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Monetary policy and other issues

Overview

2.1 Strong global commodity prices continue to fuel Australia's sustained period of economic growth. In these expansionary conditions, the role of the RBA is crucial in ensuring that inflation is controlled and monetary policy facilitates the stability of the Australian currency and the maintenance of full employment.

2.2 It is widely recognised that Australia is experiencing capacity constraints – shortages of capital and labour – as a result of its strong and extended period of economic growth. The unemployment rate remains very low by historical standards, and the effects of this are further heightened by record high labour participation rates. At the February 2007 hearing, the RBA Governor, Mr Glenn Stevens, took care to point out that full employment is a goal of monetary policy and as such, should be welcomed.[1]

2.3 Job vacancies continue to increase, and strong demand for labour is confirmed by a range of business surveys and liaison reports. A high level of business investment, however, is expected to bring about expansions in capacity, particularly in the resources sector.[2]

2.4 In the present environment of full capacity utilisation, the moderating growth and domestic demand that has been seen in recent quarters is

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

2 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 4.

considered a positive development. Mr Stevens emphasised that growth in aggregate demand needs to slow down to be more aligned with the rate of growth of the economy's productive capacity.[3]

2.5 Favourable conditions in global commodities markets have created an expansionary environment in Western Australia, however Mr Stevens highlighted the spread of these effects throughout the country.[4] Resources have been shifting to areas where they are most needed, and employment growth is strong in all states.

2.6 In mid 2006, the economy experienced a mild pick-up in inflation as a result of solid economic growth and the associated capacity constraints. This had been anticipated by the RBA with adjustments to interest rates in May and August. The Bank made a further adjustment in November 2006, taking the cash rate to 6.25 per cent.

Forecasts for 2006/07

2.7 The RBA reported that the world economy is expected to continue growing strongly with 'most observers expecting world growth in 2007 to be a little below last year's pace, but still above trend.'[5] This solid global growth is expected to support an increase in Australian exports over the coming period, 'although in the near term higher resource exports will be offset by a decline in the volume of rural exports.'[6]

2.8 The RBA predicted that while farm GDP could reduce overall GDP growth by around half a percentage point in the coming year, conditions are expected to remain solid in the rest of the economy. The Australian economy has experienced an easing of its previous high rates of growth in business investment, but the RBA reported that the level of investment remains high and should continue to add to the nation's capital stock.[7] Household consumption and housing construction activity are both expected to exhibit growth, supported by firm underlying housing demand.[8]

3 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 3.

4 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 22.

5 RBA, *Statement on Monetary Policy,* February 2007, p. 1.

6 RBA, *Statement on Monetary Policy,* February 2007, p. 27.

7 RBA, *Statement on Monetary Policy,* February 2007, p. 2.

8 RBA, *Statement on Monetary Policy,* February 2007, p. 27.

2.9 During the February 2007 hearing, Mr Stevens suggested that the RBA was 'considerably more comfortable'[9] with inflation expectations now than it was in August or November 2006. The RBA reported that a range of measures suggest that underlying inflation was around 3 per cent over 2006.[10] The Bank forecast underlying inflation to fall to 2¾ per cent in 2007 and 2008.[11] At the February hearing, Mr Stevens also discussed the RBA's forecast of headline inflation:

> We will see some very big movements in CPI inflation over the coming year. It will fall quickly over the next six to nine months, from over three per cent currently to less than two per cent on an annual basis, as falling petrol and banana prices have their effect. They are, of course, temporary impacts on the annual inflation rate and, as they fade, the CPI headline inflation rate, measured on an annual basis, will go back up again to, we think, around 2 ¾ per cent by this time next year and remain at around that rate after that – that is, it will be lower than the rates we have seen in the past year or so but closer to the top, rather than the bottom, of the two to three per cent target range.[12]

2.10 The RBA cautioned that 'many of the factors that have pushed up underlying inflation over the past few years persist.'[13] During the February hearing, Mr Stevens elaborated on these risks:

> Most of the indicators we have available still suggest a very fully employed economy, so there would be some risk of inflation remaining uncomfortably high were demand growth to be unexpectedly strong in the near term. The outlook for demand and the extent to which capacity constraints are being eased in a range of sectors will be key elements in forming a judgement about the inflation outlook and the appropriate stance of policy.[14]

2.11 The Governor was also asked whether interest rates were more likely to rise or fall. He responded:

> If you think the [underlying inflation] forecast is in the top part of the range and the distribution of possible surprises is symmetric – and that is what we would say at the moment – then the likelihood that you get some surprising set of events that takes us above the

9 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 7.

