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Monetary policy and related issues

Review of the 2003 year

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

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

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

2.3 On the domestic front, the RBA revised its forecasts for GDP due to higher growth in the second half of the year, including a growth in domestic spending. At the public hearing in Melbourne in June 2003, the RBA forecast that GDP would grow by 3 percent in real terms

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

over the course of the 2003 calendar year. The RBA's revised forecasts at the December 2003 hearing were for GDP growth to finish a little higher at 3.5 percent.

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

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

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

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

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

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

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

Forecasts for 2004

2.7 Looking ahead, the RBA expects GDP to grow by 4 percent over the course of 2004. If the world economy continues to strongly grow, the RBA expects that GDP growth could be even higher.[4]

2.8 Over the course of 2004 the RBA expects the CPI to increase by 2 percent overall, with the higher Australian dollar impacting in the first half of the year. In other words, the profile for inflation will be U -shaped:

> … falling from its present 2½ per cent to below two per cent in mid-2004, then rising back to two per cent by end 2004, 2½ per cent by mid-2005 and, in our view, being under upward pressure thereafter.[5]

2.9 At the Brisbane hearing the Committee questioned the Governor about a solution to the current account deficit (CAD) at over 6 percent of GDP. Mr Macfarlane referred to the 6 percent as a peak and forecast the CAD would fall as the world economy grows and Australia's rural exports pick up.[6]

Inflation targeting and monetary policy

2.10 The *Second Statement on the Conduct of Monetary Policy* of July 2003 reaffirmed the understanding between the Treasurer and the Governor of the RBA on the operation of monetary policy in Australia. It states:

> In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the cycle while preserving a clearly identifiable benchmark performance over time.[7]

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

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

6 *Official Hansard*, 8 December 2003, Brisbane, p. 34.

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

2.11 The RBA has conducted monetary policy by targeting an underlying inflation rate of between 2 and 3 percent since 1993. At the Brisbane hearing the Governor stated that it is that average of 2 to 3 percent by which the RBA should be judged or made accountable. Over this 10 year period, inflation has averaged 2.4 percent.[8]

2.12 At the May 2002 hearing the Governor suggested that a neutral interest rate is inflation plus between 3 and 3.5 percent.[9] At the most recent hearing in Brisbane, however, the Governor added a caveat to the idea of a 'normal' interest rate: it is a general guide only and it is not essential to fit within the range 'come what may'.[10]

2.13 Mr Macfarlane referred to the RBA's most recent moves in interest rates as a gradual process of 'returning interest rates to more normal levels'. The Governor explained that if the RBA had maintained the low level of interest rates, there would have been a gradual build-up in inflationary pressures as the growth rates of the world and Australian economies rose.[11]

2.14 The Governor emphasised that the RBA does not try to finetune inflation:

> What we try to do is get the impression of where we think the forces are coming from. In our view, had we persevered with that lower level of interest rates then, in time, forces would have built up which would have meant that, in that two- to three-year horizon, in all probability inflation would be on an upward trajectory—and not just a temporary one but one that you would have to do something about. So that is why we did it early.[12]

2.15 The Governor claimed the RBA had been accused of setting monetary policy in relation to the Sydney and Melbourne housing markets and ignoring the rest of the country. He stated, however, that this cannot be true given housing prices in Sydney and Melbourne had already started to fall. The Governor also made it clear that the purpose of tightening monetary policy was not to cool down the property market.

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

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

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

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

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

> It was only when it became clear that good economic growth had returned both globally and domestically that rates were raised. I have often stressed that monetary policy has to be set taking into account the average of all the parts of the economy, not just what is happening in one sector.[13]

2.16 In summarising the RBA's monetary policy framework, the Governor stated:

> I want to assure the committee that the bank remains committed to the inflation targeting framework and that decisions taken over the past 18 months have been fully consistent with that approach. It does not seem plausible to us to argue that the bank could have been confident of meeting its inflation commitments if interest rates had been held at 30-year lows in the face of the pick-up in the international and domestic economies that is currently under way.[14]

Monetary policy in other countries

2.17 In discussion on comparisons with central banks in other world economies which had not increased interest rates, the Governor maintained that Australia's economy 'is in much better shape'. The Governor claimed that many economies are still recovering from the aftermath of bursting asset price bubbles or recessions, and therefore may not change interest rates before they are fully confident of recovery.

2.18 The Governor claimed that, even though the RBA has increased interest rates, Australia's economy has been growing better than comparative countries around the world and this is something to be pleased with:

> I think we should in some sense rejoice in that rather than look on the gloomy side of things and say, 'Oh, but our interest rates are higher.' The two things go together, and I know which one I would prefer to have—a good healthy economy with normal interest rates, rather than a sick economy with low interest rates.[15]

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

14 *Official Hansard*, 8 December 2003, Brisbane, p. 5.

