Statement to Parliamentary Committee

Opening remarks by Mr I.J. Macfarlane, Governor, in testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, Melbourne, 17 June 1999. The Bank's Semi-Annual Statement on Monetary Policy *was released on 6 May 1999.*

Thank you, Mr Chairman. It is a pleasure to be here in Melbourne again appearing in front of the Committee.

Like last time, the *Semi-Annual Statement on Monetary Policy* has already been released a month before the hearing. On this occasion, it was the Budget that caused the delay in the hearing, but I do not think this is a serious matter because the *Statement* is still relevant. If anything, the advance release of the *Statement* may have been helpful in giving more time to digest the material contained in it. We have more recently sent to the Committee some new material in the form of a paper on bank fees.

I would now like to start off in my customary manner by comparing what I told you last time with what now appears to be the most likely outcome. I do this in the interests of accountability, but I also think it has the advantage of drawing out the limitations of economic forecasting and the necessity of seeing policy formulation as an iterative process.

Last time, I indicated our expectation that our growth rate was likely to be lower in 1998/99 and that there would be some pick-up in inflation (though to a rate consistent with our target). I said that the current account deficit would expand, and would probably reach 6 per cent of GDP on a quarterly basis at some stage. I indicated that not much further progress could be expected in reducing unemployment from the rate of 7.9 per cent which had prevailed in the three months before the hearing.

It is now well known that growth has not, as yet, declined. In all likelihood, growth for the 1998/99 year has been in excess of 4 per cent, measured either in year average terms or for the four quarters to June. This makes this expansion, which began in the middle of 1991, the longest continuous upswing since the 1960s. Nor is there any sign yet that the expansion will come to an end soon.

We are still of the view, however, that some decline in growth is likely, but from a considerably stronger starting point (and, of course, more delayed) than earlier thought. The outcome for calendar 1999 will, in our judgment, be lower than the growth recorded in 1998 – something between 3 and 4 per cent. This is a fairly mild decline, given the size of the external shock to which we have been subject.

More importantly, the risks of a sharp slump have lessened considerably since we last met. Last December, we had just been through a period in which confidence in the prospects for the global economy, including, of course, the US economy, had reached its lowest point. Behind this were concerns about extreme instability in global financial markets and the possibility of a 'credit crunch'. Since then, the US economy has continued its strong performance and concerns about credit crunches have disappeared. Indeed, there is now a widespread expectation that the strength of the US economy means that a tightening of US monetary policy is on the cards. Evidence has also continued to accumulate of a turn for the better in the countries in east Asia which slumped so sharply during 1997 and 1998.

Inflation in Australia, meanwhile, has risen, but very slightly and considerably more slowly than our central forecast of six months ago had suggested. A possibility which we flagged in our November 1998 *Statement* – that competitive pressures in international markets would have a dampening impact on the rises in prices for imported goods – has in fact turned out to be the case. In our latest *Statement*, we have forecast inflation to be about 2 per cent in underlying terms by the end of 1999. In headline terms, the CPI also is likely to be about 2 per cent. This is a little higher than we suggested in the *Statement*, as we have now taken full account of higher international oil prices, which roughly offset the effect of the health care changes.

The current account deficit has turned out to be something like $5^1/_2$ per cent of GDP for 1998/99, and was almost 6 per cent in the March quarter. It is highly likely that a quarterly figure over 6 per cent will be recorded in the June quarter. It seems to us that numbers something like that might well be seen over the next few quarters, with the result that the outcome for 1999 as a whole will be about 6 per cent of GDP.

The unemployment rate has fallen further, in line with the stronger than expected growth in the economy, and over the past three months has averaged 7.5 per cent, its lowest for about a decade. Given the amount of growth we have had over the past year, some further moderate decline in unemployment will probably be recorded, in net terms, over the remainder of this calendar year.

Even though the outcome has turned out better than expected, if someone wanted to score a point, they could say we are not very good forecasters. I would concede that we have been a little conservative in our forecasts, but it has not led us astray in a policy sense, i.e. it has not jeopardised the achievement of a good economic outcome.

As someone who has been involved in forecasting and economic policy in the lean years as well as the good, there is a more interesting question that has to be asked. It is this: How is it that the Australian economy has been able to grow at $4^1/_2$ per cent plus per annum in the seventh and eighth years of an economic expansion without generating significant wage and price pressures? It certainly was not able to do so in earlier expansions.

