The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2007 (First Report)

House of Representatives Standing Committee on Economics

May 2008
Canberra

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ISBN 978-0-642-79044-6 (Printed version)
978-0-642-79045-3 (HTML version)

Chair's foreword

The current upward trend in inflation has prompted the Reserve Bank of Australia (RBA) to increase the official cash rate to 7.25 - up 75 basis points since the former committee met with the Bank in August 2007. The RBA has now increased the cash rate 12 times since 2001; with a total of a 100 basis point increase from 8 August 2007. The April 2008 hearing, therefore, provided a timely opportunity to scrutinise the RBA's conduct of monetary policy.

On top of these official rate rises, commercial banks have been raising rates independently of the RBA. This has placed a heavy load on people struggling with their mortgages who, at the same time, are facing increasing pressures to pay their bills. High rate environments which are designed to slow the economy and bring downward pressure on inflation have a human cost which cannot be ignored.

The committee, taking these issues into account, will continue to scrutinise the RBA over its conduct of monetary policy and seek the most up to date forecasts for inflation, growth and rates. The RBA's forecasts for inflation indicate that underlying inflation should start moderating from June 2009 and reach about 2.75 percent by December 2010. The public hearing scheduled for 8 September 2008 will be an opportunity for the RBA to report on the most recent data available.

The role of commercial banks in lifting rates independently of the RBA has not gone unnoticed. The banks have argued the need to increase their rates because of problems arising from the US sub-prime mortgage crisis and the consequent increasing cost of credit. These banks should be responsive to the needs of their customers. At the next hearing, the RBA's report on credit conditions will be particularly useful as part of the wider community debate about the actions of commercial banks.

On behalf of the committee, I would like to thank the Governor of the Reserve Bank, Mr Glenn Stevens and other representatives of the RBA for appearing at the hearing on 4 April. The next hearing will be held on 8 September 2008 in Melbourne.

Craig Thomson MP
Chair

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Membership of the Committee

Chair	Mr Craig Thomson, MP	
Deputy Chair	Hon Chris Pearce, MP	
Members	Mr David Bradbury, MP	Mr Richard Marles, MP
	Hon Michael Dutton, MP	Ms Julie Owens, MP
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Terms of reference

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on the annual reports of government departments and authorities tabled in the House that stand referred to the Committee for any inquiry the Committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the Committee.

List of abbreviations

CAD	Current Account Deficit
CPI	Consumer Price Index
GDP	Gross Domestic Product
GST	Goods and Services Tax
RBA	Reserve Bank of Australia

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Introduction

Background

1.1 The House of Representatives Standing Committee on Economics (the committee) is responsible for scrutinising the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the community, and the financial sector.

1.2 The RBA Governor's appearances before the committee at biannual public hearings are an important element of the Bank's accountability framework. The details of this framework are set out in the *Fourth Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Wayne Swan, MP, and the RBA Governor, Mr Glenn Stevens. The statement formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix C, states:

> The Governor has also indicated that he plans to continue to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Treasurer expresses continuing support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy—and therefore the credibility of policy itself.[1]

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1 RBA, *Fourth Statement on the Conduct of Monetary Policy*, December 2007.

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual reports of the RBA.

Scope and conduct of the review

1.4 The first public hearing of the committee with the RBA during the 42nd parliament was held in Sydney on 4 April 2008.

1.5 The proceedings of the hearing were audio streamed over the internet through the Parliament's website, allowing interested parties to hear the proceedings as they occurred. The Governor's opening statement was taken as a submission and the transcript of the hearing is available on the committee's website.[2]

1.6 Before the hearing, the committee received a private briefing from Mr Kieran Davies, Chief Economist, ABN-AMRO. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Davies' cooperation and assistance.

1.7 The committee also appreciates the provision of additional briefing material from Mr Kali Sanyal of the Parliamentary Library Research Service.

1.8 The hearing was well attended by members of the public and staff and students from East Hills Girls Technology High; Sydney Secondary College; Newington College; Fort Street High; Caringbah High and Methodist Ladies College.

1.9 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and also have assisted in providing a public face to parliamentary committees and the RBA. The committee welcomes the Governor's frank and open comments at the hearings. In addition, the hearings are an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.10 The report focuses on matters raised at the public hearing, and also draws on issues raised in the RBA's *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA's website.[3]

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2 See: <http://www.aph.gov.au/house/committee/efpa/index.htm>

3 See: <http://www.rba.gov.au>

Next public hearing with the RBA

1.11 The committee will conduct the next public hearing with the RBA on Monday, 8 September 2008 in Melbourne. More details will be circulated in the weeks leading up to the hearing.

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Monetary policy and other issues

Overview

2.1 The current upward trend in inflation has prompted the Reserve Bank of Australia (RBA) to increase the official cash rate to 7.25 - up 75 basis points since the former committee met with the Bank in August 2007. The RBA has now increased the cash rate 12 times since 2001; with a total of a 100 basis point increase from 8 August 2007. The April 2008 hearing, therefore, provided a timely opportunity to scrutinise the RBA's conduct of monetary policy.

2.2 The year 2007 was yet another strong year for the Australian economy, with growth of more than 4 per cent over the year to the December quarter. In particular, domestic demand expanded by 5.5 per cent 'well in excess of the trend growth in the economy's productive capacity.'[1] The rate of unemployment declined further, to record its lowest level since the mid-1970s.[2]

2.3 The Governor noted that 'indicators of capacity utilisation reached their highest levels for two decades', resulting in challenges for expanding operations due to shortages of suitable staff.[3]

2.4 In contrast to increasing capacity constraints, the RBA noted that the 'deterioration in financial market sentiment has been associated with a

1 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 2.

2 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.

