The Parliament of the Commonwealth of Australia

Review of the Reserve Bank of Australia Annual Report 2005 (Second Report)

House of Representatives
Standing Committee on Economics, Finance and Public Administration

November 2006
Canberra

ISBN 0 642 78869 3 (Printed version)
0 642 78870 7 (HTML version)

Chairman's foreword

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 Reserve Bank of Australia (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.

This long period of expansion has resulted in capacity constraints which are creating some inflationary concerns. The RBA is quick to point out that full capacity is not something to fear. For example, the unemployment rate is the lowest in 30 years. Nevertheless, the RBA, taking into account capacity constraints and domestic pressure on prices, together with rising global inflationary pressures has recently raised rates taking the cash rate to 6.25 per cent.

The RBA advised that the current level of interest rates were in the 'neutral' area where interest rates are having neither an expansionary nor contractionary affect on the economy.

In relation to housing affordability, the RBA was surprised at the enormous public focus placed on the recent rate increases and their apparent impact on housing affordability. Mr Macfarlane, the then Governor of the RBA, suggested that the real problem for people was not the rate increases but the fact that houses were so expensive.

During the examination of housing affordability, scrutiny focused on the role of state governments in relation to land release. Mr Macfarlane commented that the 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, and footpaths - has enormously increased the price of the new, entry level home.

The public hearing held on 18 August 2006 was particularly productive and marked the final appearance of Mr Macfarlane who retired during September. I take this opportunity, on behalf of the committee, to congratulate Mr Macfarlane on his leadership of the RBA over ten successful years and commend him for his outstanding contribution to the stability and growth of the Australian economy.

I would also like to take this opportunity to welcome Mr Glenn Stevens as the new Governor of the RBA and look forward to formally meeting with him at the next public hearing with the RBA in February 2007.

The Hon Bruce Baird MP
Chair

Contents

APPENDICES

Membership of the Committee

Chair	The Hon Bruce Baird MP	
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Members	Mr Steven Ciobo MP	Mr Stewart McArthur MP
	Mr Joel Fitzgibbon MP	Mr Patrick Secker MP
	Ms Sharon Grierson MP	The Hon Alex Somlyay MP
	Mr Michael Keenan MP	Mr Lindsay Tanner MP

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Terms of reference

The House of Representatives Standing Committee on Economics, Finance and Public Administration is empowered to inquire into, and report on the annual reports of government departments and authorities tabled in the House that stand referred to the Committee for any inquiry the Committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the Committee.

List of abbreviations

CAD	Current Account Deficit
CPI	Consumer Price Index
GDP	Gross Domestic Product
GST	Goods and Services Tax
OPEC	Organisation of Petroleum Exporting Countries
RBA	Reserve Bank of Australia

1

Introduction

Background

1.1 The House of Representatives Standing Committee on Economics, Finance and Public Administration (the committee) is responsible for scrutinising the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the community, and the financial sector.

1.2 The RBA Governor's appearances before the committee at biannual public hearings are an important element of the Bank's accountability framework. The details of this framework were set out in the July 2003 *Second Statement on the Conduct of Monetary Policy,* agreed between the Treasurer, the Hon Peter Costello, MP, and the then RBA Governor, Mr Ian Macfarlane. On 18 September 2006 the *Third Statement on the Conduct of Monetary Policy,* agreed between the Treasurer and the new RBA Governor, Mr Glenn Stevens, was released. The statement provides for the RBA's accountability framework and formalises the biannual appearance before the committee. The statement, which is reproduced at Appendix C, states:

> The Governor has also indicated that he plans to continue to be available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration. The Treasurer expresses continuing support for these arrangements, which ensure the continued transparency and accountability of the

Reserve Bank's conduct of monetary policy—and therefore the credibility of policy itself.[1]

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make. Accordingly, the committee may inquire into aspects of the annual reports of the RBA and the Bank's Payments System Board.

