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Monetary policy and other issues

Overview

2.1 Australia's current economic expansion has continued for an unprecedented 15 years. This is an enviable performance and one which many western countries would like to emulate. The RBA has played a critical part in this success by carefully monitoring inflation and conducting monetary policy so that it contributes to the stability of the Australian currency, the maintenance of full employment, and the continuing economic prosperity and welfare of the people of Australia.

2.2 Australia's long period of expansion has led to some capacity constraints. For example, ongoing labour and equipment shortages have reportedly been causing delays in some resource projects. The RBA points out that capacity constraints in an economy experiencing such a long expansion is not surprising, and should not be considered in a negative context.

2.3 Full capacity utilisation has led to low unemployment. The current unemployment rate of 4.8 per cent is the lowest in thirty years, and incomes are higher than they might otherwise have been. The RBA Governor commented that 'what would have been a bad thing is if, after fifteen years of growth, we still found ourselves with significant excess capacity, that is with significant resources of labour and capital that were not fully utilised.'[1]

2.4 Mr Macfarlane pointed out that capacity constraints do not generally occur suddenly but rather occur in stages and in different ways across industry sectors. It is also the case that the capacity of the economy will

1 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 2.

grow over time as the labour force grows, and investment and economic reforms lift productivity. However, it is important that capacity does not lag too far behind growth. Mr Macfarlane stated:

> There are limits, however, to how quickly capacity can be raised, though increased investment, as is taking place at present, will boost the rate of increase. But it takes time. In the meantime, it is helpful if demand can slow sufficiently to allow capacity to catch up or perhaps even get a little ahead. If this fails to happen then there is a risk of a generalised pick-up in inflation. Some rise in prices and wages in the areas where the bottlenecks exist are unavoidable but a generalised inflationary process is avoidable. This is why last year I started staying that we should get used to GDP growth with a '2' or '3' in front of the decimal point rather than the '3' or '4', as we had been accustomed to throughout most of the expansion.[2]

2.5 The RBA reported that over the past two years, the economy has slowed from its earlier fast pace of growth. Growth rates have been in the 2 to 3 per cent range. In particular, domestic demand has slowed more than GDP. It was running at about 6 per cent in 2003-04 but is now growing at about 3.5 per cent.[3] Mr Macfarlane commented that 'there is some evidence to suggest that the slowing in consumption was due, in part, to the fact that household spending was no longer being stimulated by the apparent wealth increases associated with the house price boom.'[4]

2.6 The RBA pointed out that while consumption has been falling, investment has grown strongly which is important 'because investment in plant and equipment and in construction is crucial to the process of increasing the economy's capacity to grow.'[5]

2.7 Mr Macfarlane noted that the capacity constraints caused by shortages of labour are harder to remedy in the short term. He noted that interstate movement of labour can help to provide skilled and unskilled labour to the areas of greatest shortages.

2.8 Most significantly, Mr Macfarlane noted that the process of slowing demand and expanding capacity, which has been going on for several years, has not prevented some general upward pressure on producer and consumer prices. The June quarter CPI headline rate increased to over 4 per cent over the year to June. The underlying rate of inflation was slightly below 3 per cent.

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2 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 3.

3 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 3.

4 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 3.

5 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 3.

2.9 In line with RBA's mandate to keep inflation between 2 and 3 per cent, the Bank, taking into account capacity constraints and domestic pressure on prices, together with rising global inflationary pressures, raised rates by 25 basis points in May and August 2006.

Forecasts for 2006-07

2.10 The RBA noted that 'the global economy remains very strong with output expanding at an above-average pace for the fourth year in a row.'[6] The RBA stated that the Australian economy has continued to grow at a good pace recently, with GDP expanding by around 3 per cent over the year to the March quarter.'[7] The RBA noted that the expansion has been driven by domestic spending, with business investment the fastest growing component. In particular, growth in investment spending has been strongest in the mining industry, where investment has roughly doubled over the past year.[8]

