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Monetary policy and related issues

Review of forecasts presented at the 2002 hearings

2.1 At the May 2002 public hearing held in Sydney (for the Committee's review of the RBA's *Annual Report 2001),* the Governor of the RBA, Mr Ian Macfarlane, advised the Committee of expected GDP growth for the 2002-03 financial year of between 3.5 and 4 percent. The hearing was preceded by the first increase in official interest rates since August 2000, from 4.25 to 4.5 percent, followed on 5 June 2002 by a further increase to 4.75 percent.

2.2 The Governor's candid advice at the May 2002 hearing was that the increase earlier that month was likely to be the start of a process of returning official interest rates to "a more neutral setting", as "the outlook for economic growth and inflation is such that the economy no longer needs the boost provided by an expansionary stance of monetary policy".[5]

2.3 However, the cash rate subsequently remained unchanged from the June 2002 increase until November 2003, when the rate was increased by 0.25 percent.[6] At the first of the hearings for the Bank's *Annual Report 2002*, held in Warrnambool in December 2002, the Governor noted that forecast GDP growth for 2002-03 had been revised down to

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5 *Official Hansard*, 31 May 2002, Sydney, p.3. See further discussion of the Governor's view of official interest rates under "normal" economic conditions at *Official Hansard,* 6 December 2002, Warrnambool, pp.10-12.

6 See "Statement by the Governor, Mr Ian Macfarlane: Monetary Policy", 5 November 2003 at www.rba.gov.au / MediaReleases / mr_03_15.html (as at November 2003).

3 percent due principally to the drought but also, to some extent, to a weaker world economy than had been anticipated[7] (paragraphs 2.10 to 2.17 refer).

2.4 At Warrnambool the Governor presented an updated forecast for economic growth of 3.75 percent for the 2003 calendar year, based on an assumption of a recovery from the drought in the second half of 2003, and a forecast for underlying inflation for the calendar year of approximately 2.75 percent (a slight downward revision to the figure advised in May 2002, due again to lower forecasts for world and Australian economic growth).[8]

2.5 At the June 2003 hearing in Melbourne the Governor presented a further update of those forecasts. He noted that the RBA, in its May 2003 *Statement on Monetary Policy*, had slightly reduced its underlying inflation forecast for the calendar year from 2.75 to 2.5 percent, due largely to the higher exchange rate for the Australian dollar (see further discussion of the inflation outlook at page 12).[9] On economic growth, the Governor advised that:

> …growth through the [2002-03] financial year will be close to the 3 percent forecast, or perhaps a little bit below it. We only have one more quarter of data to receive and then we will know the answer to that. As we look slightly further ahead, however, prospects are not as strong as they were. Instead of 3¾ percent through calendar 2003, we now think the figure will be more like 3 percent.[10]

2.6 Average economic growth for 2002-03, following release of the June quarter National Accounts, was 2.75 percent. GDP growth for the quarter stalled at 0.1 percent (for a final figure for 2002-03 of 2 percent), following a substantial fall in exports attributed to factors including weak world economic conditions, the drought, recent appreciations in the currency (see page 22), the war in Iraq and the SARS epidemic.[11]

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7 *Official Hansard*, 6 December 2002, Warrnambool, p.4.

8 *Official Hansard*, 6 December 2002, Warrnambool, p.4.

9 *Official Hansard*, 6 June 2003, Melbourne, pp.42-43; Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.53.

10 *Official Hansard*, 6 June 2003, Melbourne, p.42.

11 The Hon Peter Costello MP, “National Accounts: June Quarter 2003” (Media release, 2 September 2003), at *www.treasurer.gov.au/tsr/content/pressreleases/2003/076.asp?pf=1* (as at September 2003).

2.7 Mr Macfarlane attributed the reduced forecast for economic growth for the 2003 calendar year to the weaker performance of the world economy, and the subsequent negative effect on Australia's trade performance.[12] The RBA, in its May 2003 *Statement on Monetary Policy*, had noted that the decline in aggregate exports had been offset by an "exceptionally rapid" expansion in domestic demand. The combination of strong domestic demand and a weak external sector had resulted in a substantial widening of the Current Account Deficit (CAD) over the preceding year.[13]

2.8 In response to questioning from the Committee at the June hearing, the Governor noted that the CAD had widened to 5.3 percent of GDP:

> I will be very surprised if it does not go over 6 [percent] at some stage later this year. That is a pattern that we have had in Australia for 20 years or more: when we are doing well and the rest of the world is doing badly, our current account deficit goes over 6 percent. People could say, 'That's okay, but what if it goes a lot higher than that?' We cannot rule that out. If that were to happen, I think it would still be mainly a reflection of what we have been seeing, which is domestic demand in Australia being strong relative to the rest of the world. If that were to happen, would that lead to some disastrous result? I think it may well lead to a reaction, but I suspect the main reaction would be for people to become more wary about holding the Australian dollar and the Australian dollar would then start to go down.[14]

2.9 The CAD for the June quarter was subsequently confirmed as 6.7 percent of GDP; in line with the Governor's prediction, the Australian dollar fell to a three-month low after the announcement (US 63.81 cents at the close of trading on 28 August 2003), before resuming its upwards trend.

