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Review of the Reserve Bank of Australia Annual Report 2018 (Second Report)

House of Representatives
Standing Committee on Economics

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Chair's foreword

After a long period of interest rate stability, the Reserve Bank of Australia lowered the cash rate in June and July 2019 to 1 per cent. Commenting on the decision to leave rates on hold in August 2019, the Governor said the RBA judged that, 'after having moved twice in quick succession, it was appropriate to wait and assess developments internationally and domestically.'

These two reductions by the RBA were scrutinised at length at the committee's public hearing on 9 August 2019. The Governor said the RBA expects growth in the Australian economy to strengthen gradually, with the RBA's central scenario forecasting GDP growth of around 2.5 per cent over 2019 and 2.75 per cent over 2020. This outlook, the Governor commented, is being supported by 'the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, signs of stabilisation in some housing markets and a brighter outlook for the resources sector.'

However, the Governor also identified that Australia is vulnerable to economic headwinds from the global economy, in particular the ongoing trade and technology dispute between the United States and China. The Governor remarked that the dispute has disrupted trade flows, resulted in business investments being postponed or reconsidered, increased volatility in financial markets and has increased the likelihood of other central banks reducing their interest rates.

Inflation remains low in the Australian economy and underlying inflation has been below 2 per cent for around three years. CPI inflation was 1.6 per cent in June 2019 and is forecast to lift gradually to around 2 per cent by 2021.

The Governor defended the effectiveness of the RBA's inflation target, which aims to keep CPI inflation between 2 and 3 per cent, on average, over time. He noted that recent inflation data suggests that there was more spare capacity in the economy than previously thought and that the Australian economy can have a lower unemployment rate without producing inflation pressures. Consequently, the RBA has revised down its estimate of the non-accelerating rate of unemployment (NAIRU), an indicator of full employment, from 5 per cent to 4.5 per cent. The Governor commented that 'the economy has generated a huge number of extra jobs, and the employment-to-population ratio has never been higher in Australia than it is right now.'

Despite this, within only three months, the RBA reduced the cash rate further to a historical low of 0.75 per cent in October 2019. Commenting on the decision to keep rates on hold at 0.75 per cent in November 2019, the Governor said that the RBA Board 'is prepared to ease monetary policy further if needed to support sustainable growth in the economy, full employment and the achievement of the inflation target over time.'

After three relatively quick reductions in interest rates, the efficacy of monetary policy is being publically brought into question.

In answers to Questions on Notice to another inquiry the committee found that, following the June and July interest rate cuts, between only 0.4 and 7 per cent of the big four bank's principal and interest mortgage holders actively requested a reduction in their interest repayments. By comparison the overwhelming majority of customers passively accepted higher principal repayments. This data suggests that the benefits of interest rate cuts according to economic theory are not being realised in practice.

Similarly, the data also showed that the impact for interest-bearing depositors was immediate and real. While low interest rates may encourage some people to borrow and invest, low rates reduce interest income for others. Many Australians, particularly those relying on interest-bearing deposits for their income, have been negatively affected by persistently low interest rates and further reductions in the cash rate in June, July and October this year.

The RBA's rate cuts also sit against a global backdrop where currency effects appear to be a core motivation for monetary policy decisions. As Governor Lowe rightly cautioned foreign central bankers at a conference in Jackson Hole, Wyoming, 'if all central banks ease similarly at around the same time, there is no exchange rate channel: we trade with one another, not with Mars.'

The committee will continue to hold the RBA to account for the effects of its rate decisions on all Australians, and the Australian economy; as well as the emerging discussion surrounding unconventional monetary policy options as global interest rates head towards zero.

During the global financial crisis the RBA used a form of unconventional monetary policy through extending the repayment terms of funding for banks to increase liquidity. That decision was made in the face of a temporary liquidity crisis.

The challenges facing Australia's economy today are neither temporary nor as a result of liquidity. The challenges are structural.

If enacted, quantitative easing (QE) would be one of the most significant economic decisions made since the floating of the Australian dollar. We acknowledge and accept the right of the RBA to independently set monetary policy, but this does not render them immune to scrutiny. Monetary policy is currently determined independent of the government and the Parliament. The independence of the RBA obliges Parliamentarians to scrutinise their decisions on behalf of Australians as part of their core representative function. This justifies heightened scrutiny of the preparation of any measures for consideration by the RBA, the decision pathway for their use, their practical implementation and their efficacy – particularly unconventional monetary policy.

In answers to Questions on Notice posed by the committee, the RBA outlined that unconventional monetary policy options range from 'purchasing government securities', 'providing longer-term funding to banks to support credit creation', 'purchasing private sector assets, such as mortgage-backed securities' and 'foreign exchange intervention'.

Through speeches and interactions with the media, the RBA has continued to familiarise Australians with its thinking on potential unconventional monetary policy approaches. The practical consequences of these approaches should be considered. Recently former RBA Board Member, Warwick McKibbin, warned that QE is corrosive to capitalism itself through the misallocation of capital and may reduce business investment in innovation, decreasing their long term viability.

A 2018 study from Wei Cui and Vincent Sterk from University College London concluded that 'QE comes with strong side effects on inequality, which can substantially lower social welfare.'

