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Monetary policy and other issues

Overview

2.1 On 2 September 2008 the Reserve Bank of Australia (RBA) announced a 25 basis point reduction in the official cash rate. The first rate cut since December 2001. Since the start of the US sub-prime mortgage crisis there has been severe instability in global financial markets. The level of uncertainty and fluidity in international financial markets has provided a challenge for financial regulators around the world.

2.2 In April 2008 when the RBA previously appeared before the committee, the focus was on the underlying rate of inflation and the need to bring this under control with a restrictive monetary policy setting. At the April hearing, the RBA advised that 'current policy settings should remain unchanged' but 'there exists some evidence that a moderation in demand is occurring, which should, in due course, slow price growth.'[1]

2.3 The change in economic conditions between April and September provided the RBA with the evidence to cut rates. The Governor of the RBA in his statement announcing the 2 September rate cut noted the tighter financial conditions but also Australia's terms of trade which were working in the opposite direction. The Governor stated:

> Given the opposing forces at work, considerable uncertainty has surrounded the outlook for demand and inflation. On balance, however, it is looking more likely that household demand will

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1 Mr G Stevens, Governor of the RBA, *Transcript*, 4 April 2008, p. 5.

> remain subdued and overall economic growth slow over the period ahead. Inflation is likely to remain relatively high in the short term, with the CPI affected by the high global oil prices in mid year and other increases in raw materials prices. But looking further ahead, the outlook for demand suggests that inflation in both CPI and underlying terms is likely to decline over time, provided wages growth remains contained. The Bank's forecast remains that inflation will fall below 3 per cent during 2010.
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> Weighing up the available domestic and international information, the Board judged that there was now scope for monetary policy to become less restrictive.[2]

2.4 A measure of the volatility in global financial markets is the significant downturn in conditions that occurred between the 2 September and the 7 October meetings of the RBA Board. The series of events that occurred during this period led the RBA Board to cut the official cash rate by 100 basis points, the largest single reduction since 1992. The Governor, in announcing the 7 October decision, stated:

> Conditions in international financial markets took a significant turn for the worse in September. Large-scale financial failures in several major countries were accompanied by serious dislocation in interbank markets and heightened instability in other markets, including sharp falls in share prices. Official actions in a number of countries have been aimed at restoring stability, by adding to short-term liquidity and laying a foundation for longer-term recovery in the health of balance sheets. Nonetheless, financing is likely to be difficult around the world for some time ahead. This is also affecting Australia, albeit by less than in many other countries, given the relative strength of the local banking system.[3]

2.5 In particular, the Governor noted that 'economic activity in the major countries is also weakening, and evidence is accumulating of a significant moderation in growth in Australia's trading partners in Asia.'[4]

2.6 The RBA seemed confident that inflation was under control but noted that the year ended September CPI would come in about 5 per cent but would start to decline in 2009. The Governor's statement announcing the 7 October decision was now very much focused on growth. The Governor stated that 'the recent deterioration in prospects for global growth,

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2 RBA, *Media Release*, 2 September 2008.

3 RBA, *Media Release*, 7 October 2008.

4 RBA, *Media Release*, 7 October 2008.

together with much more difficult market conditions even for creditworthy borrowers, now present the risk that demand and output could be significantly weaker than earlier expected.'[5] The Governor concluded:

> Given that background, the Board judged that a material change to the balance of risks surrounding the outlook had occurred, requiring a significantly less restrictive stance of monetary policy. The Board also took careful note of movements in funding costs in wholesale markets. Having weighed these considerations, the Board decided that, on this occasion, an unusually large movement in the cash rate was appropriate in order to bring about a significant reduction in costs to borrowers. The Board does not, however, regard that movement as establishing a pattern for future decisions.[6]

2.7 On the upside, and compared to the impact the global financial crisis is having on other advanced economies, the Australian economy and financial system was notable for its robustness. The Governor stated:

