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Monetary policy and related issues

Review of the 2003 year

2.1 At the Brisbane 2003 hearing the Governor of the RBA described the 2003 calendar year as ‘a very unusual one for the world economy’. Uncertainty on the world economy stemming from issues such as possible deflation in the USA, a weakening European economy, and a SARS outbreak in Asia, saw weaknesses in the first half of the year. In the June quarter most major countries saw declines in GDP. This prompted many central banks, including in the USA, England, Canada and Europe, to reduce interest rates.

2.2 However, the Governor stated that this was followed by a sharp turnaround and by the September quarter those economies were growing strongly.

> Talk of deflation ceased and the short-lived bout of monetary policy easings stopped. Business and consumer confidence around the world rose back to levels which were consistent with reasonable economic growth.[1]

2.3 On the domestic front, at the June hearing the RBA revisited its forecasts for GDP growth in 2003. Forecasts in Brisbane had predicted GDP growth would finish a little higher than previously expected at 3.5% due to higher growth in the second half of the year, including a

1 *Official Hansard*, 8 December 2003, Brisbane, p. 2.

growth in domestic spending. At the public hearing in Sydney in June 2004, the Governor noted that GDP growth had come in at 3.9%, following much stronger than expected growth in the second half of the year.

2.4 In Brisbane the RBA had revised its expectations on the CPI, largely due to the exchange rate being higher than earlier forecast - at the hearing in June 2003 the RBA expected the CPI to increase by 2.5 percent over the calendar year 2003, however, at the December 2003 hearing the RBA expected the CPI to be a little lower at 2.25 percent.

2.5 With perceptions about the world economy raised and economic indicators in Australia improving, the cash rate was raised:

> Economic conditions here and abroad had returned to something relatively normal, and, as a consequence, we judged that we no longer needed such an expansionary setting of monetary policy, so interest rates were raised accordingly in November and December.[2]

2.6 The two increases in interest rates preceding the 8 December 2003 public hearing were in November (from 4.75 to 5 percent) and in December (from 5 to 5.25 percent). These were the first rises in official interest rates for 17 months. In reaching the decision to increase the cash rate in December, the RBA stated that it took into account the following considerations:

- economic conditions around the world continued to improve;
- the economy strengthened considerably in Australia with consumer spending accelerating, business confidence high, and the labour market firming;
- the inflation rate was close to the RBA's target mid-point and a rising trajectory on CPI inflation was expected once the effects of the higher exchange rate had faded; and
- domestic credit continued to expand due to the cash rate remaining 'below neutral'.[3]

2.7 Interest rates have remained unchanged since December 2003.

2 *Official Hansard*, 8 December 2003, Brisbane, p. 2.

3 *Statement by the Governor, Mr Ian Macfarlane on Monetary Policy*, 3 December 2003.

Forecasts for 2004

2.8 At the December 2003 hearing the RBA's prediction for growth in GDP was slightly more optimistic than it was six months later. At that time, the RBA expected GDP to grow by 4 percent over the course of 2004, possibly by even more if the world economy continued to grow strongly.[4] The Governor revised this forecast downwards at the June hearing, noting that weaker than expected exports and retail trade and stronger imports had brought the RBA forecast for growth through 2004 to 3 ¾ percent.[5]

2.9 The Governor noted the market reaction to the subdued March quarterly GDP figures, following the March quarter national accounts and commented that:

> I must say in passing that I think the markets have overreacted to the March quarter GDP figure. It only lowered our forecasts in the mechanical sense that one of the four quarters is now lower that we predicted in our earlier forecast. It did not materially change our view about the trajectory over the rest of the year….[6]

2.10 In Brisbane the RBA noted its expectation that, over the course of 2004 inflation would increase by 2 percent overall, with the higher Australian dollar impacting in the first half of the year. In other words, the profile for inflation will be U -shaped:

> … falling from its present 2½ percent to below two percent in mid-2004, then rising back to two percent by end 2004, 2½ percent by mid-2005 and, in our view, being under upward pressure thereafter.[7]

2.11 At the Sydney hearing Mr Macfarlane reaffirmed this prediction, stating that while headline inflation would be heavily influenced by movements in oil prices, the RBA predictions for underlying inflation remain steady at about 2 percent through 2004, moving up to about 2½ percent towards the end of 2005.[8]

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4 *Official Hansard*, 4 June 2004, Sydney, p. 2.

