2

Conduct of Monetary Policy

Review of forecasts presented in December 1998

2.1 The Governor began proceedings by reflecting back on the economic forecast he presented at the previous hearing with the Committee in December 1998. He did this, he said, '…in the interests of accountability and also because I think it has the advantage of drawing out the limitations of economic forecasting and the necessity of seeing policy formulation as an iterative process.[1]

2.2 The Bank's projections for the end of the 1998-99 financial year had included slower economic growth rates of between 2.5% - 3%, a slight lowering of the unemployment rate, a rise in inflation to around 2.5%, and a widening of the current account deficit (CAD) to about 5.5% of GDP, and even possibly to 6% of GDP. [2]

2.3 Actual figures differ somewhat. The Governor said it was well known that economic growth had not as yet declined, with growth rates up until the March quarter exceeding four per cent, and the likelihood that rates for the 1998-99 financial year would exceed four per cent. In contrast to what was expected, Australia was, he said, '…in the longest continuous upswing since the 1960s', and there was no sign yet of when the expansion would come to an end.[3]

---

1 Evidence, p 44.

2 *Review of the Reserve Bank of Australia Annual Report 1997-98 Interim Report*, Parliament of the Commonwealth of Australia, Feb 1999, pp 11-12.

3 Evidence, p 44.

2.4 Obviously, the Committee is very pleased with the better than expected economic results of the past year.

2.5 The unemployment rate has fallen slightly, in line with stronger than expected growth in the economy, averaging 7.5 per cent over the past three months compared with 7.9 per cent for the equivalent period immediately before the last meeting with the Committee.[4] The Bank's *May Semi-Annual Statement* reported that the unemployment rate averaged 7.4 per cent in the March quarter, over half a percentage point lower than the rate six months earlier, but noted also that the workforce participation rate has declined slightly over the past year.[5]

2.6 Inflation has risen very slightly, but '…considerably more slowly than our central forecast of six months ago…'[6] The Bank's *May Semi-Annual Statement on Monetary Policy* reports that inflation was 1 ¾ per cent in underlying terms over the year to March, and is expected to be about 2 per cent in underlying terms during 1999, as was forecast by the Bank in February.[7]

2.7 The Governor said that the CAD was around 5 ½ per cent of GDP in 1998-99, though the CAD was almost six per cent in the March quarter and he expected a figure of over six per cent to be recorded in the June quarter.

2.8 Reflecting on the accuracy of the Bank's forecasts, the Governor said:

> Even though the outcome has been better than expected, if someone wanted to score a point they could say that we are not very good forecasters because this is the second time in a row where the outcome has been much better than our forecasts. I would have to concede that we have been a little conservative in our forecasts, but it has not led us astray in a policy sense – that is, it has not jeopardised the achievement of a good economic outcome.[8]

2.9 The Committee accepts the Bank's explanation for the variation in its forecasts and notes that the Bank's views are a little more accurate than those of many other forecasters. Furthermore, it wonders whether other forecasters might take the Bank's lead.

4 Evidence, p 45.

5 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999*. Sydney, RBA, p 21.

6 Evidence, p 44.

7 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999*. Sydney, RBA, p 1.

8 Evidence, p 45.

Reasons for Australia's economic success

2.10 The Governor speculated about the reasons why the Australian economy has been able to expand at the rate it has for the number of years it has, without generating significant wage and price pressures.[9]

2.11 Micro-economic reforms of the past fifteen years, including tariff reductions, privatisations, financial deregulation, competition policy and labour market reforms, have resulted in improved productivity growth which has fueled Australia's economic expansion. The Governor said, though, that while productivity gains might explain economic growth, these gains do not provide an adequate explanation for the length of the expansion; for this, a macro-economic explanation was required.[10]

2.12 The other 'macro-economic' reason for Australia's economic success was low inflation. The Governor argued that the low inflation and low inflationary expectations characterising the current economic expansion distinguish it from earlier expansions in the 1970s and 1980s, which ended either in wage explosions or asset price booms and busts. Low inflation has helped to contain wage increases, while low interest rates have impacted favourably on business behaviour, reducing the attractiveness of entrepreneurial recklessness which has in the past contributed to asset price boom / bust cycles.[11]

2.13 The Committee asked the Governor whether productivity increases meant that the Australian economy could now sustain an increased rate of economic growth, exceeding the growth rate 'speed limit' of about 3 to 3 ¼ per cent, beyond which some have presumed the economy would overheat. [12]

2.14 The Governor acknowledged that in the past there had been a perception that the RBA had a ceiling on growth of around 3 ½ per cent. He had never accepted the notion of a ceiling though, as he believes that '…Whatever the sustainable rate of growth is, it will emerge from our process of monetary policy formulation'.[13] According to the Bank, there is nothing intrinsically worrying about high growth rates; these can be accommodated, provided inflation forecasts are within the target range.

