

## 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.'<sup>1</sup> The rate of unemployment declined further, to record its lowest level since the mid-1970s.<sup>2</sup>
- 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.<sup>3</sup>
- 2.4 In contrast to increasing capacity constraints, the RBA noted that the 'deterioration in financial market sentiment has been associated with a

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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.<sup>4</sup> 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.<sup>5</sup>
- 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.<sup>6</sup> 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.<sup>7</sup>
- 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.<sup>8</sup> 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.'<sup>9</sup>
- 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.<sup>10</sup> 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.<sup>11</sup>

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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'<sup>12</sup>; while 'growth in the euro area and Japan is also slowing.'<sup>13</sup>
- 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.'<sup>14</sup>
- 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.'<sup>15</sup> 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.'<sup>16</sup>
- 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.'<sup>17</sup>
- 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.'<sup>18</sup>

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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.<sup>19</sup>
- 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.<sup>20</sup>
- 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.<sup>21</sup>

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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.<sup>22</sup>

- 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.<sup>23</sup>
- 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.'<sup>24</sup>
- 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.'<sup>25</sup> Further, by keeping a 'stable trend inflation rate, nominal interest rates cycle around a stable mean as well.'<sup>26</sup> 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.'<sup>27</sup> 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.'<sup>28</sup>
- 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

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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.<sup>29</sup> Hence, in order to compute the central tendency, you can and should 'exclude certain things from the basket on a consistent basis'.<sup>30</sup>

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'.<sup>31</sup>

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.<sup>32</sup>

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.'<sup>33</sup> 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.<sup>34</sup>

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.<sup>35</sup>

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.<sup>36</sup>

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.'<sup>37</sup>

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.<sup>38</sup>

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.<sup>39</sup>

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,

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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.<sup>40</sup>

- 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.<sup>41</sup>

## 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.'<sup>42</sup>
- 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.'<sup>43</sup>
- 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

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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.<sup>44</sup> 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.'<sup>45</sup>

- 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.'<sup>46</sup> 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.'<sup>47</sup>
- 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'<sup>48</sup>, and that he is working with a 'framework where there is no long-run trade-off between unemployment and inflation.'<sup>49</sup>

## 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.'<sup>50</sup> The Australian dollar traded at 91.2 US cents as at the hearing date.<sup>51</sup>
- 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.'<sup>52</sup>

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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.<sup>53</sup>
- 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.<sup>54</sup>
- 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.<sup>55</sup>

## 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.<sup>56</sup> In response, interest rates have declined sharply, and a fiscal stimulus package is being delivered as of late April.<sup>57</sup>
- 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.<sup>58</sup> 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.<sup>59</sup>

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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.'<sup>60</sup> 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.'<sup>61</sup>
- 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'<sup>62</sup>, whereas now it is often referred to just as people who 'spend more than 30 per cent of their income on housing.'<sup>63</sup> 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.'<sup>64</sup>
- 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.'<sup>65</sup>
- 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

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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.<sup>66</sup> 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.'<sup>67</sup>

2.51 The committee also examined home loan lending practices and its 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.'<sup>68</sup> Mr Battelino stated that in 'the current system the onus is more now on the individuals to be careful about accessing finance.'<sup>69</sup> 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.'<sup>70</sup>

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.<sup>71</sup>

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

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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.<sup>72</sup> 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.'<sup>73</sup>

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.<sup>74</sup>

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

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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.<sup>75</sup>

## 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.'<sup>76</sup>

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.<sup>77</sup>

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.<sup>78</sup>

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

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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.<sup>79</sup>

- 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.'<sup>80</sup>
- 2.63 Mr. Stevens added that 'listing the price mechanism as part of the solution will be critical.'<sup>81</sup>

## 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:

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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.<sup>82</sup>

- 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.<sup>83</sup>
- 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'<sup>84</sup>, making this an issue that the RBA has to 'watch very carefully from an inflation point of view.'<sup>85</sup>

## 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.<sup>86</sup>
- 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

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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.<sup>87</sup>

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

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