

## Monetary policy and other issues

### Overview of 2005

- 2.1 The RBA noted that 'growth in world GDP is estimated to have been well above average in 2005, and most observers expect this to continue in 2006.'<sup>1</sup> This has provided a favourable background for the Australian economy. In particular, the RBA noted that 'notwithstanding the inevitable short-term fluctuations in growth, the Australian economy over recent years has been more stable than most, and is now in its fifteenth year of expansion.'<sup>2</sup>
- 2.2 The unemployment rate has declined from a peak of around 11 per cent in 1993 'to a current level of just over 5 per cent, which is around its lowest since the 1970s.'<sup>3</sup>
- 2.3 The buoyant conditions in world financial markets are attributed to strong economic growth, low inflation and low interest rates. The RBA noted that central banks in the major economies, with the exception of Japan, have 'begun normalising official interest rates from the unusually low levels they reached in the early part of the decade.'<sup>4</sup>
- 2.4 Strong global expansion has led to an increase in commodity prices which has resulted in 'sharp rises in the prices of coal, iron ore and a wide range of other minerals.'<sup>5</sup> The RBA noted that this 'has contributed to a

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1 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

2 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

3 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

4 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

5 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

substantial lift in Australia's terms of trade, which have increased by around 30 per cent over the past three years, their largest cumulative increase since the 1970s.<sup>6</sup>

- 2.5 The rise in the terms of trade has contributed to a highly stimulatory environment for the business sector. The RBA reported that 'business investment is now undergoing a major upswing, having expanded by 18 per cent over the past year and at an average annual rate of 14 per cent over the past three years.'<sup>7</sup> This pattern is in contrast to household expenditure. The RBA stated:

...households have moderated the growth of their spending in the past year or two. Previously, households had been expanding their borrowing and spending at rates that could not be sustained, but they now appear to have entered a period of financial adjustments. They are still increasing their levels of debt, but are doing so at a slower pace than they were a couple of years ago. Another moderating influence on the growth of household spending has been the mild downturn in the housing construction cycle.<sup>8</sup>

- 2.6 The RBA noted that while the growth in the economy was favourable there were concerns about its composition. The RBA Governor commented that 'the growth of the economy over the past few years has been more than fully accounted for by growth in domestic spending, while Australia's export performance has been disappointing.'<sup>9</sup> As a result, 'Australia's current account deficit has remained relatively high, at around 6 per cent of GDP in recent quarters.'<sup>10</sup> The RBA concluded that 'with substantial investment in the resources sector and in related infrastructure projects currently underway, it is likely that export volume growth will pick up, though the expected improvement has been slow to eventuate.'<sup>11</sup>

## Forecasts for 2006

- 2.7 The RBA stated that 'global economic conditions are continuing to provide a favourable environment for the Australian economy.'<sup>12</sup> The RBA Governor, Mr Macfarlane, reported that 'with strong investment growth

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6 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

7 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

8 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

9 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

10 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

11 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 2.

12 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 1.

and an expected improvement in exports, our forecast for the economy overall is that annual GDP growth will pick up modestly during 2006 to about 3.25 per cent.<sup>13</sup> Mr Macfarlane noted that 'given the maturity of the expansion it should not be surprising if the average growth of the economy is now less than it was in the earliest stages.'<sup>14</sup> Mr Macfarlane stated:

As a general principle, it is easier for an economy to grow quickly when there is a large pool of unused resources to be re-employed. In Australia's current position in the cycle, that source of growth is now much more limited. So, in the absence of a significant lift in trend productivity, **we should expect to see GDP growth rates mainly in the twos and threes rather than the threes and fours**, as was typical for most of the expansion.<sup>15</sup>

2.8 In relation to inflation, Mr Macfarlane reported that 'in the latest year, inflation in underlying terms has been close to 2.5 per cent, though the headline CPI figure is higher, principally reflecting the effect of rising fuel prices.'<sup>16</sup>

2.9 It was noted that the inflation forecast was subject to uncertainty. This uncertainty mainly relates to the risk that 'current labour market tightness will result in expected wage increases.'<sup>17</sup> At the same time, however, global disinflationary forces may be stronger than expected which raises the question 'whether these latter forces prove sufficient to contain inflation in an economy operating with little spare capacity.'<sup>18</sup>

2.10 In view of these circumstances, the RBA Board at its most recent meeting judged:

...the current policy setting to be broadly consistent with the economy's requirements for the time being. Looking ahead, however, it felt that, on balance, **based on the considerations I have outlined here today, it is more likely that the next move in interest rates will be up, rather than down.**<sup>19</sup>

2.11 Mr Macfarlane's advice that the next move in interest rates 'will be up, rather than down' proved to be accurate. On 3 May 2006 the RBA announced that it would increase the cash rate by 25 basis points to 5.75 per cent. The RBA stated:

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13 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.