I have already given part of the answer to this question in my December testimony, and in a couple of speeches since. It is that the economy has achieved improved productivity growth as a result of the microeconomic reforms of the past fifteen years. The main changes have been reductions in tariffs, privatisations, financial deregulation, competition policy and labour market reforms. Of course, businesses have also become much leaner and more adaptable as they have responded to increased competitive pressure. The key piece of evidence for this is the higher growth of multi-factor productivity in Australia in this expansion compared with previous ones. A lot more could be said about this subject, but I will leave it to others, and move on to a related subject.

It seems to me to be quite possible to have higher productivity growth and yet to still encounter macroeconomic imbalances which would bring an economic expansion to a halt. In other words, higher productivity growth can explain why the economy's average growth

rate is faster, but I do not think it can provide an adequate answer for why the expansion will last longer. To do this, I think a macroeconomic explanation is required.

Here I have to come back to low inflation and low inflationary expectations, which have characterised the 1990s expansion, but were clearly absent from earlier expansions. As the earlier expansions matured, inflationary pressures built up which simultaneously pushed up prices (requiring a monetary policy response) and squeezed businesses and business confidence. In the mid seventies and early eighties the expansions came to an end with a wage explosion, while in the late eighties it was an asset price boom and bust. This time we have had neither of these.

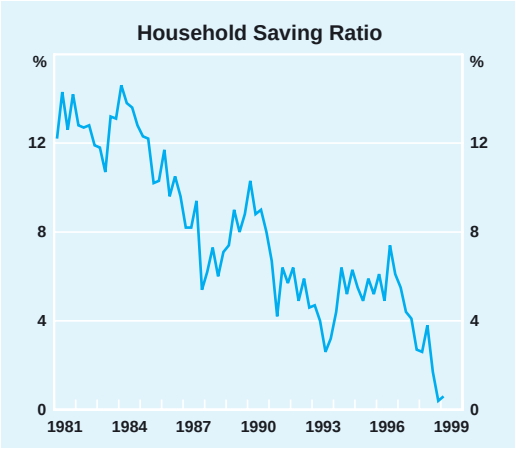
As I said, a recent history of low inflation has been crucial this time. It certainly has helped the wage bargaining process. Employees have seen that quite modest nominal wage increases have translated into decent real wage increases because inflation has been contained. They have not had to build anticipatory increases into their wage bargains to safeguard themselves against inflation getting away from them. Increased flexibility in industrial relations arrangements has also helped.

Similarly, low inflation and low interest rates have had a favourable impact on business behaviour. An important reason for this is that with low interest rates, there is little or no scope for negative gearing. Most of the reckless schemes of the entrepreneurs of the 1980s were simply negative gearing writ large. This was the biggest contribution to the boom and bust in asset prices. It was not the only reason – I accept that the rapid increase in the number of lenders associated with the deregulation of the finance sector also played a role. We could argue about the relative weights of these two factors if we wish, but the relevant fact for today is that neither of these two factors is present in the current expansion.

If we do not seem to be developing our usual ailments, as I have argued above, are there some new ailments that may bring our progress to a halt? A number of possibilities could be identified, but one that has attracted a fair bit of attention is the fall in the household saving ratio. In contrast to the business sector, which has become more cautious in the 1990s, the household sector has become less cautious, as shown by:

- The household saving ratio falling from 12 per cent in the first half of the 1980s to about 1 per cent at present. This has been a pretty steady trend (Graph 1).
- Household borrowing rising as a percentage of annual income.

Graph 1



This less cautious attitude by households is a surprise to many people because it seems to be at odds with the usual media depiction of a public worrying about its future, anxious about job security and generally insecure. If we were instead to judge the public by what they actually do, we would conclude the opposite. Unlike their parents and grandparents, who saw a great need to save for a rainy day and who had the privations of the Depression still in their minds, the spending and saving pattern of the current generation indicates a totally different attitude.

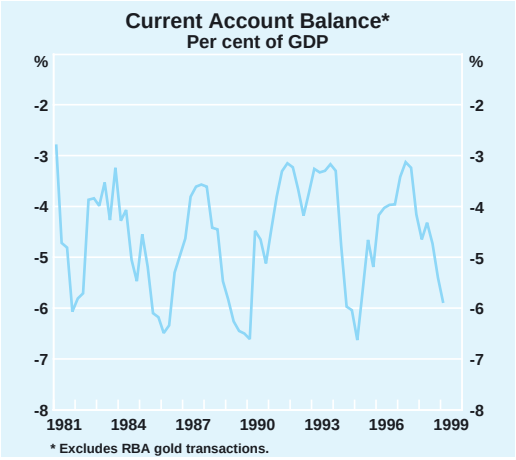
Of course, developments on the supply side have made this a lot easier. At today's low interest rates, it is possible to service a much bigger loan than it was at the start of the decade. Also, banks and other financial

intermediaries have found new ways of providing credit based on previously inaccessible collateral.

