

Monetary policy and other issues

Overview

- 2.1 The August 2007 hearing was conducted in the light of a strong domestic economy but at the same time some volatility on global markets as a result of growing problems in the US sub-prime mortgage market.
- 2.2 The strength of the domestic market was further demonstrated on 8 August 2007 by the decision of the Reserve Bank of Australia (RBA) to raise the cash rate by 25 basis points to 6.50 per cent. In explaining the rate rise, the RBA commented that 'domestic economic data in recent months have signalled a pick-up in the pace of growth in demand and activity.' In particular, the RBA noted that 'capacity utilisation is high after a lengthy period of expansion, and unemployment over recent months has continued to decline.' The RBA concluded that 'for some months, the Board has recognised that stronger economic conditions were likely to put upward pressure on inflation, notwithstanding some dampening influence from the higher exchange rate.'¹
- 2.3 The RBA noted that following the three rate adjustments in 2006 'the improving short term trend in inflation afforded us time to watch developments.'² However, the June 2007 quarter CPI showed a pick-up-in inflation which demanded an adjustment to monetary policy.

1 Reserve Bank of Australia, *Media Release*, Statement by Glenn Stevens, Governor, Monetary Policy, 8 August 2007.

2 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 3.

- 2.4 The RBA reported that growth picked up sharply in the December and March quarters. Real GDP is estimated to have expanded by about 3.75 per cent over the year to March.
- 2.5 In this growth environment the demand for labour has continued to expand. Unemployment is at its lowest rate for over 30 years and job vacancies are high.
- 2.6 The global economy remains strong with estimates of growth for 2007 likely to be over 5 per cent. In particular the growth and demand from China and India is significant.

Forecasts for 2007-2008

- 2.7 Global economic growth remains favourable. The RBA reported that 'current expectations of official and private-sector observers are that the world economy will continue to grow at an above-average pace in both 2007 and 2008.'³ Slower growth in the US is expected to be offset by stronger growth in China and other major economies.
- 2.8 Problems in the US sub-prime mortgage market have resulted in some volatility on world financial markets. The RBA concluded that 'the extent to which these financial events might affect global growth remains uncertain.'⁴
- 2.9 Growth in the domestic economy also remains strong. Prices for commodities remain high and in some cases have strengthened. The RBA reported that 'analysts forecasts of contract prices for Australia's bulk commodity exports have generally been revised upward, reflecting further increases in expected demand from China.'⁵
- 2.10 The strength of commodity prices together with higher interest rates in Australia have underpinned the rise in the Australia dollar against the US dollar. Although there was some depreciation following the disturbances in credit markets.
- 2.11 In relation to the domestic economy, GDP over the year to the March quarter has grown by 3.8 per cent. Non-farm GDP is estimated to have grown by 4.6 per cent over the same period. The RBA stated that 'while some allowance needs to be made for the inevitable quarterly volatility in these figures, the broad picture from the national accounts accords with a

3 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 1.

4 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 1.

5 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 2.

range of other information pointing to above-average growth in the non-farm economy.’⁶

- 2.12 The RBA notes that prospects for the farm sector have improved following good rainfall in the eastern states. A recovery in farm output is expected to add about 0.5 percentage point to overall GDP growth in 2007-08.⁷
- 2.13 Domestic spending and consumer sentiment remain strong with the exception of housing construction.
- 2.14 With the economy growing at an above average pace, the RBA concluded that capacity pressures are likely to persist in the near term. However, ‘there is little sign that these pressures are leading to any generalised pick-up in wages growth, although strong wage increases are occurring in industries facing particular labour scarcity such as construction and mining.’⁸
- 2.15 In particular, the RBA noted that prices data have indicated a pick-up in inflation. The CPI for the June quarter showed an increase in quarterly inflation in both headline and underlying terms. The **headline CPI** rose by 1.2 per cent in the quarter and by 2.1 per cent over the year. The RBA noted caution with the headline figure commenting that ‘the CPI in recent quarters has been influenced by some sharp fluctuations in fuel and food price, and so the headline figures at present are a poor guide to the underlying trend.’⁹
- 2.16 The RBA’s measure of **underlying inflation** seeks to remove temporary influences from the data. Underlying inflation shows ‘an increase of 0.9 per cent in the quarter and 2.75 per cent over the year, higher than was incorporated in the forecasts presented in the May statement.’¹⁰
- 2.17 The RBA Board at its August meeting considered the strength of the domestic economy and the risks this posed to inflation. At the same time, the Board considered that global growth remained strong notwithstanding recent difficulties in credit markets in the US. Mr Stevens commented that ‘the credit market developments add a further degree of uncertainty about the outlook.’ Mr Stevens stated:

Subject to that uncertainty, the picture is one of growth close to trend and the economy remaining close to full employment. Under

6 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 2.