14 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.

15 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 2.

16 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, pp. 6-7.

17 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

18 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

19 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

International developments are continuing to provide stimulus to growth in Australia. The world economy is growing at an above-average pace for the fourth successive year and, significantly, forecasts have recently been revised upwards. Commodity prices have been increasing strongly for some time, and they have risen further in the year to date. This suggests a strengthening in the outlook for Australia's export earnings, with consequent expansionary effects on incomes and spending.<sup>20</sup>

## Inflation targeting and monetary policy

2.12 The *Second Statement on the Conduct of Monetary Policy* between the Treasurer and the Governor of the Reserve Bank sets out the objective of monetary policy and provides an inflation target. The goals of monetary policy as set out in the *Reserve Bank Act 1959* requires 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.<sup>21</sup>

2.13 In relation to inflation targeting, the 2003 Statement states:

In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 percent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time.<sup>22</sup>

2.14 Mr Macfarlane noted that Australia's inflation performance over the last decade has been consistent with the bank's medium-term target. He commented that since '1993, when the two to three per cent objective was first articulated, average CPI inflation – excluding the one-off GST effect – has been 2.5 per cent per annum.'<sup>23</sup> Mr Macfarlane pointed out that the bank's inflation objective is expressed as an average and there are periods where it has been above 3 per cent and below 2 per cent.

2.15 Mr Macfarlane cautioned that while inflation has remained contained over the past decade 'it is important, as always, to consider how inflationary

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20 RBA, Statement by the Governor, Mr I McFarlane, *Monetary Policy*, media release, 3 May 2006.

21 RBA, *Second Statement on the Conduct of Monetary Policy*, July 2003.

22 RBA, *Second Statement on the Conduct of Monetary Policy*, July 2003.

23 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 15.

pressures might evolve from here.’<sup>24</sup> Some of the factors identified that could lead to upward pressure on inflation are the high level of capacity utilisation, the tight labour market, and large increases in costs for some raw materials. Mr Macfarlane stated:

Aggregate wages growth has picked up over the past year, and businesses generally are reporting difficulty in attracting labour. These conditions underpin the current forecast of a modest rise in underlying inflation over the year ahead. Based on the current level of oil prices, **this forecast implies that headline CPI would remain close to three per cent over the forecast period.**<sup>25</sup>

- 2.16 Mr Macfarlane was asked about the impact of tax cuts on inflation and interest rates. He was not overly concerned about this commenting that ‘we can afford some changes to taxes or to expenditure’ concluding that it was ‘simply a matter of what is the right amount.’<sup>26</sup> Mr Macfarlane stated:

As we go through the year, surprise surprise, taxes are stronger than we thought which is exerting a contractionary influence through the year and then you get to nearly the end of the year and you give it back again. So you have an expansionary impact right at the end of the year. So you really have a within-year seasonal swing in fiscal policy, but from year to year all the years look very similar. From our perspective, it is the fiscal impact, which is the change from year to year, which could potentially cause us difficulties but which has not because the change has been relatively small. Despite the fact that it is talked about frequently in the financial press and amongst economists, it has never figured as an important part of our deliberations on monetary policy.<sup>27</sup>

- 2.17 During the August 2005 hearing, the committee examined the Reserve Bank’s methodology for forecasting inflation. At the February 2006 hearing, the committee focused on the appropriateness of the bank’s target of keeping inflation between 2 and 3 per cent. Australia’s mid-point target is 2.5 per cent. Table 2.1 shows the mid-point inflation targets of some leading economies.