2.11 In relation to inflation, the RBA reported that the 'combination of rising world commodity prices, strong domestic demand, and tight capacity has contributed to increased inflationary pressure in Australia.'[9] The headline CPI increased to 4 per cent over the year to the June quarter. This reflected fuel price increases and a sharp rise in the price of bananas following the devastation caused by Cyclone Larry. The June quarter 'underlying inflation is estimated to have picked up to a rate of just under 3 per cent.'[10] The RBA noted that 'these developments indicate that underlying inflationary pressures have been a little stronger than was expected at the time of the May *Statement*.'[11]

2.12 In view of these circumstances, the RBA Board stated:

> …the situation reviewed by the Board at its recent monthly meetings was one in which evidence of stronger domestic conditions and inflation pressures was accumulating. The global economy was maintaining its strong pace of growth, while inflation in a number of countries was rising…

6 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 4.

7 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 2.

8 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 2.

9 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

10 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

11 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

> As a result of these considerations, the Board judged at its August meeting that a further increase in the cash rate was warranted in order to contain inflationary pressures in the medium term.[12]

2.13 During the hearing, Mr Macfarlane was pressed on the chances of a further rate rise in the short term. He commented that 'with the sorts of capacity constraints we are talking about and with the economy growing at a reasonable rate and probably inflationary pressures coming from abroad, it is more likely that there will be than there won't.'[13]

Inflation targeting and monetary policy

2.14 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. On 18 September 2006, the Treasurer and the new Governor of the Reserve Bank, Mr Glenn Stevens agreed on the *Third Statement on the Conduct of Monetary Policy*.

2.15 The Treasurer, the Hon Peter Costello, MP, commented that 'the Third Statement does not contain substantive changes but incorporates amendments to reflect the appointment of Mr Stevens as Governor, with existing practices and governance arrangements to continue unchanged.'[14] During the August hearing, Mr Macfarlane elaborated on the advantages of the agreement:

> I think it has worked very well. The other thing I should point out is that the agreement endorses the independence of the Reserve Bank, as contained in the Reserve Bank Act. The Reserve Bank Act makes it quite clear that we have obligations not just regarding inflation. We have obligations towards the welfare of the Australian people and towards employment. The best way to achieve those broader responsibilities, as I have said ad nauseam, is to have a long expansion, and the only way you can have a long expansion is if it is a low-inflation expansion. That is why there is no contradiction between having an inflation target and having responsibility for a good employment outcome.[15]

2.16 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:

12 RBA, *Statement on Monetary Policy*, 4 August 2006, pp. 3-4.

13 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 6.

14 The Treasurer, *Press Release*, Third Statement on the Conduct of Monetary Policy, 18 September 2006.

15 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 29.

- 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.[16]

2.17 In relation to inflation targeting, the 2006 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. [17]

2.18 During the February 2006 public hearing, 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.'[18] 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.

2.19 During the February 2006 public hearing Mr Macfarlane was asked about the impact of tax reform on inflation and interest rates.[19] 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.[20]

16 RBA, *Third Statement on the Conduct of Monetary Policy*, September 2006.
17 RBA, *Third Statement on the Conduct of Monetary Policy*, September 2006.
18 Mr I Macfarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 15.
19 Mr I Macfarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.
20 Mr I Macfarlane, Governor of the RBA, *Transcript*, 17 February 2006, p. 14.

2.20 As part of the August 2006 public hearing, Mr Macfarlane stated that his comments from the February hearing about tax reform were 'completely misinterpreted.' Further, he told the committee that 'he was trying to pour a bit of cold water on the idea of having really big tax cuts and a big fiscal expansion.'[21] Mr Macfarlane commented on the possible fiscal stimulus of federal and state budgets:

> We are now entering a period, as I said, where there are capacity constraints, where we really do not want the economy growing much faster than the twos to threes. The economy is in a situation where it is more sensitive to what happens with fiscal policy than it has been in the past. In our statement we said: 'Our best guess was that, if the federal budget outcome is as it is budgeted, that would be equivalent to a fiscal stimulus of half a per cent of GDP. If we add up all the state budgets that would be another half a per cent of GDP. If you put the two together, that is something that really could not be ignored. If you put the two together and you have a one per cent stimulus, that is something that is now starting to get into the realm where it is relevant for monetary policy.'[22]

2.21 Mr Macfarlane noted that tax cuts should not be considered just by themselves but the budget in totality, and 'the crucial figure you want to look at is the fiscal impact, which is the change in the surplus or, if it were a deficit, the change in the deficit.' He concluded that 'if you make tax cuts that do not have a significant fiscal impact then one cannot say those tax cuts are inflationary.'[23]

The 'neutral level' of interest rates?

