2

Monetary policy and related issues

Overview of 2004-05

2.1 The RBA stated that, throughout 2004 the strong global economy continued to push up commodity prices which in turn provided Australia with a significant stimulus to national income and spending, with the prospect of more to come.[1] Growth remained strong in the US and China over the first half of 2005, and Japan started to show signs of an improvement compared to 2004.[2] On the other hand, growth in the rest east Asia slowed and conditions in the euro region weakened further.[3]

2.2 Domestically, both business and consumer confidence remained high throughout 2004.[4] However, domestic demand continued to grow more slowly in the first half of 2005 than it did in 2004.[5] According to the Governor of the Reserve Bank, the pace of growth in domestic demand had clearly been unstainable in 2002 and 2003 when it was

---

1 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2005, RBA, Sydney, p 1 (hereafter referred to as *Statement on Monetary Policy*, February 2005)

2 *Statement on Monetary Policy,* August 2005, p 5.

3 *Statement on Monetary Policy,* August 2005, p 5.

4 *Statement on Monetary Policy*, February 2005, p 2.

5 *Statement on Monetary Policy,* February 2005, p 1.

running at about six per cent.[6] It needed to be brought back to a more sustainable pace and this involved some slowing in consumption.[7]

2.3 Gross national expenditure (GNE) increased by one per cent in the March quarter and by 3.5 per cent over the year ending March 2005, compared to 6.25 per cent over the previous four quarters.[8]

2.4 The RBA reported that on the domestic front, the cooling of the domestic housing market during 2004 was associated with an easing in credit growth to the household sector from the exceptionally high rates seen in previous years.[9] Nevertheless, the growth of credit to both household and business sectors remained high and was still growing at around at 12 per cent at the end of 2004.[10] According to the recent Statement on Monetary Policy, August 2005,

> Households now seem to have entered a phase in which they are consolidating their balance sheets, borrowing less and increasing their spending less quickly than they were a year or two ago. Combined with the mild downturn now underway in the housing construction cycle, the adjustment in consumer spending is helping to put overall growth in domestic demand onto a more sustainable trend….[11]

2.5 Inflationary outcomes for 2004 were higher than expected Mr Macfarlane said, coming in at 2.6 per cent for the year. At the August hearing, Mr Macfarlane restated the situation that inflation had been restrained by the appreciation of the Australian dollar from mid 2001 until the beginning of 2004.[12] Against this development, the Governor noted at both the February and August hearings that inflation was likely to rise because of capacity constraints, rising input prices (including oil) and the likelihood that the dollar would not continue to appreciate. According to the Governor, these signals were very strong in February and there was an expectation that credit was likely to pick up again and as a result, the Bank raised the cash rate by 25 basis points in March 2005.[13]

---

6 *Transcript,* 12 August 2005, p 3.

7 *Transcript,* 12 August 2005, p 3.

8 *Statement on Monetary Policy,* August 2005, p 25.

9 *Statement on Monetary Policy*, February 2005, p 3.

10 *Statement on Monetary Policy*, February 2005, p 3.

11 *Statement on Monetary Policy,* August 2005, p 1.

12 *Transcript,* 12 August 2005, p 3.

13 *Transcript,* 12 August 2005, p 3.

2.6 By the middle of the year, there was some evidence that the earlier tightening may have had a quicker effect than expected and that there was no longer an upward risk to the Bank's inflation forecast.[14]

Forecasts for 2005-06

2.7 The RBA stated in its February 2005 Statement that after a strong year in 2004 it is expected that the world economy will continue to grow in 2005 at an above average pace but not as strong as was experienced in 2004.[15]

2.8 At the August hearing, the Governor of the Reserve Bank stated that the global expansion which has been going for about 3.5 years will continue for a good while yet.[16] Most private forecasters, according to the Reserve Bank, believe that economic growth for the remainder of 2005 and 2006 will continue at above averages rates; albeit not as strong as in 2004.[17]