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24 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

25 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

26 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

27 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

Table 2.1 Mid-point inflation targets of some leading economies

Country	Mid point target	Comments
Australia	2.5%	'between 2 to 3 per cent, on average over the cycle'
Switzerland	1.0%	'Below 2%'
Euro area	1.9%	'Positive inflation below, but close to, 2%'
UK, Canada, Sweden, New Zealand	2.0%	UK: CPI revised down from 2.5% NZ: 1-3%, revised from 0-3% and lower previously
Norway	2.5%	
Japan	No target	No official numerical targets are in place. After Japan's experience with deflation, observers would urge a positive target clear of zero.
US	No target	No official numerical target has been set.

Source: *Erskinomics*

- 2.18 Table 2.1 shows that Australia's mid-point inflation target is towards the upper end of the countries selected. The committee has heard from alternative sources that there would be merit in reviewing Australia's existing inflation target.
- 2.19 If, for example, the target was changed to between 1 and 3 per cent then the mid-point inflation target would reduce from 2.5 to 2 per cent. During the hearing, the Reserve Bank was asked about the merits of reducing Australia's inflation target. Mr Macfarlane noted that the decision to revise the target was a decision for government. This, for example, could form part of any revision of the statement on the conduct of monetary policy. Mr Macfarlane, however, noted that 'my inclination would be that they probably would not be interested in it, because it seems like very finetuning – half a per cent is a very small change.'<sup>28</sup>

## Conclusions

- 2.20 The Reserve Bank has an objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This objective is expressed in the *Second Statement on the Conduct of Monetary Policy*. The committee examined the adequacy of the current 2 to 3 per cent target and also considered other possible targets. The committee notes Mr Macfarlane's view that changing the target range to 1 to 3 per cent 'seems like very finetuning.'

28 Mr I Macfarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 10.

## Exchange rates and external trade

- 2.21 At the February 2005 hearing, the Governor indicated that over a 12 to 18 month period, a change in the exchange rate can be the biggest influence on inflation. That is, an appreciating dollar will help keep inflation down, but once the dollar settles at a new level, this impact on inflation dissipates.<sup>29</sup>
- 2.22 During the February 2006 hearing, Mr Macfarlane noted that the Australian currency had remained relatively stable. He stated:
- The Australian dollar has remained in a relatively steady range over the past couple of years, at levels that are a little bit above average against the US dollar and about 10 per cent above average in trade weighted terms. The currency has been remarkably stable over the last two years. Some people have found this steadiness puzzling against a background of continuing very strong rises in commodity prices and our terms of trade, as such episodes in the past have been associated with strong rises in the currency.<sup>30</sup>
- 2.23 Mr Macfarlane suggested that the key to understanding this pattern was the interest differential with the United States which has narrowed appreciably over the past 18 months.
- 2.24 In real trade-weighted terms, the Australian dollar is 12 per cent above its post-float exchange average. The RBA noted that 'at this level, the exchange rate is restraining activity in some trade-exposed sectors, particularly in the manufacturing sector.' The RBA, however, concluded that 'for the economy as a whole, the benefits from the increased terms of trade are likely to have more than offset the adverse effects of the high exchange rate.'<sup>31</sup>
- 2.25 Mr Macfarlane noted that while the growth of Australia's economy was impressive 'there has been concern expressed about its composition.' In particular, he noted that 'Australia's export performance has been disappointing.'<sup>32</sup> The trade deficit, at around 2 per cent of GDP, and the current account deficit (CAD), at around 6 per cent of GDP, 'both remain large by historical standards.'<sup>33</sup> Mr Macfarlane noted that the level of the CAD has remained high at around 6 per cent of GDP recently despite 'a strong international environment and rising commodity prices.'<sup>34</sup>

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29 Mr I McFarlane, Governor of the RBA, *Transcript*, 18 February 2005, p. 7.

30 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

31 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 45.

32 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

33 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 41.