World economy

2.10 At the Warrnambool hearing in December 2002, the Governor noted that the international economic outlook had weakened over the second half of the year.[15] The continuing weakness in the world

12 *Official Hansard*, 6 June 2003, Melbourne, p.42.

13 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.2.

14 *Official Hansard*, 6 June 2003, Melbourne, p.58.

15 *Official Hansard*, 6 December 2002, Warrnambool, p.3.

economy remains a concern, as indicated by Mr Macfarlane at the June 2003 hearing:

> A return to firmer growth was expected early in 2003, but observers watching for signs of that quickly found the picture clouded by concerns about the growing likelihood of war in Iraq and then its actual occurrence. The relatively quick resolution of hostilities and the associated drop in the oil price was a major plus for the global economy compared with the possible alternative. Confidence recovered some ground, and attention returned to underlying economic trends, but the incoming data did not give any encouragement.
>
> It is now clear that a pick-up in global growth has not occurred in the first half of 2003. The international forecasting community have now pushed the forecast pick-up back to the second half of the year, though there are few signs in support of this.[16]

2.11 The Governor noted that two pieces of news from the United States had dampened the "short-lived optimism" that followed the end of the Iraq war and the fall in oil prices. The first was statements from the US Federal Reserve which were interpreted as suggesting that deflation was at least a possibility for the US economy, sending US bond yields to 45-year lows. The second was comments by the US Secretary of Treasury which were viewed as signalling that a declining US dollar was in the interests of the US economy. As explained by the Governor:

> …many countries which so far have enjoyed the stimulus of exporting to the United States when the US dollar was high will need to find domestic sources of expansion. There is a great deal of scepticism about how successful the two main areas outside the United States – Japan and the euro area – will be in this endeavour.[17]

2.12 It was in this general context that some overseas central banks reduced interest rates in the few days before the hearing – notably, a reduction of 0.5 percent by the European Central Bank the day before the hearing. The Governor, in explaining why the RBA had not followed suit, drew attention to Australia's stronger domestic

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16 *Official Hansard*, 6 June 2003, Melbourne, p.42. See also Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, pp.1-2.

17 *Official Hansard*, 6 June 2003, Melbourne, pp.44-45.

conditions and higher inflation than other countries, noting in particular the virtual absence of growth in the Euro area economy.[18]

2.13 The Governor stated that the “major risk” presently facing the Australian economy is the possibility of continued weakness in the world economy feeding through to our economy through a further weakening of exports.[19] He acknowledged that there had been differing opinions between the RBA and the Treasury (see page 44) on the magnitude of that risk, with Treasury placing “a higher risk of a big surprise on the down side”.[20]

2.14 The Committee asked Mr Macfarlane, “If there were a difference of view and a suggestion from Treasury that perhaps rates should be cut by a quarter of a per cent, then – looking at that as a policy move – do you think that would be sending an entirely wrong signal to the property market at the moment?”. The Governor responded that:

> It could, yes… there is a risk that that could give another final boost to a credit cycle that was very late in its maturity and was probably almost about to turn down. That would not be very helpful.[21]

2.15 In response to a further question from the Committee about the effect of international events on the direction of interest rates in Australia, Mr Macfarlane indicated that:

> What we really are talking about is whether interest rates stay the same or whether they go down… All the central banks around the world are grappling with that issue, and we are no different to the others in that sense.[22]

2.16 Following the June hearing, however, interest rates remained unchanged until the increase in November 2003, with the RBA citing as reasons for that increase improved conditions in the international and domestic economy and persistent high levels of credit growth (driven largely by housing investment; see page 15). In September 2003 Mr Glenn Stevens, the RBA’s Deputy Governor, had commented that while in early June a case to ease interest rates had looked like it was building:

> …it had not strengthened sufficiently by the time of the July [Board] meeting to warrant action. In August the case got

18 *Official Hansard*, 6 June 2003, Melbourne, p.45 and p.47.

19 *Official Hansard*, 6 June 2003, Melbourne, p.45 and p.47.

20 *Official Hansard*, 6 June 2003, Melbourne, p.51.

21 *Official Hansard*, 6 June 2003, Melbourne, p.52.

22 *Official Hansard*, 6 June 2003, Melbourne, pp.46-47.

> weaker, and it got weaker again by early September. Essentially what happened was that the risks to growth from abroad abated, while those posed by the rapid rise in [household] debt did not.[23]

2.17 The Committee's next hearing with the RBA, on 8 December 2003, will provide an opportunity for the RBA to elaborate on the reasons for the November 2003 rate increase and the impact of the improving world economy.