---

9 Evidence, p 45.

10 Evidence, p 45.

11 Evidence, pp 45- 46.

12 Evidence, p 59.

13 Evidence, p 60.

Australian economy passes the Asian crisis stress test

2.15 The Bank's *Semi-Annual Statement, May 1999* reported that economic conditions over much of east Asia had improved in recent months and that, in most of the countries which first entered the financial crisis in 1997, activity had generally stabilised. However, the Statement also noted that to date there has not been any sustained pick-up in export demand, despite large exchange rate depreciations experienced in these countries, and – more generally - recovery is being impeded by the poor state of financial and corporate sectors.[14]

2.16 The Committee asked the Governor to comment on a remark by the Treasury Secretary that the Australian economy had been successfully stress-tested by the Asian experience and, in particular, to say whether it was premature to make such a positive judgment.[15]

2.17 The Bank agreed with the Treasury assessment, and the Governor said:

> …The longer the expansion keeps going, the less plausible it would be for us to blame any subsequent problems on the Asian crisis, because I think the major impact of the Asian crisis has probably already come through. The period of contraction in Asia has finished. The Asian economies have by and large flattened out and are perhaps going upwards a little bit, so we have basically got through that particular stage, I think… [16]

Australia's links with the US business cycle

2.18 In May the US Federal Reserve shifted to a tightening bias on interest rates,[17] and in the lead up to the June hearing there was speculation in the Australian media about the possibility of a similar shift in monetary policy in Australia. Despite assurances from the Treasurer and the Reserve Bank Governor that inflation in Australia would remain low, and there were

14 Reserve Bank of Australia. *Semi-Annual Statement, May, 1999.* Sydney, RBA, p 11.

15 Evidence, p 69.

16 Evidence, p 69.

17 On 1 July 1999, the US Federal Reserve raised interest rates by 0.25 of a per cent, but shifted their monetary policy bias back from 'tightening' to 'neutral'.

significant differences between the American and Australian economies, Australian financial markets followed with a rise in interest rates.[18]

2.19 At the hearing in June the Committee asked the Governor what effect a tightening of US monetary policy would have on Australia's monetary policy settings. As he had done in the past, the Governor reiterated comments on the differences between the Australian and US setting. He explained that the US had eased monetary policy three times in the second half of 1998 because it feared a credit crunch, which had now passed. US easings were an emergency operation which now needed to be 'unwound' by monetary policy tightenings.[19] The reasons for the US easings were contrasted with those leading to Australia's easing of monetary policy in December 1998[20], which occurred because the Bank judged there was a high probability of a significant undershooting of the inflation target. [21]

2.20 The Governor said that the US may have to move up interest rates soon to reverse the temporary measures that were taken in the second half of last year, but:

> …when I say that, when I explain what has happened in the US…you can see that we are not really in that position here, even though we have a growth rate which is in fact higher than that of the US…we do not, at this stage, judge the Australian economy to be subject to any significant wage and price pressures. So we would see ourselves, domestically, as being in a very different position from the US.[22]

2.21 When pressed on this matter by the Committee, the Governor said:

> Monetary policy in Australia is made primarily in relation to domestic considerations. Our inflation targeting regime, which we are still very confident in and we are still very happy with, says that the Australian monetary policy is principally adjusted in response to what our inflation target says. If our inflation forecast has us at or in the band [of 2 – 3 per cent], then there is not prima facie a case for an adjustment to Australian monetary policy.[23]

---

18 The RBA's June *Bulletin* revealed (p S55) a jump in the 10-year bond rate from 5.71 at the start of May to 6.00 on 31 May. The July *Bulletin* (p S46) showed the 10-year bond rate continued to rise throughout June from 6.02 per cent on 1 June to 6.27 per cent on 30 June.

19 Evidence, p 49.

20 On 2 December 1998 the Bank announced a cut of 0.25 of a percentage point in the cash rate.

21 Evidence, p 70.

22 Evidence, p 50.

23 Evidence, p 50.

Impacts of tax reform and the GST

2.22 At the Committee's December 1998 meeting with the Reserve Bank, the Governor was asked for his views on the effect that tax reform was likely to have on the performance of the Australian economy. His response was that he believed that the long term effects of tax reform would be good. The tax base was too narrow, and tax reform to reduce the distortion would be beneficial.[24] The Governor made similar comments at the June hearing.