2.22 In May and August 2006 the RBA increased the cash rate by 25 basis points each time, taking the cash rate to 6.0 per cent. During the hearing, the RBA was asked whether this level of interest rate was 'neutral'. Interest rates are generally referred to as 'neutral' if they are not having an expansionary or contractionary effect on the economy. The RBA Governor stated:

> The best I can come up with is that there is a band called 'neutral' and we are probably near the top of the neutral band, but you could not really make a case that they are restrictive or contractionary yet. I think when I was first asked this question I said that the real interest rate that had prevailed over the low-inflation period was about three per cent. If we were at 2½ per cent

21 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 11.

22 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, pp. 11-12.

23 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 19.

> inflation, which is the average that you would hope that in the very long run you would come out at, that would give you a neutral rate of about 5½, plus or minus half a per cent for rounding error. So 5½ to six would be the neutral rate. We have an underlying inflation rate now of about three. Three plus three is six. We are either at neutral or at the top end of the neutral band.[24]

Exchange rates and external trade

2.23 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.[25]

2.24 The RBA reported that the 'Australian dollar is little changed in net terms since the last *Statement*, both against the US dollar and on a trade weighted basis.'[26] Over the period, the Australian dollar has moved in a range between US$ 73 and US$ 77. The RBA stated:

> The relative stability of the currency over the past few years is the result of two opposing forces. The continuing strong rise in the terms of trade has been supportive of the currency but the narrowing of the interest differential with the US has had the opposite effect.[27]

2.25 The RBA reported that 'in real trade-weighted terms, the Australian dollar is about 14 per cent above its post-float average, and has been broadly flat for more than a year.'[28] The RBA stated:

> Accordingly, while the relatively high level of the exchange rate continues to restrict activity in some trade-exposed sectors, particularly manufacturing, this effect is likely to have been more than offset by the stimulus to the overall economy from the stronger terms of trade.[29]

24 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 31.
25 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 February 2005, p. 7.
26 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 18.
27 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 18.
28 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 34.
29 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 34.

2.26 In relation to trade, the RBA reported that 'despite the strong conditions prevailing internationally, Australia's export performance had been disappointing.'[30] The RBA stated:

> While it is true that export revenues have been growing strongly, and thus have added to the growth of national income, this revenue growth has been largely accounted for by higher prices, with volumes increasing only modestly. Nevertheless, while the expected pick-up in export volumes has been slow to materialise, prospects for growth in resource-based exports should be assisted by the substantial investment underway in that sector.[31]

2.27 The RBA reported that 'the value of exports increased by 14 per cent in the three months to May compared with the same period a year earlier.'[32] This mostly reflected the impact of higher commodity prices. Export earning on manufactured goods increased by around 2 per cent in the three months to May compared to the same time last year. The RBA commented that 'manufactured exports are expected to continue to grow at only a moderate rate due to intense competition from developing countries and the relocation of some operations offshore.'[33]

2.28 The value of imports increased by around 13 per cent over the year to the three months to May, partly reflecting the large increase in world oil prices. The RBA commented that the 'volume of total imports grew by 6 per cent over the year to the March quarter, a pace much slower than the 10-15 per cent rates recorded over the previous three years.'[34]

2.29 The current account deficit (CAD) narrowed to 5.8 per cent of GDP in the March quarter, compared with 6.0 per cent in the December quarter.

