SOME OBSERVATIONS ON RECENT ECONOMIC DEVELOPMENTS

Address by Mr IJ Macfarlane, Governor, to the Australian Business Economists Annual Forecasting Conference Dinner, Sydney, 13 December 2005.

I see from my records that this is the sixth time that I have addressed the Australian Business Economists, but the last time was four years ago. At that time most of the G7 countries were in recession and interest rates were still heading down. The world looks a lot better now as it adjusts to stronger growth and a new set of challenges.

I confess that I had difficulty in deciding on a topic for tonight's talk. There were, in my view, no burning issues that I wanted to address, or messages that I wanted to leave my listeners with. In the event, I have decided to talk about three topics: how the world has coped with a tripling of oil prices, how the world is emerging from a period of exceptionally low interest rates, and, quite separately, is there an Australian model of macroeconomic policy?

Oil Prices

I will start with oil prices. At the beginning of 2002, when oil prices averaged about $US20 per barrel, most observers would have been very apprehensive if they had known that over the following three years prices would more than treble to a recent peak of $US70 per barrel. I think it would have been assumed that this event would lead to a significant rise in inflation and a major slowing, if not contraction, in the world economy. Memories of OPEC I in 1973 and OPEC II in 1979 when oil prices rose by a factor of three or four were still being seen as a guide to possible outcomes.

Certainly, over the past couple of years, the media has been full of stories about rises in oil prices and the dislocations and hardships they have caused. But looking back from our current vantage point, the thing that stands out is how comfortably the world economy has handled developments. Virtually all of the rise in oil prices has by now been reflected in statistics on inflation and GDP growth, and the results have been surprisingly small.

Global GDP growth was 4 per cent per annum or higher in 2003 and 2004 and is expected to remain so in 2005 and 2006. Of course, a lot of this growth has come from outside the OECD area, with the figures for OECD area growth being more than 1 per cent lower than for global growth. On inflation, the pick-up has been quite modest, with most OECD countries still recording headline inflation below 3 per cent per annum in the 12 months to September 2005. Interestingly, the United States where headline inflation was 4.7 per cent, stands out on the upside and lifts the OECD average inflation rate to 3.3 per cent. In Australia, as you are aware, headline CPI rose by 3.0 per cent in the year to the September quarter, up from a recent low point of 2.0 per cent eighteen months earlier.

There have been a number of reasons for these favourable outcomes around the world, including the developed world's lower oil dependency compared with earlier years, but I will concentrate on a few that I think are important. The main reason that economic growth was so little affected was that the rise in oil prices was *caused* by strong world growth, particularly from developing countries such as China and India. For the world as a whole, the rise in oil prices was not a negative supply shock, as it was in the seventies, but was the result of a positive demand shock. Of course, global growth could well have been stronger in the absence of the oil price rise, but even with its constraining effect, there was still plenty of growth to go around and current forecasts are still looking good.

On why the rise in inflation was so modest, the story is very interesting. We should start by reviewing a bit of history; this shows that even before OPEC I and II came along, OECD area inflation was rising year by year. Immediately before OPEC I, it had already risen to nearly 9 per cent, with Australia being one of the highest at 10.1 per cent. Inflationary expectations were also on the rise. In the business community the assumption was that any increase in costs could be easily passed on into prices, and the unions assumed that all wages would be indexed to rising inflation.

The situation is very different now. After more than a decade of low and stable inflation, inflationary expectations are better anchored. Discipline in goods markets from domestic and foreign competitors means the old 'cost plus' mentality no longer prevails. While pass-through at the first round still occurs, as the rise in retail petrol prices demonstrates, subsequent price pressures are often absorbed. With only limited and manageable increases in overall inflation throughout the world, monetary tightenings specifically directed at oil-price-instigated inflation have not been needed.

That is all I wish to say about oil prices, other than to add the caveat that I am only talking about the increases to date. Obviously, if we enter a new round of similar increases, the situation would have to be reassessed.

World Interest Rates

It is well known that the world has recently gone through a phase of exceptionally low interest rates, but I am not sure that people appreciate how low they were by historical standards. In fact it is not much of an exaggeration to say that interest rates in mid 2003 were at their lowest level for a century. This was the time when official overnight rates – the ones set by central banks – were 1 per cent in the United States, 2 per cent in the euro area, and zero in Japan. The only qualifications I have to make to my earlier generalisation is to concede that rates may have been slightly lower during the second world war in some countries such as the United States and United Kingdom when quantity rationing was the norm, but they have not been lower in peace time.