10 RBA, *Statement on Monetary Policy,* February 2007, p. 51.

11 RBA, *Statement on Monetary Policy,* February 2007, p. 55.

12 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 5.

13 RBA, *Statement on Monetary Policy,* February 2007, p. 55.

14 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 5.

> target is higher than the likelihood that you would get a set of events that takes us below. It follows more or less axiomatically from that that, as a statement of probability, a rise is more likely than a fall.[15]

Inflation targeting and monetary policy

2.12 The *Third Statement on the Conduct of Monetary Policy*, agreed on 18 September 2006 between the Treasurer and the new Governor of the Reserve Bank, Mr Glenn Stevens, outlines the objective of monetary policy and provides an inflation target.

2.13 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. [16]

2.14 The Third Statement on the Conduct of Monetary Policy also states that

> 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]

2.15 The statement also outlined the new Governor's intention to continue to report to the House of Representatives Standing Committee on Economics, Finance and Public Administration twice a year.

The "neutral level" of interest rates?

2.16 During the August 2006 public hearing, the former governor, Mr Macfarlane, was asked whether the prevailing interest rate was 'neutral'. Interest rates are generally referred to as 'neutral' if they are not

15 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 6.

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

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

having an expansionary or contractionary effect on the economy. Mr Macfarlane responded:

> 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 percent 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.[18]

2.17 Since Mr Macfarlane appeared before the committee in August 2006, the Reserve Bank Board has increased the cash rate once, by 25 basis points, on 8 November 2006, to 6.25%. The RBA has reported that underlying inflation rate is currently 'around 3 percent'.[19]

2.18 At the February 2007 hearing, Mr Stevens indicated that current interest rates are 'mildly on the restrictive side of neutral'.[20]

Monetary policy in an election year

2.19 During the hearing, Mr Stevens was asked whether the Reserve Bank would be sensitive to the fact that 2007 is an election year when considering possible adjustments in monetary policy. Mr Stevens stated:

> There seems to be a view abroad that there is some almost unspoken tradition that we do not adjust rates in an election year. I have seen a number of references to my predecessor supposedly having said that. I do not recall that he did say that. What I can recall is that he said we would not be all that keen to be changing them in the election campaign. I know that the political process often talks about being in permanent campaign mode, but what I think he meant by that was the formal campaign in the month prior. He also said that if it had to be done it would be. So I do not accept, and I do not think we ever could accept, the idea that in an election year – which, after all, is one year out of three – you

18 Mr I Macfarlane, Governor of the RBA, *Transcript,* 18 August 2007, p. 31

19 RBA, *Statement on Monetary Policy,* 12 February 2007, p. 55.

20 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 24.

> cannot change interest rates. When you think about that, I do not think any central bank could accept the notion that somehow a rate change is off limits for one year out of three. That would be crazy. So the answer to the question is: if in August it needs to be done it will be done.[21]

Exchange rates and external trade

2.20 Australia's terms of trade, defined as the ratio of our export to import prices, continued to rise solidly through 2006 due to the strength of commodity prices, which drove export prices up by seven per cent in that year.[22] This rise brings the increase over the last three years to 30 per cent, and the terms of trade are now estimated to be at their highest level since the 1950s. However, the RBA noted an easing in the growth of commodity prices in recent months, resulting from expansions in supply and a possible slowing of growth in demand.[23]

2.21 At the February 2007 hearing, Mr Stevens indicated that 'our judgement remains that Australia's terms of trade will be higher on average over the years ahead than they tended to be through the 1980s and 1990s'.[24] Mr Stevens added:

> For macroeconomic policy, it is a matter of ensuring that the economy adjusts to the change as smoothly as possible. That task is considerably easier today than it once would have been. A more flexible economic structure, a floating exchange rate and a better macroeconomic policy framework mean that the adjustment is proceeding much more smoothly than it did on some other occasions in history when the terms of trade rose steeply. As a result, such adjustments to monetary policy as have been needed have been gradual.[25]

2.22 Export values have exhibited strong increases, predominately driven by growth in prices, accompanied by only modest increases in volumes. However, 'growth in the volume of overall resource exports is expected to pick up solidly over the coming year, supported by the completion of a

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21 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 10.