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

Household debt

2.19 Household credit continued to grow strongly in 2003, at about 21 percent over the year to September 2003. Of this, housing credit was growing at an annualised rate of 25 percent.[16] About 85 percent of household debt is housing debt and credit card debt makes up around 6 percent.

2.20 About 30 percent of households in Australia have a mortgage, 40 percent own their house outright, and 30 percent are renting. The Governor noted that about 1.3 million people have invested in rental property and it is sections of this group which may be vulnerable to interest rate rises; even modest rises in interest rates and falls in certain sorts of property prices will cause distress. [17]

2.21 The Governor stated he did not believe the distress will be for owner-occupiers, although some who have taken out the most expensive mortgage they can afford may be vulnerable:

> Of the people with a mortgage, somewhere between 50 and 60 per cent probably will not actually have their weekly payment go up, because they are already ahead on their repayment schedule. So, rather than 30 per cent, it is maybe 15 per cent of households that will see their monthly mortgage payment go up. I feel sorry for people who have just taken out a mortgage and interest rates go up, but you cannot really make economic policy on the basis of that.[18]

2.22 The Governor emphasised that there are always people at the margin who are going to be vulnerable to either a rise in interest rates or a fall in interest rates. For example, self-funded retirees may be vulnerable to a decrease in interest rates. The Committee notes the Governor's comment in Brisbane that "at the end of the day we have to make the monetary policy decision on what we think is best for Australia".[19]

2.23 In discussion on the effect a half-a-percent increase in interest rates would have on the behaviour of borrowers, the Governor stated:

> It is not a very big squeeze on people, but in some areas it has already had quite a big impact on people's expectations about

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

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

18 *Official Hansard*, 8 December 2003, Brisbane, p. 22.

19 *Official Hansard*, 8 December 2003, Brisbane, p. 23.

> whether they want to borrow. It is not whether they can afford to; a lot of it is whether they really want to borrow at the same rate. If a lot of this borrowing was generated by housing, there is evidence that attitudes have changed to some extent—not a lot.[20]

Exchange rates

2.24 **Over the last two years the Australian dollar has risen 45 percent against the US dollar.** The Governor assured the Committee that these factors are taken into account, along with many other variables, when making assessments on monetary policy.

2.25 The Governor also made the point that the Australian dollar did not rise due to interest rates rising. Rather, it can be explained by two factors – firstly, the return from a very low figure during the Asian economic crisis, and secondly, the fall of the US dollar against all currencies:

> The US dollar has fallen by 23 per cent against [the major floating currencies] and it has fallen by 29 percent against the Australian dollar – or ours has risen by 29 percent against the US dollar. In other words, 23 of the 29 is basically the US dollar falling against everyone.[21]

2.26 Besides these two factors, the Governor claimed that the recent lift in the Australian dollar is also influenced by the growing world economy and Australian economy and the rise in many commodity prices. The Governor stated that while interest rates do have an effect on the exchange rate, these other factors are driving it:

> I do not want to use that to say that interest rates do not matter, because they normally do. They are normally quite important. They are a bit difficult to quantify over any particular period but quite important. At the moment I think the big dynamic on the Australian dollar is being driven by the weakening US dollar, the strengthening world economy and rising commodity prices. They are doing most of the work. Even if we were to change our view of the world and say that we are no longer going to conduct monetary policy

20 *Official Hansard*, 8 December 2003, Brisbane, p. 16.

21 *Official Hansard*, 8 December 2003, Brisbane, p. 9.

> for the whole economy but we are going to try and direct it at what is happening to the exchange rate—that is, by not raising interest rates—I would doubt whether it would have much effect, just as in New Zealand the fact that they did not put up their interest rates had no effect.[22]

2.27 The Governor also claimed that moves in the exchange rate do not have the same effect on inflation as they have done in the past:

> We do spend a lot of time looking at this issue of how changes in the exchange rate flow through to inflation. We are finding that it is symmetrical, that the falls in the exchange rate were not as inflationary as they would have been 10 or 20 years ago and the rises in the exchange rate are not as disinflationary as they would have been.[23]

2.28 The Governor also stated that rises or falls in exchange rates have not affected product prices to the same extent as in past years; businesses are absorbing the changes in profit margins.[24] However, the Committee notes the growing pressure on many exporters, particularly as in January 2004 the Australian dollar went up to US80c.

2.29 At future hearings the Committee will revisit this issue, and the tension between the exchange rate (including the effect on the export sector) and the rapid rise in household debt in determining monetary policy settings.

Unemployment

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

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22 *Official Hansard*, 8 December 2003, Brisbane, p. 9.

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

24 *Official Hansard*, 8 December 2003, Brisbane, p. 11.

2.31 The Governor stated that there are skills shortages in some industries, for example, the building industry. The wage cost index is not showing any major rises, however, at the margin it is there. The Governor stated that it is certainly something that is considered when the RBA makes a judgement about where inflation will be in two years time.[25]

25 *Official Hansard*, 8 December 2003, Brisbane, p. 15.