> …what we see in Australia is an order of magnitude less troubling than what we see abroad. That, I think, is an important point to emphasise. The balance sheets of the bulk of corporate Australia are not overgeared. Australian financial institutions continue to present a contrasting picture to their peers in the US, Europe and the UK. They have adequate access to offshore funding, albeit at higher prices than a year ago. They have tightened credit standards for some borrowers, particularly those associated with property development and some other high-risk areas, and are holding a higher proportion of their balance sheets in liquid form. Some have had to make provisions for unwise exposures that had been accumulated earlier. But even in those cases, capital, asset quality and profitability remain very sound.[7]

2.8 The International Monetary Fund (IMF) in its October 2008 World Economic Outlook commented in relation to both Australia and New Zealand that 'sound fiscal positions provide scope for allowing automatic stabilizers to operate in full and for judicious use of discretionary stimulus if the outlook deteriorates further.'[8]

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5 RBA, *Media Release*, 7 October 2008.

6 RBA, *Media Release*, 7 October 2008.

7 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 3.

8 International Monetary Fund, *World Economic Outlook, October 2008, Financial Stress, Downturns, and Recoveries*, p. 63.

Forecasts for 2008-2009

2.9 The RBA's forecasts, are more so than in previous reporting periods, subject to the volatility of the global economy. The IMF October 2008 World Economic Outlook highlighted the depths of the global downturn by comparing it to the experience of the 1930s. The IMF stated:

> The world economy is now entering a major downturn in the face of the most dangerous shock in mature financial markets since the 1930s. Against an exceptionally uncertain background, global growth projections for 2009 have been marked down to 3 percent, the slowest pace since 2002, and the outlook is subject to considerable downside risks. The major advanced economies are already in or close to recession, and, although a recovery is projected to take hold progressively in 2009, the pickup is likely to be unusually gradual, held back by continued financial market deleveraging. In this context, elevated rates of headline inflation should recede quickly, provided oil prices stay at or below current levels.[9]

2.10 The IMF noted that 'the financial crisis that erupted in August 2007 after the collapse of the US sub-prime mortgage market entered a tumultuous new phase in September 2008 that has badly shaken confidence in global financial institutions.'[10] The RBA's output and inflation forecasts shown in Table 2.1 below were included in the August 2008 *Statement on Monetary Policy*.

Table 2.1 RBA Output and Inflation Forecasts

Percentage change over year to quarter shown

	Dec 2007	Mar 2008	June 2008	Dec 2008	June 2009	Dec 2009	June 2010	Dec 2010
GDP	4.3	3.6	2¾	2	2¼	2½	2½	2¾
Non-farm GDP	4.2	3.6	2½	1.5	1¾	2½	2½	2¾
CPI	3.0	4.2	4.5	5	3¾	3¼	3	2¾
Underlying inflation	3.6	4.2	4.4	4.5	3¾	3¼	3	2¾

Actual GDP data to March 2008 and actual inflation data to June 2008. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.91, TWI at 70, cash rate at 7.25 per cent, and WTI crude oil price at US$118 per barrel and Tapis crude oil price at US$122 per barrel.

Source *Reserve Bank of Australia, Statement on Monetary Policy, August 2008, p. 62.*

9 International Monetary Fund, *World Economic Outlook, October 2008, Financial Stress, Downturns, and Recoveries*, p. 1.

10 International Monetary Fund, *World Economic Outlook, October 2008, Financial Stress, Downturns, and Recoveries*, p. 1.

2.11 The Governor noted in his 7 October statement announcing the October rate cut that the CPI is likely to increase to 5 per cent over the four quarters to September. The August *Statement on Monetary Policy* advised that 'the current forecast profile implies that year-ended inflation will remain outside the target range until mid 2010.'[11] However, the Governor in his October statement noted that the recent deterioration in the prospects for global growth 'now present the risk that demand and output could be significantly weaker than earlier expected.' The Governor concluded that 'should that occur, inflation would most likely fall faster than earlier forecast.'[12]

2.12 Table 2.1 shows GDP declining to 2 per cent over the year to the 2008 December quarter and staying in the 'twos' through to the 2010 December quarter. The RBA noted that the unemployment rate is forecast to rise in line with slowing domestic activity and employment.[13] As part of the September hearing, the Governor advised that during economic slowdowns, 'the rate of unemployment growth will slow.'[14] When the Governor was pressed on the extent to which unemployment would increase he referred to the experience of the mid cycle pause in 2001. The Governor stated:

> …we could see what is going on at the moment as rather akin to the mid-cycle pause in 2001. In that episode the rate of unemployment rose by a percentage point over a year to 18 months. I am not setting that up as a precise forecast but, qualitatively, that sort of episode I think is probably what we are experiencing now.[15]

2.13 During the hearing, the RBA was questioned about the impact of a carbon pollution reduction scheme (CPRS) on CPI forecasts. The RBA noted in its August Statement on Monetary Policy that the forecasts do not incorporate the effects of a CPRS. The RBA reported that 'the introduction of the proposed measures would be expected to boost CPI inflation near the end of the forecast period.'[16] The RBA concluded that it 'will incorporate estimates of initial and ongoing effects into its forecasts as further details are released.'[17]

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11 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 62.
12 RBA, *Media Release*, 7 October 2008.
13 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 63.
14 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 11.
15 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 11.
16 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 63.
17 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 62.

2.14 The Governor did not consider that the introduction of a CPRS would create serious problems for managing monetary policy and compared the potential effect of a CPRS with the introduction of the GST. The Governor stated:

> I do not at the moment assume that we are going to have a serious problem for monetary policy here at all. I think if it is well handled we will be fine, the way we were with the GST. With that there was quite a big one-time rise in the CPI but within a year it was out of the inflation rate. We looked through that, the community looked through that, and we kept on about our lives without getting pushed seriously off track.[18]

Inflation targeting and monetary policy

2.15 The *Fourth Statement on the Conduct of Monetary Policy*, agreed on 7 December 2007 between the Treasurer and the Governor of the Reserve Bank, outlines the objective of monetary policy and provides an inflation target.

2.16 The goals of monetary policy as set out in the *Reserve Bank Act 1959* require the Reserve Bank Board to conduct monetary policy in a way that, in the Board's opinion, will best contribute to:

- the stability of the currency of Australia;
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

2.17 The Fourth Statement on the Conduct of Monetary Policy also states that:

> In pursuing the goal of medium-term price stability, both the Reserve Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short-run variation in inflation over the cycle while preserving a clearly identifiable performance benchmark over time.[19]

2.18 One of the key functions of the committee in scrutinising the RBA is to hold it to account for its conduct of monetary policy and, in particular, that its decisions are in the best interest of the economy. In line with this

18 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 18.

19 RBA, *Fourth Statement on the Conduct of Monetary Policy*, December 2007.

objective, the committee was intent on examining the need for the official rate increases of 25 basis points each that occurred in February and March 2008. There was concern that these rate rises may have been too much for the economy to tolerate. The RBA defended its decision to raise rates on both these occasions based on the information that was available. The Governor stated:

> I do not think they were unnecessary. I think they had to be done. If you think back to the information that was coming in at that time and that has continued to come in, particularly on inflation, I think the likelihood that we were going to be able to credibly sit through one bad CPI, then another and then a third—and there is actually a fourth coming that will not look too good—and not respond at all was pretty unlikely. When inflation is rising like that you have to respond. The earlier you respond the sooner you can get to a position where you can sit and say, as we did, 'That's tight. That will do the job. It will take time but it will work.' I do not think we would have been in that position without those two changes at the beginning of the year. In fact, I think we could well have found ourselves much later in the year agonising over whether we should be raising rates even then rather than being in the position that we were in—being steady and then starting to think about coming down a bit.[20]

2.19 The action of monetary policy in seeking to slow growth and bring down inflation can be a balancing act and there may be marginal difference in achieving a 'soft landing' as opposed to a recession. In response to the possibility that the Australian economy may be verging on the edge of recession, the Governor stated:

> I do not think we are in recession now. I do not think there is the evidence to suggest that. We are in a period of slow growth, rather like two or three episodes of that nature that I can recall over the years. I think it would be dishonest to deny that there is any possibility at all that we could have a recession. There is clearly some probability of that, but I think the most likely outcome continues to be the one that is in the outlook that we have put out over the last six months publicly.[21]

2.20 During the hearing, the committee contrasted the Governor's confidence in the economy with business confidence surveys. The RBA's August 2008 Statement on Monetary Policy includes a business confidence survey

20 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 6.

