
TRANSCRIPT OF Q & A

**AUSTRALIAN BUSINESS ECONOMISTS
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DINNER**

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RESERVE BANK OF AUSTRALIA

Q & A SESSION

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MR HENDERSON: Thank you very much for that address, Mr Macfarlane. We will now take questions from the floor. There are two microphones at each end of the room so I'd ask you to walk up to those microphones if you'd like to ask a question and before you do so could you please state your name and affiliation.

MS AUSTIN: Carol Austin from Contango Asset Management. Ian, when I was at BHP in the mid 80s, we brought out a former finance minister from Chile to Australia and he had discussions with a number of people including some at the Reserve Bank. One of the questions he posed was the timing of the floating exchange rate and he said the debate in Chile had focussed on whether you liberalised the labour market first and then the exchange rate, or the exchange rate and then the labour market. He posed to question, why did Australia chose to liberalise their exchange rate before they liberalised the labour market because the shock absorber that you had to use for external shocks was total the exchange rate. They thought you needed a flexible labour market to have a flexible exchange rate.

MR MACFARLANE: I think the answer to that, Carol, is we liberalised the exchange rate or deregulated the exchange rate first because it was easier. Deregulating a labour market is a much more demanding task. It involves numerous decisions, on-going decisions, whereas with an exchange rate it only really involves one decision which is to tell the central bank to stay out of the market and let the market equilibrate itself. So there was really one decision involved there and I don't know any more sophisticated economic explanation other than to say that, in economic policy making, you take your opportunities when they arise. You can't sit down with a blank sheet of paper and say, "We'll do this one first and that one second and that one third and when we've completed this we do that." You never have those options.

You basically take the opportunities when they arise and we were fortunate that we had an opportunity to float the currency at a time when it was under upward pressure but I think, as my speech made clear, we did have a lot of the groundwork done. We had already deregulated the capital market

and the bond market and the money market and so it wasn't as though floating the exchange rate was the first thing. It was the third or fourth, but it's true that we did do that before any significant progress was made on deregulating the labour market.

MR POTTER: Michael Potter from the Australian Chamber of Commerce and Industry. I wanted to explore your comment about the fact that the oil prices have had less of an adverse effect because it has been a demand-related shock rather than a supply-related shock. I guess, from the perspective of a price-taking economy such as is Australia's, should it make a difference whether the shock to oil prices has been caused by supply or has been caused by demand? From Australia's perspective, shouldn't both of those shocks have exactly the same effect which is to increase the price of oil to the Australian economy and therefore it doesn't really matter that it was supply shock or a demand shock?

MR MACFARLANE: Well, the first answer to that is, to the extent that there is a contractory effect, you're taking it off a much high baseline. If the world economy is growing strongly, you're taking something off a strongly growing baseline rather than, in the case of a supply shock, where basically in OPEC 1 and an OPEC 2 you woke up one morning and you discovered the price of oil had trebled overnight and that the producers of oil would cut back their supply however much was necessary to maintain that high price.

So the biggest single difference when we look over the last 3 years and compare that with those earlier supply shocks is in each of the last 3 years the world has used more oil. Oil production has continued to go up whereas in OPEC 1 and OPEC 2 oil production was cut back. There was a supply constraint that cut in and that is a huge difference between the two situations. It's true for an individual country you see the price go up but for the world economy there has not actually been a shortage of oil; it has just cost more, whereas in OPEC 1 and OPEC 2 there was a shortage and it cost more.

Now, I suppose another way of looking at that is, from our perspective, what we are seeing at the moment is a generalised increase in commodity prices. At the same time as oil prices going up, a lot of the

commodities that we produce are going up, so it's very hard for us to think that in any sense we have suffered a loss of real income. In fact, we haven't. Our real income has gone up. Now, I think if you were sitting in Europe, maybe you would think that it looks somewhat similar to OPEC 1 and OPEC 2 but for the world as a whole, it doesn't, and for Australia it certainly doesn't.

MR MELLISH: Governor, Morgan Mellish from the Financial Review. I have a question about Robert Gerard.

MR MACFARLANE: That's a surprise.

MR MELLISH: I was hoping you could tell us when you became aware that Mr Gerard had a dispute with the Tax Office and also whether you discussed that with the Treasurer at that time?