2.9 Back in February 2005, the Governor outlined in his opening remarks to the hearing, Australia was now into its fourteenth year of expansion and, as would be expected, there is much less spare capacity today than was the case in the early phases of expansion.[18]

2.10 Annual growth averaged 3.7 per cent for the past 14 years prior to 2004. Throughout 2004, growth forecasts were revised downwards. The actual figure for the year ending December 2004 came in at 1.5 per cent.[19]

2.11 At the February 2005 hearing, Mr Macfarlane suggested that the slowdown in growth is explained by the supply side of the economy.[20] A good deal of his subsequent discussion went into the nature of those constraints. He went on to say that demand could not be sustained at the recent levels and if it continued to outpace output growth then the Australian economy would risk rises in inflation.[21]

14 *Transcript,* 12 August 2005, p 4.

15 *Statement on Monetary Policy*, February 2005, p 1.

16 *Transcript,* 12 August 2005, p 2.

17 *Transcript,* 12 August 2005, p 2.

18 *Transcript,* 18 February 2005, p 2.

19 Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product Main Features Production Chain Volume Measures*, cat. 5206.0 ABS, 2 March 2005, ABS, Canberra, p 2.

20 *Transcript,* 18 February 2005, p 4.

21 *Transcript,* 18 February 2005, p 4.

He said that there are signs that demand is starting to slow and gross domestic product (GDP) growth will be in the range of 2 to 3 per cent rather than 3 to 4 per cent for a period of time.[22]

2.12 Mr Macfarlane told the committee back in February 2005 that there comes a time when we have to accept some moderation in growth in order to prevent the build-up in the sort of imbalances that have got the economy into trouble in the past.[23]

2.13 In August, with two sets of more reassuring price data, the Bank is now able to conclude that the CPI increase will peak at three per cent in the second half of next year – and the crucial word there is "peak".[24]

2.14 The risks, according to the Governor of the Bank, are now balanced rather than being on the up side.[25] Mr Macfarlane stated that while the Bank expected inflation to rise over the coming year, it is of very small orders of magnitude and compared to the past….. "this is nirvana".[26]

2.15 According to the Reserve Bank Board, the current economic situation has been characterised by a number of favourable developments. These include:

- Slowing in domestic demand to a more sustainable trend;
- Households have entered a period of balance sheet consolidation;
- National income is still being boosted by Australia's favourable terms of trade;
- Farm sector prospects have risen following recent rains; and
- Economy is operating at high levels of capacity utilisation and is growing at a manageable pace.[27]

2.16 Against this background, the Reserve Bank Board has come to the view that the medium term inflation risks are not as high as they were at the beginning of the year.[28]

22 *Transcript*, 18 February 2005, p 4.
23 *Transcript,* 18 February 2005, p 5.
24 *Transcript,* 12 August 2005, p 4.
25 *Transcript,* 12 August 2005, p 5.
26 *Transcript,* 12 August 2005, p 5.
27 *Statement on Monetary Policy,* August 2005, p 3.
28 *Statement on Monetary Policy, August* 2005, p 3.

Inflation targeting and monetary policy

> 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 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 benchmark performance over time.[29]

2.17 In February 2005 at the Sydney hearing Mr Macfarlane said,

> On inflation: our forecast of a year ago for underlying inflation in the four quarters to December 2004, was 1.5 per cent. At our June meeting here in this building in Sydney with the committee, we had raised it to 2 per cent. In the event, underlying inflation came in at 2 ¼ per cent while the headline figure was 2.6 per cent.
>
> Looking ahead, we forecast gradual rises in underlying inflation, with it reaching 2 ½ per cent by the end of this year and three per cent by end of 2006...[30]

2.18 Mr Macfarlane stated at the August hearing that even though the Bank did not revise its inflation forecast, this movement is not major; in fact he said that when the Bank sits down and does its inflation forecast the figures come out within this quite small band.[31]