34 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

2.26 The strength of the global economy and recovery from the global downturn of 2001 has resulted in a marked upswing in Australia's terms of trade, defined as the ratio of our export to import prices. Mr Macfarlane commented that 'currently Australia is benefiting from the largest cumulative increase in our terms of trade since the early 1970s.'<sup>35</sup> In particular, there have been sharp rises in the prices of coal, iron ore and a wide range of other minerals. The Governor stated:

Over the past three years, Australia's terms of trade have increased by 30 per cent. This is estimated to have added 1½ to two percentage points per annum to the growth in national income, or our real income and capacity to spend over this period, which has been a significant expansionary force on the economy. The effect of this can be seen in a number of areas, including strong growth in business investment, company profits, share prices and imports. Increased export prices also tend to boost government revenues through company taxes and a range of federal and state royalties.<sup>36</sup>

2.27 Earnings from manufactured goods were less favourable. The RBA stated:

Earnings from manufactured goods exports increased by around 8 per cent over 2005, with volumes estimated to have grown more strongly than overall exports, albeit at a rate well below that seen during the 1990s. Nonetheless, recent business surveys report a pessimistic outlook for manufactured exports, and the Bank's liaison with Australian manufacturers reports that producers are finding it difficult to compete with developing economies in Asia.<sup>37</sup>

2.28 The committee is particularly concerned about this trend and the ongoing challenges faced by Australian manufacturers. In May 2006 the committee commenced an inquiry into the state and future directions of Australia's manufactured export and import competing base.

## **United States, China and the global economy**

2.29 The global economy is expanding strongly. The Governor noted that while this growth has been mainly led by the US and China, 'there have been encouraging signs over the past year that growth is becoming very

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35 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

36 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

37 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 42.



broadly based, with conditions improving in Japan as well as in a number of other economies.'<sup>38</sup>

- 2.30 Importantly, this global growth has been accompanied by generally subdued inflation outcomes. Mr Macfarlane suggested that one factor behind this was 'the increased focus on inflation control by central banks around the world, after the high inflation of the 1970s and 1980s.'<sup>39</sup>
- 2.31 The US economy posted above trend growth in 2005 with real GDP expanding by 3.5 per cent. The RBA suggested that recent hurricanes and the spike in retail petrol prices 'had little lasting impact on the US economy, and stronger growth is expected to resume in the first half of 2006.'<sup>40</sup>
- 2.32 The US unemployment rate at 4.7 per cent is at a 4 and 1/2 year low. In September 2005 CPI inflation peaked at 4.7 per cent but as the year ended inflation declined to 3.4 per cent.
- 2.33 Interest rates stood at 4.5 per cent which is now 'closer to neutral levels, although the Federal Reserve's January policy statement signalled that some further tightening may still be needed.'<sup>41</sup> The Federal Reserve at its meeting on 27–28 March 2006 raised the target federal funds rate 25 basis points to 4.75 per cent. The minutes of the meeting stated:
- Most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy. However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance. The need for further policy firming would be determined by the implications of incoming information for future activity and inflation.<sup>42</sup>
- 2.34 China is now the world's fourth largest economy, and the second largest when measured at purchasing power parity exchange rates. The RBA reported that 'in real terms, the average growth rate since 1992 has been revised up from 9.4 per cent to 9.9 per cent.'<sup>43</sup> At the same time, inflation remains low, with consumer prices rising by 1.6 per cent over the year to December 2005.

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38 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

39 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 3.

40 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 6.

41 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 7.

42 Federal Reserve Board, *Minutes of the Federal Open Market Committee*, 27–28 March 2006 [<http://www.federalreserve.gov/FOMC/MINUTES/20060328.htm>]

43 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 9.

- 2.35 The Governor noted that it was China that was contributing strongly to the rapid growth in global demand for resources. As noted previously, this rapid growth has resulted in increases in world prices which Australia is benefiting from.<sup>44</sup>
- 2.36 Mr Macfarlane commented that the industrialisation of China and the 'huge pool of low-cost labour that this has brought into play has put sustained downward pressure on a wide range of prices of internationally traded goods.'<sup>45</sup> This downward pressure on prices is one of the key forces contributing to disinflationary pressures. Mr Macfarlane stated:
- ...this business of producing more than you are consuming brings us back, principally, to China and the fact that, as they bring on stream a massive supply of extremely cheap labour and find more and more ways of producing standard products, internationally traded manufactured goods, cheaper and cheaper, this puts downward pressure on everyone's CPI around the world. That is what we think of as global disinflationary pressure.<sup>46</sup>
- 2.37 Growth in the Asia-Pacific, while not at the levels of China, was running at 5.2 per cent over 2005. Economic recovery has continued in Korea and Thailand with growth being slower in Indonesia and the Philippines. The RBA noted that 'increasing confidence in the Korean economy contributed to the 50 per cent increase in Korean share prices over 2005 and to the appreciation in the Korean won exchange rate, which in January reached its highest levels in eight years.'<sup>47</sup>
- 2.38 India, through its strong growth, has contributed to world expansion. The RBA commented that GDP grew by 1.8 per cent in the September quarter, to be 7.9 per cent higher over the year, well above India's 30-year average growth rate of 5.5 per cent.'<sup>48</sup>
- 2.39 In New Zealand, economic growth is slowing but inflation remains a concern. Consumer prices have risen to 3.2 per cent over the year to December. The RBA noted that wages growth has been strong and house price growth has remained rapid at 13.5 per cent over the year to December. The Reserve Bank of New Zealand increased the official cash rate in both October and December bringing it to 7.25 per cent.<sup>49</sup>

