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, Melbourne, 11 May 2001. The Bank's Statement on Monetary Policy *was released on 7 May 2001.*

Mr Chairman, a lot has happened in the economy since we last met in Wagga Wagga at the beginning of December. This has resulted in a significant shift in the stance of monetary policy. I think I owe it to the Committee to give a full account of these developments and the thinking behind our reactions.

There were two major changes to the economic landscape that occurred shortly after we met in December. The first was that the outlook for the world economy changed rather sharply in a downward direction at the turn of the year. This was mainly a result of developments in the United States, but it was widespread enough to cause significant downward revisions to world growth prospects. The second major change was that it became apparent that the Australian economy had been a lot weaker in the second half of 2000 than we had formerly thought. Although this was information about a period that had by then passed, and was mainly due to a transitory factor, it had significant implications for the development of the economy in the period ahead. I would now like to explain these two developments more fully, then move on to our monetary policy reaction, before concluding with some comments on the current outlook.

The slowdown in the US economy is something that had been widely expected for a few years, but the economy kept surprising everyone by powering ahead. Almost six months ago, it became apparent that the slowdown was in process, and had the potential to be very pronounced. The United States had several economic imbalances that, fortunately, we do not have. Their share prices were (and still are) very high by historical standards, there had been an investment boom in plant and equipment (particularly IT and telecommunications) which was probably unsustainable, and the US dollar was high and rising. The US Fed moved very quickly to lower interest rates. Such action could not be expected to prevent a slowing in the economy, but it would reduce the chances of something more serious, such as a recession occurring.

The first Fed easing on 3 January was a clear recognition that the world business cycle had entered a new phase, and this had implications for all countries. We soon saw easings of monetary policy in Canada, the United Kingdom, New Zealand, Switzerland, Sweden and most Asian countries – and, of course, Australia – the Euro area was the exception. The slowing US economy, and particularly the cutbacks in investment in computing and electronics, also has had an impact on exports from Asia, with the result that aggregate east Asian GDP growth in the final quarter of 2000 seems to have been about zero (leaving aside the special case of China). The Euro area has been less affected, but there is evidence from the manufacturing sector and from business surveys that growth is edging down nevertheless.

I turn now to the second factor, namely the weakness in the Australian economy in the second half of 2000, and its flow-on effects to the first part of this year. As I have conceded before, we did not foresee the extent of this weakness, and I am not aware of anyone who did, although some probably got closer than us. If you had told me before the event that the fall in house-building, a sector which only accounts for 5 per cent of the economy, would be large enough to outweigh reasonable growth in the other 95 per cent of the economy, I would not have believed you. Our analysis of other countries' GST experience had suggested a much smaller fall than actually occurred.

I am not saying that the housing contraction was the only thing that happened to the economy; other things have also clearly slowed. But it was the thing that turned a relatively unexceptional slowdown into a small contraction. Of course, what we were witnessing was not the normal cyclical development of an economy, but the transitional effects of a once-in-a-generation structural change to the tax system. The fact that it led to a negative number for the change in GDP had a big effect on people's confidence. We saw this most clearly in the reaction to the release of the December quarter national accounts in early March. The Australian dollar lost 3 US cents over the next ten days to fall below 50 US cents for the first time. At about the same time, consumer confidence, which had until then held above its long-term average, fell sharply to well below that average. The reaction was so large that a number of commentators raised the possibility that the country could 'talk itself into a recession'. I am pleased to say that the mood has improved somewhat since that time.

There were some other signs of weakness during the second half of last year, such as the fall in business confidence. This was something we spoke about at the December hearing, when I suggested it could be largely due to the fall in house-building and resulting reductions in sales by those parts of the manufacturing sector which service the housing sector.

It was difficult for a while to discern the trend in consumption behaviour because of shifts in spending patterns caused by the introduction of the GST and the Olympic Games. But now that the dust has settled, it is clear that consumption, while doing quite well over recent months, is no longer growing at the heady rates it was a year or 18 months ago. Employment also fell for a few months in the second half of 2000, and there is no doubt that the labour market has softened following the strong growth recorded in the middle two quarters of 2000. Again, however, the construction sector is the main explanation for the weakness in the second half of last year. Over the period from August last year to February this year, construction employment fell by 48 000, while employment other than in construction rose by 41 000.

At the same time as we were receiving this information on business confidence, spending and employment, we were also receiving news on inflation. Here the most important data were the CPIs for the September and December quarters, both of which were below our expectation. They suggested that inflation was well under control – in fact, we lowered our estimate of underlying inflation after receipt of the December quarter figure in late January – and they also pointed to the possibility that business profit margins were being squeezed. They thus reinforced the impression that was building of an economy that was slowing more than expected, in a world that was slowing more than expected, and where current inflation and future inflation were within the target zone we aim for under our inflation-targeting regime for monetary policy.

The decision to ease monetary policy at our first meeting this year was a relatively easy one, and as you know, we eased again at the following two meetings so that the cash rate fell by 125 basis points in a little over two months. Collectively, this represented an uncharacteristically large move and deserves some explanation. Basically, we realised that a significantly lower *level* of real interest rates was required so that the stance of monetary policy would be clearly expansionary in that it would be supportive of economic activity. We felt we should, and could, get to such a position relatively quickly for two main reasons:

(i) We had undergone a relatively abrupt change in our view of the world. As I said before, it became clear that the world was entering a new phase of its business cycle – a fact that was recognised in most countries. The fall in house-building, because it brought forward our own slowdown, reinforced the message from the world.