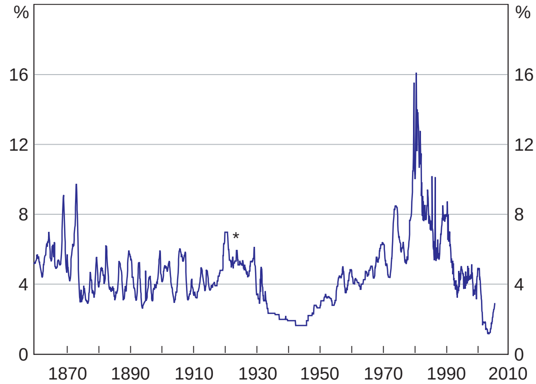
We can construct an indicator of world interest rates for a century or more using a weighted average of the rates for the United States, United Kingdom, Germany and Japan. Graph 1 shows the results for official overnight interest rates or their nearest equivalent since 1860. Although the graph is dominated by the high interest rates during the great inflation of the 1970s, the readings for 2002 and 2003 are lower than any other time in this long span of years.[1] Part of the explanation is that inflation was low, but it was only low compared with the post-war standard – it was not low compared with most of the period covered by the graph. In fact if we construct simple measures of real interest rates (based on realised inflation rates), they were also low by the standards of earlier low inflation periods.[2] In Table 1, real interest rates in the first five years of this decade are lower than in any previous decade apart from those containing the two world wars and the 1970s.

We could ask the question of why such low interest rates were put in place in this decade when it had not been seen to be necessary to do so on earlier occasions. This is a very big question and I do not propose to answer it tonight.[3] Nor do I wish to maintain that a different global monetary policy should have been put in place. Defenders of the monetary policy that was pursued would argue that it resulted in continuing low inflation and reasonable economic growth for the world economy, apart from the mildest post-war recession in 2001. They would say that in light of this outcome, it would be hard to argue for a higher level of interest rates during the period.

Graph 1

Major Economies Overnight Rates

Weighted average of US, UK, Germany and Japan[1]



1 Does not include Japan until 1882
* Excludes peak in 1923 at time of hyperinflation in Germany
Sources: Global Financial Data: RBA calculations

Table 1: Major Economies Real Overnight Interest Rates

Weighted average of US, UK, Germany and Japan

Decade beginning	Real overnight interest rates
1860	1.5*
1870	5.1*
1880	2.7*
1890	1.7
1900	1.3
1910	–4.4
1920	1.3
1930	4.0
1940	–8.1
1950	1.3
1960	1.5
1970	–1.2
1980	3.7
1990	2.2
2000	0.8

* Does not include Japan until 1882
Sources: Global Financial Data; RBA calculations

1 *The observation for 1923, the year of the Weimar inflation in Germany, had to be deleted because it did not fit on the scale.*
2 *The problem with most measures of real interest rates is that they become negative during periods of unanticipated rises in inflation such as the 1970s. For this reason, meaningful comparisons of real interest rates (using realised inflation rates) should only be made for periods of low and stable inflation such as the present.*
3 *For a partial answer see IJ Macfarlane, 'What are the global imbalances?', Reserve Bank* Bulletin, *October 2005, pp 19–27.*

Usually when interest rates are kept very low for an extended period the main risk is that there will be a pronounced pick-up in inflation. As we know, there has been little of that on a global scale, or indeed in individual countries, even though commodity prices have risen sharply. Where the risks have mainly arisen has been in the financial sphere, where there has been a 'search for yield' and a driving-up of many asset prices. So far this decade, the most obvious sign of the latter phenomenon has been the surge in house prices, particularly in those anglo countries with very competitive financial sectors such as the United States, United Kingdom and Australia.

What I have been describing so far is a global development, and although we in Australia have shared it in some aspects, in others we have differed. The main aspect in which we differed was that we did not reduce interest rates to anywhere near the extent they were reduced in the three biggest monetary areas – the United States, Japan and the euro area. The low point in our short-term interest rates of 4¼ per cent this decade was not very different to the low point in the 1990s of 4¾ per cent. We were also the only country of any significance to resist the general trend to lower interest rates during 2003. Nevertheless, we still have shown many of the same symptoms in our asset markets that others have shown.

What we are seeing now around the world is a gradual return to normality in interest rates. We in Australia can make some claim to being the first in this process because we began in mid 2002. Over the past two years the predominant tendency among countries has been to raise interest rates. Virtually every developed country except Japan has now participated, with the move by the ECB earlier this month being an important step.

The point I want to make that links the first two parts of this talk together is that the major reason for the rises in interest rates is, I think, the need for a return to normality, not a specific fear about oil prices. Of course the two are related in that the low level of interest rates has accommodated the growth in demand that lay behind the rise in oil prices. But the most important factor behind the recent moves is the realisation that the world could not have safely continued with the sort of interest rates that prevailed in 2002 and 2003.