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44 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

45 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 4.

46 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

47 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

48 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

49 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 10.

## Oil prices

- 2.40 During the August 2005 hearing, the committee examined the implications of rising oil prices. At that hearing, the RBA Governor noted that the rise in oil prices was more due to strong world demand rather than supply restrictions as was the case with OPEC1 and OPEC2. Mr Macfarlane pointed out that the rise has not added much to inflation or inflationary expectations. He also noted that oil prices only affect the CPI when they are going up. When oil prices reach a higher level and stay there, then after a quarter or two there will be less effect on the rate of change of the CPI.
- 2.41 During the February 2006 hearing, the RBA Governor reiterated his views about the impact of oil price increases. Mr Macfarlane stated:
- We know the economy has slowed, but I do not think that [oil price increases] was a major player in it. If you look around the world, every economy has had to face this big increase in oil prices and very few of them have slowed. In fact, most of them have chugged along at the same rate as before or have actually picked up. It seems to me that the contractionary effect of the rise in oil prices has been remarkably small in virtually all countries. I think that is the case here too.<sup>50</sup>
- 2.42 While this is reassuring, the impact of growing fuel prices remains a concern with the public. During April 2006 petrol prices went past \$US70 a barrel. On 19 April 2006 the Treasurer, the Hon Peter Costello, MP, commented that 'we are basically living through another oil shock.'<sup>51</sup> Mr Costello noted that in the first instance increased oil prices will result in increased prices at petrol bowsers which will feed into the CPI. He commented that 'I believe we can contain it as long as businesses that use petrol don't use that as an excuse to move secondary prices, because then you will get a second movement back into the CPI.'<sup>52</sup>
- 2.43 The concern about oil prices must be couched against key points made by the RBA Governor. First, the current growth in oil prices, as opposed to OPEC1 and OPEC2, is due to strong demand and not supply side restrictions. In addition, while there may be some initial inflationary effects, there are competing disinflationary forces. Mr Macfarlane stated:

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50 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 13.

51 The Hon Peter Costello, MP, transcript of doorstep interview, Odyssey House Richmond, Wednesday, 19 April 2006.

52 The Hon Peter Costello, MP, transcript of doorstep interview, Odyssey House Richmond, Wednesday, 19 April 2006.

I think that, in the short term, oil prices had a bigger short-term effect, if you want to measure it over the last year or 18 months. In the medium term, it is the other – the worldwide reduction in the prices of internationally traded manufactured goods, and China is the biggest single reason behind that.<sup>53</sup>

- 2.44 As part of the next hearing with the RBA on 18 August 2006, the committee will seek an update on the impact of oil price increases.

## Housing and household debt

- 2.45 The RBA focused some of its comments on the implications of the growth of household debt. The RBA Governor summarised key aspects of the most recent cyclical peak, noting that in around 2003 household credit growth reached an annual rate of over 20 per cent. He noted that since the bulk of household debt is housing related it is not surprising that this peak was closely associated with a sharp run-up in house prices. Mr Macfarlane stated:

Nationwide house prices increased strongly for several years up to late 2003, reaching a peak growth rate of around 20 per cent in that year. The increases in credit and house prices were interrelated, with credit availability fuelling price rises, while rising house prices meant people had to borrow larger amounts to achieve home ownership.<sup>54</sup>

- 2.46 Mr Macfarlane noted that since 2003 the housing market and the demand for credit have cooled. In particular, 'nationwide house prices have been broadly flat over the past two years and prices have fallen in Sydney.'<sup>55</sup> The RBA noted that the price falls in Sydney for the second year, 'together with stable or increasing prices in other capitals, have brought price relativities between Sydney and the other capitals back to the pre-boom levels of the early to mid 1990s.'<sup>56</sup>
- 2.47 The downturn in housing construction continued in 2005. The RBA reported that dwelling investment has fallen by around 4 per cent from its early 2004 peak, with the decline fairly evenly spread between the two main components, construction of new dwellings and alterations and additions.<sup>57</sup>

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53 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 23.