The important issue is whether this trend change in household behaviour is going to cause problems for the economy, particularly whether it is going to endanger the present expansion. I think there are three possible problems that could arise, so I will discuss each one briefly.

1. The first possible problem is that if inadequate household saving persists, it could mean inadequate provision for retirement. This, in turn, would put increased demands on future taxpayers. This is an issue of inter-generational equity. I do not want to suggest that this is not a problem – it may well be a big one, but the solution to it would be found in improvements to our policies regarding retirement income.
2. The second possible problem is that any reduction in saving, other things equal, would lead to an increase in the current account deficit. Has the trend decline in household saving over the past decade caused the balance of payments to deteriorate? The answer seems to be no: the current account deficit has shown roughly the same cyclical movement that it has exhibited over the past twenty years (Graph 2), but no change in trend. The reason for this is that there is not a one-for-one relationship between household saving and the current account deficit. We have to also take into account government sector saving, business sector saving and, of course, investment before we get to the current account of the balance of payments, and movements in some of these factors have offset the reduction in household saving.
3. The third possible problem is that increased indebtedness makes the household sector more vulnerable when interest rates rise. This is probably true, but the main implication is that to achieve a given macroeconomic effect, interest rates would not have to be raised as much as formerly was the case.

Graph 2



I now want to turn to a totally different subject, but one that will be very important over the next seven months. I refer, of course, to the issue of the end of century date change – or Y2K as it is colloquially known.

The main point I want to make is that the Australian financial system is very well prepared for Y2K. The formal processes of fixing and testing their systems began in the mid 1990s and it has been under the scrutiny of APRA and the Reserve Bank since early 1997. Financial intermediaries have devoted over a billion dollars and thousands of staff to checking and updating computer systems. Where problems have been found, they have been fixed. Outmoded ATMs and EFTPOS machines have been replaced, computer programs have been rewritten or new software has been installed. With all this effort, the Australian financial system rightly enjoys a world-class reputation for its high level of Y2K preparedness.

The Reserve Bank's own computer systems are, of course, Year 2000 ready. In particular, the systems that the Reserve Bank uses to distribute pensions and other government payments to banks, building societies and credit unions on behalf of Centrelink have been thoroughly tested. Pension payments will be made on time.

So much work has now been completed to ensure that the system works, that the big issue facing us is no longer a technical one – it is

instead an issue of public reaction. While I am very confident that the overwhelming majority of the Australian public will act sensibly, there are no doubt a few who are inclined to believe doomsday scenarios. With this in mind, there are a few preparations that we at the Reserve Bank have been putting into place to help reassure the community.

An important step was to talk to the banks, building societies and credit unions to make sure that they were communicating with their customers in clear language to reassure them that their deposits were safe. Because the simple fact is that their *deposits are safe* and their records are not at risk from Y2K-related problems.

All financial institutions have extensive back-up systems to ensure that each night they keep multiple physical records of all account information. While some members of the public have expressed concerns for the safety of their deposits because they think records might disappear, there is no basis for this type of concern. The safest place for people to keep their savings is in the financial institution that they are already with. Withdrawal and conversion to cash would expose them to a lot of unnecessary risks.

The vast majority of people, I believe, do not have those concerns, but they probably still have a few uncertainties. Many will wish to take more cash out to tide them over the New Year period than they normally do. To this group, I just want to make a few points:

- Do not, for a minute, fear that you need to take out more cash because there may not be enough to go round. There will be. The Reserve Bank has printed, and is carrying in stock, a lot more notes than usual so that it can meet any increased demand.
- If you are worried about high-tech systems such as ATMs or EFTPOS letting you down, remember you are only dependent on them for the first three days of the new year. After that, the banks, building societies and credit unions open their doors again and you can go back to the old-fashioned ways of obtaining cash. You are really only dealing with a long weekend.
- Even in those three days, you are not completely dependent on cash – credit cards can, if necessary, still operate in their traditional paper-based mode and cheques can be used as normal.

Overall, our view is that the system will be able to operate on a 'business as usual' basis and the public should view the new year as just another long weekend. That is what I will be doing. For those who want a little extra reassurance in the form of extra cash, they can be confident that it will be readily available.

That is all I wish to say in general terms about Y2K at this stage, but I will be happy to answer any detailed questions you wish to put to me. I am also conscious that I have been talking for quite a while, so that I have not left any time to cover the subject of bank fees. But with a copy of our paper at your disposal, I am sure you will find plenty of material to supply you with questions on that subject also. ☆