WORLD ECONOMIC FORUM - 11 SEPTEMBER 2000

TRANSCRIPT OF QUESTION AND ANSWER SESSION FOLLOWING TALK BY RESERVE BANK GOVERNOR IJ MACFARLANE

Gottliebsen: Ian, just taking you up on the reasons for the fall in the Australian dollar I'd like you to elaborate a little bit more if you could, and could it be that the world looks at Australia and says you are facing a very big technology import bill in the next ten years because you are not generating enough technology yourself and technology development yourself and to maintain the standard in this new economy will require huge imports of technology and we are being marked back accordingly?

Macfarlane: The first thing to say is no-one can really explain or forecast the exchange rate with any element of accuracy. No-one has ever produced a model that can explain month-to-month or quarter-to-quarter or even, I would probably suggest, year-to-year. You can explain very big movements over cycles but it is very difficult to explain small ones.

There is a tendency, I think, when the exchange rate falls, for people to say first of all that they think they can't explain it, and then the second reaction is to go back and say well it must have been caused by a number of things which they have always thought was a shortcoming of the economy. But, in nearly every case, they are shortcomings that have been around for nearly twenty or thirty years and that's why one of the common explanations we heard about a month ago was "oh, it's the current account". Well, if it was the current account, why wasn't it happening last year when we had a bigger current account than we've got this year.

I think some of these other structural ones, like that one Bob mentioned, are things that have been with us for a long time. We have always been an importer of technology and I don't really think that that particular characteristic of the economy has changed quickly enough or recently enough to explain the fall in the exchange rate in the year 2000. Although, I suspect there is one aspect in which that explanation does have some content in that I think there has been a change of preferences where people, because of the success of the US economy, probably now place a greater weight on technological factors than they did before. The aim of the game really is - the reason you have technology - is to improve productivity and we have been doing that; we have been improving productivity at a faster rate than just about anyone. I think what matters at the end of the day is how fast you improve productivity and how fast profitability goes up with employment and all those other good things.

It's unlikely that there's a huge range of countries that can be really at the cutting edge of all forms of technology and I think maybe we should do better than we've been doing. We have had some successes, we've got some areas where we have been quite good, maybe we should do better. I'm not suggesting for a minute that we shouldn't do better and that we shouldn't put more resources into innovation and science and what have you. But I do have trouble in thinking that's the explanation for the fall in the exchange rate in the year 2000.

Gottliebsen: You mentioned in your speech that for whatever reason, if you have a lower dollar, it can cause damaging effects. What will the lower Australian dollar mean to monetary policy?

Macfarlane: I was wondering when someone would ask that. Bob, you recognise of course, that I really can't give a very precise answer to a question like that.

Gottliebsen: We're just among friends here, we won't tell anyone.

Macfarlane: Well I can tell you the sign of the co-efficient we are talking about.

Gottliebsen: Well good.

Macfarlane: Well I think we all know that a weakening currency tends to put upward pressure on inflation, and also puts upward pressure on domestic activity. So we know that, other things being equal, there will be some pressure on inflation, but we don't know whether we are talking about a situation which is important enough or big enough to warrant a response. Although we would know what direction the response would be in.

In order for us to get a better feel to really be able to give a firm answer on that, we really have to get some understanding of how the exchange rate would pass through into final goods and service prices. And of course this depends on a variety of things; it depends very much on how strong are competitive pressures and what is happening to the price of domestically produced goods for example, that are competing with imports. The most important one of all, I suppose is, we need to know whether the movement in the exchange rate is short lived or long lived. We have to make some assessment of what will be the reaction of wages; that has to be a forecast of course, you can't wait until you've found out what's happened there.

And of course there's a heap of other things that are influencing inflation, as well as the exchange rate. For example there are other external factors, the price of oil being an example. And there's a whole host of domestic factors. But, I am not sure I can really say a lot more than that at this stage.

Gottliebsen: The GST as well?

Macfarlane: Well we have been very specific about the GST and our view on that has not changed. Our view on the GST was that we will assume that it will lead to a once off lift of a specified amount and that once that lift has occurred, inflation will go back to its normal rate because people who are setting prices and wages will not try and build that into ongoing inflation. We still believe that is a sensible assumption and as far as we can see everything that's happened in the two and a bit months since the implementation of the GST suggests to us that that assumption is probably firmer now than when we first made it.

Gottliebsen: I'm now going to throw the questions to you. I might say that anyone who asks a question to give me their name and organisation and I'm going to loose a lot of friends over this but first preference will go to the delegates and not the press. So, first question?