22 RBA, *Statement on Monetary Policy,* February 2007, p. 13.

23 RBA, *Statement on Monetary Policy,* February 2007, p. 11.

24 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 4.

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

number of additional projects and a further easing in infrastructure bottlenecks, especially in the case of coal'.[26]

2.23 The RBA reported that the domestic demand that has outstripped output 'for some time' has been largely met by imports.[27] The volume of imports increased sharply in the December quarter, bringing growth to around 10 per cent over the year.[28]

2.24 The Bank noted that oil prices have fallen by around 25 per cent since their peaks in July 2006. This decrease 'appeared to reflect a combination of increasing supply from non-OPEC countries, some softening in growth of demand, and some easing in speculative pressures.'[29]

2.25 The RBA reported that the Australian dollar, supported by increasing terms of trade, appreciated by around four per cent on a trade-weighted basis in 2006.[30] While volatility of the currency has intensified in recent months, it has remained low by historical standards.[31]

United States, China and the global economy

2.26 The world economy continues to grow strongly. The RBA reported that 'the US economy has remained robust… [and] information on other parts of the world remains consistent with expectations of strong aggregate growth.'[32]

2.27 The RBA commented that 'consensus forecasts are for above-trend global growth of 4.7 per cent in 2007, down from 5.4 per cent in 2006, reflecting moderating in growth in most of the major regions.'[33]

2.28 The US economy remained healthy throughout 2005, despite concerns about a weak housing construction sector potentially bringing about a slowdown in economic activity. Mr Stevens stated:

> To date, at least, that risk does not seem to have materialised.
> Housing is quite weak there, but overall the US economy seems to

26 RBA, *Statement on Monetary Policy,* February 2007, p. 34.
27 RBA, *Statement on Monetary Policy,* February 2007, p. 2.
28 RBA, *Statement on Monetary Policy,* February 2007, p. 35.
29 RBA, *Statement on Monetary Policy*, February 2007, p. 12.
30 RBA, *Statement on Monetary Policy*, February 2007, p. 23.
31 RBA, *Statement on Monetary Policy*, February 2007, p. 24.
32 RBA, *Statement on Monetary Policy,* February 2007, p. 1.
33 RBA, *Statement on Monetary Policy,* February 2007, p. 5.

> have been recording growth pretty close to trend, even with that housing sector being weak.[34]

2.29 Inflation in the US has fallen since the middle of 2006 and the RBA reports that 'the Federal Reserve expects inflation to continue to ease as a result of lower energy prices and moderating domestic demand growth, although upside risks remain, especially from the tight labour market.'[35] US unemployment remains low at 4.6% in January 2007.

2.30 GDP in China continued to increase at around 10 per cent over 2006, for the fourth year in a row. The RBA reports that this growth 'has been concentrated in the business sector as rapid investment drives the development of the economy and the expansion of manufacturing capacity, and thereby exports.'[36]

2.31 During the February 2007 hearing, Mr Stevens discussed recent efforts in China to shift the emphasis from high levels of investment that it 'probably cannot sustain'[37]. Mr Stevens added

> There is always the risk, of course, that they somehow overdo it and the economy goes into a big slowdown. If that occurred, we would certainly notice that here, and so would the rest of the world. I think, for the past 10 years anyway, the authorities up there have done remarkably well managing things, given the rudimentary tools at their disposal. Even if China does have a big slump it will get up and run again pretty quickly because it is just that part of history where they are going to grow to be a very big economy. There will no doubt be a few trips along the way but they will get up and run again.[38]

2.32 GDP in the rest of east Asia continued to grow at a healthy pace in 2006, increasing by 5.3 per cent in the region.

Housing and household debt

2.33 Amidst rising employment and increasing real wages, consumer spending strengthened slightly in the December quarter.[39] The RBA reported that

34 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 3.

