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, Warrnambool, 6 December 2002. The Bank's Statement on Monetary Policy *was released on 11 November 2002.*

I would like to endorse the remarks of the Chairman and say what a pleasure it is to be in Warrnambool, for the second hearing to be conducted outside the Sydney-Melbourne-Canberra triangle. The first was in Wagga Wagga, and I remember at the time suggesting that the second should be a little further away from Canberra. Warrnambool passes that test and is an important agricultural and tourist centre, so it is a fitting venue for this meeting. I would also like to thank the Mayor of Warrnambool, Councillor James Nicol, for his hospitality in hosting a civic reception for the Committee and the members of the Bank appearing before it.

I would like to start the substance of this statement by observing that in the six months between this Hearing and the previous one in May quite a lot has changed, and this has had an important influence on our judgment about what we have needed to do with monetary policy. This change has happened relatively steadily, with the result that the financial markets and the public more generally have had no trouble in adjusting to the changed outlook. We have assisted, where we thought necessary, by way of several speeches and articles on the subject over the past six months; they have probably helped at the margin, although I think the public was not having any difficulty in recognising the changing outlook as it unfolded.

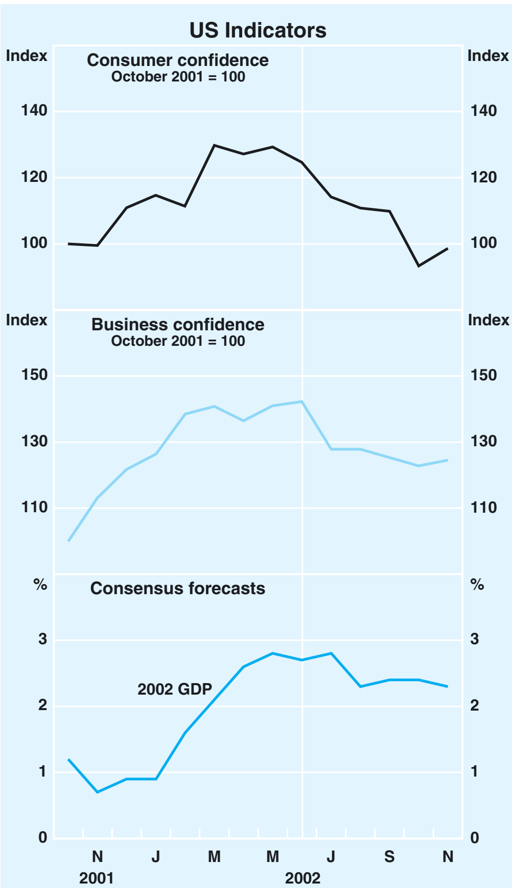
That being so, it could be argued that there is nothing further to add on the subject. However, I am very aware of the fact that I gave some quite frank indications about the expected future direction of monetary policy at the previous Hearing, and that those indications have not been followed through. So I would like to place on the record before this Committee another account of the changing circumstances, even at the risk of being accused of going over old ground.

In May I said to this Committee that since the Australian economy was behaving normally, and the world economy was getting back to normal, unless unforeseen developments intruded, we should continue the process of getting real interest rates back to normal, while all the time carefully examining incoming data, both from here and abroad, to ensure that developments remained on track. We did continue the process of getting interest rates up towards normal in June, but have not done anything more in that direction in the following six months. Why not? I think the answer has been obvious to nearly everyone – something *did* intrude and the incoming data from abroad showed that developments were *not* remaining on track.

After a promising start to the year, the world economy began to weaken about mid year. Financial markets – particularly equity and bond markets – were the first to show this from about the beginning of the second quarter of the year. By mid year there were also signs from a range of economic indicators in the United States and the euro area that the recovery was likely to be weaker than formerly thought. These signs tended to become clearer as events progressed during the second half of the year. A good way of summarising this large body of data is to look at three indicators of perceptions of economic conditions: business confidence, consumer confidence, and consensus forecasts of GDP growth. As can be seen in the graphs for the United States and the euro area, these indicators show a clear improvement in the first half of the year followed by a clear deterioration in the second half (Graphs 1 and 2). So what we have seen for the world economy is a weakening through calendar year 2001, an apparent strong recovery in the first half of 2002, followed by a relapse in the second half of 2002. The relapse does not mean that the world economy is returning to recession, but it indicates that the recovery is going to be weaker than was thought likely in mid year.