3 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.

weakening in the outlook for global economic growth.'[4] The US has posted only moderate growth with many observers forecasting a recession. Growth in the Euro area also appears to be moderating although not to the same extent as in the US. Japan's economy is also weakening, yet in other parts of Asia economic conditions remain solid.[5]

2.5 The Governor noted that demand growth 'well and truly exceeded any plausible estimate of the rate of growth of the economy's supply potential' causing inflation to increase.[6] Mr Stevens reported that the year end Consumer Price Index (CPI) was 3 per cent, but was expected to rise. The March quarter CPI, released after the hearing, showed that both the headline and underlying rates of inflation had increased to 4.2 per cent.[7]

2.6 Domestic capital spending was pronounced in the resources sector, but robust growth has not been confined to this sector. Public financial spending rose in response to demand for upgrades to infrastructure, rising at twice its trend over 2007.[8] In addition, the Governor noted that consumer demand rose at a pace well above average, 'fed by a rate of growth of real household disposable income as high as anything seen in the past 20 years.'[9]

2.7 Indicators of domestic performance have largely remained strong over early 2008. Demand growth, however, is in the process of moderating and credit demand for households is weakening. The RBA explained that the businesses they survey are experiencing tightened financial conditions, lower share prices and heightened concerns over global finance.[10] Mr Stevens noted that while there is evidence of a slowing in demand, 'there remain powerful conflicting forces at work' which will be closely monitored.[11]

4 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 1.
5 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.
6 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.
7 RBA Website [http://www.rba.gov.au/]
8 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.
9 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.
10 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.
11 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.

Forecasts for 2007-2008

2.8 The US economy showed 'only modest growth in the December quarter, and most observers have revised down their expectations for 2008'[12]; while 'growth in the euro area and Japan is also slowing.'[13]

2.9 Growth in the domestic economy remains strong. The latest national accounts show growth of more than 4 per cent over the year to the December quarter in the Australian economy, with domestic demand expanding by 5.5 per cent.'[14]

2.10 The RBA reported that 'global commodity prices have generally stayed high in the recent period, and this continues to boost incomes and spending in Australia.'[15] The RBA noted that 'based on these developments, the prospects are that Australia's terms of trade will rise further this year, after the sharp increases already seen over the past four years.'[16]

2.11 The **CPI rose by 1.3 per cent** in the 2008 March quarter, lifting the year-ended rate to 4.2 per cent. The RBA's measure of underlying inflation seeks to remove temporary influences from the data. **Underlying inflation** increased by 1.2 per cent in the March quarter taking the year ended rate to 4.2 per cent - identical to the year ended CPI.

2.12 In relation to monetary policy, the RBA board is of the view that current policy settings should remain unchanged. The Governor stated that there exists some evidence that a moderation in demand is occurring, which should, in due course, slow price growth.[17]

2.13 Mr Stevens noted that the goal of monetary policy going forward will be to secure a gradual reduction in inflation by restraining demand, thereby protecting Australia's good macroeconomic performance over the past decade and a half, and creating an avenue for sustainable growth into the future.[18]

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12 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 1.

13 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 1.

14 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 2.

15 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 2.

16 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 2.

17 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April, 2008, p.5.

18 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April, 2008, p.5.

Inflation targeting and monetary policy

2.14 The *Fourth Statement on the Conduct of Monetary Policy*, agreed on 7 December 2007 between the Treasurer and the Governor of the Reserve Bank, outlines the objective of monetary policy and provides an inflation target.

2.15 The goals of monetary policy as set out in the *Reserve Bank Act 1959* require the Reserve Bank Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

- the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

2.16 The Fourth Statement on the Conduct of Monetary Policy also states that:

> In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.[19]

2.17 The RBA in its February 2008 Statement on Monetary Policy (SMP) stated:

> The inflation forecasts have been revised upwards following the high December quarter outcome. Underlying inflation is forecast to be around 3.5 per cent over the year to the December quarter 2008. The forecast of a continuing high level of underlying inflation reflects the expectation that pressures on capacity will remain for some time. Indeed, in the near term, it is likely that the year-end rates of underlying and headline inflation will rise somewhat from current levels, reflecting the succession of large quarterly increases in the three last quarters.[20]

2.18 During the hearing the committee asked for the RBA's assumptions behind recent inflation forecasts. In forecasting an underlying inflation rate of 3.5 percent at 2008 end, and trending down, the RBA answered that it relied on exchange rate, oil price and cash rate movement assumptions.[21]

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19 RBA, *Fourth Statement on the Conduct of Monetary Policy*, December 2007.

20 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 55.

21 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 5.

The Bank had factored in a cash rate of seven percent, which was the rate at the time the forecasts were made, before the March rate rise.[22]

2.19 The Governor stated an expectation of seeing forecasts for growth and inflation go down in the RBA's next SMP in early May—which was the intention of the rate rise made in March.[23]

2.20 When asked what the average inflation rate over the current cycle might be, the Governor stated that looking back since 1993 the average has been roughly 2.5 per cent; hence to get the same average over the coming 10 years or so, 'we need tight policy to put some downward pressure on inflation.'[24]

2.21 The committee further put to the Governor the question of what would happen to the economy and interest rates if inflation was ignored. The Governor's response was that if inflation is not controlled 'then ultimately you end up with higher interest rates.'[25] Further, by keeping a 'stable trend inflation rate, nominal interest rates cycle around a stable mean as well.'[26] Hence it is important to act promptly to contain inflation and preserve the nominal interest rate structure Australia has had since the 1990s.