5 *Official Hansard*, 4 June 2004, p. 2.

6 *Official Hansard*, 4 June 2004, Sydney, p. 2.

7 *Official Hansard*, 8 December 2003, Brisbane, p. 3.

8 *Official Hansard*, 4 June 2004, Sydney, p. 2

Inflation targeting and monetary policy

2.12 The *Second Statement on the Conduct of Monetary Policy* of July 2003 reaffirmed the understanding between the Treasurer and the Governor of the RBA on the operation of monetary policy in Australia. It 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. [9]

2.13 At the Brisbane hearing the Governor stated that it is that average of 2 to 3 percent by which the RBA should be judged or made accountable. Over this 10 year period, inflation has averaged 2.4 percent[10], an average likely to be maintained over 2004-2005.

2.14 At the May 2002 hearing the Governor suggested that a neutral interest rate is inflation plus between 3 and 3.5 percent.[11] At the hearing in Brisbane, however, the Governor added a caveat to the idea of a 'normal' interest rate: it is a general guide only and it is not essential to fit within the range 'come what may'.[12]

2.15 In Sydney in June 2004, the Committee questioned Mr Macfarlane further on the normalcy or otherwise of interest rates, but the Governor reiterated his view from the Brisbane hearing that the RBA's moves in interest rates in December 2003 were part of a gradual process of 'returning interest rates to more normal levels'. The RBA held the view that had it maintained the low level of interest rates, there would have been a gradual build-up in inflationary pressures as the growth rates of the world and Australian economies rose. [13]

2.16 The Governor discussed the transition to 'a set of conditions that were in line with a firming in the world economy and some easing in

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9 *Second Statement on the Conduct of Monetary Policy*, June 2003 [Online: http://www.rba.gov.au/MonetaryPolicy/second_statement_on_the_conduct_of_monetary_policy_2003.html].

10 *Official Hansard*, 8 December 2003, Brisbane, p. 13.

11 *Official Hansard*, 31 May 2002, Sydney, p. 6.

12 *Official Hansard*, 8 December 2003, Brisbane, p. 36

13 *Official Hansard*, 8 December 2003, Brisbane, p. 3.

domestic pressures.' These conditions had been one of the possible scenarios put forward by the RBA at earlier hearings and identified as the most favourable for the Australian economy. Mr Macfarlane noted that the emergence of such conditions was most likely to result in a more balanced growth for the Australian economy and had negated the need for further action on monetary policy over the course of this year so far.[14]

2.17 In Brisbane, the Governor rejected claims that the RBA had set monetary policy in relation to the Sydney and Melbourne housing markets while ignoring the rest of the country.

2.18 In Sydney, Mr Macfarlane re-emphasised that the RBA makes decisions on monetary policy based on balancing a range of factors:

> Monetary policy is determined by developments in the economy as a whole, not by developments in any one component. For example, for much of 2002-03, domestic demand was increasing at an exceptionally strong pace but the external sector was subtracting from growth…Even so we did not use monetary policy to rein in the growth of domestic demands, because, for the economy as a whole…growth was not excessive and was not threatening our inflation objective over the medium term…[15]

2.19 Nonetheless, the Governor also made some explanatory remarks regarding the housing sector's influence upon monetary policy, acknowledging that much of the bank's attention had been taken up by growth in housing credit and house prices.

> Those parts [of the economy] that are obviously exhibiting a serious imbalance will attract more of our attention than those parts that are relatively well-behaved. This explains why we have spent so much time talking about and researching the excessively rapid growth in housing credit and, until recently, house prices. While other economic variables were more important for the overall economic outlook—for example, consumption or wage growth—their behaviour was not as clearly aberrant and therefore not in need of such intensive study.[16]

2.20 The housing sector is discussed further at page 12.

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14 *Official Hansard*, 4 June 2004, Sydney, p. 3.

15 *Official Hansard*, 4 June 2004, Sydney, p. 4.

16 *Official Hansard*, 4 June 2004, Sydney, p. 4.