1.4 The biannual hearings coincide with the release of one of the RBA's quarterly *Statements on Monetary Policy*. At the August 2006 hearing in Sydney, the committee scrutinised the RBA's *Statement on Monetary Policy* released on 4 August 2006.

Scope and conduct of the review

1.5 The fourth public hearing of the committee with the RBA during the 41st parliament was held in Sydney on 18 August 2006.

1.6 The proceedings of the Sydney hearing were audio streamed over the internet through the Parliament's website, allowing interested parties to hear the proceedings as they occurred. The Governor's opening statement was taken as a submission and the transcript of the hearing is available through the committee's website.[2]

1.7 Before the hearing, the committee received a private briefing from Mr Stephen Walters, Chief Economist, JPMorgan. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Mr Walters cooperation and assistance.

1.8 The committee also appreciates the provision of additional briefing material from Mr Dave Richardson of the Parliamentary Library Research Service.

1.9 The Sydney hearing was well attended by members of the public and students from secondary schools, including Woolooware High School, Gymea High School, Caringbah High School, East Hills Girls Technology High School, Fort Street High School, MLC School, Pymble Ladies College, Sydney Secondary College, Domremy College and St Augustine's College. The committee appreciates the work of Ms Anne Nelson from the Parliamentary Education Office in organising these schools to attend.

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1 RBA, *Third Statement on the Conduct of Monetary Policy*, September 2006.

2 See:< http://www.aph.gov.au/house/committee/efpa/RBA2003_04/index.htm>

1.10 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and also have assisted in providing a public face to parliamentary committees and the RBA. The committee welcomes the Governor's frank and open comments at the hearings. In addition, the hearings are an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.11 The report focuses on matters raised at the public hearing, and also draws on issues raised in the RBA's *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA's website[3], and the transcript of the hearing is available from the committee's website[4].

Next public hearing with the RBA

1.12 The committee will conduct the next public hearing with the RBA on Wednesday, 21 February 2007 in Perth. More details about the hearing will be circulated in the weeks leading up to the hearing.

3 See: <www.rba.gov.au>

4 See:< http://www.aph.gov.au/house/committee/efpa/index.htm>

2

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

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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]

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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]

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

A

Appendix A — Submission

Number	Provided by
1	Reserve Bank of Australia (*Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, public hearing Sydney, 18 August 2006)*

B

Appendix B — Hearing, briefings, and witnesses

Public hearing

Friday 18 August 2005 – Sydney

Reserve Bank of Australia

Mr Ian Macfarlane, Governor
Mr Glenn Stevens, Deputy Governor
Mr Ric Battellino, Assistant Governor (Financial Markets)
Dr Malcolm Edey, Assistant Governor (Economics)
Dr Philip Lowe, Assistant Governor (Financial System)

Private briefing

Thursday 17 August 2005 – Canberra

Mr Stephen Walters, Chief Economist, JPMorgan

C

Appendix C — *Third statement on the conduct of monetary policy*

The Treasurer and the Governor of the Reserve Bank

18 September 2006

This statement records the common understanding of the Governor, as Chairman of the Reserve Bank Board and the Government on key aspects of Australia's monetary policy framework. It builds on the 1996 and 2003 Statements between the Treasurer and the former Governor on the respective roles and responsibilities in the operation of monetary policy in Australia.

Monetary policy is a key element of macroeconomic policy and its effective conduct is critical to Australia's economic performance and prospects. For this reason, and given the appointment of a new Governor of the Reserve Bank, it is appropriate and timely for the Governor and the Treasurer on behalf of the Government to affirm their mutual understanding of the operation of monetary policy in Australia.

This statement should continue to foster a clear understanding, both in Australia and overseas, of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Bank.

Relationship Between the Reserve Bank and the Government

The *Reserve Bank Act 1959* (the Act) gives the Reserve Bank Board the power to determine the Bank's monetary policy and take the necessary action to implement policy changes. The Act nominates the Governor as Chairman of the Board.