2.22 In relation to the 'lag' effect between when a decision is made on rates and when it takes effect in the marketplace, the committee asked the Governor what he believed to be the right time to reduce interest rates before the economy dips. The Governor responded that often the effects of earlier decisions are still affecting the economy, which is why he is 'keen to move in relatively small increments.'[27] The current level of rates is on the high side, however, 'when they have done the job, they can come down.' In particular, Mr Stevens noted that 'we do not wait to conclude that the job is done to the point where inflation itself has actually gone all the way back down to the target.'[28]

2.23 The committee sought clarification on the measurement of underlying inflation and, in particular, the use of trimmed mean and the weighted mean. The Governor noted that both measures seek to accurately measure the 'central tendency of the inflation rate that distils out some of the noise we can get' and added that 'CPIs can often be affected by large but

22 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 5.
23 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 5.
24 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 6.
25 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 6.
26 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 6.
27 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 24.
28 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 24.

temporary movements', to which monetary policy should not be responding.[29] Hence, in order to compute the central tendency, you can and should 'exclude certain things from the basket on a consistent basis'.[30]

2.24 Further questions sought to clarify how many measures of inflation are looked at, and whether this process equated to looking at CPI ex volatiles. The Governor responded that 'CPI ex volatiles takes out more than just food and energy which is what is commonly done in other countries.[31]

2.25 The Governor was asked a series of questions focusing on possible factors influencing inflationary expectations. In 2007 the Governor, as part of a speech to the Sydney Institute, stated:

> Even more important are expectations of future inflation. When people expect prices to rise rapidly, they bring forward purchases, put up their own prices, demand higher wages and so on. That helps to create the very inflation they expect.[32]

2.26 The Governor responded that outcomes play a role, and what is currently needed is for the RBA to have a 'credible story…as to why inflation…is going to come down.'[33] Secondly, he stated that over the long run a monetary policy framework is required which

> (a) has a demonstrated track record and (b) has a measure of public confidence that the central bank is serious about containing inflation.[34]

2.27 In response to the latter question of inflationary expectations and monetary policy, the Governor reiterated that high expectations do make it harder to bring inflation down, however, the impact these should have on interest rates is not always clear cut. He added that what is generally required is to manage these expectations, which the RBA is currently trying to do.[35]

2.28 In relation to concerns that inflation may be 'out of control', Mr Stevens stated:

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29 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 12.

30 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 12.

31 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 12.

32 Mr G Stevens, Governor of the RBA, Central Bank Communication, Address to the Sydney Institute, Sydney, 11 December 2007.

33 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 7.

34 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 7.

35 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 7.

> …what we have said is inflation has risen and that is a problem. It has to be dealt with and we are dealing with it. We will contain it and it will come down. Is it out of control? No, I have never said that. I have tried, if you like, to make balanced comments that one cannot say that there is not a problem. There is a problem, but I do not think it is out of control. I think it will be controlled, and that is why we are doing what we are doing. So, there is a problem, a response is needed, it is being made and it will work. [36]

2.29 In respect to competition in the lending market, the Governor stated that lenders relying on wholesale funding have had to slow down as 'profitability of that business model changed', adding that what has happened is 'that the larger banks have basically made up for that, so the market shares have swung around.'[37]

2.30 The Governor added that he does not see any short-term implications of bank market share growth on RBA policies. Though in the longer term, there emerges an issue of competitiveness of the mortgage market, and that at some stage, stronger competition should come back to the Australian mortgage market. [38]

2.31 The role of fiscal policy as a complementary tool for helping to reduce overall demand was examined. The Governor stated:

> I would not argue against some role for fiscal policy at all. It is not my place to give advice on it. If people propose particular fiscal initiatives that are complementary, well and good, that is just fine with me, provided that we remember that even fiscal measures are going to have to produce a slowing in demand—the same size slowing in demand as what we are looking at. There are no two ways around that issue. It will probably prove pretty difficult to have really finely calibrated fiscal measures, but I could be wrong there; I would be happy to be proved wrong. [39]

2.32 The committee sought clarification on the impact of a loose fiscal policy on inflation. The Governor explained that:

> In an economy like ours, where we have no debt and the budget is continually in surplus, it seems to me there is an obvious structural case that can be made for lower taxes. At the same time,

36 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 8.
37 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 9.
38 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 9.
39 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 15.

> in the current environment an obvious cyclical case can be made for fiscal policy to be tighter.
>
> So you have a structural case to lower taxes and a cyclical case not to, or even to raise taxes if you are really serious. Where to strike the balance is not an easy judgement for any government to make.[40]

2.33 The committee sought further clarification on what level of fiscal tightening would be required to take pressure off inflation. Mr Stevens stated:

> We are talking quite big amounts here. It will take very major changes in fiscal policy to completely obviate the need for what we are doing. I do not think it is realistic to expect that it can be obviated completely, but every little bit helps. I will be happy to see any support from fiscal policy we can get, but I think we have to be realistic about how much any government will be able to do in the environment we face. When all is said and done, containing inflation is mainly the central bank's job.[41]

Wages growth and a deregulated labour market

2.34 In relation to the role of the deregulated labour market in the containment of inflation over the last decade, Mr Stevens stated that in response to the recent terms-of-trade shock, initially 'productive resources, labour and capital flowed to the areas and industries where they were needed. Relative wages have changed, in effect, 'relative prices adjust to the shock we have had, but you contain the aggregate.'[42]

2.35 Whilst the RBA is monitoring for signs of wages pressure, Mr Stevens stated that the 'labour market has performed very well in adjusting to the nature of the shock. He added, 'I do not have any doubt that a long series of liberalising changes by both sides—by governments of different persuasions—over probably 15-plus years has made a big difference to that outcome.'[43]

2.36 The Governor stated that fostering labour productivity plays a role in how the labour market is regulated. He agreed with the committee that 'flexibility and freedom in the labour market is good in terms of being able

40 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 34.

41 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 34.

42 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 10.