> …my general argument is that I think that some reweighting of the tax system away from income tax to sales, expenditure or GST type taxes would be beneficial for a number of reasons. The main reason is that it does something about relieving the very high marginal tax rates that apply in Australia on quite moderate incomes...[25]

2.23 Also at the June hearing the Committee asked the Governor about the capacity of the Australian economy to absorb the fiscal stimulus of $12 billion which is now expected to flow from the tax reform package in the form of tax cuts and compensation for low-income earners. The Committee questioned whether the stimulus, '…coming at a time when imports are way ahead of exports, national savings are fairly stagnant, and we are still growing faster than our trading partners…', might boost inflation and lead to the need for a rise in interest rates.[26]

2.24 The Governor replied by saying that economic forecasts for the middle of the year 2000, when tax reform is to be implemented, are for a slowing of domestic consumption and growth rates and for a strengthening of the world economy. These forecasts, which are 'the conventional view' for the coming year, mean that the Australian economy should be 'in a very good position to handle' the fiscal expansion created by the 'very generous compensation package' attached to the introduction of the GST. [27]

2.25 As for the monetary policy implications of a GST, the Governor reiterated what he said at the last hearing with the Committee,[28] that the GST would

---

24 *Review of the Reserve Bank Annual Report 1997-98 Interim Report*, Commonwealth of Australia, Feb 1999, p 10.

25 Evidence, p 70.

26 Evidence, p 50.

27 Evidence, p 51.

28 *Review of the Reserve Bank of Australia Annual Report 1997-98 Interim Report*, Commonwealth of Australia, Feb 1999, p 10.

have a ‘once and for all effect’ on price level. Prices would be adjusted upwards, and:

> Monetary policy allows it to happen, and it then gets on with the normal business of making sure it does not become continuous inflation. So the price level goes up. During that period the measured rate of inflation goes up, and then the measured rate of inflation returns to what it was before. That is the way we would be handling it. What that means is that a GST per se has no implication for monetary policy.[29]

2.26 The Committee questioned the Bank in more detail about the price effects of the GST, in particular about whether the Bank agreed with Treasury’s forecast of a 1.9 per cent once-off price level effect. In reply, the Bank said they did not have an alternative forecast to Treasury’s,[30] but they had looked at Treasury’s estimates, and:

> The answer is that we have had some discussions on this with the relevant Treasury people so we can understand their modelling and their methodology and how they have arrived at that 1.9 per cent cost-of-living figure, which will probably be lower now with the changes to the package anyway. I think the methodology is fine. All these things are subject to the nature of the model you have and the assumptions you make, but I think what they have done is perfectly reasonable, so that number I think is fine.[31]

2.27 The Bank also noted that the short-term impact of the GST would be bigger than its long-term impact; 1.9 per cent is the long-term impact which takes into account compensation and ‘…is the right number to focus on...’[32] Short-term impacts would be bigger than long-term ones because ‘…the passing through of cuts in sales taxes and so on – where prices come down – will take a while’...[33] The Bank remarked that the first-year impact of the GST could be as high as 3.1, a number cited by Treasury in some Parliamentary hearings.[34]

2.28 Regarding the price effects of the GST in future wage claims, the Governor said he thought the compensation package would take that into account.

---

29 Evidence, p 51.

30 Evidence, p 52.

31 Evidence, p 53.

32 Evidence, p 53.

33 Evidence, p 54.

34 Evidence, p 54. The original reference to Treasury’s first-year GST CPI impact forecast of 3.1 per cent may be found on page 27 of the *Senate Select Committee On a New Tax System : First Report*, Commonwealth of Australia, February 1999.

> The Bank will also be monitoring the indirect effects of the GST on inflationary expectations and factoring this into its analysis.[35]

Business investment

2.29 The Bank's May *Semi-Annual Statement on Monetary Policy* noted that, while the business sector was not constrained by the availability of funds for investment , and despite the recovery in business sentiment towards the end of 1998, recorded business investment declined sharply in the December quarter to a level almost 3 per cent below that of a year ago.[36] The Bank further reported an 'overall softness' in the forward indicators of investment, although it concluded that the 'flat spot in overall investment' would prove to be short-lived.[37]

2.30 The Committee took up the issue of business investment with the Bank at the June hearing by asking the Governor to comment on the 'blip' in business investment, in particular with regard to investment as a component of aggregate demand, and the prospects of a sustainable economic expansion.

2.31 The Governor said that if you looked over the whole period of the expansion since 1991, investment had actually been very healthy, despite the fact that there have been individual years when investment has been weak and consumption strong. The current 'flat spot' in investment is minor, he said, compared with '…the medium term performance we have had, where investment has grown very strongly'.[38]

2.32 The Governor said he was not surprised that, after investing so much over the last eight years, there was a bit of a pause in business investment. In terms of keeping a sustainable expansion going, he was not particularly worried by the numbers.