Monetary policy in other countries

2.21 At the Sydney hearing, the Governor described an optimistic international outlook. Mr Macfarlane noted that the forecasts for growth in the world economy in 2004 were around the 4 percent mark with a similar figure expected in 2005. The Governor noted:

> We are in the third year of an international expansion and, unless something unforeseen comes along, we should expect the expansion to last for a good few years longer.[17]

2.22 In his opening statement the Governor said, with respect to upside risk that 'it may turn out to be the case that the very low world interest rates were kept in place for too long.'[18]

2.23 In response to a question from the committee as to how the conduct of monetary policy in Australia could be measured against that benchmark, Mr Macfarlane said:

> Throughout that period we were to some extent inhibited by the fact that we had this extraordinarily low world interest rate structure that we had to make our monetary policy against.[19]

2.24 The Governor noted that while Australia did not match the very low interest rates in the US and Japan, the RBA could not completely ignore the fact that around the world we had the lowest interest rates since the post war period.

2.25 The Committee asked whether this meant that Australian interest rates had therefore been maintained at a lower level than would otherwise have been thought desirable or Australia's domestic circumstances, to which the Governor responded, 'One could make that case'[20].

2.26 In light of this positive outlook for the world economy, Mr Macfarlane expressed the view that interest rates would start to rise in those countries where they had fallen to record low levels, in particular in the US. He also noted that the US economy was clearly in recovery, citing rising employment and a return of interest in lending to the US.

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17 *Official Hansard*, 4 June 2004, Sydney, p. 3.

18 *Official Hansard*, 4 June 2004, Sydney, p. 3.

19 *Official Hansard*, 4 June 2004, Sydney, p. 8.

20 *Official Hansard*, 4 June 2004, Sydney, p. 8.

2.27 While the RBA expressed the view that interest rates in the US were very likely to rise, possibly by 1 percent over the remainder of this year[21]and to continue to rise gradually over the next one to two years, Mr Macfarlane did not link US monetary policy to any possible movement in Australia's interest rates in the near future.

> If we talk about the short term—for example, between now and the end of the year, or slightly longer, maybe six, nine or twelve months ahead—I do not think there is a close relationship[between US and Australian monetary policy]. We have demonstrated that by the fact that when everyone else in the world went down in 2003 we did not: we stayed steady. In fact we went up towards the end of 2003.[22]

2.28 This view reaffirmed the earlier discussion in Brisbane on comparisons with central banks in other world economies that had not increased interest rates. At that hearing, the Governor had maintained that Australia's economy was 'in much better shape' than many overseas. The Governor claimed that many economies were still recovering from the aftermath of bursting asset price bubbles or recessions, and therefore would probably not change interest rates before being fully confident of recovery.

2.29 In reference to concerns expressed about the rapid expansion in the Chinese economy (page 21 also refers to the Chinese economy), Mr Macfarlane noted that :

> A number of others in the market worry that policy tightening in China will be overdone, leading to a collapse in the Chinese economy. I have more confidence in China than that, and I welcome the news that the Chinese authorities have been taking steps to rein in the excessive growth—particularly excessive investment.[23]

Exchange rates

2.30 The exchange rate for the Australian dollar against the US dollar has experienced significant fluctuation in recent years**.** After peaking at US80 cents in mid February 2004, it fell through the second half of

21 *Official Hansard*, 4 June 2004, Sydney, p. 7.

22 *Official Hansard*, 4 June 2004, Sydney, p. 8.

23 *Official Hansard*, 4 June 2004, Sydney, p. 3.

February and March, temporarily recovered in early April then fell again in mid-April , reaching a low of US71.24 cents [24](At the time of writing, June 2004, the dollar was hovering around the US 70 cent mark).

2.31 In addressing the fall in the Australian dollar since early 2004 the RBA noted, in its May 2004 *Statement on Monetary Policy,* that some of the fall had been a reflection of the strengthening US dollar . The RBA also noted that the Australian dollar had fallen against all currencies in the TWI except the New Zealand dollar, indicating that the fall was broadly based and not as a result of action on monetary policy in late 2003.[25]

2.32 The Governor advised the Committee that the RBA, having seen rapid acceleration in the exchange rate towards the end of 2003, was certain that the move to raise interest rates was the correct course of action. He said:

> …we would have been in a very awkward position if we had come back after Christmas and realised in our February or March meeting …that there was a need for higher interest rates… the exchange rate of the Australian dollar against the US dollar went up by 10 big figures… I think we were conscious all the time that we had to keep an eye on that.[26]

Impact of the Budget on monetary policy

2.33 The Sydney hearing took place less than a month after the handing down of the Federal Budget. The Committee and the RBA discussed any effect the Budget may have on monetary policy.