7 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 2.

8 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 3.

9 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 3.

10 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 3

such circumstances, **inflation is likely to be around 3 per cent over the coming year, and near the top of the target zone in the following year.** As far as risks to that forecast are concerned, the possibility that the world economy might end up being weaker than assumed, due to a persistence of credit difficulties, is one that everyone will have in mind at present. At the same time, there is also the possibility that ongoing strength of demand in a fully employed economy might leave us with inflation pressure that is harder to manage than expected.¹¹

Inflation targeting and monetary policy

2.18 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.

2.19 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.¹²

2.20 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.¹³

2.21 During the hearing the committee focused on the background behind the 8 August rate rise and the short to medium term outlook for monetary policy. In addition, the committee scrutinised the RBA on the accuracy of its modelling which underpins its CPI forecasts. The RBA in its May 2007 *Statement on Monetary Policy* forecast underlying inflation to the December

11 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 5.

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

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

2007 quarter to be 2.5 per cent.¹⁴ In the August statement this figure was revised up to 3.0 per cent.¹⁵ The May forecast was based on actual data to March 2007 and the August forecast was based on actual data to June 2007. Mr Stevens explained the background behind the RBA's CPI modelling:

We are not tied to any one particular statistical or econometric model, if that is what you are referring to. We have at least half-a-dozen models of inflation that I know of, and probably more. We run all of those. The forecast that we end up with is model informed but also heavily influenced by our judgement. Perhaps where this line of questioning takes us towards is the fact that it has been a little bit difficult to read what the current trend in inflation has been over recent quarters. As you will recall, last time we met we had had some trend towards a pick-up in inflation during 2006 and then we had one quarter of a softer figure. I said at the time that that was good news but it was not clear whether that was a new trend or just an aberration and we felt that the inflation episode was not yet complete. Subsequent to that, we got another low figure.¹⁶

2.22 As previously discussed, the 8 August rate rise was heavily influenced by the higher than expected June quarter CPI figures. Other factors bearing on the RBA are the continuing capacity constraints, the strength of the economy and the tight labour market. Mr Stevens commented that 'ongoing strength of demand in a fully employed economy might leave us with inflation pressure that is harder to manage than expected.'¹⁷ On the outlook for inflation, Mr Stevens stated:

If you face an economy in our circumstances, we are clearly very fully employed. We are getting a stimulus from the rest of the world which is quite powerful and which is, I would say, beyond in some sense the normal cyclical ups and downs of our terms of trade. So there is quite a big set of forces at work there. I think you would have to be feeling that, in that world, you have got to be on the look-out for inflationary pressures. So, if that is the world we face and that is the world we are assumingly facing in putting these forecasts together, we are at a point where we are certainly

14 RBA, *Statement on Monetary Policy*, 4 May 2007, p. 58.

15 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 63.

16 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 7.

17 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 5.

more worried about inflation being too high than we would be about growth being too low.¹⁸

- 2.23 While unemployment is running at 4.3 per cent and the tight labour market has been emphasised repeatedly, there has not been a wages breakout leading to inflationary pressure. The flexibility in the wages system was examined. Mr Stevens stated:

The system we have today, which we have evolved over many years of gradual changes to labour market institutions, is one where there are big gains in wages in mining or some parts of manufacturing and construction but very small wage gains are going on if you work in retailing or some parts of the hospitality industry. So a relative shift in labour costs is occurring just as the textbook says it should in a circumstance where you have had a shock to the economy which delivers big income gains via one sector. So, in the broad, qualitatively, the shift in relative wages that is occurring, I would say, makes sense from an economic point of view. The aggregate growth in labour costs – and we had a figure just a day or two ago – shows that it is still trundling along at about four in overall terms, which was quite a good outcome, given that those wage rises have not budged in aggregate for about three years, while the unemployment rate has kept falling. That is clearly, I think, a much more flexible labour market handling the shock much better than it would have 20, 30 or 40 years ago. I think that has been quite important.¹⁹

- 2.24 The committee also sought information about the extent to which current interest rates were neutral or contractionary, the ‘lag effect’ behind monetary policy, the setting of monetary policy during a caretaker period of an election campaign and the influence on Australian rates, if any, of monetary policy adjustments by the Federal Reserve.

The ‘neutral level’ of interest rates

- 2.25 A feature of past hearings has been to confirm with the RBA the desired impact of the current level of interest rates. In August 2006, the then Governor confirmed that the level of the cash rate which at that time was 6.00 per cent was near the top of the neutral band. In February 2007 Mr Stevens confirmed that the cash rate of 6.25 per cent was ‘mildly on the restrictive side of neutral.’ At the August 2007 hearing, with the cash rate

18 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 9.