(ii) Because inflation was not threatening to rise above our target, we had no conflict of objectives, and so could act quickly.

In view of the foregoing, you will not be surprised to hear that the forecast of GDP growth that I put before the Committee six months ago has been well and truly overtaken by events. I said that I would not quibble with Treasury's figure of 4 per cent for year-on-year growth in the 2000/01 financial year. It now looks like being about half of that figure, but we would expect considerably stronger growth in the following year, probably somewhere between 3 and 3½ per cent. Incidentally, this is only the second time out of the eight occasions that I have been putting these reviews of forecasts before you that we have over-estimated the outlook for growth; all the others have been small under-estimates.

On inflation, I said last time that it could be approaching 3 per cent by the second half of 2001, that is after the impact of the GST has dropped out of the four-quarter-ended growth rate. Our current guess, now that we have two quarters more of CPI data, is about 2½ per cent for the same period.

So far, I have spent most of my time covering events leading up to our decision to ease monetary policy, so it is time I moved on to more recent events. As I said before, March was a bad month for the economy, mainly because people received the news that there had been a decline in GDP in the December quarter. This was a great disappointment to most people, and they could not easily understand how such an outcome could have happened so soon after the buoyant conditions of mid-year. Inevitably, it affected people's confidence, and their views of the future.

The area where this lack of confidence showed up most visibly was in the exchange rate. On 6 March, the day before the release of the national accounts data, the Australian dollar was worth 52.2 cents and was 49.1 in trade-weighted terms. By 3 April, it had fallen to an intra-day low of 47.75 US cents and 46.6 in trade-weighted terms – a fall of 9 per cent against the US dollar and 5 per cent against the TWI. In the process, the Australian dollar set new low points on both these measures, although against the TWI it was only by a tiny margin.

I mention these details because I want to make two points. The first is that at a very detached and macroeconomic level, we all know that a low, and hence competitive, real exchange rate helps a country cope more easily with external adversity. Indeed, a floating exchange rate has as one of its virtues its capacity to automatically bring this about. This is one reason why our exports have been so strong, and why there is a widespread opinion that the exchange rate is a factor supporting future growth in the Australian economy.

The second point is that when you already have a low exchange rate, further falls can be very unsettling, especially if they are accompanied by headlines about new lows being reached and new barriers being breached. People inevitably see this as a loss of international confidence in their country, and they in turn lose confidence. The falling Australian dollar was a widely cited reason by respondents to the consumer sentiment survey for why their confidence had fallen. The fall in the Australian dollar in March did not do the country any good, and it is pleasing to see that it has been reversed.

April was a much better month than March, and it is possible to discern some signs that confidence is returning. Internationally, all eyes are still on the United States, where financial markets have gained confidence over the past month. All US share indices have risen appreciably, as have bond yields, consumers have continued to spend, and the first quarter GDP figure was better than expected. These developments are good news for Australia, at least in the short term. On the other hand, US employment has fallen over the past two months and businesses do not seem to be as cheerful as financial markets. There is still a lot of uncertainty overhanging the outlook for the US economy.

Domestically, we have also had some developments indicating greater confidence in the outlook. The stock market has risen by 7 per cent since late March and is again close to record levels, bond yields have risen, and we have also had the recovery in the exchange rate I referred to earlier. Here, as in the United States, greater confidence returned to financial markets, even if wider measures of business confidence have not shown it. There are also some indications from banks and the Housing Industry Association that house-building – which had been the chief contractionary force – is in the process of turning around, and that its upswing could be very pronounced.

Under these circumstances, it was perhaps not altogether surprising that financial markets' expectations about monetary policy began to change. They became less sure that we would ease again in May and, in fact, by the time of the meeting the majority of economists surveyed expected no change in interest rates.

In our own thinking, we asked the question 'what behaviour of ours can most contribute to building confidence?' At the April meeting, knowing that we still had some more work to do to get interest rates down to levels that were clearly expansionary, we had decided that a move larger than some people expected would probably be preferred to a more cautious approach, and might foster confidence.

By May, we had three moves in quick time under our belt. We knew that interest rates were not acting as a constraint on the economy, but rather were at levels likely to assist growth. With financial markets slightly more upbeat about the outlook, we felt that a steady setting of monetary policy would help confidence. We were also sensitive to the possibility that, on this occasion, a surprise fall in interest rates could easily cause people to think that 'things must be worse than we thought' and prompt the question 'what does the Reserve Bank know that we don't?' Such a reaction, had it occurred, would have been counter-productive.

What can we say about the future? Inevitably, we can say less, I suspect, than you would like! Policy has been returned to an expansionary setting, with the easing 'front-loaded'. Interest rates are close to the low points reached in the two most recent episodes of monetary policy easing. Given that fact, and given that we see some promising signs in the economy and financial markets, there is a reasonable chance that the current stance of policy will turn out to be easy enough to achieve the desired results.

But equally, while it is reasonable to expect that the promising trends of late will develop into stronger momentum for growth, we cannot as yet be confident. This, in turn, means that we cannot be sure that further monetary policy easing will not be required. The growth outlook rests on various assumptions, not least that international conditions stabilise before too long, and improve somewhat during 2002. That is a reasonable assumption on which to make a central forecast, but we need to be, and are, alert to the possibility of a weaker outcome, which would have implications for the Australian economy.

We will continue to evaluate new information as it arrives, particularly as it bears on the outlook for growth and, of course, inflation as compared with our target. We remain prepared to adjust monetary policy in response to changes in the balance of risks.