2.34 The Governor noted that the Budget formed only a part of the RBA's considerations in formulating economic forecasts. Mr Macfarlane made clear that the Budget is not a particularly significant factor and is just one of the factors in determining monetary policy:

> I have to go back and reiterate that once we try to move directly from budgets to monetary policy we are taking an almighty leap because monetary policy, as I said, is based on what is happening to the totality of the economy, not what is

24 *Statement on Monetary Policy May 2004*, Reserve Bank of Australia, p. 19.

25 *Statement on Monetary Policy May 2004*, RBA p. 19.

26 *Official Hansard*, 4 June 2004, Sydney, p. 8.

> happening in one particular sector. So although we take the budget and fiscal policy into account, it gets into our forecast in the same way that investment, import, exports and all those factors get into the forecast.[27]

2.35 The Governor discussed the effect of the budget over a period of years and noted that on the whole, there had been very limited fiscal impact from the budget. That is , the change in the underlying cash position from year to year has been no more than plus 1 and no less than minus 1.4 over the past seven years. Mr Macfarlane described this as a 'long period [in which] fiscal policy has been remarkably neutral.'[28]

Housing

House prices

2.36 About 30 percent of households in Australia have a mortgage, 40 percent own their house outright, and 30 percent are renting. At the December 2003 hearing the Governor noted that about 1.3 million people have invested in rental property and it is sections of this group which may be vulnerable to interest rate rises; even modest rises in interest rates and falls in certain sorts of property prices will cause distress. [29]

2.37 At the Brisbane hearing the RBA reported that household credit continued to grow strongly in 2003, at about 21 percent over the year to September 2003. Of this, housing credit was growing at an annualised rate of 25 percent.[30] About 85 percent of household debt is housing debt and credit card debt makes up around 6 percent.

2.38 In Sydney, however, the Governor noted the RBA's relief to see this trend begin to abate. Mr Macfarlane noted a reduction in loan approvals, down from a peak of $15 billion per month last year to $12 billion per month, and saw this as a positive step:

> Certainly 12 billion per month is still far too high but at least some progress has been made. The prospect of a return to sustainable rates of growth of credit now seems brighter than

27 *Official Hansard*, 4 June 2004, Sydney, p. 10.

28 *Official Hansard*, 4 June 2004, Sydney, p. 10.

29 *Official Hansard*, 8 December 2003, Brisbane, p. 18.

30 *Statement on Monetary Policy*, November 2003, pp. 20-23.

> it has for several years—and with that comes the increased likelihood that the run of good economic outcomes will continue.[31]

2.39 The Governor agreed with the Committee that the rise in interest rates late last year had had some effect on property prices but was at pains to point out the other factors that had had an impact on the situation:

> Just this year the dynamics of the cycle were meaning that [house prices] were at the point were they could go down. I think constant propaganda and reminding people of just how ridiculously high the prices were, how ridiculously low the yields were and how high the vacancy rates were got a lot of coverage and sank in. I think a fortuitous event—namely, the collapse of the Henry Kaye spruiking outfit, which got a huge amount of publicity—was extremely helpful. So I think it was a number of factors.[32]

2.40 The RBA seemed pleased that the slow-down showed signs of being gradual and therefore perhaps not the 'hard landing' that some had predicted for the economy. On the whole, the Governor noted that 'the average owner-occupier is not going to be affected very much' by the reduction in house values.

2.41 The positive effects of the drop in house prices were directed mainly at owner-occupiers. The Governor saw it as quite positive that potential buyers would be in a position to wait longer before buying:

> I think owner-occupiers…now have a lot more time to make their decision. They can look at a lot more things and they can drive a harder bargain. They can possibly wait until they have a bigger deposit.

2.42 For investors, he noted the 'prospective profitability' had evaporated and with it the sense of urgency that had pervaded the real estate industry in the previous months. With fewer looking to borrow for investment, the Governor expected that the cycle had reached the phase where the demand for credit would begin to fall.

2.43 In discussion on the probable effects of the slow down, Mr Macfarlane commented that the likelihood of a major financial crisis due to slowing property prices was minimal. Noting that a financial crisis usually means bank failure or the failure of significant lending

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31 *Official Hansard*, 4 June 2004, Sydney, p. 5.