54 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

55 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

56 R RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.

57 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.

- 2.48 The RBA reported that the value of household loan approvals increased by around 6 per cent in the three months to November and by 11.5 per cent over the year to be around its highest level since the end of 2003. The RBA noted that 'recent growth has mostly been driven by an increase in loan approvals to owner-occupiers, although loan approvals to investors have retraced some of their previous falls.'<sup>58</sup>
- 2.49 The RBA Governor also discussed the growth of household indebtedness, which for more than a decade 'has grown at a rate well in excess of the growth in household incomes.'<sup>59</sup> He pointed out that 'this has meant that the aggregate ratio of household debt to household income has trended upwards, as has the proportion of household income required to service the debt, and the gearing ratio (debt to value of household assets).'<sup>60</sup>
- 2.50 Mr Macfarlane warned that these household debt ratios may rise further. This was because in a low inflation environment, nominal interest rates are also low and 'households are able to service much higher levels of debt than they could in the past.'<sup>61</sup> There were risks for households who were subject to a high debt servicing ratio. Mr Macfarlane stated:
- ...if the economy does experience some negative shock, the classic one being significant increases in unemployment or even households that lose a high-paying job and have to take a lower paying job, some of those households would be very vulnerable, given the huge amounts of debt servicing. This is a thing we have drawn attention to repeatedly.<sup>62</sup>
- 2.51 The RBA Governor pointed out that the fact that Australian households do carry so much debt is something that influences the RBA's decisions on monetary policy. He noted that the level of household debt was 'one of the reasons why this tightening cycle has been more drawn out than previous tightening cycles.' Although in reducing the impact of a rate rise, Mr Macfarlane was not enthusiastic about moving away from a 25 basis points rise to something less such as two 12.5 basis point rises.<sup>63</sup>
- 2.52 The RBA noted that growth in household consumption slowed during 2005 with real spending increasing by 2.7 per cent over the year to the September quarter. This is a reduction from an annual growth rate of around 6.5 per cent at the start of 2004. The RBA stated:

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58 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 31.

59 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.

60 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.

61 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.

62 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 32.

63 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 19.

Although the saving rate as measured is still negative, the fact that consumption is now growing more slowly than income suggests that households are taking a more cautious approach to their finances. This would be consistent with the further easing in growth in household debt in the September quarter. Nevertheless, the debt-serving ratio increased marginally in the quarter to 10.9 per cent.<sup>64</sup>

- 2.53 A further issue examined as part of this debate was access to finance and lending practices. Banks and other providers in the competition to provide credit to households have progressively eroded lending standards. Mr Macfarlane commented that 'lenders are now engaging in practices that would have been regarded as out of the question five or 10 years ago'.<sup>65</sup>

## Australian share market

- 2.54 The RBA Governor commented that the Australian share market 'has behaved quite differently from the global market over the past decade.'<sup>66</sup> For example, the Australian share market was less affected by the 'tech bubble' and subsequent collapse. Mr Macfarlane noted that 'along with the Canadian share market, it is the only major market that is currently above earlier peak levels, whereas in Europe and the United States share markets are still about 20 per cent below their early 2000 peaks.'<sup>67</sup>
- 2.55 Mr Macfarlane in response to a question about the wealth effect of shares commented that 'all the international evidence is that the wealth effect from shares is much smaller than the wealth effect from housing.' He noted that 'I do not think the fact that we are above peak levels makes us vulnerable.'<sup>68</sup>

## Supply side (capacity) constraints

- 2.56 During the August 2005 hearing some of the supply side constraints to growth that were discussed included capacity constraints as a result of 14 years of growth, and deficiencies in infrastructure. Similarly, the RBA's February 2006 statement on monetary policy reported that 'consistent with

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64 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 30.

65 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 6.

66 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

67 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 5.