35 RBA, *Statement on Monetary Policy,* February 2007, p. 7.

36 RBA, *Statement on Monetary Policy,* February 2007, p. 9.

37 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 31.

38 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 31.

39 RBA, *Statement on Monetary Policy,* February 2007, p. 2.

real retail sales increased sharply in the December quarter, and consumer sentiment was above long-run average levels.[40]

2.34 The RBA noted that dwelling commencements and investment increased over the September quarter although preliminary data for the following quarter suggest some slowing in activity in response to the 2006 increases in interest rates.[41] Mr Stevens outlined the RBA's expectation of a 'gradual expansion in residential construction activity'[42] in the coming year.

2.35 At the February 2007 hearing, concerns were raised as to whether the existing level of household debt posed a significant risk to the economy in the event of a downturn. Mr Stevens explained that greater household leverage would exacerbate the effects of an adverse shock to income levels. However, Mr Stevens stated that 'there is not a great deal we can do about that, other than point out the issue and try to keep people aware of it when they make their decisions.'[43]

2.36 Mr Stevens was later asked about the potential risk of the range of financial products available to households allowing greater leverage. The Governor responded:

> To some extent, I do not think there is a lot wrong with the idea that someone who is asset rich and income poor in the later stages of their life ought to be able to access some of the equity. The question is really to do with at what price they do that and whether they are fully cognisant of the risks that they run. That really is the main question in many financial issues. [44]

2.37 At the February 2007 hearing, the RBA commented on the issue of apparently low levels of household saving. While national accounts figures indicate very low levels of household savings, the RBA suggested that this is a misleading measurement:

> Australian and US households hold a huge proportion of their wealth in financial assets where the return is coming from capital gains. Basically, they hold their financial assets in the form of equity, and the national accounts deliberately do not pick up capital gains on equities as part of the return… Australian households are actually in very good financial condition. It is just

40 RBA, *Statement on Monetary Policy,* February 2007, p. 28.
41 RBA, *Statement on Monetary Policy,* February 2007, p. 29.
42 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 4.
43 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 29.
44 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 35.

> that the traditional measures that are used to measure saving do not really apply to countries like Australia and the United States.[45]

Housing affordability

2.38 House prices rose by six per cent over the year to December across the nation, although there were significant differences between the states. The RBA reports that average capital city house prices have grown by around 175 per cent since the mid 1990s.[46]

2.39 At the August 2006 hearing, the then governor, Mr Macfarlane suggested that the public debate about housing affordability had placed too much emphasis on interest rate rises rather than the increasing cost of housing.[47]

2.40 At the February 2007 hearing, Mr Stevens was also asked about housing affordability, and he responded with a similar message:

> People worry greatly about affordability for those people and whether interest rates rises might make that affordability more difficult. But the real problem for those people is not that the rate of interest is high. We could argue about 25 or 50 points here or there but, by and large, interest rates today by historical standards, for those of us who remember earlier times, are low. The real problem is that house values are so high. Frankly, if one is really concerned about aspiring entrants to the home market, what you really want is lower prices.[48]

2.41 While the Governor emphasised that high house prices had a much greater effect on housing affordability than interest rates, he added that the effects are not independent. It was noted that the increase in house prices in the late 1990s was partially attributable to very low interest rates.[49]

2.42 With respect to the prospect of further increases in house prices, Mr Stevens reported that 'the evidence seems to be that the rate of growth of house prices has begun to slow down'.[50]

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45 Mr R Battellino, Deputy Governor of the RBA, *Transcript,* 21 February 2007, p. 29.

46 RBA, *Statement on Monetary Policy,* February 2007, p. 30.

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

48 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 25.

49 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 26.

50 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 8.