43 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 10.

to operate to contain inflation in a period of expansion.'[44] In addition, the Governor agreed with the proposition that productivity increases are best gained when employers and employees have a broader range of issues to bargain about. He commented that you 'have fairness considerations to keep in mind here as well, as everyone knows.'[45]

2.37 Commenting on the relationship between demand growth and unemployment, Mr Stevens stated that 'five percent plus demand growth cannot be sustained. That has to slow down. GDP growth will slow, and that is our forecast. Employment growth will slow as well.'[46] However, he noted that the 'extent to which unemployment would rise depends on a range of other factors, not least of which is how flexibly and quickly the labour market responds to the slower growth in output.'[47]

2.38 The Governor added that 'where you have a mid-cycle pause in the growth trend, which is what we are talking about here, the unemployment rate goes up a bit for a while and then it starts to go down again'[48], and that he is working with a 'framework where there is no long-run trade-off between unemployment and inflation.'[49]

Exchange rates and external trade

2.39 The Australian dollar has traded in a large range in the proceeding months. The RBA reported that looking through 'recent fluctuations, the Australian dollar has appreciated in trade-weighted terms over the past year and is still well above its post-float average.'[50] The Australian dollar traded at 91.2 US cents as at the hearing date.[51]

2.40 Commodity prices generally remain at very high levels. Over the three months to February 2008, the RBA's index of commodity prices changed very little, 'as weaker base metals prices have been offset by higher prices for rural commodities and gold.'[52]

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44 Mr G Stevens, Governor of the RBA *Transcript*, 4 April 2008, p. 11.

45 Mr G Stevens, Governor of the RBA *Transcript*, 4 April 2008, p. 13.

46 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 17.

47 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 17.

48 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 17.

49 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 17.

50 RBA, *Statement on Monetary Policy*, 11 February 2008, p. 21.

51 RBA Website [http://www.rba.gov.au/]

52 RBA, *Statement on Monetary Policy*, 11 February 2008, p.10.

2.41 In particular gold prices have increased by more than 30 per cent over the past year to around US$900 and are at their highest level in real terms in more than 20 years.[53]

2.42 Rural commodity prices increased by four per cent over the three months to January, with further strength in wheat prices. Crops used in the production of biodiesel and ethanol, such as canola and sugar, also rose in price over recent months, partly reflecting high oil prices.[54]

2.43 The RBA reported that despite the slowing in the world economy, Australia's terms of trade are expected to rise in the near term. This forecast is largely driven by expected ongoing commodity demand, suggesting that terms of trade will reach fresh highs in mid 2008, before declining as the market responds to current high commodity prices.[55]

United States, China and the global economy

2.44 The US economy is subdued, and deleveraging continues as lenders retreat from risk. In conjunction with this, US financial markets became more volatile. Credit concerns have kept capital markets from functioning normally, and forecasters have been revising down for 2008.[56] In response, interest rates have declined sharply, and a fiscal stimulus package is being delivered as of late April.[57]

2.45 To a lesser extent, growth in the Euro area is also moderating, as is Japan's economy. In contrast, economic conditions in the rest of Asia have proven to remain solid, with growth in industrial production and strong exports overall.[58] The Chinese economy exhibits strong growth, with continuing demand for natural resources. Asian banks continue to act on a capacity to extend credit, and domestic financial conditions remain expansionary. This all leads to strength in domestic demand in Asia, with inflation remaining a concern.[59]

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53 RBA, *Statement on Monetary Policy*, 11 February 2008, p.10.

54 RBA, *Statement on Monetary Policy*, 11 February 2008, p.11.

55 RBA, *Statement on Monetary Policy*, 11 February 2008, p.53/54.

56 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.

57 Thomson Financial Website [http://www.thomsonfxhub.com]

58 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.

59 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 4.

Housing and household debt

2.46 The March 2007 *Financial Stability Review* referred to 'pockets of financial stress', and identified Western Sydney as one such area. Since then, there have been four increases in the cash rate. The committee asked the Governor whether the bank is concerned about the latest cycle of tightening and its financial impact on families struggling to pay their mortgages. In particular, the committee sought detail on data relating to mortgage defaults, arrears and home repossessions.

2.47 The Governor stated that the RBA is 'certainly conscious that, when we raise interest rates that is not sufficiently precisely targeted to not impact others.'[60] He added that they 'have an aggregate instrument that has to be geared to aggregate conditions' and that 'arrears rates on mortgages in Australia are very low and, indeed, they have fallen a bit in the second half of 2007.'[61]

2.48 The committee raised the question of whether the RBA had done any research in relation to mortgage stress. The Governor noted that the term 'stress' has become more loosely defined. The original definition was if 'you were in the bottom 40 per cent of the income distribution and you spent more than 30 per cent of your income on housing'[62], whereas now it is often referred to just as people who 'spend more than 30 per cent of their income on housing.'[63] Mr. Stevens further commented that there has 'been a trend for the community as a whole to be more affluent' and with that 'a decision to spend a higher proportion of income on housing.'[64]

2.49 Dr Edey added that the RBA has 'published various bits of analysis on the question of who has the housing debt and how that correlates with different levels of income and household characteristics'. This research shows that 'at a very broad level, the people who have the debt are mostly the people who you would expect, would be able to afford to service it – that is to say, people with high incomes.'[65]

2.50 Dr Edey also stated that household debt has been going up for two decades. He commented that 'it is now about 160 per cent of household income in aggregate and still rising, and that does mean that any given

60 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 14.
61 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 14.
62 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 16.
63 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 16.
64 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 16.
65 Dr M Edey, Assistant Governor, *Transcript*, 4 April 2008, p. 14.

interest rate move has a bigger net effect on the amount of income available to households after interest.'[66] However, he added that due to the last year being a period of very rapid growth in household incomes overall, 'you still have a very high level of real income growth for the household sector as a whole.'[67]

2.51 The committee also examined home loan lending practices and it relationship to mortgage stress. The committee asked if the RBA has any view in relation to a current range of lending practices that were dubious, in terms of the pressures that they put on particular groups of people.