Is There an Australian Model?

I was recently visited by the Chilean Minister of Finance who, like many in the same position in Latin America, is a very good professional economist. Our discussions were very interesting, and at one stage he answered one of my questions by saying that Chile 'was following the Australian model'. He meant this in a very specific way, and it is worth examining exactly what he meant by the term.

First, he was talking about a macroeconomic policy model that had the following structural features:

- a floating exchange rate with a currency viewed as a commodity currency;
- a monetary policy regime based on central bank independence and an inflation target; and
- a disciplined fiscal policy which aims at balance or surplus in the medium term.

These were important, but the most important characteristic he wished to focus on was the internationalisation of the currency, i.e. the ability for Australian entities to borrow abroad in

Australian dollars, or to borrow abroad in foreign currency and hedge back into Australian dollars. This allows Australian corporations and banks to participate fully in international financial markets without incurring foreign currency risk (or to only incur it where they have a 'natural hedge' such as foreign currency export earnings or to finance a foreign acquisition).

We, of course, have been very aware of the importance of this characteristic and regard it as a virtual necessity if a country is to be able to run a floating exchange rate regime successfully. But many, if not most, countries do not reach this stage. It was foreign currency exposure which led to the collapse of many Asian banks and corporations when their currencies fell during the Asian crisis. In Latin America, traditionally all foreign borrowing was in US dollars, which made their countries extremely vulnerable to falls in their exchange rates. It also gave rise to what is known as 'fear of floating' which means the tendency for their central banks to quickly resort to raising interest rates whenever the exchange rate is in danger of falling.

What the Chilean Finance Minister called the Australian model, of course, is not unique to Australia,[4] but it is associated with Australia in Latin American and Asian economic circles because of Australia's success in withstanding the Asian crisis. While some countries such as Chile see it as a sort of role model, many Asian countries have chosen a different path by running current account surpluses, building up large holdings of international reserves and resisting changes in their exchange rates. As you know, we think this is a major reason for the growing global payments imbalances, and would be happier if they followed a model closer to our own. But that is another story.

The interesting issue for other economies, particularly emerging-market economies, is how do you reach the situation where you can borrow abroad in your own currency, or, to put it differently, where investors in other countries will willingly hold assets denominated in your own currency. When we look back and see how Australia reached this position, it is a very interesting (and reasonably recent) story.

The major step occurred when the Government decided that it would borrow honestly from its own citizens. That is, it would stop using captive arrangements that force financial institutions to take government paper, and stop *setting* the interest rate on its own paper. In our case this occurred when we introduced the tender system for selling Treasury notes in 1979 and bonds in 1982, and soon after made clear that the Government would no longer borrow from the Reserve Bank, but instead borrow from the public to finance the budget deficit dollar for dollar. At first we had to accept very high interest rates, but in time demand for government paper expanded, and most importantly overseas investors began to find Australian government bonds denominated in Australian dollars an attractive investment. It was not necessary to ask them to invest, nor to do 'road shows' on Wall Street to entice them. At the same time, old habits died hard so that as recently as March 1987 the Australian Government made its last overseas borrowing in the US market in US dollars.

4 *Canada and New Zealand also have the characteristics listed when describing the Australian model. For a discussion of the difference between Australia and some other commodity exporters, see: Barry Eichengreen and Ricardo Hausmann (1999), 'Exchange rates and financial fragility', in Federal Reserve Bank of Kansas City,* New challenges for monetary policy, *pp 329–368; and Ricardo J Caballero, Kevin Cowan and Jonathan Kearns (2005), 'Fear of sudden stops: lessons from Australia and Chile',* Journal of Policy Reform, *8(4), pp 313–354.*

In time, overseas investors became comfortable with holding Australian government paper, semi and local paper, and eventually corporate bonds and asset-backed securities. Turnover in the Australian dollar is sixth amongst the world currencies and there is ample liquidity in both currency and asset markets. The relevant derivative contracts have grown, and so provided hedging opportunities. As we point out in a forthcoming *Bulletin* article, Australia as a whole has for some time had a long foreign-currency position. That is, we have more foreign-currency-denominated assets than foreign-currency-denominated liabilities, a far cry from our position in the early post-float period.

I want to conclude now by briefly revisiting the subject of why economies, including our own, have exhibited more stability than in earlier periods. Is it because policy-makers have become better forecasters and more adept at timely adjustment to the levers of economic policy? It would be tempting to answer yes to this, but I suspect it is only a small part of the answer. A more plausible explanation is that our economy has become more resilient. That is, we have systematically modified our institutional framework so that it is more flexible and more able to adjust to economic shocks than formerly. What I have described above is a good example of this process at work.