21 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 10.

which shows that business confidence has fallen to minus 15, the lowest result since 1991. The Governor was asked to reconcile the current low business confidence with his broader view of the economy. The Governor stated:

> I am saying that business confidence has come down. I think, regarding the differences between what we see thus far and what we see in some of these other episodes, the number is a bit lower, but I am not sure that is a major statistical difference. It is true that it was minus 15 in 1991. By that stage we had had a recession, actually. By this time of the year in 1991 the recovery was underway. I do not think this is going to be like the early 1990s again. I think that is highly unlikely. Confidence is down, though. The top panel shows what they say is actually happening as opposed to what they feel; I am not saying what they feel is unimportant, but what is happening on the ground has come down to a bit below average, and it is probably going to go a bit lower.[22]

2.21 A further issue that was examined during the hearing was the continuing effectiveness of monetary policy to influence the market if there has been a 'de-coupling' between the official cash rate the decision of the commercial banks to pass on rate cuts. The RBA was quick to point out that there is no formal link between movements in the cash rate and commercial bank interest rates. The Governor noted that for the last decade there has been a form of coupling between mortgage rates and the cash rate but this was not the case in the 1990s. The Governor stated:

> …if you go back into history earlier than just the past 10 years or so, it was not like that to anything like the same extent. There was less of a coupling—to use that word—in those days. The market conditions that we have seen in the past year have been such that that relationship has not been as close as it was for some years…
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> There is not any law that says banks can only adjust interest rates when we do. It is just that most of the time in the past decade what the Reserve Bank has done has been a pretty close proxy for what all the other funding costs did, so the practice grew up the way that it did.[23]

2.22 The Governor was confident, however, that movements in the cash rate would still exert influence over the economy. In addition, he noted that

22 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 34.

23 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 14.

Australia was in a better position than some other advanced economies. The Governor stated:

> As for whether monetary policy gets less effective if the coupling, as you call it, is not as strong, yes, to some extent, but it strikes me as still pretty likely that movements in the cash rate will still have a fair amount of influence, even if not exactly one for one. You can compare the situation that we are in with that of the United States, where it is actually long-term rates that matter most for borrowers. The Fed has got the fed funds rate at a very low level, but in fact mortgage rates for borrowers have declined hardly at all, if at all, because they key off those five-year or 30-year Treasury yields plus a margin. So in that case the capacity of the central bank to affect a lot of the rates that borrowers actually pay is much less direct than we have, even now that, in our case, the cash rate and some loan rates are not exactly one for one necessarily every time but there is still quite a lot of influence there compared with what you see in some other countries.[24]

2.23 In relation to independent rate increases by the commercial banks, the Governor noted that the funding costs of banks is complex and it was probably 'unlikely that banks will volunteer reductions in loan rates independently of the Reserve Bank lowering the cash rate, because the quantum of additional market funding costs that went into the system earlier in the year mostly is still there.'[25] The RBA 100 basis point rate cut of 7 October resulted in the major banks cutting their rates by 80 basis points. The Commonwealth Bank of Australia (CBA) in announcing its rate cut commented on future reductions. The CBA stated:

> While we are not reducing our variable home loan rates by as much as the RBA reduction, we do expect global financial markets to normalise over time and once that does occur we will be able to reduce rates by more than the RBA adjustments.[26]

2.24 The CBA's announcement is positive and it will be important to note if the other banks match or better this commitment. The committee will certainly be observing the actions of the commercial banks as global markets normalise.

2.25 The issue of competition in the banking and non-banking sector was also raised. In particular, the RBA was asked about the ability of the non-bank

24 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 14.

25 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 7.