2.19 The February hearing devoted a considerable amount of time to the question of where interest rates were heading over the medium term. Media attention at that time also focussed on the issue of interest rates. Many commentators were predicting another rise of 25 points as early as March 2005 with some going further and suggesting another rise of 25 points by the middle of the year. If anything, media attention around the time of the August hearing focussed on the possibility of a sustained period of no further changes to rates or, in some cases, even the possibility of a fall. However, Mr Macfarlane stressed that,

> We have not rung the bell. We think that there is a 50 per cent chance we may have to go up again and a 50 per cent chance

---

29 *Second Statement on the Conduct of Monetary Policy: The Treasurer and the Governor of the Reserve Bank*, July 2003, www.rba.gov.au/Monetary Policy/, viewed 8 March 2005, p 2.

30 *Transcript*, 18 February 2005, pp 4-5.

31 *Transcript*, 12 August 2005, p 5.

> we may go down again. I just want to make people aware of that…..We felt six months ago that there was definitely more than a 50 per cent chance that it had not finished; now we think there is about a 50 per cent chance…..So I think it is a big mistake for people to think that once you are not actually contemplating the next tightening there will be no more tightenings.[32]

2.20 At the August hearing, committee members were keen to follow up with the Reserve Bank their methodology for forecasting inflation given that the Bank's monetary policy is very much based on inflation targeting. Mr Macfarlane explained that two to three per cent band for inflation is not an end in itself but the maintenance of low inflation is a necessary condition for having a long economic expansion in output and employment.[33] Looking back at the March 2005 rate rise, the impact may have been a lot quicker due to the intense media coverage and the fact that households are carrying higher levels of debt and need to service that debt. [34]

Exchange rates and external trade

2.21 At the hearing in February, over a 12 to 18 month period, according to the Governor, 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, and this impact on inflation dissipates.[35]

2.22 When asked at the August hearing about the likely impact of a depreciating dollar on an inflation-targeting monetary policy, Mr Macfarlane stated that the bank has to look behind the movement in the exchange rate and look at underlying domestic costs and prices.[36] In reference to the recent movements in interest rate, the Governor said,

> During the period when we have been raising interest rates…..measured inflation was quite low because the exchange rate shot up. Someone could have come along and

32 *Transcript,* 12 August 2005, p 6.

33 *Transcript,* 12 August 2005, p 3.

34 *Transcript,* 12 August 2005, p 4.

35 *Transcript*, 18 February 2005, p 7.

36 *Transcript, 12 August 2005, p 21.*

> say, "Inflation is below two per cent; you should be easing." We used the argument that you had to look beyond just the straight figures for inflation and you had to look at what the underlying movements in domestic costs and prices are, because that rise in the exchange rate is going to stop at some point. And even if it does not go down, if it merely stops going up, then all the downward pressure that it has been exerting on inflation will melt away and you are left with whatever the underlying rates of increase in domestic costs and prices are.[37]

2.23 If you responded solely to exchange rate movements you would end up with a very destabilised monetary policy and a very destabilised economy, according to the Reserve Bank Governor.[38]

2.24 Interestingly, the Governor said that he was unable to explain why the terms of trade had risen faster than the trade weighted index (TWI) over the last two years. Normally one would expect a very close relationship between the two but the fact the dollar had not risen as much could simply be a matter of good luck.[39] It may have arisen because people believed that the rise in our terms of trade was only going to be short-lived; whereas in fact, it has continued to rise and this has resulted in a very big increase in real incomes in Australia.[40]

2.25 The Governor stated last February that what is disappointing about Australia's current trade position is that we have been unable to match the world growth in demand for raw materials and manufactured goods even though our terms of trade gain over the last 2-3 years has been of the order of 20-25 per cent.[41] He noted that there has been an increase in competitiveness for manufactured goods because of China's presence in the world market and this has had a downward pressure on prices for such goods.[42] Australia has run into some major bottlenecks that have resulted in an inability to increase supply (volume) to satisfy this demand for basic materials.

---

37 *Transcript,* 12 August 2005, p 21.

38 *Transcript,* 12 August 2005, p 21.