> Basically, business is very profitable; business can borrow very cheaply, business can raise equity very cheaply and business has a lot of retained earnings. There is no reason in the medium term to think that business is going to decide that it cannot afford to

35 Evidence, pp 62-63.

36 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy May 1999*. Sydney, RBA, p 20.

37 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy May 1999*. Sydney, RBA, p 21.

38 Evidence, p 54.

> invest. It is just that in the year-to-year numbers they go up and down.[39]

The household saving ratio

2.33 While past usual ailments of wage and price pressures are not being experienced, the Governor identified the fall in the household saving ratio as a possible 'ailment' with the potential to bring Australia's economic progress to a halt.[40]

2.34 Australia's household saving ratio, as measured in the national accounts, has declined substantially over the past two decades. It reached 0. 4 per cent in the March quarter[41], its lowest recorded level, and well below the average of around 12 per cent prevailing in the early 1980s.[42]

2.35 People are not only saving less, they are borrowing more, encouraged by the low cost of borrowing. The level of household debt in Australia increased by over 13 per cent in the year to March and while the level of indebtedness of Australian households is about average compared with that of other countries,

> …a continued period of rapid growth in household credit could generate concern, given that households will have to service their higher debt levels out of nominal incomes that are growing at a much slower rate than in the higher-inflation era of the 1970s and 1980s.[43]

2.36 The ABS March quarter Financial Accounts released on 28 June 1999 showed that Australian household debt grew by $10.8 billion during the March quarter.[44] In June 1995 Australian households owed $258 billion, or about $14,276 per person. By June 1998 households owed $357.5 billion, or

---

39 Evidence, p. 55.

40 Evidence, p 46 and p 55.

41 ABS, *Australian National Accounts: National Income, Expenditure and Product, March Quarter 1999* (Cat.No. 5206.0), 2 June, 1999.

42 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May 1999.* Sydney, RBA, p 24. Reiterated in Evidence, p 46.

43 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999*. Sydney, RBA, p 18.

44 ABS, *Financial Accounts* (Cat. No. 5232.0), March Quarter 1999, p 15.

around $19,066 per person, and by March 1999 the total level of household debt had risen to $387.9 billion, or to an average of $20,554 per person. [45]

2.37 At the June hearing, the Governor said there are three ways in which the trend in household savings could cause problems for the economy and endanger the present expansion. [46]

2.38 The first possible problem '…is that if inadequate household saving persists it could mean inadequate provision for retirement...'[47] This, he said, would put increased demands on future taxpayers and was a matter of 'intergenerational equity'. The solution to this would be found in improving policies regarding retirement income.[48] Questioned by the Committee about the need for a new pre-retirement savings policy, the Governor said he didn't agree a new policy was necessary, but:

> …you should be reviewing all the time structural aspects of your economy to see whether some of them are inadvertently having an antisaving effect – for example, if your tax policy is leading to a reduction in savings... [49]

2.39 The second problem relating to the falling household saving ratio is the possibility that this, other things being equal, could lead to an increase in the current account deficit (CAD).[50] A larger current account deficit results from a decline in aggregate saving relative to aggregate investment. [51] So far, the reduction in household saving has been offset by movements in other factors (government sector saving, business sector saving and investment) and the current account has shown the same cyclical movement it has been exhibiting over the past 20 years. [52]

2.40 The third possible problem cited by the Governor is '…that increased indebtedness makes the household sector more vulnerable when interest rates rise'…[53] The Committee questioned the Governor about the Bank's concerns with regard to this, in particular, what implications there were for monetary policy. In response, the Governor said:

---

45 ABS, *Financial Accounts* (Cat.No. 5232.0) and ABS, *Australian Demographic Statistics* (Cat. No. 5232.0). Numbers calculated by the Statistics Group, Information and Research Services, Dept. of the Parliamentary Library.

46 Evidence, p 46.

47 Evidence, p 46.

48 Evidence, p 47.

49 Evidence, p 83.

50 Evidence, p 47.

51 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999.* Sydney, RBA, p 25.

52 Evidence, p 47.

53 Evidence, p 47.

> We do not have a moralistic approach to monetary policy. We cannot say to people, 'Look, you are doing the wrong thing. You are borrowing too much money. We are going to tighten monetary policy.' We cannot target monetary policy to individual borrowing patterns. [54]

2.41 While the Governor said that the only way indebtedness enters 'the monetary policy equation' is when consumption threatens to drive up inflation, he did acknowledge that increased indebtedness meant that interest rates would not need to be raised 'as much as was formerly the case' to achieve a given macro-economic effect.[55]

2.42 The Committee recognises that public savings have improved, corporate savings are about the same, but household savings are now at historically low levels. The decline in household savings has occurred despite the move towards compulsory superannuation. Fiscal policy addresses the level of government savings while various industry, tax and related measures address business' capacity to provide for its investment needs.