2.52 Mr Stevens responded that 'when you have got a highly competitive mortgage market and you have got fringe lenders coming in, you will get some practices that should not occur.'[68] Mr Battelino stated that in 'the current system the onus is more now on the individuals to be careful about accessing finance.'[69] Notwithstanding these concerns, the RBA noted that of the total number of home borrowers there are only '15,000 people in the whole of Australia who are running 90 days overdue on their housing loans.'[70]

2.53 The RBA noted that the current turmoil going on in the market is actually cutting back on some of the practices that were growing. Mr Battelino stated:

> One of the practices that I think is quite dangerous is that lenders have started using agents to market loans. There is no doubt that the agent does not have the same incentives to maintain high standards as the bank itself. I think it is very important for banks to maintain a direct relationship with their clients and not to use agents. I think it is very important that individuals who are licensed to be agents meet very strict criteria and are highly qualified, because they can do a lot of damage by inappropriate selling.[71]

2.54 The committee in the previous parliament conducted an inquiry into home loan lending practices and the processes used to deal with people in

66 Dr M Edey, Assistant Governor, *Transcript*, 4 April 2008, p. 14.
67 Dr M Edey, Assistant Governor, *Transcript*, 4 April 2008, p. 14.
68 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 17.
69 Mr R Battelino, Deputy Governor, *Transcript*, 4 April 2008, p. 18.
70 Mr R Battelino, Deputy Governor, *Transcript*, 4 April 2008, p. 18.
71 Mr R Battelino, Deputy Governor, *Transcript*, 4 April 2008, p. 18.

financial difficulty.[72] In particular, the committee recommended that the Commonwealth Government regulate credit products and credit including the regulation of mortgage brokers and non-bank lenders.

2.55 In relation to the committee's recommendations on the regulation of credit products, the RBA reported that at the 'recent COAG meeting, it was agreed that that would be taken over at the Commonwealth level, which seems like a very sensible thing to do. Uniform national regulation of mortgage broking would address the licensing requirements and provide a dispute resolution mechanism.'[73]

2.56 In relation to housing affordability it was noted that since the late 1980s housing prices have decoupled from CPI, and have gone up. It was also noted that the US experienced asset inflation in house prices but is now experiencing a big fall. In response, Mr Stevens stated:

> I do not think there is any doubt that the big problem of affordability is not that interest rates are too high. They are above average at the moment, but that will be for a while until the job is done and then they will be normal again. The big problem is that the prices are very high. We have very high prices in Australia relative to income. I think there are probably both demand and supply elements to that story, if you take a 15- to 20-year view. The availability of finance and the big decline in nominal interest rates when inflation came down meant that people who would have liked to have afforded better quality housing than they could have, now could. So demand rises and, in any short period, there is a finite stock, so the prices rise.
>
> On the comparison you made with some other housing markets in other countries, it is important to remember that a big difference between ourselves and the US is that they have got a very large stock overhang—they built too many.[74]

2.57 In relation to the previous point, the committee examined the connection between rising property prices and increasing rental stress. Mr Stevens stated:

> What we have observed is that asset values in the property market rose a lot in the period from about 1996 to around about the end of

72 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Home Loan Lending: Inquiry into home loan lending practices and the processes used to deal with people in financial difficulty*, September 2007.

73 Dr P Lowe, Assistant Governor, *Transcript*, 4 April 2008, p. 21.

74 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 19.

> 2003. They have slowed down and fluctuated a bit since then, but that was a big rise. So the yields to the investor in rental property fell.
>
> They were too low (yields) and either the price had to decline, which did happen to some extent in some areas, or the rents had to rise, and that is what we are seeing.[75]

Climate change and its economic impact

2.58 During the hearing, the committee also focused on climate change and the implications of an emissions-trading scheme. In particular, the RBA Governor was asked to comment on a statement by Professor Ross Garnaut that the impact of an 'ETS (Emissions Trading Scheme) is large enough to have implications for macroeconomic stability' and 'the direct price effects will be substantial.'[76]

2.59 Mr Stevens noted that the RBA is not currently involved in policy advice or formulation on this matter. However, he did comment on the possible price impact of any changes on CPI. Mr Stevens stated:

> But let us suppose, for the sake of argument, that there is at some point a set of policies which increase the price of energy. At a first pass, I would expect that the way we would think about that from the point of view of the inflation target would be roughly the same as the way we thought about the GST when it came in. In that episode, there was a quite large one-time rise in the price level. Some prices rose, others fell, but the net effect was positive and the CPI inflation rate went to six per cent. But it was a one-time level shift; it was not an ongoing inflation effect, provided there were no second rounds—which, of course, we have to watch for.[77]

2.60 The Governor cautioned that where the situation becomes more difficult is when there are 'small increases over a whole run of years' – as the economic effects of this are harder to distil out. [78]

2.61 The committee further inquired whether this was the more likely scenario, and whether the RBA had done any modelling around this issue, and what action the RBA would take if people had to pay higher energy prices

75 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 32.

76 Ross Garnaut website [http://www.garnautreview.org.au]

77 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 27.

78 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 27.

due to inflationary pressures. The Governor agreed firstly that having a series of small inflation rate rises was the more likely outcome, and did not specify that the RBA had any extensive modelling around this issue. Mr Stevens stated:

> Presumably the intention of these policies is to shift relative prices in order to affect behaviour to reduce consumption of energy—or at least those forms of energy.
>
> So our job is to preserve price stability over the medium term…and watch for second-round impacts. (One of the things the community will have to accept) is that this is a reduction in living standards insofar as our purchasing power over energy-intensive things is concerned.
>
> If we were to try to collectively push up our wages to get that back, that…would defeat the intention of the policy. Obviously that would present a second-round problem for us if that occurred. If the policy is well explained, then that need not occur.[79]

2.62 The committee sought information on whether the economic impacts of climate change form part of the discussion at the RBA. The Governor responded that it does not, but has on its board Mr Warwick McKibbin who is an expert in the field. Furthermore, the Governor stated that climate change is essentially a volatility question, in which case the RBA would look through temporary shocks and use underlying measures to get to ongoing trends. He noted that the 'real economic implications of climate change are probably not in the monetary policy area.'[80]

2.63 Mr. Stevens added that 'listing the price mechanism as part of the solution will be critical.' [81]

Capacity constraints

2.64 The committee has at previous hearings examined the issue of increasing capacity constraints and the implications this has for inflation and monetary policy. The economy has been growing for 17 years and capacity utilisation is close to full. The Governor stated:

79 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 28.