39 *Transcript,* 12 August 2005, p 21.

40 *Transcript,* 1 2 August 2005, p 21.

41 *Transcript,* 18 February 2005, p 21; *Statement on Monetary Policy*, February 2005, p 37.

42 *Transcript,* 18 February 2005, p 21.

2.26 In August 2005, the Governor thought that the widening of the CAD reached its peak in the March quarter of 2005.[43] Further signs of an improvement were evident in June as evidenced by a slowing in domestic demand (ie. less pressure on imports), continued lift in the terms of trade (taking $1billion off the trade deficit as it fed through in April, May and June) and there is evidence that export volumes have picked up.[44]

2.27 Mr Macfarlane said that the trade deficit would continue to improve having come off a peak of seven per cent of GDP a few months ago and is now running at around 6.25 per cent and is likely to fall further.[45] If the CAD stays within a particular range, then it is expected that the ratio of debt to GDP flattens out notwithstanding the fact that we still continue to incur monthly trade deficits.[46]

2.28 Buoyant global demand conditions and large increases in contract prices for iron ore and coal have pushed the RBA index of commodity prices to a 23 year high.[47] Following on from earlier increases in contract prices (70% for iron ore and 120% for coking coal) further increases in $(US) terms have been reportedly achieved in the three months to June 2005 of 57 per cent for iron ore and 54 per cent for coking coal.[48]

2.29 On the other hand, the value of manufactured exports increased by only 7.5 per cent over the year to June 2005.[49]

United States and the global economy

2.30 The US economy continued to grow throughout 2004-05 achieving a GDP growth rate of 3.6 per cent.[50] US house prices continue to rise rapidly and this is underpinning a historically high investment in dwellings.[51]

43 *Transcript,* 12 August 2005, p 18.
44 *Transcript,* 12 August 2005, p 18.
45 *Transcript,* 12 August 2005, p 18. *Statement on Monetary Policy,* August 2005, p 41.
46 *Transcript,* 12 August 2005, p 18.
47 *Statement on Monetary Policy,* August 2005, p 43.
48 *Statement on Monetary Policy,* August 2005, p 44.
49 *Statement on Monetary Policy,* August 2005, p 42.
50 *Statement on Monetary Policy,* August 2005, p 5.
51 *Statement on Monetary Policy,* August 2005, p 6.

2.31 Unlike Australia, the Federal Reserve continued to raise rates through out the period rising to 3.25 per cent in June 2005 with the possibility of more rises to come.[52] This has resulted in rates rising by 225 basis points since June 2004.[53]

2.32 Interestingly, no mention was made by the RBA at the August hearing whether this continued rise in US rates would eventually increase the pressure on the RBA to increase rates at home.

2.33 Following on from a statement made by Governor Macfarlane at the February 2005 hearing, he restated his view in August 2005 that the US current account deficit has been financed relatively easily due to the more than adequate supply of world savings.[54] Contrary to some views, the financing of this deficit has not put downward pressure on the $(US) but rather, over the past 12 months the $(US) has risen.[55]

2.34 The Governor of the Reserve Bank was quick to point out that the world economy was not in a parlous state as a result of a number of events such as rising oil prices.[56] On the contrary, even with oil prices rising above $(US) 60 a barrel, forecasts are for world growth of 4.25 per cent in both 2005 and 2006 which is still above the historical average.[57]

2.35 In the Asia pacific, Japan is showing signs of a revival with positive growth of 1.2 per cent in the March quarter and consumer and business sentiment suggest that this expansion may prove to be a bit more durable.[58]

2.36 The Chinese economy continued its rapid expansion into 2005 with real GDP reportedly growing at around 9.5 per cent over the year to June 2005 with industrial production also growing by 17 per cent compared to 14 per cent in 2004. [59] Mr Macfarlane did not see this rate of growth as a potential risk and with the recent changes to its exchange rate regime, although small, will improve its prospects at the margin.[60]

---

52 Statem*ent on Monetary Policy*, August 2005, p 7.

53 *Statement on Monetary Policy* ,August 2005, p 19.