68 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 29.

business surveys, capacity constraints continue to be reported in liaison with firms in most industries.<sup>69</sup> However constraints appear to have eased in the residential construction industry and 'in parts of manufacturing where trading conditions have been difficult.'<sup>70</sup>

- 2.57 Labour market shortages including unskilled and skilled labour were discussed. The RBA stated that 'recent data shows that wages are continuing to grow at a rate above the average of recent years, which is consistent with other indications of tight labour market conditions and shortages of suitable labour.'<sup>71</sup> Mr Macfarlane elaborated on the possible consequences of an undersupply of labour:

The ultimate consequence is that some production just does not get done. This is the sort of thing that does happen, not just here but in other countries, when you get to very high levels of capacity utilisation. In our case, not only are we at high levels of capacity utilisation but also we have a skewed demand in that an inordinate amount of the demand is for expansion of resource capacity. That is why it is not surprising that a Western Australian is bringing this question up. The answer is: some things do not get done, which is disappointing.<sup>72</sup>

- 2.58 Mr Macfarlane commented that it was labour shortages and aggregate wages growth which has underpinned the current forecast of a modest rise in underlying inflation over the year ahead.<sup>73</sup>

## Corporate governance

- 2.59 The process of appointing people to the RBA board was examined. In particular, the committee examined this in the light of the appointment and subsequent resignation of Mr Robert Gerard. The RBA Governor was asked whether he was consulted about the appointment and whether the events surrounding Mr Gerard's resignation suggested a need for reform of the appointments process. Mr Macfarlane indicated that the Treasurer informed him that he was appointing Mr Gerard. Mr Macfarlane commented that 'I had not heard of Mr Gerard and therefore was not in a position to express an opinion.'<sup>74</sup>

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69 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 33.

70 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 33.

71 RBA, *Statement on Monetary Policy*, 13 February 2006, p. 59.

72 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 20.

73 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 7.

74 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 15.

2.60 The RBA Governor acknowledged that the Gerard appointment had revealed a flaw in the process but this should be compared against previous appointments which had proved successful. Mr Macfarlane stated:

I think it did expose a problem – there is not much doubt about that – in that someone was appointed who had engaged in some behaviour such that, had it been known, they would not have been appointed. So I think that that does show up a flaw. I am not quite sure how you overcome that particular thing, given the confidentiality of the tax system. As to whether we should adopt a very different way of making board appointments, it is always up to people to come up with suggestions. I am not totally wedded to this one, but I would point out that, in the time I have been in this position, there have been 20 appointments made to the Reserve Bank board or the Payments System Board, including reappointments. Nineteen of them have been excellent and one caused intense controversy.

2.61 Mr Macfarlane, in considering the appointments process, discussed the merits of having parliamentary committee oversight of appointments. Mr Macfarlane stated:

...would it be improved if a committee such as this could interview prospective board members? That is done in the UK, but my understanding is that that committee does not have a right of veto; it just has the capacity to interview people. As far as I am concerned, that is entirely a decision for the government, the parliament or whoever has strong views on that. I would neither support it nor oppose it; I could live with it.<sup>75</sup>

2.62 Other matters that were discussed as part of the examination of corporate governance included board composition and access to inside information. On the first point, Mr Macfarlane noted that the RBA board was not a group of specialist economists. This was in contrast to other countries where the board members are normally specialist economists who are mostly full-time.<sup>76</sup>

2.63 The issue of board members being in receipt of inside information was also examined. Mr Macfarlane acknowledged that once a recommendation regarding rates is provided at a board meeting, board members are in receipt of 'inside information.' Mr Macfarlane commented that 'to the best of my knowledge, no one has ever acted on it'.<sup>77</sup> The RBA Governor was

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75 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.

76 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.

77 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 24.



asked why board decisions are not announced immediately at the end of a meeting rather than the next day. Mr Macfarlane acknowledged that some non-executive board members do not like the delay. However, he believed it was preferable to make the announcement 'when the money market starts rather than have something change halfway through a money market day.'<sup>78</sup>

## Conclusions

2.64 The Gerard appointment to the RBA board brought attention to the process for appointing board members. It should be noted that while the Gerard appointment resulted in controversy the record of appointments has been positive. The RBA Governor noted that of the 20 appointments, including reappointments, that were made during his period as Governor, 19 'have been excellent'.

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78 Mr I McFarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 23.