Overview of the domestic economy

2.18 As already noted, economic growth for 2002-03 was 2.75 percent. While a reduction on previous years, the growth figure nonetheless represents 12 consecutive years of expansion for the Australian economy, a remarkable performance by international standards.[24]

2.19 At the Melbourne hearing the Governor offered the following general overview of the economy[25]:

- domestic demand continues to grow at a high rate – while some deceleration from the current rate of approximately 5.5 percent is expected, "the most recent data do not suggest that the deceleration will be large";
- consumption had grown by 3.5 percent over the year to the March quarter with more recent data, such as retail trade, showing good rises in March and April 2003. Prospects for consumption look "quite good", given growth in employment and incomes and consumer confidence above its longer-term average. Private investment is similarly holding up well, with growth for the year likely to be in the order of 10 percent;
- most surveys show above-average results for business conditions and business confidence. The corporate sector as a whole is in "excellent financial health", with conservative gearing, good profitability and ready access to credit (albeit not being utilised to a great extent because of ready access to internal funds). According to the RBA's May 2003 *Statement on Monetary Policy*, the current

23 Address to the Australian Business Economists and the Economic Society of Australia (NSW Branch) quoted in Reserve Bank of Australia, *Bulletin*, October 2003, p.15.

24 See also table in *The Economist*, 24 May 2003, in which Australia's GDP forecasts saw it assessed as having better growth prospects than all other economies surveyed, including 11 European economies, the United States, Japan and Canada.

25 *Official Hansard*, 6 June 2003, Melbourne, pp.42-43.

upswing in business investment appears to have "some way yet to run" – business surveys suggest further expansion in aggregate investment and there is a large volume of work outstanding in a range of resource and infrastructure projects[26]; and

- employment had grown by 2.5 percent over the preceding year, with the unemployment rate of 6.1 percent (as at the June 2003 hearing) being "about as low as it has been in the present expansion".

2.20 The Governor noted that although overall growth had been good, the experience amongst different industries was varied. Large sections of agriculture are still suffering the consequences of the drought, and the tourist and international transportation sectors had suffered a sharp fall in activity associated with the public reaction to the SARS virus, compounding the drop in travel associated with the Iraq war.[27]

2.21 In relation to the state of the domestic economy and monetary policy settings, the Governor concluded that, overall:

> …an examination of the domestic economy leads us to conclude that there is little or no evidence to suggest that monetary policy has been too tight or is currently exerting a restrictive influence on domestic demand. But that is only part of the story, and possibly the smaller part. Policy must also take into account the impact of international forces.[28]

Impact of the drought

2.22 In relation to the economic impact of the drought, the Governor advised the Committee (based on information from the Australian Bureau of Agricultural and Resource Economics, ABARE) that farm production had fallen by approximately 30 percent in 2002-03, taking approximately 1 percent off GDP.[29] With the breaking of the drought, ABARE is forecasting a rebound in agricultural production, adding approximately 0.75 percent to GDP in 2003-04.[30]

26 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.28.

27 *Official Hansard*, 6 June 2003, Melbourne, p.43.

28 *Official Hansard*, 6 June 2003, Melbourne, p.44.

29 The Treasurer similarly noted, upon the release of the June 2003 National Accounts, that "the ABS estimates that the drought reduced agricultural production by 28.5 percent in 2002-03, subtracting 1 percentage point from overall GDP growth". See the Hon Peter Costello MP, "National Accounts: June Quarter 2003" (Media release, 2 September 2003), at *www.treasurer.gov.au/tsr/content/pressreleases/2003/076.asp?pf=1* (as at September 2003).

30 *Official Hansard*, 6 June 2003, Melbourne, p.61.

2.23 The Governor also noted, at the Warrnambool hearing, that the drought had not had the adverse impact on farm debt and capacity to service that debt that might have been expected, based on past experience:

> Farm debt is not actually rocketing up… Farmers have been quite responsible. In the good seasons, they have paid down their debt; they have put money away in farm management deposits…
>
> I think it is one of the success stories of financial management over the last five years – the way the farm sector has managed to reduce its debt and build up these deposits.[31]

2.24 The Governor indicated that the RBA did not have the authority to direct commercial banks in relation to lending to the rural sector, and that if the government felt that the banks "were not being sympathetic to farmers or were taking too short run a point of view" it would be up to the government, rather than the RBA, to attempt to influence the banks.[32]

2.25 The Committee's own discussions with the banking sector would suggest that the banks have taken a more prudent, long-term approach than during previous droughts, when in some instances an inflexible attitude did substantial harm to individuals and businesses in the rural sector and to the image of the banks themselves.

Inflation outlook

2.26 The RBA has a formal target range for underlying inflation of between 2 and 3 percent. The inflation outlook is therefore a major determinant of interest rate policy, with implications for mortgage repayments, new business investment, the purchase of consumer durables, and – given the implications for the exchange rate – the well-being of farmers and other exporters.[33]

2.27 At the June 2003 hearing the Governor advised that consumer prices were rising at 3.4 percent per annum and wage costs at about 3.6 percent. Inflation had been close to, or above, 3 percent (the top end of the RBA's target range) for more than a year. According to the Governor:

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31 *Official Hansard*, 6 December 2002, Warrnambool, pp.12-13. See also pp.17-18.

32 *Official Hansard*, 6 December 2002, Warrnambool, p.37.