Rental market

2.43 The RBA reported continuing tightening in residential rental markets, resulting in the lowest national vacancy rate since the early 1980s. Information on new rental contracts further suggest significant rent increases, which are yet to be reflected in the ABS measures.[51]

2.44 At the February 2007 hearing, Mr Stevens suggested that low vacancy rates have come about because rental prices have not kept pace with house prices. This has resulted in an approximate doubling in price-rent ratios or a halving in rental yields, making it less attractive for investors to supply rental property, resulting in a shortage of supply. Mr Stevens stated that:

> In the period when the investor was getting a return from price appreciation he was getting some of the return that way, although rental yield did not seem to matter so much. But it is hardly sustainable for a major asset market to continually give you most of your return through capital appreciation. That does not sound to me like a sustainable equilibrium. Ultimately, the running yield, the rental yield, has to be higher than it has been. That is what is starting to happen. In time, as the rental yield improves, I expect there will be more interest on the part of potential investors to supply rental accommodation, so the market will work. But at the moment, you have a tight supply situation because the rental yield is very low—historically quite low.
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> One way or another it is going to need to rise. That could happen by the rentals going up; it could happen by the prices coming down… So one way or another that higher rental yield will need to be re-established and that will alleviate this excess demand situation.[52]

Growth and productivity

2.45 The RBA reported that the non-farm economy continues to expand at a moderate pace, although the effect of the drought on the farm sector has slowed growth of the economy as a whole.[53]

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51 RBA, *Statement on Monetary Policy*, February 2007, p. 31.

52 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, pp. 8-9.

53 RBA, *Statement on Monetary Policy*, February 2007, p. 27.

2.46 After a protracted period of growth, the economy is experiencing capacity constraints. At the February hearing, Mr Stevens was confident that the economy was adjusting well – with a flexible economic structure, a floating exchange rate and a better macroeconomic policy framework allowing a smooth transition as labour and capital resources shift to where they are most needed.[54]

2.47 During the hearing, the Governor was also asked about the apparent slowdown in productivity. He agreed that, according to the latest figures at the time of the hearing, employment growth was growing faster than GDP growth. Mr Stevens continued:

> Of course, over short periods, productivity is not an easy thing to measure, and that short-run relationship can have a lot of slack. So I would be wary of drawing strong conclusions based on that snapshot. Having said that, there are quite careful measures of productivity which can be made over longer periods, and they certainly do, on the face of it, suggest a slowdown.[55]

2.48 Mr Stevens added 'we cannot know whether this trend of a couple of years is now going to be a permanent state of affairs or not.'[56] Since the hearing, the RBA has stated that:

> [The March National Accounts] go some way towards resolving the apparent conflict between earlier soft GDP outcomes and the increase in employment growth in the second half of the year. A corollary of that is that the figures show a pick-up in estimated productivity growth. The Statistician's measure of market-sector GDP per hour worked rose by 1½ per cent over the latest year. This is reasonably close to its longer-run average, though it is still the case that average productivity growth over the past two to three years has been lower than it was earlier in the current expansion.[57]

"Two speed" economy

2.49 During the hearing, Mr Stevens was asked about the "two speed" domestic economy. He agreed that the impact of the relative change in the price of resources was not uniform across the economy. Western Australia

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

55 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 16.

56 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 32.

57 Mr M Edey, Assistant Governor of the RBA, Address to the Australia and Japan Economic Outlook Conference 2007, 16 March 2007.

and Queensland are benefiting more than the Southeastern states – a trend that is exacerbated by the effect on local producers of the relative decline in prices for some manufactured products.[58]

2.50 At the August 2006 hearing, the former RBA governor, Mr Macfarlane, suggested that unemployment rates are the best test of dispersion, given that growth rates do not take into account different rates of population growth.[59] At the February 2007 hearing, Mr Stevens made the point that, although New South Wales is growing below average, its unemployment rate has fallen, suggesting that 'the differences across the states, while noticeable, are perhaps not quite as big as popular opinion and commentary like to say.'[60]

2.51 Mr Stevens suggested that some level of regional difference is inevitable, and that the economy is well-equipped to handle these changes. He stated:

> This adjustment is proceeding considerably better than it might once have done. Labour and capital resources are shifting to the strong parts of the economy where they are needed. Relative wages in those industries are rising relative to others, and that helps the labour resources flow. That is what is supposed to happen in a shock of this nature. While it is not without a few bumps on the road, this adjustment is not proceeding too badly. [61]