Recommendation

Whilst recognising that the majority of Government economic policy settings are sound, the Committee notes the concern about the level of household savings and recommends the Government give appropriate attention to this issue.

Employment

2.43 Although the unemployment rate is edging down, it is still too high. In the March quarter it averaged 7.4 per cent, over half a percentage point lower than it was six months earlier, but the participation rate has also declined over the past year.[56]

2.44 In the May *Semi-Annual Statement*, the Bank said that:

> While the labour market has clearly benefited from the overall strength of the economy over the past two years, employment

54 Evidence, p 56.

55 Evidence, p 47. Elaborated on p 57.

56 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999.* Sydney, RBA, p. 21.

> growth appears to have lagged the growth in output a little more than usual.[57]

2.45 The Committee asked the Bank why, when the economy was growing at the rate it is, there hadn't been a corresponding rise in employment. The Governor said the Bank was surprised the rise in employment over the last three or four months hadn't been greater, given the data on GDP growth, vacancy levels, and business hiring intentions. He speculated that 'lumpy' economic data could be responsible for the 'bump' in the series, and said that the Bank is still expecting to see employment growth come through.[58] Pressed by the Committee for a 'ballpark figure' for the expected reductions in the unemployment rate, the Assistant Governor (Economic) said the rate could come down 'A bit further below seven, seven per cent – something like that - at the end of this calendar year...'[59]

2.46 With regard to unemployment figures being 'higher than we would like', the Governor remarked on the frequent comparisons of Australia's unemployment figures with those of the United States. He said that, while the US level of unemployment is lower than ours, Australia's rate of progress in reducing unemployment is actually slightly better:

> But the interesting thing is that we have actually brought our unemployment rate down more than the US has, at the same length of expansion roughly – ours is only a quarter less – so we have made the same progress. The problem is we just started from a much higher base.[60]

2.47 The Committee also questioned the Bank on its views of the relationship between monetary policy and employment. As the Committee pointed out, the Bank has some employment-related goals in its Charter.[61] The Governor said he was comfortable with the Bank having references to employment and unemployment in its mandate[62], and that the best thing that could happen for unemployment was for Australia to have a long, sustained expansion.[63] He said:

> Our position is that history has demonstrated quite conclusively that if you want to have a sustainable expansion it can happen only under periods of low inflation. So in achieving that low

57 Reserve Bank of Australia. *Semi-Annual Statement, May, 1999.* Sydney, RBA, p. 22.

58 Evidence, p. 58.

59 Evidence, p. 59.

60 Evidence, p 58.

61 Evidence, p 71.

62 Evidence, p 72.

63 Evidence, p 59.

> inflation you will maximise your chances of having a sustainable economic expansion and you will, therefore, maximise the benefits for employment.[64]

The current account deficit

2.48 The Bank's *Semi-Annual Statement on Monetary Policy, May, 1999*, reported that:

> Continued growth in import values coupled with falling exports has seen a widening of Australia's current account deficit. In the December quarter, the deficit reached a level of 5.4 per cent of GDP.[65]

2.49 The report noted that the CAD as a proportion of GDP has risen by 1 ½ percentage points since 1996, but qualified this by stating that the increase in the CAD could be accounted for mainly by '…movement in the statistical discrepancy'. The implications of this are that the gap between savings and investment could be even wider than that demonstrated by current estimates of saving and investment.[66]

2.50 The Bank has forecast a CAD of 6 per cent of GDP over the next few quarters[67] and the Committee asked the Governor to comment on the sustainability of this figure, given that in the past the Bank had held the view that a CAD of 6 per cent was unsustainable. [68]The Governor replied that he thought there was less fear now about a CAD of this size; he said his announcement on the prospect of a CAD of six per cent had not caused the sorts of reactions it would have in the mid –1980s.[69] He explained the apparent shift in attitude by referring to retrospective analyses of 'debt to GDP' and 'debt to service ratio' data which show that fears of unsustainability have often proved, with the benefit of hindsight from ten or fifteen years into the future, to have been unfounded.[70]

2.51 The Committee asked the Bank to comment on how it sees the CAD with regard to the so-called 'consenting adults defense' of the size of the

64 Evidence, p 71.

65 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999.* Sydney, RBA, p 29.

66 Ibid., p 25.

67 Evidence, p 45.

68 Evidence, p 63.

69 Evidence, p 64.

70 Evidence, p 64.

deficit, which suggests that market reactions to its growing size are benign because public accounts are in surplus, and the borrowings that the CAD represents are the result of private sector saving and investment decisions which are not the concern of government.

