: the shorter-term cyclical fluctuations in household credit growth, and the fact that various debt ratios have trended upwards over time.

Regarding the first of these issues, the most recent cyclical peak in household credit growth occurred around the end of 2003, when it reached an annual rate of over 20 per cent. Since the bulk of household borrowing is housing-related, it is not surprising that this phenomenon was closely associated with a sharp run-up in house prices. Nationwide house prices increased strongly for several years up to late 2003, reaching a peak growth rate of around 20 per cent in that year. The increases in credit and house prices were inter-related, with credit availability fuelling the price rises, while rising house prices meant people had to borrow larger amounts to achieve home ownership. Much of this behaviour was driven by expectations, particularly in the investor market, of future price gains – the classic definition of bubble-like behaviour.

In the period since late 2003, both the housing market and the demand for credit have cooled. Nationwide house prices have been broadly flat over the past two years and prices have fallen in Sydney. Household credit growth has eased back to an annual rate of around 12 per cent. Although this might still be regarded as quite high in absolute terms, it is towards the lower end of the range in which it has fluctuated in the past two decades. While there are some tentative signs that credit and housing market conditions have firmed a little in recent months, the risks to the economy posed by the over-heating in housing and credit markets in the period up to late 2003 have eased. Households now seem to have entered a period of greater financial caution, and this may act as a restraining influence on the growth of household spending for a while to come.

The second issue is the high average growth rate of household credit over an extended period. This is a longer-run issue and one on which it is more difficult to make firm judgments. For more than a decade, household indebtedness has grown at a rate well in excess of the growth in household incomes. This has meant that the aggregate ratio of household debt to household income has trended upwards, as has the proportion of household

income required to service the debt, and the gearing ratio (debt to value of household assets).

Simple rules of thumb would suggest that this cannot be sustained indefinitely. Yet there are a number of reasons why these ratios may rise further. In a low-inflation environment, nominal interest rates are also low, and households are able to service much higher levels of debt than they could in the past. A significant proportion of households still carry little or no debt, and in the years ahead might choose to borrow more. Attitudes towards borrowing appear to be changing, with people becoming more willing to borrow against assets later in life.

For these and other reasons, it is quite possible that the rise in household debt ratios could go a good distance further. The risk, of course, is that the process goes too far and that a painful correction ensues. There has been much debate around the world about the role of monetary policy in these circumstances, with the consensus being that the best it can do is to continue to pursue the general objectives of macroeconomic stability and low inflation.

We should also not forget influences on the supply side. Banks and other providers of credit to households have been competing vigorously to expand or protect their market share. In the process, lending standards have been progressively eroded so that lenders are now engaging in practices that would have been regarded as out of the question five or ten years ago. These are matters in which prudential regulators are taking a strong interest.

While the growth of household borrowing has been relatively high throughout the current expansion, business borrowing on average has been more restrained. This is the reverse of the pattern that was observed in the 1980s and, as a result, the business sector generally is in good financial shape with low levels of debt. In the past two or three years businesses have begun to take advantage of that position by again expanding their borrowing and lifting the rate of growth in their investment spending. Business credit has thus strengthened quite markedly, so that it is now growing at a rate of 16 per cent, well above that for the household sector.

Inflation

Australia's inflation performance over the past decade or so has been consistent with the Bank's medium-term target. Since 1993, when the 2-3 per cent objective was first articulated, average CPI inflation

(excluding the one-off GST effect) has been 2.5 per cent. Of course, the inflation rate has inevitably fluctuated quite a bit from year to year, including periods where it has been above 3 and below 2. But it should be remembered that the Bank's objective is expressed in terms of average outcomes, and should not be thought of as a rigid commitment to eliminate short-term fluctuations in inflation. In the latest year, inflation in underlying terms has been close to 2½ per cent, though the headline CPI figure is higher, principally reflecting the effect of rising fuel prices.

While inflation has remained contained over the past decade it is important, as always, to consider how inflationary pressures might evolve from here. At the current stage of the expansion there are a number of factors that might be expected to put upward pressure on inflation. The economy is operating at a high level of capacity utilisation, the labour market is relatively tight, and there have been some large increases in raw materials costs. Aggregate wages growth has picked up over the past year, and businesses generally are reporting difficulty in attracting labour. These conditions underpin the current forecast of a modest rise in underlying inflation over the year ahead. Based on the current level of oil prices, this forecast implies that headline CPI inflation would remain close to 3 per cent in the short term.

This outlook is, as usual, subject to significant uncertainty. One area of uncertainty relates to wages growth, where there is a risk that current labour market tightness will result in higher-than-expected wage increases. This will be an important area to watch in the months ahead. On the other hand, the latest CPI figure was a little below expectations, and may indicate that global disinflationary forces are stronger than had been expected. There are also some tentative signs that conditions in the labour market are easing. The issue over the period ahead will be whether these latter forces prove sufficient to contain inflation in an economy operating with little spare capacity.

In these circumstances, the Board at its recent meeting judged the current policy setting to be broadly consistent with the economy's requirements for the time being. Looking ahead, however, it felt that on balance, based on the considerations I have outlined here today, it is more likely that the next move in interest rates would be up rather than down.

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