The Government recognises the independence of the Bank and its responsibility for monetary policy matters and respects the Bank's independence as provided by statute.

Section 11 of the Act prescribes procedures for the resolution of policy differences between the Reserve Bank Board and the Government. The procedures, in effect, allow the Government to determine policy in the event of a material difference; but the procedures are politically demanding and their nature reinforces the Bank's independence in the conduct of monetary policy. Safeguards like this ensure that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

The Act also provides that the Board shall, from time to time, inform the Government of the Bank's policy. Such arrangements are a common and valuable feature of institutional systems in other countries with independent central banks and recognise the importance of macroeconomic policy co-ordination.

Consistent with its responsibilities for economic policy as a whole the Government reserves the right to comment on monetary policy from time to time.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act which requires the Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

a. the stability of the currency of Australia;

b. the maintenance of full employment in Australia; and

c. the economic prosperity and welfare of the people of Australia.

The first two objectives lead to the third, and ultimate, objective of monetary policy and indeed economic policy as a whole. These objectives allow the Board to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term. Price stability is a crucial precondition for sustained growth in economic activity and employment.

Both the Bank and the Government agree on the importance of low inflation and low inflation expectations. These assist businesses in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of Australians and preserve the value of the currency.

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 business cycle while preserving a clearly identifiable performance benchmark over time.

Since the first Statement on the Conduct of Monetary Policy in 1996 inflation has averaged around the midpoint of the inflation target band. The Governor expresses his commitment to the inflation objective, consistent with his duties under the Act. For its part the Government indicates again that it endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving such an outcome.

Transparency and Accountability

Monetary policy needs to be conducted in an open and forward looking way. A forward looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the Bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements.

The Reserve Bank takes a number of steps to ensure that the conduct of monetary policy is transparent. Changes in monetary policy and related reasons are clearly announced and explained. The Bank's public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses, its quarterly statements on monetary policy and monthly statistical bulletins, promote increased understanding of the conduct of monetary policy. The Bank will continue to promote public understanding in this way.

The Governor has also indicated that he plans to continue the practice of being available to report on the conduct of monetary policy twice a year to the House of Representatives Standing Committee on Economics, Finance and Public Administration.

The Treasurer expresses continuing support for these arrangements, which ensure the continued transparency and accountability of the Reserve Bank's conduct of monetary policy — and therefore the credibility of policy itself.

The Government and Bank continue to recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.

D

Appendix D — Glossary of terms

Australian Competition and Consumer Commission (ACCC). A Commonwealth statutory authority responsible for ensuring compliance with the *Trade Practices Act 1974* and the provisions of the Conduct Code and for administering the *Prices Surveillance Act 1983*. The Commission's consumer protection work complements that of State and Territory consumer affairs agencies.

Australian Payments Clearing Association Limited (APCA). A public company owned by banks, building societies and credit unions which has specific accountability for key parts of the Australian payments system, particularly payments clearing operations

Australian Prudential Regulation Authority (APRA). APRA is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry

Australian Securities and Investments Commission (ASIC). One of three Australian Government bodies (the others being the Australian Prudential Regulation Authority and the Reserve Bank of Australia) that regulates financial services. ASIC is the national regulator of Australia's companies. ASIC has responsibility for market protection and consumer integrity issues across the financial system.

accrual accounting. Revenues and expenses are recorded as they are earned or incurred, regardless of whether cash has been received or disbursed. For example, sales on credit would be recognised as revenue, even though the debt may not be settled for some time.

acquirer. An institution that provides a merchant with facilities to accept card payments, accounts to the merchant for the proceeds and clears and settles the resulting obligations with card issuers.

average weekly earnings. Average gross (before tax) earnings of employees.

average weekly ordinary time earnings (AWOTE). Weekly earnings attributed to award, standard or agreed hours of work.

average weekly total earnings. Weekly ordinary time earnings plus weekly overtime earnings.

balance on current account. The difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

bankruptcies. Bankruptcies and Administration Orders under Parts IV and XI of the Bankruptcy Act.

basis point. A basis point is 1/100th of 1 percent or 0.01 per cent. The term is used in money and securities markets to define differences in interest or yield.