19 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 7.

at 6.50 per cent, Mr Stevens stated that rates were 'slightly more on the restrictive side.'²⁰ Mr Stevens stated:

Those kinds of calibrations are done by just looking at the average of history. I think that is a reasonable thing to do. It is probably also worth asking this question: how restraining are the borrowers actually finding it? The way we would probably try to answer that is to look at what the demand for credit is doing. That has actually increased somewhat over the past six months. The very short-term data have been affected by what appears to have been a large amount of borrowing to put money into superannuation in June, and we have to wait until next month's number to see how far that falls back. But prior to that there looked to be some slight firming in demand for credit by households and quite a big pick-up in business borrowing, with business credit actually growing over the past six months at the highest pace for 20 years. So I think we are exerting some mild restraint that is probably affecting the households, and now slightly more after last week. That would be my judgement.²¹

The 'lag effect' of interest rates

2.26 The impact of monetary policy adjustments are not always immediate. There is a lag between the time of a rate change and the flow on effects through the economy. As there have been three rates rises during 2006 and another in August 2007 the committee examined the RBA on its knowledge of the impact of these rate rises. Mr Stevens explained that while 'lags' can be fairly long there are some immediate effects relating to consumer confidence. Mr Stevens stated:

It has always been thought that the lags can be fairly long. There is an initial confidence impact that is very quick, at least on some occasions. You typically see, and we did this time as well, the index of consumer confidence constructed by Westpac Bank and the Melbourne Institute going down very sharply just after a rate move. It tends to bounce back again pretty quickly. There is a confidence effect. If you think about a change in interest rates today, the time from that moment until the last worker produces the last consumer durable that is put in the last house that is built or not built because rates changed today is quite long. It is probably three years away. In the interim, the effect builds.

20 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 27.

21 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 27.

Typically, the econometrics used to be that the mean lag—that is, when you get half the total effect—was about a year and a half, and the rest of it keeps coming more gradually after that. It does take time. Of course, that is important because in evaluating whether we have the level correct we have to keep in mind what we have already done and that what we are doing now has effects that last some time into the future. Lags can be long and most of the time they are long.²²

Monetary policy and the election timetable

2.27 As part of the February 2007 hearing, the Governor responded to a question regarding the conduct of monetary policy and the fact that 2007 is an election year. 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.²³

2.28 As part of the current hearing, further clarification was sought as to whether the RBA Board would adjust interest rates during the caretaker period of an election campaign. Mr Stevens stated:

...if it is clear that something needs to be done, I do not know what explanation we could offer the Australian public for not doing it, regardless of when the election might be due. I do not think that there is any case for the Reserve Bank board to cease doing its work for a month, in the month that the election is going to be. I doubt very much that members of the public would regard that as appropriate. So, should that data, or other data for that matter, make a clear case, I feel we have no choice; nor should we have any choice.²⁴

2.29 The RBA Governor's position is noted. In recent times there has not been a conjunction of events in which a possible election date is coinciding with possible monetary policy adjustments. The RBA Board meets on the first

22 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 21.

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

24 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 8.

Tuesday of each month and the outcome of Board meetings are announced the following day at 9.30am. Based on the 2006-2007 calendar of meetings, the Board did not meet in the eight week period between the December 2006 meeting and the February 2007 meeting.

- 2.30 As a comparison, the Federal Open Market Committee of the US Federal Reserve holds eight regularly scheduled meetings a year, and other meetings as needed. During 2008 no meetings of the FOMC are scheduled for February, May, July or November.

Federal Reserve rate adjustments

- 2.31 During the hearing, the Governor was asked if any possible rate reductions by the US Federal Reserve would lead to a rate reduction in Australia. The Governor responded that domestic inflationary factors would remain significant. Mr Stevens stated:

I doubt that we would be contemplating a rate cut any time soon. We would have to have quite a different view on the outlook for inflation than we presently do. I am not saying that could not happen, but a fair few more developments would need to occur before we do. The markets are pricing cuts by the Fed, which does not mean the Fed will do it. They are pricing that, but I think they are still pricing an increase by us within the next year. That does not mean we have to do that either, but current expectations are quite different between the two countries—and not without reason, I would say.²⁵

- 2.32 On 17 August 2007 the Federal Reserve announced a 50 basis points reduction in the discount rate in order to assist market liquidity and promote the restoration of orderly conditions in financial markets following liquidity problems caused by the sub-prime mortgage market. The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility. In contrast, the federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.²⁶ The next meeting of the FOMC is scheduled for 18 September 2007.