2.30 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. The RBA stated:

> After strong rises in the terms of trade through 2004 and 2005, there was a further modest increase in the first half of 2006. The rise of over 30 per cent in recent years has lifted the terms of trade to around their highest level in 50 years. This increase mainly reflects sharp rises in the prices of Australia's major commodity

30 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 2.
31 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.
32 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 32.
33 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 33.
34 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 33.

exports, which have taken the RBA's index of commodity prices to around its highest level since the series began in 1982.[35]

United States, China and the global economy

2.31 The global economy is expanding strongly. The RBA reported that 'US economic growth remains solid, although it moderated somewhat recently; the rapid growth in the Chinese economy shows no signs of slowing; and Japan's economic expansion is looking increasingly robust.'[36]

2.32 The RBA commented that 'the consensus forecast for world growth in 2006 was revised up again over the past three months and now stands at 5 per cent, well above the trend rate of growth.'[37] World growth in 2007 is expected to remain firm and the growth outlook for Australia's major trading partners in 2006 and 2007 is similar to that for the world as a whole.

2.33 GDP growth in the US slowed to 0.6 per cent in the June quarter and 3.5 per cent over the year, 'as demand has started to respond to the increases in interest rates over the past couple of years, the recent slowing in the housing market, and high energy prices.'[38]

2.34 The RBA reported that 'energy price increases pushed headline inflation up to 4.3 per cent over the year to June, and core inflation picked up to 2.6 per cent its fastest pace in over four years.'[39] The US unemployment rate fell to a five year low of 4.6 per cent in June.

2.35 The US Federal Reserve raised rates by a further 25 basis points at its June meeting taking rates to 5.25 per cent. The RBA reported that 'leading indicators such as housing starts and permits to build have fallen noticeably since the start of the year, while builders' confidence is at the lowest level since the early 1990s.'[40]

2.36 China is now the world's fourth largest economy, and the second largest when measured at purchasing power parity exchange rates. The RBA noted that 'rapid growth in the Chinese economy continues to support growth elsewhere in Asia, Australia and around the world.'[41]

35 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 31.
36 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 5.
37 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 8.
38 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 6.
39 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 7.
40 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 7.
41 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 9.

2.37 The RBA reported that China's 'real GDP is estimated to have increased by more than 11 per cent over the year to the June quarter, its fastest pace in over a decade.'[42] At the same time, inflation remains low, with consumer prices rising by 1.5 per cent over the year to June.

2.38 Mr Macfarlane noted that the 'latest stage of globalisation with the emergence of China and India cannot help but be very beneficial to Australia.'[43]

2.39 The Indian economy expanded particularly strongly in the March quarter, taking year-ended growth to 9.3 per cent, its fastest pace for over two years.

2.40 Growth in the Asia-Pacific, while not at the levels of China, increased by 1.0 per cent in the March quarter to be 6.0 per cent higher in year-ended terms. The RBA reported that 'most countries have experienced favourable outcomes, but a decline in confidence in response to a rise in consumer credit card defaults has led to weaker growth in Taiwan, and growth has slowed in Indonesia in response to high interest rates and a fall in government consumption.'[44]

Oil prices

2.41 During the August 2005 and February 2006 hearings, the committee examined the implications of rising oil prices. At the August 2006 hearing, the RBA Governor reiterated the point 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 affect on the rate of change of the CPI.

2.42 Mr Macfarlane observed that OPEC1 and OPEC2 were both followed by recessions but it was not clear that they were the cause of the recessions. Mr Macfarlane drew attention to the differences between the current situation and OPECs 1 and 2:

> On this occasion, of course, that has not happened. In fact, on this occasion the world economy has proved remarkably unaffected by the rise in oil prices. If you had told most of us three years ago that oil prices would treble, we probably would have expected a much

42 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 9.

43 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 28.

44 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 9.

> worse economic outcome than the one that has occurred. Basically, economic growth around the world has not slowed at all. It has had no impact in terms of slowing economic growth, and inflation has gone up only by a small amount. It has been much, much better than anyone, even the greatest optimist, could have predicted. Part of the explanation for that is that the rise in oil prices was due to strong world growth; it was not due to a cartel withholding supply, as it was on the previous two occasions.[45]

2.43 In the August *Statement on Monetary Policy*, the RBA reported that oil prices recently traded around $75 per barrel, up slightly from their level around the time of the May Statement.[46] Prices have increased from around US$60 per barrel at the start of the year.