33 Briefing material prepared by the Parliamentary Research Service.

> This would be a source of concern if we expected the situation to persist long enough to become entrenched in expectations but, as I said earlier, inflation is likely to decline in coming quarters and overall growth in labour costs is consistent with our inflation target. So the inflationary situation is not a cause for concern.[34]

2.28 The Governor's assessment has since been reiterated in the August 2003 *Statement on Monetary Policy*, in which the RBA advised that due to further net appreciation of the Australian dollar, year-ended underlying inflation appears likely to further decline to 2 percent in the first half of 2004.[35]

2.29 The outlook for wage costs – which account for approximately 70 percent of the movement in prices – also suggests a benign inflation outlook. The budget forecast for wage increases in 2003-2004 is just 2.75 percent.[36]

Deflation

2.30 At the Melbourne hearing the Committee asked the Governor whether the Australian economy was at any risk of deflation, given the deflation experienced in some Asian economies and the risk of deflation in some European countries. Mr Macfarlane responded by noting that a recent IMF study had classified the world into four groups, with Australia in the group least likely to suffer from deflation. The RBA's Deputy Governor, Mr Glenn Stevens, added:

> It is true that there are several countries in Asia which are now experiencing, or have recently experienced, falling prices. Taiwan, if they are not there, are close. Hong Kong, of course, has had quite a pronounced deflation. China has had some, though in China at present they are back to a very slight positive inflation rate. Japan, of course, has had declining prices for several years and they, I think, are the clearest case of the bad form of deflation, which is due to chronically weak demand and which arguably feeds back into making demand weak again, so that you get a kind of vicious cycle. Apart from them, one has to say that inflation rates generally in most industrial countries are quite low and they are tending to fall, so it is not at all inconceivable that one or two more countries might find prices declining at some point

34 *Official Hansard*, 6 June 2003, Melbourne, p.43.

35 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2003, p.56.

36 Briefing material prepared by the Parliamentary Research Service.

> briefly during the current downswing… If the question is: is this likely to be a problem which we confront? I think that is quite unlikely. For a start, we are starting with a higher inflation rate than most countries. A lot of things would have to go wrong around the world for us to find ourselves in deflation, so I regard that as a very low likelihood outcome.[37]

Unemployment and monetary policy

2.31 The Committee asked the Governor about the extent to which the unemployment rate is taken into account in determining official interest rates, given that the *Reserve Bank 1959* requires the RBA's Board to conduct monetary policy in a way that will best contribute to factors including "the maintenance of full employment in Australia". Mr Macfarlane responded that the Board interprets that requirement in the Act to mean the provision of sustained economic growth, "which is an absolute necessity for getting any employment growth".[38] He added that employment outcomes are subject to factors over which the RBA has no control, such as minimum wages, hiring and firing conditions and award structures.

2.32 In response to a further query as to whether the RBA should continue to focus heavily on inflation when determining monetary policy settings – given that inflation has been moderate for some time – or whether other factors such as employment should now be given greater prominence, the Governor stated that:

> The reason you have an inflation targeting regime when you do not have an unemployment targeting regime is not because you are not interested in unemployment, not because you think it is unimportant; it is because history has told you that you can achieve a particular inflation rate with monetary policy but you cannot achieve a particular unemployment rate just with monetary policy; it depends on all these other factors. That is why not just Australia but so many other countries have an inflation targeting regime, not an unemployment targeting regime, even though they may be equally or more interested in employment in the long run than in inflation.[39]

37 *Official Hansard*, 6 June 2003, Melbourne, p.50.

38 *Official Hansard*, 6 June 2003, Melbourne, p.73.

39 *Official Hansard*, 6 June 2003, Melbourne, p.73.

2.33 On a related subject, the Governor was asked for his perspective on the extent to which inflexible unfair dismissal laws affect employment outcomes, based on the European experience:

> Most of Europe has unemployment rates well above ours. There are a few exceptions, but even then you have to look very closely. Some of the countries that have low unemployment rates have an incredible number of people on disability pensions, and if you were to put the two together you might get a fairer assessment… There is some evidence around the world that stringent unfair dismissal rules lead to higher levels of unemployment. This used to be summarised by people who contrasted the huge growth of employment occurring in America with the almost zero growth of employment occurring in Europe and said that the country that fires the most hires the most. That is why it is a big issue in some of these European countries. I think there is recognition that it enormously reduces the flexibility of their economies, and it makes firms very reluctant to hire if that flexibility is taken away from them. Once again, I am not an expert on the subject, but certainly a lot has been written about the capacity for creating jobs in countries with flexible labour forces and the difficulty of creating new jobs in the heavily regulated European economies.[40]

Housing sector

2.34 A major area of concern to the Committee, the RBA and other observers is the sustained growth of household credit – according to the Governor, far higher than in any comparable country – being driven by speculative activity in the investment housing sector. As explained by Mr Macfarlane at the Melbourne hearing:

> Aggregate credit has grown by 13 percent over the past year, which is quite a high figure in an economy where nominal GDP has grown by 6 percent. When we look more closely, we find that household credit has grown by 20 percent and that credit to the household sector for housing purposes has grown by 21 percent. Credit for investors in housing is estimated to be growing at about 28 percent. Thus, we have a situation where credit is growing a good deal faster than

40 *Official Hansard*, 6 June 2003, Melbourne, p.74.