BPAY. BPAY is a payments clearing organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay billing organisations which participate in BPAY, using account transfers initiated by phone or internet. The transfers may be from savings, cheque or credit card accounts.

business investment. Private gross fixed capital formation for machinery and equipment; non-dwelling construction; livestock; and intangible fixed assets.

card issuer. An institution that provides its customers with debit or credit cards.

cash rate (interbank overnight). Broadly defined, the term cash rate is used to denote the interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis. The Reserve Bank of Australia uses a narrower definition of the cash rate as an operational target for the implementation of monetary policy. The Reserve Bank of Australia's measure of the cash rate is the interest rate which banks pay or charge to borrow funds from or lend funds to other banks on an overnight unsecured basis. This measure is also known as the interbank overnight rate. The Reserve Bank of Australia calculates and publishes this cash rate each day on the basis of data collected directly from banks. This measure of the cash rate has been published by the Reserve Bank of Australia since June 1998.

cash rate target. As in most developed countries, the stance of monetary policy in Australia is expressed in terms of a target for an overnight interest rate. The rate used by the Reserve Bank of Australia is the cash rate (also known as the interbank overnight rate). When the Reserve Bank Board decides that a change in monetary policy should occur, it specifies a new target for the cash rate. A decision to ease policy is reflected in a new lower target for the cash rate, while a decision to tighten policy is reflected in a higher target.

charge card. A charge card is a card whose holder has been granted a non-revolving credit line enabling the holder to make purchases and possibly make cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.

consumer price index. A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

credit card. A credit card is a card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period or in part, with the balance taken as extended credit. Interest may be charged on the transaction amounts from the date of each transaction or only on the extended credit where the credit granted has not been settled in full.

debit card. A debit card is a card that enables the holder to access funds in a deposit account at an authorised deposit-taking institution.

derivative. A financial contract whose value is based on, or derived from, another financial instrument (such as a bond or share) or a market index (such as the Share Price Index). Examples of derivatives include futures, forwards, swaps and options

employed persons. Persons aged 15 and over who, during a period of one week, worked for one hour or more for pay or worked for one hour or more without pay in a family business or on a family farm.

G-10. Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and USA; plus Bank for International Settlements (BIS), European Commission, International Monetary Fund (IMF), and the Organisation for Economic

Co-operation and Development (OECD). It was formed in conjunction with the establishment of the General Arrangements to Borrow, under which members agreed to make resources available to the IMF.

G-20. Group of Twenty Forum: Members are finance ministers or central bankers from - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK and US; plus representatives of the IMF, European Union and World Bank. The G-20 aims to broaden the dialogue on key economic and financial policy issues among systemically significant economies, and promote co-operation to achieve stable and sustainable world economic growth.

G-22. Group of Twenty-two. The G-22's aim was to advance issues related to the global financial architecture. It operated through three Working Parties - on Transparency and Accountability, International Financial Crises, and Strengthening Financial Systems. The group made its recommendations in 1998, and its work has since been taken up in other forums.

G-7. Group of Seven countries: Canada, France, Germany, Italy, Japan, UK and USA. The G-7 Summit deals with issues covering macroeconomic management, international trade, international financial architecture, relations with developing countries, and other global issues.