54 *Transcript,* 12 August 2005, p 2.

55 *Transcript,* 12 August 2005, p 2.

56 *Transcript,* 12 August 2005, p 2.

57 *Statement on Monetary Policy,* August 2005, p 5.

58 *Statement on Monetary Policy,* August 2005, p 7.

59 *Statement on Monetary Policy,* August 2005, p 8-9.

60 *Transcript,* 12 August 2005, p 2.

2.37 The rest of east Asia also continues to grow but not at the rate of China. Real GDP for the region increased by 3.8 per cent over the year to the March quarter.[61]

2.38 Europe remains the only disappointing region with euro-wide GDP growing by only 1.4 per cent over the same period and this growth was mainly attributable to a fall in imports, with no growth in domestic demand.[62] Spain was the only major euro economy to go against this trend.

2.39 At the August hearing, Mr Macfarlane said that Latin America, the Middle East, the former Soviet Union and even Africa are performing reasonably well.[63]

Oil prices

2.40 The Governor of the Reserve Bank expressed some concern about oil prices but noted that the rise was primarily due to strong world demand and not to supply restrictions as was the case with OPEC1 and OPEC2.[64] He also added that these rises do not appear to have added very much to inflation or inflationary expectations and therefore not required a specific policy (world wide) response.[65]

2.41 In particular, as oil prices have risen, the Australian dollar has been rising and this has cushioned the effect.[66] Secondly, oil prices have risen proportionally less than they did back in OPEC1 and OPEC2.[67]

2.42 The Reserve Bank Governor explained that because petrol consumption is only around four per cent of people's consumption, a 10 per cent rise in petrol is only going to reduce spending capacity by 0.4 per cent.[68] Further, because we are now in a more competitive environment, oil price rises are not being passed on, and hence

61 *Statement on Monetary Policy,* August 2005, p 9.

62 *Statement on Monetary Policy,* August 2005, p 11.

63 *Transcript*, 12 August 2005, p 2.

64 *Transcript,* 12 August 2005, p 2.

65 *Transcript,* 12 August 2005, p 2.

66 *Transcript,* 12 August 2005, p 14.

67 *Transcript,* 12 August 2005, p 19.

68 *Transcript,* 12 August 2005, p 14.

inflationary, but rather a reduction in purchasing power or reduced profitability.[69]

2.43 When asked directly at what point would the Bank need to tighten monetary policy as a result of rising oil prices, the Governor said,

> We look at several measures of inflation. The main one, obviously, is the headline inflation, which includes the effect of oil prices, and our long-run average is set in terms of that. Over the shorter periods - over a period of 18 months – if, for example, the only reason inflation was going up to an unsatisfactory level was because of a rise in oil prices and the rest of the consumer price index was behaving itself, then that would enter into our thinking on it. That would be an argument for probably not mechanically reacting to the increase in the CPI caused by oil prices.
>
> The other thing you have to remember is that it is only when oil prices are going up that it affects the CPI. If they reach a high level and stay there, then, after a quarter or two, that will no longer be having an effect on the rate of change of the price level or, in other words, on inflation. So we do not mechanically just look at inflation and ignore the parts. We definitely do deconstruct it into two parts and that does affect our decision.[70]

2.44 Oil prices will impact on industries differently. Airlines all round the world will be hit severely by increases in the price of oil. However, according to the Reserve Bank Governor, Australia as a whole will benefit from oil price increases because it is a net energy exporter.[71] The only down size from global price rises in oil is the possibility of a slowdown in growth in the rest of the world but this is unlikely at this stage because the price rises in oil are demand driven and as indicated above, above average economic growth throughout most of the world will continue for some time to come.[72]

69 *Transcript,* 12 August 2005, p 14.

70 *Transcript,* 12 August 2005, p 16-17.

71 *Transcript,* 12 August 2005, p 20.

72 *Transcript,* 12 August 2005, p 2.