> appears necessary to satisfy the needs of the economy. This situation is wholly due to credit being channelled into the housing sector. When we see figures of this order of magnitude it is hard not to conclude that a significant part of this must be directed to speculative purposes.[41]

2.35 At the Warrnambool hearing the Governor had similarly noted that a disproportionate amount of the upwards pressure on property prices was coming from investors in apartments. He expressed the fear that many of these highly-leveraged investors “are just assuming that things will work out”.[42] Mr Macfarlane took the opportunity to remind investors that they are making a commercial property decision, and drew attention to excesses in the commercial property market in the 1980s and the large price falls that followed.

2.36 At the Melbourne hearing the Governor warned that the rapid growth of household credit is presently the main domestic risk to the Australian economy.[43] He raised a worst-case scenario where the household sector “continue[s] putting itself into a more exposed position at the rate it has over the past few years”[44] at the same time as a sustained weakening of the world economy:

> …if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing – the credit driven house price spiral – also continues over that 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession… I do not think that is going to happen because I can see the speculative excesses starting to abate. At the moment, the jury is still out on the world economy. It is going ahead at an unsatisfactorily low rate, but it is still growth. It is not as though it is in recession. But if that were to happen – if it were to go into recession and the speculative excesses of the housing market were to continue – then there would be a huge amount of distress at the end.[45]

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41 *Official Hansard*, 6 June 2003, Melbourne, p.44.
42 *Official Hansard*, 6 December 2002, Warrnambool, p.5.
43 *Official Hansard*, 6 June 2003, Melbourne, p.45.
44 *Official Hansard*, 6 June 2003, Melbourne, p.46.
45 *Official Hansard*, 6 June 2003, Melbourne, p.53.

2.37 The Governor noted that 40 percent of people in Australia own their homes outright, while another 30 percent are renters. Of the 30 percent who have mortgages, "probably more than half" have a long-term mortgage that has run down. The issue arises with the increasing proportion of mortgage-holders who are at the vulnerable stage of holding the largest mortgage they can afford:

> There is always a proportion in that situation: the newcomers to the market.
>
> What is happening now is [that] more and more people are permanently staying in that vulnerable state. They go out and use the equity of their home to buy another property or something else, so they keep themselves at the vulnerable end. So, instead of only a small proportion of the population being at that vulnerable stage of life, there is now a much larger proportion of the population. I do not know what the numbers are – they are probably very small. Maybe it used to be 1 percent; maybe now it is 5 or 6 percent.[46]

2.38 The Governor had previously noted that while there is nothing new about middle and upper-income households in Australia seeking to purchase investment property, there have been two substantial changes since the 1970s and 1980s. The first change relates to bank lending practices. Whereas banks used to charge a penalty interest rate for investment housing loans, and demand a deposit up front, in the 1990s those constraints disappeared. Many more people are now able to access the investment housing market, to the extent of being able to make these major financial decisions "almost impulsively":

> …banks are actually advertising for you to come and borrow from them for this purpose [and] if you are persuaded to buy and you have a house with a bit of equity in it, you just go along to an insurance company and buy a deposit bond for hundreds of dollars – not thousands of dollars. The insurance company will then guarantee to the developer that the deposit will be paid upon completion, and you just sit back and wait for 18 months. The cost to you is negligible. Then suddenly, in 18 months when you take possession, you have to do a lot of things. You have to go and get the full finance. That may be the point when you start having regrets about what you did 18 months ago which was so easy to do at that time.[47]

46 *Official Hansard*, 6 June 2003, Melbourne, p.56.

47 *Official Hansard*, 6 December 2002, Warrnambool, p.14 and p.16.

2.39 The second major change is that nearly all the apartment projects in the current cycle have been pre-sold, meaning that a large proportion of the risk has been transferred from property developers to investors. Many of those investors may not be able to handle that risk in the event that they are unable to find tenants, or if they wish to sell in a secondary market where prices are much lower than the prices at which developers have pre-sold the apartments.[48]

2.40 The Committee asked the Governor whether he would like to see another financial tool – other than interest rates – available to contain the housing sector.[49] Mr Macfarlane responded that:

> We have another financial tool. It is called open-mouth policy, and I have been using it, but it may not be as effective as other tools you could conceive of. I am not putting in a plug for another instrument, although if in the longer run things turned out badly it would not surprise me if people started looking at other arms of policy – for example, tax policy. We have a tax regime in Australia which, compared to a number of other countries, is very favourable to property speculation. I am not saying 'Change it', but I would not rule out the possibility that if things do turn out badly there may be a public desire to make some changes.[50]

2.41 It is interesting to note, in light of the then market speculation about an imminent rise in interest rates, that at the Melbourne hearing the Governor rejected the view that this is the only means through which housing activity might be slowed down. While housing booms in the past have come to an end when interest rates have increased, usually a recession has occurred at the same time. In 1985 interest rates increased to 18 percent, but there was no recession and "very little effect" on the housing industry.[51]

2.42 The Committee asked the Governor whether he had spoken to the major banks about their lending practices. Mr Macfarlane, noting in passing that under the old regulatory system the RBA was able to impose a direct limit on how much banks could lend, indicated that while he had spoken to some CEOs, the body that has responsibility for the soundness of lending practices is the Australian Prudential Regulation Authority (APRA).[52]

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48 *Official Hansard*, 6 December 2002, Warrnambool, p.15. See also p.33.