32 *Official Hansard*, 4 June 2004, Sydney, p. 15.

institutions, the RBA indicated that there were no signs that this may be an outcome of the present situation of falling house prices.[33]

2.44 At the same time Mr Macfarlane recognised that there would be investors who would be severely affected by the drop in property prices:

> I think there are a lot of people out there who thought they were going to get rich but they have this asset which is costing a lot of money to service and is not going up in price; rather it is going down, and it is hard to find tenants.[34]

Levels of household debt

2.45 In discussion on levels of household debt, which the Committee noted remain high at 18 percent compound growth, the bank indicated that it expected growth in housing credit to slow in line with the slowing property market.

2.46 Also, at the Brisbane hearing, the Governor had raised concerns about the current rate of growth in lending and borrowing.

> I have expressed concerns about the rate of growth and borrowing and lending. That is what I have expressed concerns about. I have felt that it cannot continue to grow like this. An economy that is growing at six percent in nominal terms cannot have credit growing at 15 percent, and it cannot have household credit growing at 22 percent. Something has to give at some time…I think the savings rate will probably go up a bit. That will mean weaker consumption.[35]

2.47 Further discussion, however, raised concerns about the ‘wealth effect’ and the use of borrowing against equity for non housing purposes. The Committee pointed out that up to ‘70 percent of the population can relatively easily borrow the equivalent of a year’s disposable income and then consume it, and the anecdotal evidence is that there is a lot of that going on’.[36]

2.48 The RBA agreed with these concerns and indicated that the wealth effect was a significant influence.

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33 *Official Hansard*, 4 June 2004, Sydney, p. 15.

34 *Official Hansard*, 4 June 2004, Sydney, p. 15.

35 *Official Hansard*, 8 December 2003, Brisbane, p.33.

36 *Official Hansard*, 4 June 2004, Sydney, p. 21.

> On the broader issue of whether there are wealth effects that have driven up consumption because people feel wealthier because their houses have gone up in value, we believe that some of that has been going on.[37]

2.49 Discussion continued about the use of funds accessed through equity borrowing and the RBA indicated that it was planning a survey to gain more information. The Governor speculated on the probable patterns of spending:

> The first thing that would be interesting is how much of it is going into renovation for example. Some of it will go into consumption…such as an overseas holiday or a car. Some of it will go into investment…[as] a form of quasi margin borrowing and could go into buying shares.[38]

2.50 Consolidation of debt, 'replacing expensive debt with cheaper debt'[39], was also mentioned as a major use of borrowings against housing equity. The RBA directed the Committee to its recent discussion paper on the possible dampening effect on consumption that may arise from reduced housing-related wealth.

Data collection of housing prices

2.51 At the Sydney hearing, the Committee and the RBA discussed ongoing problems with collection of data on house prices.

2.52 The RBA collects evidence on house prices from a number of sources—the Real Estate Institute, the Commonwealth Bank, the Housing Industry Association and the Australian Bureau of Statistics—and noted that all these sources have a 'significant lag' in the way the information is reported.

2.53 The result is house price data that refers to the growth rate in the previous quarter and covers settlements which were contracts entered into up to three months earlier, leading to a total delay of possibly six months. As the Governor stated:

> When you are trying to run forward-looking pre-emptive monetary policy and your data is telling you [in June] what happened in October or November, that is a very long lag.[40]

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37 *Official Hansard*, 4 June 2004, Sydney, p. 21.

38 *Official Hansard*, 4 June 2004, Sydney, p. 21.

39 *Official Hansard*, 4 June 2004, Sydney, p. 21.

40 *Official Hansard*, 4 June 2004, Sydney, p. 20.