2.52 The Bank replied that the sort of CAD we have now is more benign than the sorts of CADs we have had before.

> If you have a current account deficit and it appears to be the result of domestic policy imbalances, that is more worrying than if you have a current account deficit which is principally the result of the fact that there is a temporary slowdown in your trading partners - and I think that is true. When we had a current account deficit of six per cent of GDP and it coincided with a significant budget deficit and a period when our inflation was higher than that of our trading partners, that was more worrying than the sort of current account deficit we have at the moment. It is not related to government dis-saving and is not related to a higher inflation in Australia than in our trading partners. But it is principally due to the fact that we have been able to grow at a good rate, whereas a significant number of our trading partners have not only not grown very fast but have positively contracted.[71]

The exchange rate

2.53 The Committee queried the Bank about some information on the Australian dollar contained in the *Semi-Annual Statement on Monetary Policy, May, 1999*, which read:

> In the light of the greater stability in the market and the higher average level of the exchange rate, the Bank in mid-April resumed its normal practice of covering the Government's foreign exchange needs by purchasing foreign currencies in the market. In the period since mid 1997, the Bank had met these needs directly from its foreign currency reserves.[72]

2.54 The Governor rejected the Committee's suggestion that the Bank's use of foreign currency reserves was a 'foreign exchange intervention' designed to limit downward pressure on the Australian dollar. The Bank explained that when the Government wants to spend money abroad, it buys that

71 Evidence, p 65.

72 *Semi-Annual Statement on Monetary Policy May 1999.* Sydney, RBA, p 7.

foreign currency from the Bank, and the Bank has the choice of whether to buy back currency immediately to replenish reserves, or whether to wait a while for a better time. The Bank said:

> …during 1998, when on a couple of occasions the Australian dollar was under what we thought was quite unwarranted downward pressure, we did not want to push it or encourage it to go any further so, instead of immediately buying the foreign currency from the market, we waited. We just supplied it from our reserves and then found a more suitable time to replenish our reserves, and that is what we are doing at the moment. That is simply a standard relationship between us and the government – how we, as banker to the government, provide them with foreign currency. [73]

2.55 However, the Governor acknowledged that on three occasions in 1998 the Bank '…actually did some orthodox intervention' because the market was threatening to become destabilised, an overshoot occurred, and an even bigger one was threatening. At one stage, the Australian dollar went down to 55c against the US dollar.[74]

2.56 The Committee asked the Governor for clarification on the effect of the Bank's intervention on the level of the dollar, especially in the context of the widening CAD. The Committee asked whether, if the Australian dollar had been allowed to fall a bit further, this might have '…helped get a better balance between exports and imports'.[75]

2.57 The Governor agreed that while the Bank's intervention meant that the Australian dollar did not fall as far as it might have in 1998, the intervention did not have any effect on the long-term level of the Australian dollar. Without explicitly saying so, he denied the possibility there had been an effect on the balance of imports and exports. He said that if the dollar had been allowed to fall further, it would have fallen temporarily and would still have come up the way it has.[76]

---

73 Evidence, p 66.

74 Evidence, pp 66-67.

75 Evidence, p 67.

76 Evidence, p 67.

2.58 The Bank was asked its view of the current value of the Australian currency and the Governor replied:

> Most of the time, if you have got a floating exchange rate, you basically just accept the judgment of the market. On fortunately rare occasions, you think the market has got it wrong…[77]

2.59 A floating exchange rate is part of the reason why the Bank is not worried about the size of the CAD. At the hearing the Governor said that the financing of a big current account deficit becomes a 'huge problem' when exchange rates are fixed, but in a 'floating exchange rate world' it is not as big a problem.[78]

Hedge funds

2.60 While currency hedging can be a help in financial planning, for example for exporters seeking to limit exchange rate exposure, this type of 'risk management' hedging should be distinguished from 'speculative' hedging of the kind engaged in by hedge funds.[79]

2.61 Hedge funds attempt to make the very high possible returns that are available, on average, to those willing to accept a high degree of risk. Hedge funds attempt to operate outside regulation and tend to invest in financial derivatives (options, futures, etc) based on the fund's expectations of movements in currencies, shares or other financial values. Hedge funds often attempt to maximise their returns by relying heavily on borrowed funds to provide additional leverage.[80] Last year *The Economist* reported an estimate that there were approximately 3000 hedge funds operating globally.[81]

2.62 The Reserve Bank's November 1998 *Semi-Annual Statement on Monetary Policy* reported a sharp change in the risk-taking mentality of international banks and borrowers in mid-1998 which it attributed in large part to the activities of hedge funds, which for a number of years had borrowed heavily from banks in industrial countries to invest in emerging market assets. According to the Bank's Semi-Annual Statement,

---

77 Evidence, p 67.

78 Evidence, p 65.

79 Gain the edge with a hedge. *Australian Financial Review*, 5 July 1999.

80 Definition provided by David Richardson, Economics Research Specialist, Parliamentary Research Services, Department of the Parliamentary Library, Parliament House, Canberra.