2.44 During early October when the committee prepared this report, oil prices per barrel were trending down and were reported to have fallen below $60 per barrel.[47] The committee welcomed this slide but will continue to monitor trends in this area and seek a fresh update on the level and impact of oil prices from the RBA at the next hearing in February 2007.

Housing and household debt

2.45 In relation to broader domestic economic conditions, the RBA reported that 'the pace of economic expansion in Australia appears to have picked up over the first half of the 2006.'[48] In particular, the RBA noted that 'business investment has been particularly strong in the resource-intensive states of Western Australia and Queensland, where activity continued to run faster than in the rest of the country.'[49]

2.46 During the hearing, the issue of the 'dual economy' was raised with the RBA. It was observed that in Western Australia up to the June quarter unemployment was averaging 3.6 per cent while in New South Wales unemployment was 5.4 per cent. House prices in Perth had increased 28.8 per cent for the year up to the March quarter and fell 3.1 per cent in New South Wales.[50]

2.47 The RBA pointed out that there was always a dispersion in growth rates between the states commenting that following analysis of the last 30 years

45 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 6.

46 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 5.

47 Source Bloomberg

48 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 21.

49 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 21.

50 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 25.

the current dispersion 'is no bigger now than it has been on a number of occasions in the past.'[51] Mr Macfarlane further stated:

> …there is a lot of flexibility in this economy which is making things a lot better than they would have been 30 years ago. For example, people tend to highlight New South Wales, but the New South Wales unemployment rate of 5.1 per cent is only slightly higher than the national unemployment rate of 4.8 per cent. That suggests that there is not a big problem of people sitting around in New South Wales not having jobs.…
>
> So I think the system is working pretty well. And I think the big test is the unemployment rate. That is the really big test of dispersion. Growth rates are probably not as good a measure. One of the reasons that the New South Wales growth rate has been lower than the average for the country for some time is that the population growth rate has been lower in New South Wales. And there is the same process—people leaving to go to the faster growing areas and, as I have said in the past, I also believe, going to live in the more affordable parts of Australia.[52]

2.48 In relation to the household sector, the RBA reported that 'household demand strengthened in the first half of the year, following a period of moderate growth in consumption spending and a corresponding increase in the household saving ratio in 2005.'[53] The volume of retail sales increased by 3.6 per cent over the year. Consumer sentiment rose in July and remains above average levels 'after having eased in recent months in line with higher petrol prices and the increase in the cash rate in early May.'[54]

2.49 The RBA noted that household credit 'expanded at a solid pace, and it increased by around 13 per cent over the year to June [and] as a result, the debt-servicing ratio has been rising steadily, to stand a little below 11 per cent in the March quarter.'[55] The RBA stated:

> Despite the expected growth in disposable income, the household debt-servicing ratio is likely to rise further in the period ahead, since household debt has been growing at an even faster pace than income. Together with the recent increases in interests rates, this is likely to boost households' interest payments.[56]

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51 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 6.

52 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, pp. 6-7.

53 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 22.

54 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 22.

55 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 22.

56 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 22.

2.50 In relation to housing, the RBA reported that 'the downturn in housing construction activity since early 2004 continued into the early part of 2006.'[57] The RBA noted, however, that 'other forward indicators, such as local government building approvals, have risen a little over the past six months or so, suggesting that the current downturn may be nearing its end.'[58]

Housing affordability and land release

2.51 House prices rose by 5.5 per cent over the year to June. The strongest growth continues to be in Perth and Darwin. The issue of housing affordability was raised during the hearing. Mr Macfarlane observed that as part of the general public debate on this matter, there is significant focus placed on interest rate rises and their impact on housing affordability. Mr Macfarlane suggested that the real concern is the increasing cost of housing and not necessarily current increases in interest rates. Mr Macfarlane stated:

> I want to make the point that there is a much bigger problem for people than interest rates going up, particularly if we are concentrating on young people who have just bought a house or who have a young family or are trying to buy a house. The biggest problem for them is not interest rates; the biggest problem for them is that houses are so expensive—they have gone up so much in price.
>
> The increased outlays because of the two recent interest rate rises you can calculate in various ways, but on the average mortgage they have added $540 a year to the cost of servicing the average mortgage. If you have just bought a house and you have bought the average house and you have 85 per cent borrowing, then it is adding more—it is adding $1,700 a year. But these figures are actually tiny compared to the extra cost that you have to incur to buy the house, because the house has doubled in price over the last 10 years. To buy the same dwelling as you could have bought 10 years ago is going to cost you $200,000 more. That is really a huge number, compared to the changes in interest rates. Interest rates of course are lower now than they were 10 years ago, but the price of a house has doubled.[59]

57 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 23.