David Webb, Website.com, Hong Kong (Corporate Governance site): To what extent, if any, do you think the outward investment flows by perhaps portfolio managers or unit trust managers in particular into the US market in recent years has been an influence on your exchange rate? It is a concern that several other countries in the region have had in terms of the way the rampant Nasdaq market, until recently, has sucked in capital from overseas and helped subsidise their current account deficit.

Macfarlane: I don't know whether I can give a firm answer to that other than to say I think this is an influence that all non-US markets have experienced to a greater or lesser extent and I don't know that I could hazard a guess as to whether we have experienced it to a greater or lesser extent than every other country. I don't think there is any reason to believe that it has happened on a bigger scale here than has happened elsewhere. That's the best I can come up with.

There has been over the whole period of the float, if we go back to 1983, there has been in Australia a long term movement towards international diversification of portfolios by funds managers and so as each year has gone by they have held, I suspect, a slightly higher proportion in offshore assets than domestic assets, and that has no doubt had some long term influence. But I don't know that we have had any special propensity to suddenly diversify towards US tech stocks to an extent greater than any other country.

Maurice Newman, Deutsche Bank: We've seen some comment coming out of New Zealand recently about the longer term viability of them retaining their own currency. Would you care to speculate as to whether there is a long term future for the currencies of relatively small economies like Australia, Singapore, you could nominate any number, or do you think that there's a possibility that there will be a growing convergence into currency blocks?

Macfarlane: It's definitely true that there are a number of countries which have tried to operate a floating exchange rate system unsuccessfully who are now very attracted towards currency boards or dollarisation. This is a widespread view in Latin America and, of course, we've seen in Europe the European Monetary Union have the same effect.

By and large, countries that have successfully run a floating exchange rate regime are comfortable with keeping it. Now, I think the New Zealand case is interesting because I think the debate in New Zealand is not specifically about their exchange rate regime. It ends up getting back to that, but I think the debate in New Zealand is really on a much broader issue of can a country of 3¾ million people have a whole lot of independent features. Is it worth having them when there is another country which is nearly six times as big next door - in GDP terms six or seven times as big. So I think in my understanding of the New Zealand debate, the centre piece of it is this worry about them being small and being peripheral; about their best people, the brain drain to Australia; about their stock market about to be absorbed by you, Maurice. I think that this is the essence of the debate in New Zealand. And when they start thinking that way, one of the manifestations where it comes out is - "well perhaps we are already integrating more and more with Australia, why don't we just go the whole hog and have the same currency".

I think that that's the way the debate has gone there. It hasn't started with their unhappiness about a floating exchange rate, which is where it started in Latin America.

It's really about size and viability and that's what's dragged the exchange rate into the discussion.

Gottliebsen: Ian, do you think we have got enough size and viability? And talk about brain drains and things.

Macfarlane: Yeah. This is always the next question when you look at New Zealand very sympathetically. And you start to see the way they're thinking and the advantages that they see. Then someone comes along and says, well, what's the next step, does that mean Australia should do the same. Well, I don't think that - certainly in terms where Maurice's question started from which is exchange rates - I don't think there is a very strong case there at all. The US is a very different economy to ours, it has a very different structure of its economy and has different external shocks. There's no case at all in my view. And in fact you only have to think how we would have performed over the last three years if we had had the US dollar as our exchange rate. I think we wouldn't be talking about the economic growth I am talking about, or a 28 per cent increase in exports. We would be talking about something that was pretty sick.

I think in terms of exchange rate you can't make the jump from the New Zealand/Australia debate to Australia/US debate but in terms of other aspects of the economy, where everyone around the world people are worrying or wondering about a world where all the best and brightest (not all but a lot of people are to go where the big money is). I don't know if I can answer that but I know that monetary policy is not going to solve that problem.

Malcolm Turnbull, Goldman Sachs: While the recent weakness in the Aussie dollar has baffled most observers including most of us here, it has been explained widely as the Australian dollar being caught up in the downdraft consequent upon the sell-off of the Euro. Given that we were, until recently, linked to the currencies of our major trading partners in the region this connection with the Euro is even more baffling than the weakness in the Aussie dollar. I was wondering whether you could comment on that?

Macfarlane: I started by saying that no-one has a model or an equation that can forecast the exchange rate. The irony is that the Australian dollar was one of the few that was more forecastable than the others. There was more medium-term predictability in the Australian dollar than in the US dollar or the yen or the deutschemark. But even there, as I said, you cannot forecast on a quarter-to-quarter basis or even a year-to-year basis. And one of the reasons is that these markets become attracted to a particular rule of thumb and run with it for a while and then, when no-one can predict, drop that one and get attached to another rule of thumb.