49 See also *Official Hansard*, 6 December 2002, Warrnambool, pp.32-33.

50 *Official Hansard*, 6 June 2003, Melbourne, p.55.

51 *Official Hansard*, 6 June 2003, Melbourne, pp.48-49.

52 *Official Hansard*, 6 June 2003, Melbourne, p.55.

2.43 APRA has subsequently released the results of a "stress test" indicating that 90 percent of Australia's 120 regulated financial institutions, including the main home loan providers, could withstand a 30 percent slump in house prices over one year (it should be noted that an increasing number of mortgage originators are not regulated by APRA). Under such a scenario defaults on mortgages would increase from the current 0.12 percent to approximately 3.5 percent; however, losses incurred by the institutions would be less than 1 percent, with most of this covered by mortgage insurance.[53]

2.44 The banking sector would therefore appear to be in a position to withstand a sudden decline in the value of housing but, as the Governor noted, the capacity of individual households to withstand similar pressures is a different matter. APRA cautioned that borrowers are most vulnerable early in the life of a loan, as they have generally not built up substantial equity in their property, and noted that of the loans it surveyed, 42 percent were less than a year old and 77 percent were less than three years old.[54]

2.45 Also on the regulatory front, the Governor noted that the Australian Securities and Investments Commission (ASIC), which is responsible for investor protection, had attempted to limit the widespread growth of "investment seminars":

> …where people come along and get told how to get rich quickly by using the equity in their existing home to gear up and buy a couple more apartments. ASIC would love to stop that. The problem is they cannot demonstrate that these people are in fact financial advisers. If they were, they would have control over them. But the people who run the investment seminars say, 'No, we're not. We are humble real estate agents and we're not subject to your laws—we're subject to state laws'
>
> …I think there is a regulatory gap there. It is clearly a problem if there is one group of people who are holding seminars on how to invest your money who are regulated – the financial planners – and there is another group who are doing almost exactly the same thing, although doing it within the one asset class, which is property, who are unregulated.

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53 See "Banks Pass the Housing Crash Test", *Australian Financial Review*, 10 October 2003, p.1, and "Bank Regulator Warns of Loans Risk", *The Australian*, 10 October 2003, p.2.

54 See "Bank Regulator Warns of Loans Risk", *The Australian*, 10 October 2003, p.2.

> So I think there is a need to extend the capacity for ASIC to do that.[55]

2.46 The Committee welcomes recent indications that both ASIC and the Australian Competition and Consumer Commission (ACCC) are endeavouring to curb the practices described by the Governor.[56] The Committee will continue to pursue this issue with all relevant agencies to ensure that the practices described by Mr Macfarlane are properly scrutinised – the Annual Reports of ASIC and the ACCC, like that of the RBA, stand referred to this Committee.

2.47 The RBA's May 2003 *Statement on Monetary Policy* cautiously asserted that forward indicators of building activity have been pointing to a "fairly gradual" downturn for some time, with activity underpinned by a backlog of unfinished work and strong demand for renovations.[57] At the June public hearing the Governor similarly suggested that there are some early signs that "a degree of commonsense" is returning in the most speculative hot spots in the real estate market:

> Investor interest in inner city apartments, particularly in [Melbourne], is well down and quite a number of proposed projects have been shelved. In addition, estimates of future vacancy rates are being revised upwards and rents are falling. If this interpretation is correct, it should in time be reflected in the normal statistical collections on credit and prices. But these statistics inevitably contain quite long lags, so they will be the last indicators to turn down.[58]

2.48 On this last point, in response to questions from the Committee the Governor cautioned that it would be a "policy mistake" for the RBA to wait for irrefutable proof that the speculative element has gone out of the housing market before taking any corrective action it deemed necessary.[59]

2.49 While there may be some early signs that the housing market is softening, the Committee notes that previous assessments that activity in the sector has peaked have proved to be premature. Australian Bureau of Statistics data indicate that borrowing for investment properties increased to a record $6.81 billion in August 2003, 5 percent

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55 *Official Hansard*, 6 June 2003, Melbourne, p.55 and p.59.

56 For example, recent action against Mr Henry Kaye's National Investments Institute launched by both the ACCC and ASIC.

57 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.3.

58 *Official Hansard*, 6 June 2003, Melbourne, p.45.

59 *Official Hansard*, 6 June 2003, Melbourne, p.48.

higher than the previous month and a 35 percent increase since August 2002.[60] The RBA has indicated that housing credit increased by 21.5 percent in the year to July 2003, while in the June quarter household debt grew by $32 billion – the largest quarterly rise on record – to a record $632 billion, again due mainly to continued increases in housing lending.