80 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 29.

81 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 29.

> Indicators of capacity utilisation reached their highest levels for two decades, and firms continue to report considerable difficulty in expanding operations due to shortages of suitable staff. These outcomes for demand and output growth exceeded those in either of the two preceding years and are stronger than was expected a year ago, particularly in the case of domestic demand.[82]

2.65 The committee discussed a statement made by the RBA on 4 March 2008 which referred to shortages of suitable labour persisting. In responding, the Governor noted that this issue refers not only to skilled labour, but shortages of labour generally.[83]

2.66 Mr Stevens added that the 'economy has for a few years now been approaching a point where the level of utilisation of labour and capital is very high', and that we 'are as fully employed as we have been for 30 years'[84], making this an issue that the RBA has to 'watch very carefully from an inflation point of view.'[85]

Transparency and accountability

2.67 The Governor was asked for his view on recent transparency measures implemented by the RBA. In relation to Board minutes, he clarified that the nature of the RBA Board is unique in that it is comprised of people who are not full-time central bankers, and hence it is not always appropriate to disclose votes. Lastly, he added that the RBA now endeavours to announce decisions as soon as statements can be prepared. All in all, he views this new system as working well.[86]

2.68 On 7 December 2007, the Fourth Statement on the Conduct of Monetary Policy was agreed between the Treasurer and the Governor. It provides details on the transparency and accountability framework applying to the RBA and is reproduced at Appendix C.

2.69 In August 1996 the first statement was agreed between the then Treasurer, the Hon Peter Costello, MP and the then Governor Mr Ian Macfarlane. In particular, this agreement provided for the Governor to be available to report on the conduct of monetary policy twice a year to the then House of

82 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 2.
83 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 23.
84 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 23.
85 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 23.
86 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 31.

Representatives Standing Committee on Financial Institutions and Public Administration. This commitment has been agreed to in all subsequent Statements on the Conduct of Monetary Policy.

2.70 Since 1997 previous committees have been conducting two public hearings a year with the Reserve Bank of Australia. By all accounts these hearings have proved to be very effective and are eagerly anticipated by the community and financial sector. In particular, no previous committee has sought to change this aspect of the accountability framework.

2.71 During the current hearing, the committee examined whether there would be any advantages to be gained by increasing the frequency of hearings so that there was one hearing every quarter. In response to this proposal, Mr Stevens stated:

> I have been to almost all of these hearings since they started in this form in 1997. I think I have missed two. I think they have worked well. It seems to me, generally speaking, the frequency is about right. I think we would probably find that for large stretches of time there would not be enough new to say to come quarterly.[87]

2.72 The committee's past and current scrutiny of the RBA has been and continues to be strong and effective. The two hearings a year focusing on monetary policy and other hearings as required provide a sound base from which to hold the RBA to account.

Craig Thomson, MP
Chair
15 May 2008

87 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 35.

A

Appendix A — Submission

Number	Provided by
1	Reserve Bank of Australia (*Opening Statement to House of Representatives Standing Committee on Economics, public hearing Sydney, , 4 April 2008)*

B

Appendix B — Hearing, briefing, and witnesses

Public hearing

Friday, 4 April 2008 – Sydney

Reserve Bank of Australia

Mr Glenn Stevens, Governor
Mr Ric Battellino, Deputy Governor
Dr Malcolm Edey, Assistant Governor (Economic)
Dr Philip Lowe, Assistant Governor (Financial System)
Dr Guy Debelle, Assistant Governor (Financial Markets)

Private briefing

Friday, 4 April 2008 – Sydney

Mr Kieran Davies, Chief Economist, ABN-AMRO

C

Appendix C — *Fourth statement on the conduct of monetary policy*

The Treasurer and the Governor of the Reserve Bank

7 December 2007

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board, and the Government on key aspects of Australia's monetary policy framework.

Since the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework. Since 1996, this framework has been formalised in a Statement on the Conduct of Monetary Policy.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, it is appropriate and timely for the Governor, and the Treasurer on behalf of the new Government, to outline their mutual understanding of the operation of monetary policy in Australia.

This statement should continue to foster a better understanding, both in Australia and overseas, of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Reserve Bank.

Relationship between the Reserve Bank and the Government

The *Reserve Bank Act 1959* (the Act) gives the Reserve Bank Board the power to determine the Reserve Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Reserve Bank Board.

The Government recognises the independence of the Reserve Bank and its responsibility for monetary policy matters and will respect the Reserve Bank's independence as provided by statute.

The Government will implement two new initiatives to further enhance the Reserve Bank's independence.

The positions of the Governor and Deputy Governor will have their level of statutory independence raised to be equal to that of the Commissioner of Taxation and the Australian Statistician. As such, their appointments will be made by the Governor-General in Council, and could be terminated only with the approval of each House of the Parliament in the same session of Parliament.