G-8. Group of Eight countries: G-7 countries and Russia.

gross domestic product. The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production but before deducting for depreciation.

gross domestic product—chain volume measure. Also known as *real GDP*, this is a measure used to indicate change in the actual quantity of goods and services produced. Economic growth is defined as a situation in which real GDP is rising.

gross domestic product at factor cost. Gross domestic product less the excess of indirect taxes over subsidies.

gross foreign debt. All non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia.

household debt ratio. The amount of household debt at the end of a quarter expressed as a proportion of annual household gross disposable income.

household gross disposable income. The amount of income that households have available for spending after deducting any taxes paid, interest payments and transfers overseas.

household net disposable income. Household gross disposable income less depreciation of household capital assets.

household saving ratio. The ratio of household income saved to household net disposable income.

housing loan interest rate. The variable rate quoted by banks for loans to owner-occupiers.

implicit price deflator for non-farm gross domestic product. A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.

index of commodity prices. A Reserve Bank of Australia-compiled index (based 2001/02=100) which provides a measure of price movements in rural and non-rural (including base metals) commodities in Australian Dollars (AUD), Special Drawing Rights (SDR) and United States Dollars (USD).

inflation. A measure of the change (increase) in the general level of prices.

inflation target. A tool to guide monetary policy expressed as a preferred range or figure for the rate of increase in prices over a period. In Australia, the inflation target is between 2 and 3 per cent per annum on average over the course of the business cycle.

interchange fee. A fee paid between card issuers and acquirers when cardholders make transactions

interest rate. The term used to describe the cost of borrowing money or the return to the owner of the funds which are invested or lent out. It is usually expressed as a percent per annum of the amount of money borrowed, lent or invested.

labour force. The employed plus the unemployed.

labour force participation rate. The number of persons in the labour force expressed as a percentage of the civilian population aged 15 years and over.

labour productivity. Gross domestic product (chain volume measure) per hour worked in the market sector.

long-term unemployed. Persons unemployed for a period of 52 weeks or more.

macroeconomy. The economy looked at as a whole or in terms of major components measured by aggregates such as gross domestic product, the balance of payments and related links, in the context of the national economy. This contrasts with microeconomics which focuses upon specific firms or industries.

market sector. Five industries are excluded from the market sector because their outputs are not marketed. These industries are: property and business services; government administration and defence; education; health and community services; and personal and other services.

monetary policy. The setting of an appropriate level of the cash rate target by the Reserve Bank of Australia to maintain the rate of inflation in Australia between 2 and 3 per cent per annum on average over the business cycle.

natural increase. Excess of live births over deaths.

net foreign debt. Gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

net overseas migration. Net permanent and long-term overseas migration plus an adjustment for the net effect of 'category jumping'.

non-farm gross domestic product. Gross domestic product less that part which derives from agricultural production and services to agriculture.

overseas visitors. Visitors from overseas who intend to stay in Australia for less than 12 months.

prime interest rate. The average rate charged by the banks to large businesses for term and overdraft facilities.

profits share. Gross operating surplus (the excess of gross output over costs incurred in producing that output) of all financial and non-financial corporate trading enterprises as a percentage of gross domestic product at factor cost.

real average weekly earnings. Average weekly earnings adjusted for inflation as measured by the Consumer Price Index.

real prime interest rate. The prime interest rate discounted for inflation as measured by the Consumer Price Index.

seasonally adjusted estimates. Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

terms of trade. The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is to divide the implicit price deflator for exports by the implicit price deflator for imports.

trade weighted index. A measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners.

turnover. Includes retail sales; wholesale sales; takings from repairs, meals and hiring of goods; commissions from agency activity; and net takings from gaming machines. From July 2000, turnover includes the Goods and Services Tax.

unemployed persons. Persons aged 15 and over who, during a period of one week, were not employed but had actively looked for work in the previous four weeks and were available to start work.

unemployment rate. The number of unemployed persons expressed as a percentage of the labour force.

wage price index. A measure of change in the price of labour (i.e. wages, salaries and overtime) unaffected by changes in the quality or quantity of work performed.

wages share. Wages, salaries and supplements (the total value of income from labour) as a percentage of gross domestic product at factor cost.

youth unemployment. Number of 15–19 year olds looking for full-time work.

youth unemployment rate. Number of 15–19 year olds looking for full-time work expressed as a percentage of the full-time labour force in the same age group.

Source: Parliamentary Library and Reserve Bank of Australia