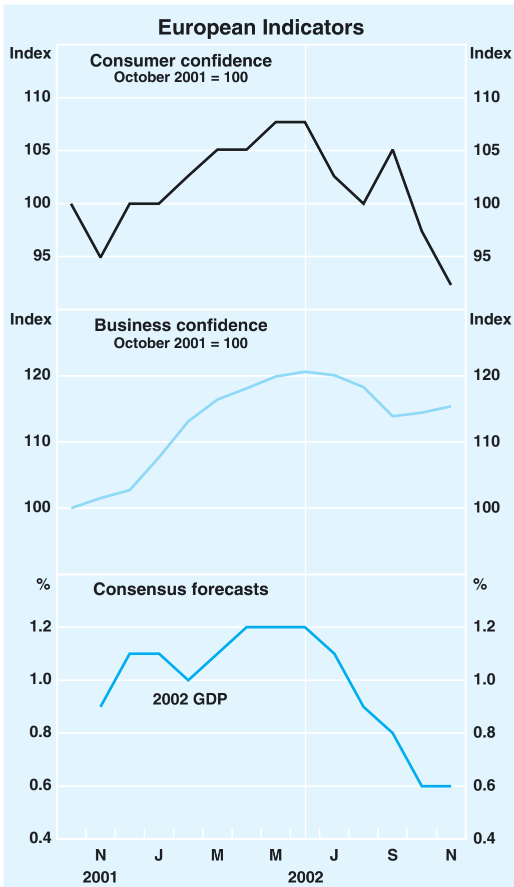
This gradual change in outlook in the second half of the year obviously had implications for monetary policy around the world. In the first half of the year, those countries with strong fundamentals, such as Australia, Canada, New Zealand and Sweden, had started the process of getting their interest rates back up to normal. This process was

Graph 1



Sources: Consensus Economics; Thomson Financial Datastream

Graph 2



Sources: Consensus Economics; Reuters; Thomson Financial Datastream occurring when we met in May, and, as I said at the time, it was a process that we thought would be continuing. In the event, it did not continue for much longer, and in fact none of these countries has raised rates since July, and one (Sweden) has cut them, as has the United States.

The caution shown by central banks such as ours derived in part from the downward revisions to world growth, but also in part from our suspicion that the risks were on the downside. In other words, if an outcome very different to the consensus were to occur, it would be more likely to be weaker than stronger. Having said that, I recognise that even though the second half of the year has been disappointing compared with the first half, equity and bond markets have become a little more confident over the past month or so. It is too soon, of course, to know whether it represents a change in direction or just another blip in the data.

Turning to the Australian economy, I will approach this by way of my usual practice of reviewing the forecasts I gave the Committee last time and presenting some new ones. Last time I said we expected GDP growth through 2002/03 to be between 3½ and 4 per cent – we are now forecasting around 3 per cent. Obviously, the major factor behind the reduction has been the drought, but the weaker world economy has also had an effect at the margin. On the other hand, the fact that house-building is now forecast to continue to expand for a longer period has pushed the forecast up somewhat.

For next year, that is calendar 2003, our forecast is for growth through the year of 3¾ per cent. The fact that it is higher than the current financial year rests importantly on the assumption that there is a recovery from the drought in the second half of the year, and that the world economic recovery gradually picks up momentum through the year. As I said before, strength in house-building has continued for longer than earlier thought: nevertheless, we still expect a downturn to occur in that sector during the course of 2003, which will subtract from growth.