25 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 32.

26 The Federal Reserve Board: [<http://www.federalreserve.gov/policy.htm>]

Exchange rates and external trade

- 2.33 The Australian dollar rose to 88.5 US cents during July before falling to 78 US cents on 17 August following problems relating to the US sub-prime mortgage market. The figure of 88.5 US cents was the highest since February 1989. By 20 August the dollar had climbed back to be just over 80 US cents.
- 2.34 The RBA attributes the broad-based strength of the Australian dollar to the terms of trade which have risen to their highest level in 50 years, and the general strength of the economy.²⁷
- 2.35 The RBA reported that 'Australia's terms of trade are estimated to have been broadly flat in the June quarter, having risen by around 40 per cent over the past four years.'²⁸
- 2.36 The RBA's index of commodity prices rose by 4.4 per cent over the year to July, which is the slowest rate of growth since late 2003.²⁹ During the hearing, the RBA was asked about projections for commodity prices. The RBA stated:
- For some time the conventional view has been that commodity prices are close to a peak and that what we would see is gradual declines from here on. If you trace back forecasts that have been made over the last three years, we always think we are close to a peak and that we are going to get that profile, and what has happened is they go up further and then we push out the expected falls. I think probably for base metals now we are seeing a bit more weakness, but that follows a period, particularly with nickel, where prices shot up very dramatically earlier this year.³⁰
- 2.37 Rural commodity prices rose by 9 per cent over the three months to July with wheat prices rising by about 15 per cent. The RBA noted that the 'recent increases in rural export prices have been in line with rising food prices both in Australia and globally.'³¹
- 2.38 The coal market has tightened as China has become a net importer after historically being a net exporter. The RBA noted that as supply constraints persist, thermal coal prices have risen sharply in 2007.³²

27 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 29.

28 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 12.

29 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 12.

30 Dr M Edey, Assistant Governor, *Transcript*, 17 August 2007 p. 27.

31 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 12.

32 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 13.

- 2.39 The RBA reported that oil prices have risen since the start of the year to be currently trading at US\$75 per barrel.

United States, China and the global economy

- 2.40 The world economy continues to remain strong. Mr Stevens commented that 'the most recent forecasts for global growth made by the IMF were revised upwards only a few weeks ago, with growth now thought likely to be over 5 per cent in 2007, close to the 2006 result.'³³
- 2.41 The RBA reported that 'growth has been fairly broad-based across countries, with rapid growth in China and other emerging economies, and firm growth in Europe and Japan.'³⁴ China and India are expected to continue growing strongly accounting for two fifths of projected global growth. The RBA commented that 'as yet, there are no indications that the recent turmoil in financial markets is having a significant effect on expectations for global growth.'³⁵
- 2.42 Growth in the US, however, has been below trend for the past year. GDP increased by 0.8 per cent in the June quarter to be 1.8 per cent higher over the year, down from year-ended rates of 3 per cent in the previous couple of years.³⁶ In particular, the economy is being held back by the housing slump and the increasing mortgage foreclosures and growing arrears in the sub-prime mortgage market. The effects of this are not just limited to the US economy.
- 2.43 The RBA noted that trends in lending practices have provided greater opportunity for risky borrowers to access finance. Mr Stevens stated:

Somewhere or other in this world, returns were eventually bound to disappoint someone. As it turns out, the problems emerged in the US housing sector. Lenders into the so called sub prime market attempted to keep the pace of business up as the US housing sector slowed during last year, but they could do this only by lowering lending standards. Before long, arrears began to rise as some borrowers struggled to meet their commitments.

Once this deterioration in underlying asset returns had occurred, those with exposures inevitably began to see losses. Because this

33 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 2.

34 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 5.

35 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 5.

36 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 6.

type of lending was via securitised structures sold into global capital markets, losses have been coming to light right around the world. In most cases, the losses are embarrassing rather than fatal for the institutions concerned.³⁷