Housing and household debt

2.45 In its Statement on Monetary Policy in February 2005,the RBA stated,

> Over the six months to December, housing credit grew at an annualised rate of 12.5 per cent, down from 22.5 per cent over the second half of 2003. Within the total, investor loan approvals and credit have slowed much more than the owner-occupier components...[73]

2.46 In its latest statement, the RBA notes that lending for housing remains above its 2004 average, but has softened in recent months with the value of monthly housing loan approvals falling from a high of $14.1 billion in February to $13 billion in May 2005.[74] The annualised rate for housing credit in the six months to June 2005 came in at 10.9 per cent which is around half the peak rates seen in late 2003.[75]

2.47 Debt servicing ratios are still running at record levels with debt growth continuing to outpace that of income, but there are signs that this growth is staring to slow.[76]

2.48 The Governor noted that during periods when house prices are rising rapidly households tend to react to this by increasing their consumption faster than their income; that is, they reduce their savings. This is generally achieved by reducing discretionary saving or by borrowing against the equity in their house (housing equity withdrawal).[77] This was particularly noticeable in Australia in 2002 and 2003. Since housing prices have come off the boil, the equity withdrawal seems to have stopped. Another way of looking at this trend is to compare the growth in retail sales in the 18 months to December 2003 when house prices were rising (10 per cent) to rates when house prices have been flat over the latest 18 month period (4.5 per cent).[78]

2.49 The pace of growth in domestic demand had been clearly unsustainable in 2002 and 2003 and had to be brought back to more sustainable levels.[79] The Governor clearly welcomed this period of

---

73 *Statement on Monetary Policy*, February 2005, p 30.

74 *Statement on Monetary Policy,* August 2005, p 28.

75 *Statement on Monetary Policy,* August 2005, p 28.

76 *Statement on Monetary Policy,* August 2005, p 27.

77 *Transcript,* 12 August 2005, p 2,3.

78 *Transcript,* 12 August 2005, p 3.

79 *Transcript,* 12 August 2005, p 3.

consolidation nevertheless, the Bank will be monitoring very closely this relationship between housing and household spending because it has become an important influence on our economic development.[80]

2.50 According to the National Australia Bank, the impact of the housing wealth effect on consumption still has a way to go. The move in housing prices from around 22 per cent at the end of 2002 to 10 per cent by mid 2004 to zero at the present point in time could be expected to lower consumption by the best part of 2.4 per cent and GDP by around 1.5 per cent.[81]

2.51 A great deal of attention was devoted to this relationship as it related to the economic performance of various states. Mr Macfarlane believed that house prices are not going to pick up for some time and this is a good thing because previously prices rose to such a level that affordability has become a real issue in particular markets such as Sydney and it was impacting badly on people in the investment sector.[82] In particular, given the size of the boom we had, the Governor was of the view that it is going to take a lot longer to correct this market than just the past 18 months.[83]

2.52 Asked whether NSW was performing poorly because of specific state policies, the Governor said that NSW has distinguished itself from other states over the past five to 10 years because it had had a bigger boom period and, as a result, is suffering a bigger downturn.[84] Notwithstanding the fact that housing prices have retreated in NSW, Sydney is still enormously more expensive than any other city in Australia.[85] Sydney house prices are still 50 to 60 per cent higher than Melbourne and other cities despite the fact that prices are down in Sydney and still rising in most other cities therefore the last thing Sydney needs is some stimulus to getting house prices up and running again.[86]

2.53 The Governor of the Reserve Bank said he did not share the view of others that have emphasised specific NSW state government policies (eg. vendor tax) as being in some way responsible for the downturn in

80 *Transcript,* 12 August 2005, p 3.

81 Statistics presented by Dr Alan Oster, National Australia Bank, to the committee, 11 August 2005.

82 *Transcript,* 12 August 2005, p 6,

83 *Transcript,* 12 August 2005, p 7.

84 *Transcript,* 12 August 2005, p 10.

85 *Transcript,* 12 August 2005, p 11.