2.54 The Governor went on to emphasise that housing is an extremely important asset class for most Australians, for the household sector it is 'about 60 or 70 percent of their total wealth'.[41] Mr Macfarlane commented that the information available is 'hopeless' compared to other economic data such as share prices, bond prices foreign exchange rates and commodity, export, import and consumer prices. He added that:

> It is probably the weakest link in all the price data in the country so I think it is something that I would like to see resources put into.[42]

2.55 The financial sector in general has also noted its dissatisfaction with the data collection of housing prices. Rory Robertson of Macquarie Bank, writing soon after the June hearing, noted that discrepancies in housing prices as well as the lag in data made discussion of monetary policy implications very difficult. He said:

> Getting the house price story right is a big deal at what might be a turning point. Having doubled on average over the past six years or seven years, the evolution of Australian house prices from here is a critical issue for monetary policy. The RBA is tracking all the data very closely, trying—like the rest of us—to figure out what is going on.[43]

2.56 The Committee notes media reports[44] that the RBA has taken steps to improve the accuracy of housing data. Meetings have been held with the Department of Treasury, the Australian Bureau of Statistics and representatives of Australia's largest real estate groups. The Committee encourages such steps towards an improved data collection of housing prices and looks forward to hearing of the RBA's progress. Notwithstanding this, the Committee believes that better data is still needed.

41 *Official Hansard*, 4 June 2004, Sydney, p. 22.

42 *Official Hansard*, 4 June 2004, Sydney, p. 22.

43 *Macquarie Research RBA Watch*, Rory Robertson, 7 July 2004, p.2

44 Klan, A., 2004, RBA homes in on housing data, *The Australian*, 29 July, p. 39

Recommendation 1

That the Australian Bureau of Statistics, working with the Reserve Bank of Australia, give priority to developing an efficient, accurate and timely method for the collection of data relating to levels and movements in prices of residential real estate in Australia.

Lending practices of banks and other providers

2.57 Mr Macfarlane discussed the changed lending environment in which the RBA is now operating. He particularly noted the vested interest banks have in keeping housing credit levels as high as possible.

> The banks obviously want to have as fast a growth as possible. The brokers are all on commission and they are desperate to do a deal for you. It is a very different world to the one of 10 or 15 years ago, when you had to beg to get credit. Now there is a very big industry out there which is utterly determined to put out as much credit as it can. [45]

2.58 As an example of the banks' willingness to provide credit wherever possible, the Committee raised a new line of 'family equity' products being offered by the Commonwealth Bank of Australia. The RBA was of the view that such 'financial innovation' was not unexpected in light of the massive increase in house prices, making purchasing for many young home buyers all but impossible without family assistance.

2.59 The Governor also pointed out that credit is not being 'foisted upon an unwilling public that did not want to have it'.[46]Banks and other lending institutions are operating in an environment where people are willing to gear up and buy assets as part of a wealth accumulation strategy.

2.60 At the Sydney hearing, the Committee expressed concern about the lending policies of banks and other institutions. While noting that regulation of bank lending policies was outside the RBA's responsibilities, Mr Macfarlane did comment that the lack of regulation around some of the non-bank lenders was a cause for concern. The Governor mentioned specifically the rise of the

45 *Official Hansard*, 4 June 2004, Sydney, p. 16.

46 *Official Hansard*, 4 June 2004, Sydney, p. 17.

spruiking industry and the 'low or no doc' loan industry as areas of concern.

> These are lenders who will lend to people who cannot or will not tell them what their income is, which is an interesting concept when you think about that one hard enough. These people are prepared to pay a percentage point or more in order not to say what their income is.[47]

2.61 Regulation of non-bank lenders has been problematic because of the tendency for it to fall between the states' responsibilities and the federal regulators such as ASIC and APRA. Mr Macfarlane commented that it was an issue deserving of attention from the State and Federal governments.

2.62 The Governor noted that as new developments occur in lending, the government structures and regulations will always be a step or two behind. He gave the example of mortgage brokers:

> One of the things that we notice is that there is no regulation at all of mortgage brokers, yet this is an industry that has grown up and is quite big now. I do not know how big it is, because no-one knows how big it is; no-one has ever counted. I guess it is no-one's job to count how many there are.[48]

2.63 In relation to real estate spruikers, in Brisbane the Governor had commented that, while unsure what the final solution to the problem should be, it was clear that a system must be implemented in some form in order to regulate people who are essentially giving financial advice and to ensure that people who give financial advice are regulated equally.[49] This position was reiterated at the Sydney hearing.

2.64 The Committee has since recommended that the Government investigate bringing investment property advisors under a similar regulatory regime as financial planners.[50]

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47 *Official Hansard*, 4 June 2004, Sydney, p. 17.

48 *Official Hansard*, 4 June 2004, Sydney, p. 18.

49 *Official Hansard*, 8 December 2003, Brisbane, p.32.