- 2.44 The RBA noted, however, that 'despite the weakness in the housing market, household consumption has remained relatively resilient in the face of the housing downturn.'³⁸ In addition, business investment rose solidly in the June quarter to be 3.4 per cent higher over the year.
- 2.45 In June, the core inflation (which excludes food and energy) was 2.2 per cent for the year, down from around 2.75 per cent late last year. The RBA noted that 'core inflation is generally expected to moderate further as growth in housing costs continues to slow, although there is some upside risk to this outlook from the high levels of resource utilisation and rising import prices.'³⁹
- 2.46 The Chinese economy continues to grow strongly with GDP increasing by almost 12 per cent over the year to the June quarter. The RBA noted that inflation 'has picked up to be 4.4 per cent over the year to June, although excluding food, core consumer price inflation is estimated to have held steady at around 1.25 per cent.'⁴⁰ In response to rising inflation, the 'People's Bank of China has continued to tighten policy, increasing its reserve requirement ratio and benchmark lending and deposit interest rates.'⁴¹
- 2.47 The Indian economy continues to grow strongly 'with real GDP increasing by 2.7 per cent in the March quarter, to be 9 per cent higher over the year.'⁴² The RBA noted that 'inflationary pressures have moderated, with wholesale price inflation slowing to below the Reserve Bank of India's 5 per cent target range.'⁴³

Housing and household debt

- 2.48 The financial position of the household sector strengthened during the first half of 2007. The RBA reported that 'real household disposable
-

37 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 3.

38 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 7.

39 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 8.

40 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 10.

41 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 10.

42 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 11.

43 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 11.

income grew by 2.1 per cent in the March quarter, and by 6.4 per cent over the year, mainly reflecting the firm growth in labour income.⁴⁴ In particular, 'household's net worth has continued to rise as the increase in the value of household assets has exceeded the increase in their debts'.⁴⁵

- 2.49 On 10 August 2007 the committee conducted a round table public hearing into home loan lending practices. In relation to household finances an alternative perspective was raised that the high level of household debt could bring on a recession. This view was not entertained by the RBA. The RBA suggested that any analysis of debt could not be done in isolation from assets. At the hearing on 17 August, the RBA Governor was asked about the status of household balance sheets and the response was favourable:

Household assets are still rising. Debts are rising too but I think that is manageable for most people. By all indications, confidence is high, incomes are growing well and, contrary to what we sometimes read in the papers about servicing debt and so on, the evidence from the lenders—and they are the people with an interest to know—is that the proportion of loans where there is a real struggle going on has gone up a bit but remains very low. I think that, on the whole, households are in good shape. That is not to deny that there are pockets where there is genuine distress. There are; but, at present at least, as distressing as those pockets are, I do not think that they are macroeconomically significant.⁴⁶

- 2.50 The RBA reported that dwelling investment has been broadly stable as a share of GDP over the past year. The RBA noted that 'while construction activity picked up in the March quarter, building approvals fell moderately in the first half of the year, which points to some weakness in dwelling investment over the next couple of quarters.'⁴⁷
- 2.51 In relation to house prices, the RBA reported that 'average nationwide housing prices continued to grow at a firm pace in recent months, with stronger growth in house prices than in unit prices.'⁴⁸ House prices increased in all state capitals with the exception of Perth.

44 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 34.

45 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 34.

46 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 31.

47 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 35.

48 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 35.

'Two speed' economy

2.52 As part of previous hearings, the committee has sought information on the variation in growth and employment between the states. In particular, attention has focused on the rate of growth between the resource rich states of Western Australia and Queensland and the other states. In the August statement, the RBA commented that 'labour markets conditions continue to be robust across all the states.'⁴⁹ Mr Stevens stated:

One feature of the state-by-state divergences which has changed a bit since we talked about this before is that New South Wales has tended to pick up some momentum over the past little while. Possibly due to the fact that there was an election in New South Wales earlier in the year, there was quite a lot of talk about it being in recession. It never was. It was weak – weaker than the other parts of the country – but it has picked up a bit of speed in recent times. So that degree of divergence has diminished a bit.⁵⁰

2.53 It was also noted that not only was there variation between states but also variation within states. For example, house prices in Western Sydney have fallen while house prices in the eastern suburbs are firming.

Capacity constraints

2.54 In previous hearings, the committee has been briefed on increasing capacity constraints. The economy has been growing for 16 years and capacity utilisation is close to full. At the February 2007 hearing, the RBA reported that 'the factor most constraining further expansion is not insufficient demand but insufficient capacity, either of labour or capital or both.'⁵¹

2.55 During the current hearing, the RBA was asked about the problem of skills shortages and the contribution made by increased levels of immigration. Mr Stevens noted that labour shortages continues to be the single most important factor constraining further expansion. In relation to immigration, Mr Stevens commented that 'immigration probably has been helpful in recent times in, at least to some extent, making these problems of shortages less than they would have been.' On the other side of the

49 RBA, *Statement on Monetary Policy*, 8 August 2007, p. 43.

50 Mr G Stevens, Governor of the RBA, *Transcript*, 17 August 2007 p. 21.

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

ledger, Mr Stevens noted that while immigrants add to supply, they also add to demand.

The Hon Bruce Baird, MP

Chair

4 September 2007