86 *Transcript,* 12 August 2005, p 11-12.

house prices.[87] The main reason for the greater volatility in Sydney prices stems from the fact that the prices levels in Sydney are so much higher (and hence affordability) than anywhere else in Australia.[88] This situation has led to a slow down in population growth in NSW because older people are cashing out their valuable asset and moving somewhere cheaper and young people are being forced to find other locations that are more affordable.[89]

2.54 Regardless of where house prices are moving at the moment, the ratio of capital city house prices to annual earnings is around 10 in NSW and between five to eight in the other states and territories.[90]

2.55 The new median house price series which takes greater account of the stratification of all sales within the different groupings in each city confirmed the comments above. In particular, the series confirmed a marked cooling in nationwide house price growth over the past 18 months (zero) compared to around 30 per cent over the previous 18 month period to December quarter 2003.[91] Further, the break down by city showed Sydney falling by seven per cent while Perth put on another 19 per cent clearly benefiting from the strength of the resource sector.[92]

2.56 Towards the end of the recent credit cycle, fierce competition amongst lenders resulted in a lot of discounting which saw around 80 per cent of new loans being discounted by about 50 basis points.[93] Mr Macfarlane said the Bank was taking this into account including its last decision to tighten.[94] If this continued credit standards would be lowered and the debt servicing ratios would rise. The buffer built into loans is likely to get smaller and smaller and hence many lenders will be adversely affected by even the smallest upward movement in rates. Remarkably, according to APRA stress testing, mortgage delinquencies in Australia have been exceptionally low over the past 15 years.[95] However, according to Mr Macfarlane this cannot go on forever and things will need to change.[96]

87 *Transcript,* 12 August 2005, p 13.
88 *Transcript,* 12 August 2005, p 13.
89 *Transcript,* 12 August 2005, p 11.
90 *Transcript,* 12 August 2005, p 12, *Statement on Monetary Policy,* August 2005, p 38.
91 *Statement on Monetary Policy,* August 2005, p 36.
92 *Statement on Monetary Policy,* august 2005, p 36-37.
93 *Transcript,* 12 August 2005, p 8.
94 *Transcript,* 12 August 2005, p 8.
95 *Transcript,* 12 August 2005, p 8.
96 *Transcript,* 12 August 2005, p 8.

2.57 In the Statement on Monetary Policy, August 2005, the Bank stated that credit continues to grow faster than nominal income, which suggests that interest rates are not overly constraining demand for credit.[97] However, in relation to households, the Bank reported that,

> …the six–month-ended annualised rate of household credit growth continued its downward trend that began in late 2003, reaching 10 ¾ per cent in June. The downward trend in household credit growth largely reflects developments in housing credit. Growth in the smaller non-housing personal component has also moderated from its recent peak in January 2005, to an annualised rate of 10 ½ per cent over the six months to June. This is consistent with the decline in personal loan approvals, and mainly reflects falls in fixed term lending, though the revolving component has also contributed.[98]

2.58 In its August Statement, the RBA noted that the earlier long boom in house prices was accompanied by a sharp rise in residential building activity.[99] Given the current cooling in prices it is not surprising that the number of nationwide private residential building approvals fell by 11 per cent over the 18 months to June 2005.[100] At the same time nationwide retail sales only increased by 4.5 per cent in the 18 month period to June 2005 compared to 10 per cent over the 18 months to December 2003.[101] As expected, on a state by state basis, activity varied with NSW and the ACT very weak while Western Australia was strong.[102]

2.59 According to the RBA, the correction in the housing market appears so far to have gone smoothly and domestic demand has not dropped greatly because of the boost to national incomes coming from Australia's favourable terms of trade. [103]

---

97 *Statement on Monetary Policy,* August 2005, p 57.

98 *Statement on Monetary Policy,* August 2005, p 57-58.

99 *Statement on Monetary Policy,* August 2005, p 38.

100 *Statement on Monetary Policy,* August 2005, p 38.

101 *Statement on Monetary Policy*, August 2005, p 38.