The Secretary to the Treasury and the Governor will maintain a register of eminent candidates of the highest integrity from which the Treasurer will make new appointments to the Reserve Bank Board. This procedure removes the potential for political considerations in the appointment process and ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Reserve Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

In addressing the Reserve Bank's responsibility for monetary policy, the Act provides that the Reserve Bank Board shall, from time to time, inform the Government of the Reserve Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act, which requires the Reserve Bank Board to conduct monetary policy in a way that, in the Reserve Bank Board's opinion, will best contribute to:

the stability of the currency of Australia;

the maintenance of full employment in Australia; and

the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed of economic policy as a whole. These objectives allow the Reserve Bank Board to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Reserve Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of jobs, protect the savings of Australians and preserve the value of the currency.

In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.

Since the adoption of inflation targeting in the early 1990s inflation has averaged around the midpoint of the inflation target band. The Governor takes this opportunity to express his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates that it endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and Accountability

Monetary policy needs to be conducted in an open and forward-looking way. A forward-looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Reserve Bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. Changes in monetary policy and related reasons are clearly announced and explained. The Reserve Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses, its quarterly statements on monetary policy and monthly bulletins, have been crucial in promoting increased understanding of the conduct of monetary policy. The Reserve Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of making himself available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The Governor has announced that the Reserve Bank Board will release a statement explaining the reasons behind its decision on monetary policy following each meeting, irrespective of whether there is a change in the cash rate target. This statement will be made on the afternoon of the day of each Board meeting (rather than the morning of the following day), with the minutes of the Board meeting being released publicly as soon as possible after the meeting.

The Governor has also indicated that the Reserve Bank will continue to extend the scope of the economic forecasts in its quarterly statement on monetary policy to enhance public understanding of the conduct of monetary policy.

The Treasurer expresses support for these arrangements, which bring the transparency and accountability of the Reserve Bank's conduct of monetary policy into line with international best practice, further enhancing the public's confidence in the independence and integrity of the monetary policy process.

D

Appendix D — Glossary of terms

Australian Competition and Consumer Commission (ACCC). A Commonwealth statutory authority responsible for ensuring compliance with the *Trade Practices Act 1974* and the provisions of the Conduct Code and for administering the *Prices Surveillance Act 1983*. The Commission's consumer protection work complements that of State and Territory consumer affairs agencies.

Australian Payments Clearing Association Limited (APCA). A public company owned by banks, building societies and credit unions which has specific accountability for key parts of the Australian payments system, particularly payments clearing operations

Australian Prudential Regulation Authority (APRA). APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry

Australian Securities and Investments Commission (ASIC). One of three Australian Government bodies (the others being the Australian Prudential Regulation Authority and the Reserve Bank of Australia) that regulates financial services. ASIC is the national regulator of Australia's companies. ASIC has responsibility for market protection and consumer integrity issues across the financial system.

accrual accounting. Revenues and expenses are recorded as they are earned or incurred, regardless of whether cash has been received or disbursed. For example, sales on credit would be recognised as revenue, even though the debt may not be settled for some time.

acquirer. An institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers.

average weekly earnings*.* Average gross (before tax) earnings of employees.

average weekly ordinary time earnings (AWOTE)*.* Weekly earnings attributed to award, standard or agreed hours of work.

average weekly total earnings*.* Weekly ordinary time earnings plus weekly overtime earnings.

balance on current account. The difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

bankruptcies. Bankruptcies and Administration Orders under Parts IV and XI of the Bankruptcy Act.

basis point. A basis point is 1/100th of 1 percent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

BPAY. BPAY is a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

business investment. Private gross fixed capital formation for machinery and equipment; non-dwelling construction; livestock; and intangible fixed assets.

card issuer. An institution that provides its customers with debit or credit cards.

cash rate (interbank overnight). Broadly defined, the term cash rate is used to denote the interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis. The Reserve Bank of Australia uses a narrower definition of the cash rate as an operational target for the implementation of monetary policy. The Reserve Bank of Australia's measure of the cash rate is the interest rate which banks pay or charge to borrow funds from or lend funds to other banks on an overnight unsecured basis. This measure is also known as the interbank overnight rate. The Reserve Bank of Australia calculates and publishes this cash rate each day on the basis of data collected directly from banks. This measure of the cash rate has been published by the Reserve Bank of Australia since June 1998.

cash rate target. As in most developed countries, the stance of monetary policy in Australia is expressed in terms of a target for an overnight interest rate. The rate used by the Reserve Bank of Australia is the cash rate (also known as the interbank overnight rate). When the Reserve Bank Board decides that a change in monetary policy should occur, it specifies a new target for the cash rate. A decision to ease policy is reflected in a new lower target for the cash rate, while a decision to tighten policy is reflected in a higher target.

charge card. A charge card is a card whose holder has been granted a non-revolving credit line enabling the holder to make purchases and possibly make cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.

consumer price index. A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

collateralised debt obligations. Collateralised debt obligations (CDOs) are securities that are exposed to the credit risk of a number of corporate borrowers. In the simplest form of a CDO, this credit risk exposure is generated in the same way as for any asset-backed security (ABS): the CDO is backed by outright holdings of corporate debt, such as corporate bonds and corporate loans. Increasingly, however, the exposure to corporate credit risk is synthesised through the use of credit derivatives. Unlike other forms of ABS, where the collateral pools usually consist of loans with broadly similar characteristics, CDO reference pools are typically quite heterogeneous, with exposures to a variety of borrower types and credit ratings and across a number of countries. A CDO will usually have exposures to between 50 and 200 bonds or large corporate loans, or up to 2,000 loans to small and medium-sized businesses.

The simplest forms of CDOs are known as ‘cash' or ‘vanilla' CDOs, and are similar to other forms of ABS. A special purpose vehicle buys loans and securities from financial institutions and other market participants, and funds these acquisitions by selling securities to investors. The manager of the CDO vehicle will usually deduct fees and expenses from the interest income received from the assets in the collateral pool, with the remainder used to make regular coupon payments to investors. The term to maturity of the loans and bonds in the collateral pool will determine the maturity of the CDO securities sold to investors..

credit card. A credit card is a card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit.