MR MACFARLANE: This will be very flattering to you but I discovered it when I read an article you wrote in the Financial Review. I think it was last Tuesday week, that's when I discovered it.

MR MELLISH: Mr Gerard wasn't under any obligation to disclose that under the Reserve Bank code of conduct?

MR MACFARLANE: He had an obligation to disclose to the Treasurer his affairs and he filled in the same form that we all fill in.

MR MELLISH: But he has an obligation to disclose annually, doesn't he, his interests?

MR MACFARLANE: Yes he does, he discloses to the Treasurer annually, yes.

MR MELLISH: Would a \$75 million payment to the Tax Office be something that should be disclosed to the Treasurer?

MR MACFARLANE: Well, I don't know what he disclosed to the Treasurer but I think the reason that he resigned is that he should have disclosed the \$75 million payment to the Tax Office.

MR HENDERSON: I think we'll move on to a question from this side, please.

MR THOMAS: Governor, Michael Thomas, ICAP. You mentioned the resilience of the Australian economy. The ABS trend estimates of GDP growth show that we've fallen short of potential for six successive quarters now. I was wondering, on that basis, what's your estimate of the output gap and more importantly the sign?

MR MACFARLANE: Well, I suppose the simplest answer to this is, trend or potential output growth is something that you will fall short of 50 per cent of the time and exceed 50 per cent of the time and according to the ABS figures we're in the falling short of 50 per cent rather than the exceeding 50 per cent at the moment, but I don't think there's really much to write home about and I certainly wouldn't pay much attention to the most recent quarter. I think the best way of looking at the most recent period is to average the last two quarters in which case you get the economy growing at an annual rate of about 3 per cent which is probably a pretty good characterisation of where we are and it's not a bad rule of thumb for where we're probably going.

MR ROLFE: Governor, John Rolfe from The Daily Telegraph. Given the legislative independence of the Reserve Bank, do you think it's appropriate that the Government selects some of the members of the Board?

MR MACFARLANE: The Government selects everyone. The Government selects me and the Deputy Governor and the Board and that's the Act we've had and as far as I know this is true in every country that I have any knowledge of. For example, the government of the United States appoints the Federal Reserve Board. The government of England appoints the Monetary Policy Committee of the Bank of England. I think independence is all very well, but there has to be some democratic accountability somewhere and I think that is the standard model that's used everywhere.

MR HENDERSON: Excuse me, can we not have any more questions on the Reserve Bank Board. We've got somebody here that can tell us about economic policy.

MR MACFARLANE: I'm enjoying the ones about the Reserve Bank Board.

MR EVANS: Governor, Bill Evans from Westpac. The use of the word fifty-fifty before reminded me of your comment at the Parliamentary presentation in August where you indicated that, in your view, there was a 50 per cent probability that the next move in rates would be up and a 50 per cent probability they'd be down. Is that still your thinking?

MR MACFARLANE: No, I think I would reiterate what we said in our November Statement on Monetary Policy which I think gave a clear indication that looking ahead it's easier to envisage upward risks to the outlook for inflation and outlook for economic activity than to envisage downward risks so I think we're roughly in the position we have been for most of the past year, apart from a brief departure in August when we thought things had become 50/50.

MR PALGHAT: Bill Evans stole my comment. Kumar Palghat from PIMCO. As a US fund manager in Australia, three things keep me awake at night. It's the US housing market, current account deficits and the unfunded pension liability. I'm wondering if there's anything that keeps you awake at night in the Australian economy since you've had such a great run?

MR MACFARLANE: People are always asking this question, what keeps you awake at night? But I'm actually not a worrier. Sometimes I wake up naturally and I think about things, but I don't get woken up by worries. There's no secret I was very worried about the housing - the asset price - boom that was occurring in Australia which took on bubble-like proportions and I was very worried about it and put a lot of effort into doing everything I could think of to bring some sanity back in that area. But that has been very stable for the last 2 years. I don't feel that I have any of those other worries - now, the worries were housing, current account and what was the other one?

MR PALGHAT: Unfunded pension liability in the US economy - - -

MR MACFARLANE: No. I think we're in better shape in all of those things than the US, undoubtedly better in all three.