On the inflation front, I said that we were forecasting the CPI to remain near the top of the target range in 2002/03, although we expected it to go down slightly for a time and to then come back up. Implicit in this forecast was that the rising phase would continue after mid 2003 and so, other things equal, begin to exceed the target range by the second half of 2003. What has happened so far is that headline CPI is slightly above 3 per cent, but our estimate of underlying inflation is that it is running at about 2¾ per cent. We see no reason now to expect underlying inflation to rise any further, and are now forecasting that it will stay around this rate through calendar 2003. The main reasons for this slight downward revision compared with our forecast six months ago are the lower forecasts for world and Australian growth. The price effects resulting from the drought will have the effect of holding up CPI inflation in the next quarter or two and then reducing it slightly later in the forecast period.

I would now like to return to a subject which the Committee spent a fair bit of time discussing in May, namely residential property prices. As you know, we became particularly concerned about this issue when we noticed that virtually all of the increase in housing loan approvals in the past year was going to investors, not to aspiring owner-occupiers. At the same time, the building approvals data showed that monthly approvals to build multi-unit developments, i.e. apartments, had speeded up to an exceptionally fast pace, while approvals to build houses were going along steadily. These developments suggested to us that a disproportionate amount of the upward pressure on residential property prices was coming from investors.

One response to this would have been to sit back and do and say nothing, on the grounds that the market would sort out the problem. We accept that it no doubt would, but it could take a lot of time, the excesses could get worse in the meantime, and the eventual resolution of the issue could cause a lot of financial distress. The problem is that the market works, but with long lags during which people are encouraged to take decisions based on little more than an optimistic extrapolation of the past.

Developers will continue to put up new apartment blocks while ever there are investors willing to pre-commit to buy. When investors purchase apartments off the plan (and it is almost exclusively investors to which the marketing is directed), they are making a financial commitment the wisdom of which may not become apparent for 18 months or so. It is only when they take possession of the apartment that they discover whether they can find a tenant willing to pay high enough rent to justify the financial calculation that underlay the original purchase. Of course, any individual investor can hope to get around the problem by selling to another investor, but they in turn will depend on finding a renter. Investors as a group are dependent on finding enough tenants willing to pay sufficiently high rents when the time comes, which may be 18 months away or more.

These investment calculations (or forecasts) are difficult, and we fear that many investors are just assuming that things will work out, which is a very dangerous thing to do if you are making a highly-leveraged investment. Certainly, recent trends would warn against such an assumption. From the best figures available, it is clear that rents are falling and that vacancy rates in apartments are rising. And, as the pipeline of partly-built buildings is completed, there will be many more new apartments coming onto the market in the next two years than in other recent years.

Our purpose in what we have been saying is to try to get the market to work a little better and so avoid the overshooting that often characterises parts of the property market. We all remember the excesses that occurred in commercial property in the 1980s and the large falls in prices that followed them. Investors should remember that even when they are buying a residential unit, they are making a commercial property decision, i.e. they are borrowing for an investment which will be rented to a tenant with the purpose of making a profit.

There are now some preliminary indications that market forces are starting to work at last. I have already referred to falling rents and rising vacancy rates, but there is also recent evidence of a flattening out or, in some cases, falls in apartment prices and marked falls in auction clearance rates in Sydney and Melbourne. There have also been reports of some of the more ambitious projects planned for Brisbane and Melbourne being withdrawn, which makes it all the more surprising that there has been such a large increase in October in approvals to build multi-unit buildings. On balance, however, these developments, if fully understood by investors, should make them very cautious and so limit the extent of over-supply in coming years.

I suppose the other big event in our area that has occurred since we met last May is that we brought down the final report on the *Reform of Credit Card Schemes in Australia* in August. In this context, we welcome your endorsement of the reforms, Chairman, as being 'an important win for Australian consumers'. Our intention, as stated in our document, is to put these reforms into effect in stages over the next year. Although the reforms are being challenged in court by the two main international credit card systems, I do not think this court action prevents me from answering questions.

I do not think I need to say any more at present. We will have plenty of time to discuss any of the subjects I have covered plus any others that Committee members may wish to raise. ✰