The credit granted can be settled in full by the end of a specified period or in part, with the balance taken as extended credit. Interest may be charged on the transaction amounts from the date of each transaction or only on the extended credit where the credit granted has not been settled in full.

debit card. A debit card is a card that enables the holder to access funds in a deposit account at an authorised deposit-taking institution.

derivative. A financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options

employed persons. Persons aged 15 and over who, during a period of one week, worked for one hour or more for pay or worked for one hour or more without pay in a family business or on a family farm.

G-10. Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and USA; plus Bank for International Settlements (BIS), European Commission, International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development (OECD). It was formed in conjunction with the establishment of the General Arrangements to Borrow, under which members agreed to make resources available to the IMF.

G-20. Group of Twenty Forum: Members are finance ministers or central bankers from - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK and US; plus representatives of the IMF, European Union and World Bank. The G-20 aims to broaden the dialogue on key economic and financial policy issues among systemically significant economies, and promote co-operation to achieve stable and sustainable world economic growth.

G-22. Group of Twenty-two. The G-22's aim was to advance issues related to the global financial architecture. It operated through three Working Parties - on Transparency and Accountability, International Financial Crises, and Strengthening Financial Systems. The group made its recommendations in 1998, and its work has since been taken up in other forums.

G-7. Group of Seven countries: Canada, France, Germany, Italy, Japan, UK and USA. The G-7 Summit deals with issues covering macroeconomic management, international trade, international financial architecture, relations with developing countries, and other global issues.

G-8. Group of Eight countries: G-7 countries and Russia.

gross domestic product*.* The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production but before deducting for depreciation.

gross domestic product—chain volume measure. Also known as *real GDP*, this is a measure used to indicate change in the actual quantity of goods and services produced. Economic growth is defined as a situation in which real GDP is rising.

gross domestic product at factor cost. Gross domestic product less the excess of indirect taxes over subsidies.

gross foreign debt*.* All non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia.

household debt ratio. The amount of household debt at the end of a quarter expressed as a proportion of annual household gross disposable income.

household gross disposable income*.* The amount of income that households have available for spending after deducting any taxes paid, interest payments and transfers overseas.

household net disposable income. Household gross disposable income less depreciation of household capital assets.

household saving ratio. The ratio of household income saved to household net disposable income.

housing loan interest rate. The variable rate quoted by banks for loans to owner-occupiers.

implicit price deflator for non-farm gross domestic product. A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.

index of commodity prices. A Reserve Bank of Australia-compiled index (based 2001/02=100) which provides a measure of price movements in rural and non-rural (including base metals) commodities in Australian Dollars (AUD), Special Drawing Rights (SDR) and United States Dollars (USD).

inflation. A measure of the change (increase) in the general level of prices.

inflation target. A tool to guide monetary policy expressed as a preferred range or figure for the rate of increase in prices over a period. In Australia, the inflation target is between 2 and 3 per cent per annum on average over the course of the business cycle.

interchange fee. A fee paid between card issuers and acquirers when cardholders make transactions

interest rate. The term used to describe the cost of borrowing money or the return to the owner of the funds which are invested or lent out. It is usually expressed as a percent per annum of the amount of money borrowed, lent or invested.

labour force. The employed plus the unemployed.

labour force participation rate. The number of persons in the labour force expressed as a percentage of the civilian population aged 15 years and over.

labour productivity. Gross domestic product (chain volume measure) per hour worked in the market sector.

long-term unemployed. Persons unemployed for a period of 52 weeks or more.

macroeconomy. The economy looked at as a whole or in terms of major components measured by aggregates such as gross domestic product, the balance of payments and related links, in the context of the national economy. This contrasts with microeconomics which focuses upon specific firms or industries.

market sector. Five industries are excluded from the market sector because their outputs are not marketed. These industries are: property and business services; government administration and defence; education; health and community services; and personal and other services.

monetary policy. The setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

natural increase. Excess of live births over deaths.

net foreign debt. Gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

net overseas migration. Net permanent and long-term overseas migration plus an adjustment for the net effect of 'category jumping'.

non-farm gross domestic product. Gross domestic product less that part which derives from agricultural production and services to agriculture.

overseas visitors. Visitors from overseas who intend to stay in Australia for less than 12 months.

prime interest rate. The average rate charged by the banks to large businesses for term and overdraft facilities.

profits share*.* Gross operating surplus (the excess of gross output over costs incurred in producing that output) of all financial and non-financial corporate trading enterprises as a percentage of gross domestic product at factor cost.

real average weekly earnings. Average weekly earnings adjusted for inflation as measured by the Consumer Price Index.

real prime interest rate. The prime interest rate discounted for inflation as measured by the Consumer Price Index.

seasonally adjusted estimates*.* Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

terms of trade*.* The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is to divide the implicit price deflator for exports by the implicit price deflator for imports.

trade weighted index*.* A measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners.

turnover. Includes retail sales; wholesale sales; takings from repairs, meals and hiring of goods; commissions from agency activity; and net takings from gaming machines. From July 2000, turnover includes the Goods and Services Tax.

unemployed persons*.* Persons aged 15 and over who, during a period of one week, were not employed but had actively looked for work in the previous four weeks and were available to start work.

unemployment rate. The number of unemployed persons expressed as a percentage of the labour force.

wage price index. A measure of change in the price of labour (i.e. wages, salaries and overtime) unaffected by changes in the quality or quantity of work performed.

wages share*.* Wages, salaries and supplements (the total value of income from labour) as a percentage of gross domestic product at factor cost.

youth unemployment. Number of 15–19 year olds looking for full-time work.

youth unemployment rate. Number of 15–19 year olds looking for full-time work expressed as a percentage of the full-time labour force in the same age group.

Source: Parliamentary Library and Reserve Bank of Australia