50 See Committee's *Review of the ACCC Annual Report*, Recommendation 1.

Recommendation 2

That the Government meet with the States with a view to assessing and implementing the most appropriate regulatory regime for non-bank lenders, consistent with current regulation of authorised deposit-taking institutions.

Oil prices

2.65 The Governor noted in his opening statement that oil prices had risen significantly and that this would be influential on headline inflation. He predicted that, as a result, headline inflation would likely be higher than underlying inflation in the short term. Mr Macfarlane also made the point that higher oil prices, together with higher interest rates, were a sign of strength in the global economy.

2.66 In discussion about the effect of rising oil prices on the economy as a whole, the Governor acknowledged that rising oil prices can have a similar effect to an indirect tax. That is, there can be a weakening effect by dampening consumption:

> People spend more of their money on higher priced oil and have less to spend on other forms of consumption.[51]

2.67 This effect is known as a 'negative supply shock' where prices are lifted and aggregate demand is forced down by the higher cost. The RBA also noted that the reason oil prices rose was due to strong growth to begin with.

2.68 The RBA maintained that while oil prices are affected by geopolitical factors (instability in the Middle East), increases in demand have had a major effect on rising oil prices. For example, over the past two years, global demand has increased by four million barrels per day. Expanding Asian economies accounted for a large proportion of this increase, China alone accounting for 1.5 million barrels of the extra 4 million per day. The Bank indicated that it expected the OPEC ministers to act to increase their quota by about 2 ½ million barrels per day by the beginning of August 2004. While demand is not the only factor affecting prices, such action should help to stabilise the market, although, to date, this effect has not occurred.

51 *Official Hansard*, 4 June 2004, Sydney, p. 25.

2.69 The RBA put increases in oil prices into long term perspective. Mr Macfarlane noted that current oil prices, although hovering around $40 per barrel, were not as high in real terms as after OPEC 2, where prices reached up to $100 a barrel (in today's prices) and that the increase in prices was no major cause for alarm:

> I would not be expecting [the price of oil] to fall in the near future. I think we should work on the assumption that it is not going to and that in fact it may even go up a little more. A lot of people therefore say, 'Oh well. This is going to have very bad effects on economic growth around the world.' I do not think it will have very big effects.[52]

Growth in the Chinese economy

2.70 The rapid expansion in the Chinese economy was a topic of discussion at the Sydney hearing. In the past three years, China's industrial output has increased by almost 50 percent and it is accounting for over one-third of the growth in global oil consumption. The Committee quoted *The Economist* as describing the growth in the Chinese economy as 'scorching'.[53]

2.71 The Governor's opening statement noted the attention being given to the rapid expansion in China but expressed no fears that a policy tightening in China would lead to a collapse in the Chinese economy with serious implications for the Australian economy. Indeed, Mr Macfarlane expressed confidence in the Chinese authorities as noted earlier in this report.

2.72 The RBA generally sees the Chinese economy as being very positive for Australia. At present China is accounting for 10 percent of our trade, up from 5 percent five years ago and continuing to grow; China's energy needs are increasing, not only for oil but also for natural gas. It is a trillion dollar economy expecting continued growth which would see it become a 'very large continental size economy in the world scene.'[54]

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52 *Official Hansard*, 4 June 2004, Sydney, p. 13.

53 *Official Hansard*, 4 June 2004, Sydney, p. 14.

54 *Official Hansard*, 4 June 2004, Sydney, p. 14.

2.73 The bank emphasised that even if a slump were to occur, China as a ‘long-run proposition for Australia—and for the rest of the world for that matter as well— is a very positive thing into the future.’[55]

Unemployment

2.74 At the Brisbane hearing, the Governor noted that long and stable expansions in the economy can produce lasting reductions in unemployment. He claimed that past increases to the unemployment rate in Australia were due to three recessions within seven or eight years of each other – these recessions took unemployment up sharply and it took years for it to go down again. He said that the best thing the RBA can do to get unemployment down is to have monetary policy settings conducive to long expansions.

2.75 The Sydney hearing did not touch on unemployment specifically other than to note that employment growth had been very strong in the March quarter and that this matched other indicators showing the economy meeting its trend rate of growth.[56]

55 *Official Hansard*, 4 June 2004, Sydney, p. 14.

56 *Official Hansard*, 4 June 2004, Sydney, p. 6.