Supply side (capacity) constraints

2.52 The RBA reported that businesses have been expressing difficulty in finding qualified staff for some time and maintain that 'the factor most constraining further expansion is not insufficient demand but insufficient capacity, either of labour or capital or both'.[62]

2.53 Mr Stevens noted at the February public hearing that the economy has 'approached what for practical purposes can be called full capacity, at least for the moment'.[63] However, business investment remains at a high

58 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 2.
59 Mr I Macfarlane, Governor of the RBA, *Transcript*, 18 August 2006, pp. 6-7.
60 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 8.
61 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, pp. 13-14.
62 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 2.
63 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 2.

level, 'adding to the capital stock of the country in a way which should, in time, ease capacity constraints'.[64]

Wages growth and a deregulated labour market

2.54 The RBA reported that the underlying annual growth in wages remains 'quite well contained'[65] at around 4 per cent.[66]

2.55 At the February 2007 public hearing, Mr Stevens discussed explanations as to why wages have not experienced an explosion, despite record high participation levels and labour shortages across a number of important sectors.

> I think there are probably a few things at work. As I alluded to before, the fact that the system is less centralised means that industry or regional pressures do not flow over 100 per cent to other areas. A more enterprise focused set of labour market arrangements is also conducive to better outcomes. I think also that much better anchored expectations of inflation on the part of wage earners are also helpful in these episodes. If you think back to the mid-1970s, there was a very high rate of background inflation that was tending to give impetus to wage claims in a way that does not happen any more because inflation is so much better controlled now. It is our job, of course, to make sure that that continues to be the case. So there are a whole range of things at work to produce what to date has been a pretty good outcome.[67]

2.56 During the February hearing, the Governor was asked about the potential impacts of a tightening of the labour market. He responded that rigid labour markets are prone to large wage increases unconnected to productivity. This 'probably would constitute something of a problem for managing resource booms like we presently have.'[68] However, Mr Stevens went on to say:

> I am not sure whether you are suggesting that someone is proposing that outcome but, in that hypothetical case, I think that could be a problem. I am not sure that we will see that hypothetical outcome.[69]

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64 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 2.
65 Mr G Stevens, Governor of the RBA, *Transcript,* 21 February 2007, p. 13.
66 RBA, *Statement on Monetary Policy*, February 2007, p. 53.
67 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 13.
68 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 33.
69 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 33.

“Full employment”

2.57 During the February 2007 public hearing, the Governor was asked about tackling the issue of a shortage of labour. Mr Stevens stated:

> Labour is a resource for the economy, and if you have not got enough of it, that does constrain your growth. If we are all working, that is it, there is no more additional supply of labour and presumably that does constrain the economy’s growth rate from that point. But the question is: how big a problem is that? Everyone who wants a job can find one, that is what we want the labour market and the economy to do for us. The problem of full employment, as I said before, is a problem you would rather have—if ‘problem’ is the right word—than the alternative where there are a lot more workers than there are jobs for them to do. [70]

2.58 However, Mr Stevens also warned that aggregate demand must slow down when full employment has been achieved, or the economy faces the risks of ‘overheating, inflation and eventually another downturn’. The RBA predicted that ‘the more moderate pace of growth in the economy that we see today compared to a few years ago will be helping not to put further pressure on capacity’[71].

Drought and the farming sector

2.59 At the February 2007 public hearing, Mr Stevens reported that rural production and incomes will be considerably reduced in 2007 due to the drought.[72] The RBA reported that while non-farm GDP increased by 0.6 per cent in the September quarter of 2006, farm GDP was estimated to have fallen by 10 per cent in the quarter.[73]

2.60 The RBA estimated that the drought will not have a large impact on the CPI or interest rates, as effects are temporary.[74] However, it is anticipated that farm GDP could fall by around 20 per cent in 2006/07, reducing GDP growth by 0.5 per cent.[75]

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70 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 34.

71 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 26.

72 Mr G Stevens, Governor of the RBA, *Transcript*, 21 February 2007, p. 3.

73 RBA, *Statement on Monetary Policy,* February 2007, p. 27.

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

75 RBA, *Statement on Monetary Policy,* February 2007, p. 27.

The Hon Bruce Baird, MP
Chair
29 March 2007