81 'Hedge funds: a guide', *The Economist*, October 3, 1998, p 92.

> The collapse of emerging market asset prices following the actions of the Russian authorities left hedge funds nursing large losses, which in turn exposed banks that had provided funding to them through both equity and debt. In addition, banks, and especially investment banks, had large positions on their own account in emerging markets on which losses were incurred.[82]

2.63 While the vast majority of hedge funds operate in the US equities market[83], at the Committee's last hearing with the Bank in December 1998 the Bank reported that work undertaken by the Australian Prudential Regulation Authority (APRA) revealed that Australian banks had been exposed as lenders to hedge funds but also simply as counterparties to currency swap transactions.[84]

2.64 The Bank's May *Semi-Annual Statement on Monetary Policy* stated that the 'reduced position-taking' by hedge funds following losses suffered in late 1998 (and subsequent tightening of credit standards by banks funding them) could 'prove to be only a temporary respite'. While qualifying the validity of its data, the Statement referred to '…market reports indicating that investment flows into hedge funds have resumed in February after three months of substantial outflows. Moreover, there are reports that traditional investors such as pension/superannuation fund…are shifting a portion of their investments into hedge funds as a form of diversification'.[85]

2.65 Questioned about hedge funds in the context of financial system stability, the Bank distinguished between 'standard, plain vanilla' hedge funds, which the Governor described as engaging in 'perfectly respectable' activities, and 'global macro funds', which comprise a very small minority of hedge funds and about which 'we have spoken disapprovingly over the last year'.[86] The Governor said he would be 'very worried' if it is the case that US endowments are putting money with these global macro funds.

2.66 The Bank is very comfortable with the trading practices of Australian exchanges such as the Sydney Futures Exchange. The problem is with trades which are done off-exchange or over-the-counter, as in these cases '…it is much more difficult to be sure that very sound practices are being

82 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, November 1998.* Sydney, RBA, p 1.

83 Evidence, p 72.

84 *Review of the Reserve Bank of Australia Annual Report 1997-98 Interim Report.* Commonwealth of Australia, February 1999, p 10.

85 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999.* Sydney, RBA, p 5.

86 Evidence, p 72.

used'...[87] As for the big banks, the Governor said the Bank thinks '…they know what they are doing'...[88] These banks have very elaborate risk management systems and take relatively small risks. The Governor said that APRA is monitoring the banks very closely on these matters. The Committee is meeting with APRA later in the year and will seek additional information on this issue at that time. This matter is also one term of reference in the Committee's current inquiry into international financial markets.

Inflation forecasting and targeting

2.67 It is generally acknowledged that mid 1993 was the time when Australian monetary policy makers began to articulate a medium-term target for inflation of 2 – 3 per cent.[89] Since the target was adopted, Australia's average annual rate of inflation has been 2.1 per cent[90], and inflation has been a little below the target for longer than it has been above. [91] Indeed, the rate of inflation in the eight quarters prior to the June hearing has been below the Bank's target rate of 2 – 3 per cent.[92]

2.68 The Committee asked the Bank whether it was happy with the fact that inflation had been coming in below target, and whether the Bank saw any value in revising the inflation target downwards. In reply, the Governor said that the Bank had not been trying to come in below target and, basically, that the Bank sets monetary policy on the basis of its inflation forecasts. The Bank is, he said, 'genuinely surprised' when inflation comes in below the forecast. One of the biggest contributors to the undershooting of the inflation target in recent times has been the fall in car prices[93], which have declined considerably, despite a significant currency depreciation.[94] There was no value in revising the inflation target at the moment, he said, '…but if this happened year after year, then maybe you would have to revise the target'.[95]

87 Evidence, p 73.

88 Evidence, p 73.

89 Reserve Bank of Australia, "Six Years of Inflation Targeting" (Address to Economic Society of Australia by Glenn Stevens), Sydney, 20 April 1999, p 1.