58 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 23.

59 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, pp. 23-24.

2.52 The issue of housing affordability and increasing house prices was further explored and, consistent with recent public debates, scrutiny focused on the role of state governments in relation to land release.

2.53 Mr Macfarlane noted that the first reason why house prices had basically doubled over the last decade was because of demand side issues. That is, because Australia returned to low inflation and interest rates were halved borrowing became easier and people borrowed more and drove up house prices. However, Mr Macfarlane suggested that a further reason relates to supply side issues and in particular the release of land. Mr Macfarlane stated:

> I think it is pretty apparent now that reluctance to release new land plus the new approach whereby the purchaser has to pay for all the services up front—the sewerage, the roads, the footpaths and all that sort of stuff—has enormously increased the price of the new, entry-level home. That is a supply-side issue, not a demand-side issue. I think there is a lot of evidence that, at the moment, those factors are becoming very important.…
>
> There is no blockage on the demand side, so it has to be on the supply side. I think there is an issue which state governments probably will have to look at: are the land release policies, the front-loading of all the charges, the right set of policies? I do not want to prejudge it but I think there is increasing attention now being focused on that.[60]

Supply side (capacity) constraints

2.54 As previously discussed, Australia's record achievement of 15 years of consecutive growth has led to capacity constraints. The recent rate increases should dampen demand enough to allow capacity to catch up and prevent inflationary pressures. The RBA reported that 'capacity utilisation levels reported by businesses in the June quarter were close to their highest levels in more than a decade.'[61]

2.55 The labour market is tight with unemployment being at its lowest level in 30 years. The RBA commented that 'business surveys and liaison reports continue to indicate that labour scarcity is a significant concern, with many businesses reporting that this is a bigger constraint on their

60 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 27.

61 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

activities than traditional concerns about the adequacy of demand.'[62] The RBA stated:

> …ongoing labour and equipment shortages have reportedly been causing delays in some resource projects, and the viability of some planned projects has been reduced by rising construction costs. Together with the additional call on resources from public infrastructure projects, this could hamper further expansion in non-residential construction activity.[63]

2.56 In relation to state infrastructure projects, Mr Macfarlane noted that the states may have difficulty in completing some of their projects. Mr Macfarlane commented that 'I think the states will probably discover, just like the private sector has, that some of the projects may not get off the ground and that some of the ones that do get completed will be completed at much higher cost than they were envisaging.'[64]

2.57 The RBA noted that 'constraints are said to have eased in the residential construction industry and in parts of manufacturing where demand has been subdued.'[65]

2.58 In looking ahead, the RBA commented that 'it appears likely that growth of the economy in the next year or two will on average be somewhat higher than it was over the year to the March quarter' and, consequently, the 'outlook implies that capacity is likely to remain tight over the period ahead.'[66]

2.59 The mining and allied sectors have experienced skills capacity constraints. Labour and skills shortages have led to high wage costs but this has been mostly offset by high commodity prices. The supply of skilled and semi-skilled workers to the manufacturing sector has also been tight, especially given the opportunity for cross-sectoral labour movement. However, unlike the resources sector, there is little scope to offset increased input costs on low-value added manufacturing goods.

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62 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

63 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 27.

64 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, p. 12.

65 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 25.

66 RBA, *Statement on Monetary Policy*, 4 August 2006, p. 3.

2.60 In light of this and the concurrent inquiries the committee is undertaking into the state of the manufacturing and services industries, the committee will inquire into the impact of capacity constraints in these sectors of the economy at the February 2006 RBA hearing in Perth.

The Hon Bruce Baird, MP
Chair
2 November 2006