For a long period, the Australia dollar was regarded as being a "dollar bloc" currency and there was a tendency for people to think it would move relatively closely with the US dollar. And over most of its life as a floating exchange rate currency, if you graph the Australian dollar against the US, against the Euro (and we have to create a synthetic Euro if you go back against the US), there was some similarity. We did have this characteristic and we were often referred to as a "dollar bloc" currency. There was a period not that long ago when, for some reason, we went for a year very close to the yen. If you graph the

Australian dollar/yen rate there was very small deviation. People were actually saying we were working on a yen standard.

In the Asian crisis, we got judged, probably quite fairly and logically by the international community as being a country which was dependent on Asia. And so our exchange rate went down, to nowhere near the same extent as the crisis troubled Asian economies, but there was similarity in movement. And now we have got this situation where, in terms of day-to-day movements and within day movements, in fact hour-to-hour movements, we have this unusual situation of whenever the Euro weakens we tend to weaken with it, although not to the same degree recently. Over the last couple of days the Euro has been a good deal weaker than we have, but we have tended to weaken with the Euro. I'm afraid I can't provide a logical explanation for that any better than anyone in this room can provide a logical explanation for that.

David Hale: This is a question about Australia's monetary relations with New Zealand. At the end of last week, the Prime Minister, Helen Clark, announced at a press conference in New York, that as a result of her country's currency weakness and recent other developments, she has had a change of mind and is now advocating a monetary union of Australia and New Zealand and the introduction of a common currency. What is the feeling right now on this subject in Australia? New Zealand …(not audible)… took a great debate, is this country ready to consider a monetary union with New Zealand?

Macfarlane: As to the New Zealand attitude, all I know is from one newspaper cutting. I have just got back from Switzerland this morning, so I haven't really been following local events closely for about the last four days. So all I know about the New Zealand position is one newspaper cutting that was sent to me, which is the one I think you are referring to David - the Prime Minister, Helen Clark, saying this is something that should be seriously looked at. Whereas in the past, I think that she has tended to dismiss it. Our attitude has always been that it is essentially a New Zealand decision. I think the benefits or the costs are going to be borne almost exclusively by the small member of the partnership, particularly if the ratio of the partnership is, as it is in our case, 1 to 7. I think that we would be cooperative but we would see it as being predominantly a decision for New Zealand to make. And I think that's been our attitude all the way along.

Ambassador for Argentina: I wish to ask the Governor, because we have a Currency Board in Argentina, I would say the behaviour of the current account is showing that, for example, with a currency board exports of goods, merchandise exports have doubled from 1994 so far. And this year they are increasing at 14 per cent with the fixed rate back to the US dollar. I see a difference with factorial movements and the situation is very similar to Australia. So the current account deficit is mostly explained in Australia and Argentina by the factorial movements that to say interest payments, profit remittances and intellectual property rights and so on. In my view, there is a reflection of the long term savings performance of the economy. I believe there is not enough savings in the domestic economy (not audible) that in the long term run you have this deficit in the factorial movements and perhaps, in the case of Argentina you have, I would say how you would we have a higher risk premium, because we have a …(not audible)… board and perhaps in the long term performance in the case of Australia you have the depreciation of the dollar. I wish a comment by the Governor about this.

Macfarlane: We do have a low household savings ratio in Australia. That's a feature of most of the Anglo Saxon economies, the US has even a lower one; Canada, New Zealand, the UK have highly deregulated financial systems and low household savings ratio. I don't think it's a function of the exchange rate regime. I think it is either cultural or a function of the sophistication of the financial systems. That would be my answer to that.

Gottliebsen: Thanks Ian. Our time has elapsed. It has been a fascinating discussion. Ian started by reminding us some features of the Australian economy that you tend to forget but then in the end we had a discussion as to why the dollar had fallen. We have canvassed a vast number of reasons and probably have not got to the conclusion as to why it has fallen. I guess everybody has their views many of you would know my views about the matter which I write in The Australian each day but, very clearly, there are different views. There is one thing that Ian said very definitely though. There is not going to be a fall in interest rates. It's very clear that if our inflation was to rise as a result of the falling dollar, Ian would be under considerable pressure. Thank you Ian for being frank about your views. We appreciate it very much and could you put your hands together in the normal way. Thank you.

Information Office
Secretary's Department

13 September 2000