90 Ibid, p 2.

91 Ibid, p 6.

92 Reserve Bank of Australia. *Reserve Bank of Australia Bulletin, June 1999*. Sydney, RBA, p S68.

93 Evidence, p 62.

94 Reserve Bank of Australia. *Semi-Annual Statement on Monetary Policy, May, 1999*. Sydney, RBA, p 44.

95 Evidence, p 62.

2.69 The Bank was asked about the role of inflationary expectations in inflation forecasting, and the Governor replied that inflationary expectations are an important component of inflation forecasting, but not the only one.[96] Asked whether the easing in December 1998 was partly driven by an expectation of easing, the Governor said:

> No, the easing of monetary policy in December was essentially driven by the fact that our inflation forecast was coming down. We were in a position where we thought there was a more than reasonable probability that we would have a significant undershooting in inflation, and therefore some easing was warranted.[97]

2.70 The short and long-term inflationary impacts of the GST had been canvassed at the hearing, and the Bank was asked whether it was seeing an associated increase in inflationary expectations. The Bank said it was certainly following these with interest, and there had been a slight rise in inflationary expectations over the past six months which may be partly attributable to the expectation of a GST. However the Governor added that:

> …It is quite possible that you could have inflationary expectations go up – as they have over the last six months – without inflation itself going up. There are a whole lot of other measures that you have to look at. The experience of New Zealand, Canada and other countries, which have had not necessarily the introduction of a GST but an increase in a GST rate, is that it has been a once and for all lift and has not followed through into a higher rate of inflation.[98]

Prospects for the rest of 1999 and 2000

2.71 The Bank has forecast a 'fairly mild decline' in growth for the rest of this calendar year and for the financial year 1999-2000. At the hearing the Governor said:

> The outcome for the calendar year 1999 will, in our judgment, be lower than the growth recorded in 1998 – something between

96 Evidence, p 63.

97 Evidence, pp 69-70.

98 Evidence, p 63.

> three and four per cent is our guess – and probably slightly lower again in the financial year 1999-2000. [99]

2.72 In its May *Semi-Annual Statement on Monetary Policy,* the Bank said that:

> The Bank expects inflation in underlying terms to be about 2 per cent during 1999, the same as its forecast in February, and a continuation of Australia's excellent inflation performance during the 1990s. CPI inflation will remain below that over the coming year, as a result of the recent changes to health insurance arrangements.[100]

2.73 At the June hearing the Governor reiterated the Bank's forecast of 2 per cent underlying inflation for the rest of 1999, but revised upwards the forecast for CPI inflation to two percent. By way of explanation, the Governor said:

> This is a little higher than we suggested in the half-yearly statement, as we have now taken full account of higher international oil prices, which will roughly offset the effect of all the health care changes.[101]

2.74 One of the reasons for the Bank's forecast of an (increased) inflation rate of around two per cent for the rest of this calendar year is the expectation there will finally be a 'pass through effect' on import prices related to the devaluation of the Australian dollar.[102] With the significant devaluation of the Australian dollar since 1997, import prices at the docks have risen, but price rises have not been passed on to consumers. Contrary to expectations, import prices have fallen.[103] The Bank admitted it had spent a lot of time pondering this mystery. Commenting on it, the Bank's Assistant Governor (Economic) said:

> All along we have tended to take the view that the implied extent of margin squeeze surely cannot persist indefinitely, that at some point something has to give and these prices have to rise; either that or eventually the exchange rate goes up and rescues their margins that way. So we have maintained the idea in our forecasts that there will be some pass through of this effect, but less than historical average and obviously more delayed. That idea

99 Evidence, p 44.

100 *Semi-Annual Statement on Monetary Policy, May, 1999.* Sydney, RBA, p 1.

101 Evidence, p 44.

102 Evidence, p 62.

103 Evidence, p 61.

underlies under the forecast of inflation returning to about two per cent over the year to December this year.[104]

2.75 The Governor predicted the current account deficit would stay at around 6 per cent of GDP for the next few quarters '…with the result that the outcome for 1999 as a whole will be about six per cent of GDP'.[105] While the Governor forecast that the CAD will stay at around six per cent of GDP in the next financial year, he also said he expects the CAD to come down after the next calendar year '…because the overall picture of the world economy that underlies all of our analysis at the moment is of a stronger world economy in the year 2000 and a weaker Australian economy'.[106] In other words, the Bank expects the CAD to peak at 6 per cent of GDP.[107]

2.76 The Bank expects '…a bit more than two per cent in employment growth to resume in the period immediately ahead, and that will be enough to just edge the unemployment rate down some more over the rest of this year'.[108] Unemployment could fall below seven per cent by the end of this calendar year (see par 2.45).[109] On 8 July the ABS released its preliminary labour force statistics reporting that in June the unemployment rate fell by 0.3 percentage points to 7.2%, the lowest rate since August 1990.[110]

2.77 The Committee will continue to monitor developments on all these matters at the next hearing with the Bank in November 1999.

104 Evidence, p 62.
105 Evidence, p 45.
106 Evidence, p 64.
107 Evidence, p 65.
108 Evidence, p 59.
109 Evidence, p 59.
110 ABS *Labour Force Australia (Preliminary)*. Cat No. 6202.0 June 1999.