2.50 The RBA's August 2003 *Statement on Monetary Policy*, while again suggesting that activity in the housing sector has peaked, also noted that:

> Apart from inner Melbourne where apartment prices are falling, there are few signs yet of these pressures easing off. The latest indicators of housing prices continue to show strong growth in most areas, and new finance approvals for housing have been accelerating in the past few months.
>
> The risk presented by these developments is that, the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn. Banks report that they are taking a prudent approach to lending for housing [but] increasingly there are signs of worrying practices elsewhere in the financial system. This is not untypical of a prolonged bull market, and could cause a great deal of distress to the economy when the housing price cycle turns.[61]

2.51 The *Statement on Monetary Policy* noted that 7.6 percent of household disposable income is now servicing housing loans, a ratio approaching that of the late 1980s when mortgage rates were as high as 17 percent. A sudden correction in the property market would have severe consequences for over-extended households and for the wider economy. The veracity of the Governor's assessment in Melbourne that "a degree of commonsense" is returning to the housing market will be a major focus of the Committee's public hearings for the RBA's *Annual Report 2003.*

Regional Australia

2.52 At the Melbourne hearing the Committee questioned the Governor on whether speculative real estate transactions pose an even greater relative risk in regional Australia. In many regional areas there has been a rapid rise in land values and property prices, due in large part to city dwellers taking advantage of increases in their property values

60 "Property Investment Loans Hit New High", *The Australian Financial Review*, 14 October 2003, p.4.

61 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2003, p.3.

to sell up and move to regional areas. The Governor responded that he did not think there was a serious financial risk involved:

> There is nowhere near as much risk in an owner-occupier buying a house to live in, because there is very little speculative element in that. The part that becomes risky is when someone signs up to pay for something that is going to be completed in 18 months time, and then at that point they hope to rent it out to someone else whom they do not know for a rent they do not know. That is where the really speculative element comes in. But if someone in the city whose house has gone up in value decides that they would prefer a different lifestyle and they sell their house in the city and move to the country, I do not find that in any way worrying. In fact, it is probably a very satisfactory development for Australia.[62]

Exchange rate

2.53 A rapid appreciation of the Australian dollar against the US dollar (due principally to a weakening US$) generated considerable public debate in the lead-up to the Melbourne hearing. In the last quarter of 2001 the dollar was valued at under US 50c. As can be seen in the graph below, which displays movements in the A$ against both the US dollar and the trade-weighted index, prior to the June 2003 hearing the exchange rate passed through the US 66c barrier, representing an increase of some 40 percent since late 2001.

62 *Official Hansard*, 6 June 2003, Melbourne, p.53.

2.54 At the time of the hearing there was concern about tension between monetary policy settings directed at speculative investment in the housing sector, and a perceived need for a rate reduction to moderate the rapid appreciation of the dollar to the benefit of Australian exporters.

2.55 In response to a direct question from the Committee as to which posed the greater risk to the economy – a large adjustment in house prices, or a further appreciation in the exchange rate with a negative impact on exports – the Governor responded:

> …depends on the orders of magnitude. Clearly, if the appreciation were big enough and it were hurting enough, that would be a much bigger factor than if the housing thing went up just a little bit more. It is all a function of the orders of magnitude. That is why the assessment changes every month as you get more information coming in.[63]

2.56 Members of the Committee expressed concern about the rapid rise in the Australian dollar and noted that financial markets appeared to have been surprised by the currency movements, with profit downgrades for many blue-chip companies prior to the hearing. Notwithstanding that the official interest rate of 4.75 percent had at that time remained unchanged since June 2002, the Governor rejected suggestions that monetary policy was too tight or that the RBA had been "asleep at the wheel":

> I want to reassure you that it is not as though we do nothing, not worry about [the exchange rate] until an alarm bell rings when it hits a critical level and then start thinking about it. The exchange rate is continuously feeding into the monetary policy decision. Every time you make a forecast of what you think economic activity or inflation is going to do, one of the important variables is the exchange rate. If the exchange rate has gone up between point of time A and point of time B then, other things being equal, your forecast for inflation will go down and your forecast for economic activity will go down, and that will influence your decision on monetary policy. It is continuously having an influence on our decision on monetary policy; it is not as though we have to wait for a particular level to be breached for us to start taking an interest in it.[64]

63 *Official Hansard*, 6 June 2003, Melbourne, p.51.

64 *Official Hansard*, 6 June 2003, Melbourne, p.49.

2.57 While the Governor acknowledged that risks would arise if the Australian dollar continued to appreciate at the rate experienced in May 2003, he rejected claims that the appreciation of the dollar in the lead-up to the Melbourne hearing could be labelled excessive. Mr Macfarlane pointed out that the trade weighted exchange rate had returned to roughly its post-float average, while the rate against the US dollar was, at that time, still well below the post-float average.[65]

2.58 While the rate of increase in the exchange rate has slowed since the hearing, the Committee notes that in October 2003 the A$ traded above US70c for the first time in six years, with concern being expressed by some exporters about the impact on their competitiveness[66], particularly given market speculation at that time that the next movement in interest rates would be an increase.