102 *Statement on Monetary Policy,* August 2005, p 38.

103 *Statement on Monetary Policy,* August 2005, p 39.

Australian share market

2.60 Mr Macfarlane commented last February that he thought it was a good thing that people started moving from housing to shares in 2004. [104] This occurred in part due to the housing equity withdrawal in 2002 and 2003.[105]

2.61 At the time of the May Statement on Monetary Policy, the Australian share market had fallen to its lowest level for the year but by July 2005 the ASX 200 had risen by 10 per cent to reach a new high.[106]

2.62 Concern was expressed by the committee at the February hearing with respect to the price to earnings ratio (PE) rising to 21 however by the middle of the year the ratio had come in at around16.5 which is a little above the long-term average (15-16).[107]

2.63 Margin lending for the purchase of shares and managed funds rose by seven percent in the June quarter to $18 billion and over the past year by 30 per cent which has been the fastest since 2002.[108] This contributed to one-quarter of the 14 per cent growth in total personal credit over the same period.[109]

Supply side (capacity) constraints

2.64 The committee received an update from the Governor of the Reserve Bank, Mr Macfarlane, on the problems that were emerging from the supply-side constraints. Mr Macfarlane said that when he last spoke about some of the problems relating to capacity constraints, the issue which he touched on briefly, deficiencies in infrastructure got more than its far share of attention. To that extent, he believed it was a good outcome and the Bank will continue to maintain an interest in developments even though it is not their area of expertise.[110]

---

104 *Transcript,* 18 February 2005, p 30.

105 *Transcript,* 12 August 2005, p 3.

106 *Statement on Monetary Policy,* August 2005, p 50.

107 *Statement on Monetary Policy,* August 2005, p 51.

108 *Statement on Monetary Policy,* August 2005, p 51.

109 *Statement on Monetary Policy,* August 2005, p 51.

110 *Transcript,* 12 August 2005, p 7.

2.65 This issue of bottlenecks had arisen simply because the Australian economy had been growing for 14 years and it would have been most unusual if no sectors were encountering some capacity constraints.

2.66 While the Governor noted that the skilled labour market wage rises have been quite pronounced he acknowledged that overall, wages have been remarkably well behaved for an economy which has been expanding for over 14 years.[111] The latest wage cost index was going up by 3.9 per cent and the Bank has factored some very moderate increases only into its forecast for inflation.[112]

2.67 Capacity utilisation remains at high levels, particularly in the mining sector and a large number of firms claim that output is still being constrained by a shortage of suitable labour.[113]

2.68 Transport infrastructure problems may be the key reason that some of our commodity exports are not growing as fast as would be expected under current world conditions. However the outlook for manufacturing exports is not as promising. In the early part of this decade, manufacturing exports were flat due to the global recession but in recent times with the global economy growing steadily, our rising exchange rate has offset this turnaround.[114] Dr Edey said that it was unlikely in the medium term that manufactured exports would repeat the experience of the 1990s when trade liberalisation expanded trade in both directions.[115]

2.69 Notwithstanding the results of ACCI and Sensis surveys, which suggest a more subdued economic outlook, capacity constraints continue to be reported as barriers to further expansion.[116] However, this appears not to be the case with housing where activity has declined from the levels experienced in earlier periods.[117]

2.70 In line with the observations above, the manufacturing sector has reported weaker conditions compared with late 2004; however recent surveys differ as to the actual and expected business conditions. ACCI-Westpac survey is more optimistic compared to AIG survey.[118]

---

111 *Transcript,* 12 August 2005, p 5,7.

112 *Transcript,* 12 August 2005, p 8.

113 *Statement on Monetary Policy,* August 2005, p 29.

114 *Transcript,* 12 August 2005, p 19.

115 *Transcript,* 12 August 2005, p 19.

116 *Statement on Monetary Policy,* August 2005, p 30.

117 *Statement on Monetary Policy,* August 2005, p 30.

118 *Statement on Monetary Policy,* August 2005, p 30.