26 Commonwealth Bank of Australia, *Media Release*, 7 October 2008.

lenders to regain some market share. The Governor was optimistic and stated:

> As those short-term market yields have come down, I think prospects are improving. They are probably not quite there yet for them to be highly profitable, but I think things are moving in the right direction there. Our feeling is that securitisation will at some point be, once again, a feature of the system—one piece of competition in the mortgage market particularly. It may not be at the pace that we saw, which was very rapid until the international turmoil began, but I do not think securitisation is dead forever. I think it will get going again.[27]

2.26 A further issue raised was the possible impact of wages growth in causing inflationary pressures. The RBA has raised this as a concern, particularly during previous periods of high capacity utilisation.

2.27 The RBA in discussing its outlook for inflation still advised that its 'assessment hinges to no small extent on growth in overall labour costs not picking up further.'[28] The RBA stated:

> Relative wages have been shifting over recent times, as would be expected given the nature of the forces that are affecting the economy, but overall the pace of growth in labour costs to date has been fairly contained, considering how tight the labour market has been. With pressure coming off the labour market in the period ahead, we think, an assumption that that moderate behaviour will continue appears to be a reasonable one at this point, but it is a critical one. The outlook also hinges on the expectation that demand growth will remain quite moderate in the near term so that pressure continues to come off productive capacity.[29]

2.28 The RBA was asked about the current rate of industrial disputation and its impact, if any, on GDP growth. The Governor noted that while there has been an increase in industrial disputation, 'I would not say that that is remarkably different behaviour from history'.[30]

27 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 10.

28 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 4.

29 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 4.

30 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 26.

Exchange rates and external trade

2.29 In mid July the Australian dollar reached a post-float high against the US dollar of just over 98.5 cents. Since that time, however, the Australian dollar has depreciated particularly during late September and early October 2008. At the time of the hearing, the Australian dollar was trading at about 83 cents against the US dollar. By 10 October the Australian dollar had fallen to less than 70 cents against the US dollar.

2.30 A higher Australian dollar helps at the margin to contain inflation but there will be less help as the exchange rate falls. The Governor did not believe that 'what has happened to date is going to seriously derail us on inflation.'[31] On the upside, the lower exchange rate is positive for Australian exporters and the tourism industry.

2.31 The RBA reported that 'Australia's terms of trade are expected to have increased by around 20 per cent over the year to the September quarter but are then forecast to gradually decline.'[32] The RBA stated:

> Basically we think that the terms of trade will fall by around five per cent in the coming year. Basically what has happened in the past six months or so is that we have locked in a set of higher prices for the bulk commodities. The outlook for those is still good. Spot prices for coal and iron ore are still above the current contract prices, so there is a fair likelihood that those prices will stay high in the year ahead. But those markets have softened in the last couple of weeks. I think we are seeing the effects of the slowdown in global growth starting to come through in those markets and probably also the effects of the expanded supply putting some downward pressure on prices.[33]

United States, China and the global economy

2.32 The condition of the United States (US) economy as a result of the sub-prime mortgage crisis has been well documented. The RBA noted that 'conditions in the United States remain weak, with continuing falls in employment, housing market activity and consumer sentiment over recent

31 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 23.

32 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 59.

33 Dr M Edey, Assistant Governor of the RBA, *Transcript*, 8 September 2008, p. 28.

months.'[34] One of the prevailing questions is whether the US is in recession or will soon be. The RBA reported that the 'preliminary June quarter national accounts suggest that GDP growth was a little stronger than in the previous two quarters, although growth in domestic demand remained weak.'[35]

2.33 The RBA commented that despite the federal government's economic stimulus package, with around US$92 billion of tax rebates, 'consumer confidence is very low, and a period of household balance sheet repair now appears to be underway, as consumers adjust to higher inflation, rising unemployment and sizable declines in financial and housing wealth.'[36]

2.34 The Governor noted that while the US was one of the strongest performing G7 countries in the June quarter, 'most forecasters continue to be pretty cautious about prospects for the US economy in the second half of the year and are now also concerned about the sorts of credit losses that are routinely associated with a period of weak macroeconomic conditions.'[37]

2.35 China expanded rapidly during 2006 and 2007 but growth is now slowing. The RBA reported that 'year ended growth has declined from a peak of over 12 per cent in mid 2007 to around 10 per cent in the June quarter of this year.'[38] The Governor stated:

> China wanted to slow down and needed to slow down. There has, I think, been pretty clear evidence of overheating in that economy. How far will they slow? I do not know. The latest growth figure would be about 10 per cent over the year. I think most forecasters probably have a slightly lower number for the year ahead but still not that much lower. Another question which is important for Australia is the extent to which China suffered from the loss of exports to the US and Europe. They clearly have suffered, and I think we can see that in the figures.[39]

2.36 Globally, growth is expected to decline in comparison to forecasts just six months ago. The Governor commented that 'the world economy actually expanded a little faster than we had expected into the early part of 2008,

34 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 6.
35 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 6.
36 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 6.
37 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 3.
38 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 8.
39 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 32.

but recent data for a number of countries have been weaker and we are assuming that weakish performance will probably continue in the near term.'[40]

Housing and household debt

2.37 The RBA reported that while household consumption increased moderately in the March quarter rising by 0.7 per cent to be 4.3 per cent higher over the year, it still represented a noticeable slowing from average quarterly growth of around 1.25 per cent during 2007.[41]

2.38 Measures of consumer sentiment have declined to levels not seen since the early 1990s. The RBA commented that the 'slowing in the pace of household spending is consistent with slower growth in disposable incomes and recent falls in household net worth.'[42]

2.39 In relation to household borrowing, household credit growth has slowed from an annualised rate of around 15 per cent in mid 2007 to an annualised rate of 7 per cent over the three months to June 'which is the slowest pace of growth since the early 1990s.'[43]

2.40 Some economists have pointed to the historical high level of household debt as a potential future problem for the economy. The RBA was more optimistic and stated that:

> …while household indebtedness is around historical highs and the interest burden has risen in the past few quarters, the latest data to June suggest that only a relatively small proportion of households are in arrears on their loans: non-performing loans account for around 0.4 per cent of the value of housing loans on banks' domestic books.[44]

2.41 In relation to housing prices, the RBA reported that residential property markets have weakened across the country since the beginning of the year. The RBA stated that 'nationwide house prices fell slightly in the June 2008 quarter, after rising by around 13 per cent over 2007.'[45]

40 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 4.

41 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 26.

42 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 27.

43 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 27.

44 RBA, *Statement on Monetary Policy*, 11 August 2008, pp. 27-28.

45 RBA, *Statement on Monetary Policy*, 11 August 2008, p. 28.

Capacity constraints

2.42 For several years the RBA has been discussing the risks associated with growing capacity constraints in the economy. The committee has previously noted that the economy has been growing for 17 years and capacity utilisation is close to full. At the February 2007 hearing, for example, the RBA reported that 'the factor most constraining further expansion is not insufficient demand but insufficient capacity, either of labour or capital or both.'[46]

2.43 Capacity constraints will lead to increasing prices and inflationary pressure. In particular, where growth is 4, 5 or 6 percent these capacity constraints will be reached more quickly. With growth reducing to the between two and three per cent, capacity constraints become less of a problem. The RBA confirmed that the risks to the economy from capacity constraints are reducing. The Governor stated:

> In some senses, it is a sign of success—by which I mean you actually want to be at full employment. You do not want to have huge amounts of spare capacity in the economy. But once you get to the buffers you have to slow down to not overdo it. That is what we were trying to say and trying to achieve. Now I think capacity constraints are easing a bit across a number of sectors. That is what the surveys are telling us. That is what you would expect if output growth has slowed down and will likely stay more modest for the next little while. The capacity constraints ease up; therefore the inflation pressure eases up and so on.[47]

46 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 2.

47 Mr G Stevens, Governor of the RBA, *Transcript*, 8 September 2008, p. 30.

Conclusions

2.44 The economic downturn arising from the US sub-prime mortgage crisis and the severe financial instability that arose in September 2008 focused the attention of governments around the world. A range of measures have been taken domestically and internationally to stabilise markets and provide financial certainty.

2.45 It is evident that the Australian economy is slowing. At the next hearing, the committee will scrutinise the Reserve Bank of Australia on its key forecasts for growth, inflation and employment.

Craig Thomson MP
Chair
23 October 2008