MR PALGHAT: So you've found a fantastic cruising altitude in monetary policy.

MR MACFARLANE: That's a new term, cruising altitude. I don't know about that.

MR PALGHAT: I think you have.

MR MACFARLANE: It sounds good.

MR BASSANESE: David Bassanese from the Financial Review. You talked in your speech about the return to normalcy of interest rates around the globe. You mentioned that Australia had begun the process. You didn't quite say whether we had finished the process of returning to normalcy and I wondered if you'd care to comment whether or not you think we are back at normal or not.

MR MACFARLANE: That's not a bad question. I like that question because I'll just give an example because I can answer it but not quite the way you probably want it answered. There is no doubt that we used the concept of return to normal or return to neutral as a major justification for the movement up in our interest rates from the low point of 4.25 per cent to where they are now, currently at 5.5 per cent. Having used the concept, I was of course asked publicly, in this case by a Parliamentary committee, what did I define as normal or neutral, and I had to answer it.

It's interesting that in the United States when Chairman Greenspan gets asked that he says, "It's too complicated. I can't answer it, but we'll know it when we get there." I couldn't get away with that in this country. We are much more blunt speaking and so when I was asked it, I said, "Well, the average real interest rate that has prevailed during periods of low inflation growth in Australia has been about 3 per cent, and if we assume that the inflation target is met and we average 2 ½ per cent inflation, then somewhere around 5 ½ per cent, plus or minus a half a per cent, would probably be the neutral range. So I actually had to specify some numbers. I still stand by those numbers but it is interesting that we're sometimes criticised for not being as transparent as we should be, but I could never have got away with what Chairman Greenspan said in this country and in this company.

MR HENDERSON: Time for one more question. Look, who we've got there now.

MR MACFARLANE: Rory, you're last this time; normally first.

MR ROBERTSON: Rory Robertson, Macquarie Bank. Governor Macfarlane, I first want to apologise for the missing speech in 2001. I still reckon it was Bob Gregory. Anyway, my question is a bit cheeky. I think pretty well every observer reckons you're one of the very best governors the Reserve Bank has had in its about half a century existence. I guess I want to be cheeky and ask a question about what's your greatest embarrassment or what's the Reserve Bank's biggest embarrassment during the past decade or two? You've had a great run for the past 15 years with good growth, low inflation. Is it the early nineties recession? Is that an embarrassment to the Bank or is that something that basically opened the door to the good run we've had over the past 15 years?

MR MACFARLANE: That's a good question. I'm not sure whether it's a good question, the way it was phrased. But if ever I was tempted to write about a particular economic event which I think has been misunderstood, I would not write about anything that's happened during my governorship, because I think I've had a pretty fair hearing and I think people have understood what's going on. They haven't always agreed with me but I've had a very fair hearing. But if I was to write something, I think I would write about the 1990s recession where I think some of the understandings in the popular imagination are completely wrong. But whether I ever actually get around to doing it is a different matter. I think some of the economic interpretations are completely wrong and, even more importantly, I think the political interpretations are completely wrong.

MR ROBERTSON: I'm thinking back that just a year ago the Federal Reserve basically had a celebratory conference, celebrating Chairman Volcker's disinflation, where he put US interest rates up to 20 per cent in the late seventies, caused the early eighties recession, brought low inflation to the US and everyone was cheering it, and yet we got something completely different coming out of the early nineties story.

MACFARLANE: It is interesting. I mean the episode in Australia which returned us to a low-inflation, sustainable-growth economy is regarded as a policy error, whereas in America it's regarded as a policy triumph. I think actually you could write the piece for me, Rory. I don't need to write it.

MR HENDERSON: Thank you, Governor, for that. I'm going to hand over now to Andrew Hughes from the New South Wales State Treasury. This of course is a joint function that the ABE runs with the Economic Society so Andrew is going to give the vote of thanks, but on behalf of the ABE, thanks to all of you that came for the conference this afternoon. I hope you got something out of that and found it enjoyable, and also obviously to everybody that's come here tonight. Thanks for your support and we look forward to your support next year. Thanks very much.

MR MACFARLANE: Thank you.

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