2.59 On a related subject, at the June hearing Committee members noted that the Current Account Deficit had performed similarly in 1997, around the time of the Asian economic crisis, but without the rapid appreciation of the dollar experienced in mid-2003. Committee members asked whether the dollar's appreciation needed to be curbed through monetary policy adjustments to cushion the economy against the growth in the CAD. The increase in the A$ appeared to be inconsistent with Australia's recent subdued trade performance, with past experience (notably during the Asian economic crisis) suggesting that the A$ should decline at times when there is concern about Australia's ability to export into a more sluggish world economy. Further, following the Asian economic crisis the RBA reduced official interest rates and for most of the period afterwards kept them at or below US official interest rates.[67] However, at the time of the Melbourne hearing the US federal funds rate was just 1.25 percent, compared with Australia's cash rate of 4.75 percent.

2.60 The Governor, while indicating that the differentials in monetary policy settings between Australia and the rest of the world (particularly the United States) were taken into account by the RBA, responded that:

> During the Asian crisis we did nothing. That was our great success: to do nothing. Everyone else tightened and we did not. We did not actually loosen, we just did not tighten, and

65 *Official Hansard*, 6 June 2003, Melbourne, p.45. See also p.57.

66 See for example "Strong Aussie – What a Drag", *The Age*, 10 October 2003. Some 25 percent of manufacturers recently surveyed by the Australian Industry Group cited an exchange rate of US70c as a trigger point for financial stress.

67 Briefing material prepared by the Parliamentary Research Service.

> we got through the Asian crisis very well. It is true the currency did weaken, but it did not weaken anywhere near as much as it subsequently weakened in 2000-01. So it turns out that our currency was more affected by the fashions of financial markets during the new economy age than it was by this very profound event: the Asian crisis. We actually entered this current phase of world weakness with an exceptionally low currency, as you know. The recession year was 2001, and in May 2001 we had an Australian dollar at 47c. So we entered this thing with an exceptionally low exchange rate, which is one of the reasons why it has gone up—the starting point was just so low.[68]

Impact of budget deficits on monetary policy

2.61 At the Warrnambool hearing the Committee questioned the Governor about the impact of budget deficits on the conduct of monetary policy. Mr Macfarlane indicated that the size of deficits or surpluses, at either the State or federal level, was for the most part no longer material to monetary policy:

> There was a time – basically pre-1982 – where the federal deficit, in particular, was of enormous influence on monetary policy, because that was a period when the government, if it had a deficit, could borrow from the Reserve Bank. Rather than issuing debt into the market, it would simply borrow from the Reserve Bank, which is what is colloquially known as ‘printing money’. In that era, in the Reserve Bank we spent more time looking at fiscal policy and the budget surplus than we did looking at monetary policy. But with the present set of institutions in place, if the government runs a deficit, it has to borrow from the public dollar for dollar at market-determined interest rates to cover that deficit, it does not have any immediate impact at all on our monetary policy. One could imagine that, if it was really huge, it might start to have an influence on long-term interest rates or something like that, but for the sort of order of magnitude that we are looking at the moment, it does not really have any impact.[69]

68 *Official Hansard*, 6 June 2003, Melbourne, p.60.

69 *Official Hansard*, 6 December 2002, Warrnambool, p.36.

Forward outlook for the Australian economy and monetary policy

2.62 The Governor suggested four possible scenarios for the Australian economy and monetary policy settings, based on the international and domestic risks he presented at the Melbourne hearing:

- a weakening world outlook together with a weakening domestic outlook (entailing an easing of domestic and asset market pressures) would provide a "reasonably clear prognosis" for monetary policy – that is to say, interest rate reductions;
- in the other direction, a combination of a clear strengthening of the world economy, and continued domestic buoyancy, would similarly "be easy" in terms of decisions about monetary policy – as subsequently was reflected in the reasoning for the November 2003 rate increase;[70]
- the most favourable outcome for Australia would be firming world economy and an easing in domestic pressures, resulting in "more balanced" economic growth;
- however, as mentioned at page 16 the combination that would be most damaging for the Australian economy would be if the household sector were to continue putting itself into a more exposed position while, at the same time, a further weakening of the world economy was starting to feed through to the Australian economy.[71]

2.63 In its May 2003 *Statement on Monetary Policy* the RBA expressed confidence that the prospects are for "a more balanced composition of growth" to emerge (ie, the third of the Governor's scenarios above), with less reliance on domestic demand and a smaller drag from the external sector.[72] The Committee will seek an update on this forecast at its next public hearing with the RBA, to be held in Brisbane on 8 December 2003.

70 See "Statement by the Governor, Mr Ian Macfarlane: Monetary Policy", 5 November 2003 at www.rba.gov.au / MediaReleases / mr_03_15.html (as at November 2003).

71 *Official Hansard*, 6 June 2003, Melbourne, pp.45-46 and p.52.

72 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2003, p.3.