This analysis is backed up by 2018 Congressional Budget Office data which shows that from the start of the Federal Reserve's QE program until 2014, average income growth before taxes was stable or declined for low and middle earners, while it increased markedly for higher income earners. Disturbingly the study identifies that 'within the highest quintile, income was highly skewed toward the very top of the distribution.'

In practice, QE acts as a wealth transfer through asset price inflation from the young, who are trying to get ahead - to those who are already established, exacerbating existing issues of intergenerational equity.

At an economy-wide level the benefits are also dubious. Stephen Roach from Yale University concluded that 'the [US] QE payback was disappointing', highlighting that over the six years from November 2008 'successive QE programs added $3.6 trillion to the Fed balance sheet' which amounted to 'nearly 25 per cent more than the $2.9 trillion expansion of nominal GDP over the same period.'

In a recent speech the RBA Governor dampened down expectations the RBA would adopt QE. He observed 'Australia's financial markets are operating normally and our financial institutions are able to access funding on reasonable terms' so QE to address liquidity is unjustified.

The RBA Governor outlined that he 'has no appetite to undertake outright purchases of private sector assets as part of a QE program' and the only option they would consider is to 'purchase government bonds' to lower 'risk-free interest rates along the yield curve' with effects on the exchange rate.

In that context the RBA Governor outlines such a scenario would be 'considered at a cash rate of 0.25 per cent, but not before that'. Consequently, the Committee has an amplified responsibility to scrutinise closely any rate cut because of the cascading consequences to license QE.

In his speeches and other public remarks the RBA Governor has outlined the options available to Australia: monetary policy, fiscal policy and structural reform. In doing so much of the discussion has focused on the progressive exhaustion of monetary policy. Media commentary on the RBA Governor's speeches appear to have overweighted focused on his remarks on fiscal policy without recognising his regular reflections on 'capacity constraints', notably in infrastructure. Obsessing over 'High GI' spending that increases public debt for an economic sugar hit is not sustainable.

More emphasis needs to be put into the RBA Governor's commentary on the potential of 'Low GI' structural reform that yields long-term results, encourages business investment and would aid in the progressive expansion of the economy. The options are manifest from further broadening and flattening of the tax base, reforming litigation funding models, the grounds for shareholder class actions and the application of responsible lending laws that can all foster unnecessary costs and risk, as well as many others.

The RBA Governor also outlined 'it is not clear that the experience with negative interest rates has been a success' outlining the risks of a ''reversal interest rate' - that is, the interest rate at which lower rates become contractionary , rather than expansionary' and that there is 'confidence we are still a fair way from it'.

The answers provided from banks to the committee on the stimulatory effects of interest rate cuts at such low levels backs up the RBA Governor's statements, narrowly. But at these levels reducing interest rates for stimulus appears to be equivalent to 'tapping an empty well' - that is, there may technically be shallow puddles of water still at the bottom, but it would be more effective and sustainable to look for alternative sources of water.

The committee notes that, on 5 November 2019, the Treasurer, the Hon Josh Frydenberg MP, announced that the current Statement on the Conduct of Monetary Policy would remain unchanged. This continues the September 2016 agreement between the Treasurer and the Governor of the Reserve Bank that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. It is the government's view that this provides continuity and consistency at a time of global economic uncertainty.

On behalf of the committee, I thank the Governor of the Reserve Bank, Dr Philip Lowe, and other representatives of the RBA for appearing at the hearing on 9 August 2019.

Tim Wilson MP
Chair

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Membership of the Committee

Chair	Mr Tim Wilson MP
Deputy Chair	Hon Dr Andrew Leigh MP
Members	Dr Anne Aly MP
	Mrs Bridget Archer MP
	Mr Adam Bandt MP
	Mr Jason Falinski MP
	Mr Craig Kelly MP
	Mr Andrew Laming MP
	Dr Daniel Mulino MP
	Mr Ted O'Brien MP
Participating Member	Ms Alicia Payne MP

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Dr John White
Office Manager	Ms Jazmine Rakic

Terms of reference

The House of Representatives Standing Committee on Economics is empowered to inquire into, and report on, the annual reports of government departments and authorities tabled in the House that stand referred to the committee for any inquiry the committee may wish to make. The reports stand referred in accordance with the schedule tabled by the Speaker to record the areas of responsibility of the committee.

Abbreviations

CPI	Consumer Price Index
GDP	Gross Domestic Product
NGFS	Network for Greening the Financial System
QE	Quantitative Easing
RBA	Reserve Bank of Australia

1

Introduction

Background

1.1 The House of Representatives Standing Committee on Economics (the committee) is responsible for scrutinising the Reserve Bank of Australia (RBA) and for ensuring its transparency and accountability to the Parliament, the community and the financial sector.

1.2 The appearance by the Governor of the RBA at biannual public hearings of the committee is an important element of the RBA's accountability framework. The details of this framework are set out in the *Seventh Statement on the Conduct of Monetary Policy*, agreed between the then Treasurer, the Hon Scott Morrison MP, and the RBA Governor, Dr Philip Lowe. The statement formalises the biannual appearance before the committee and is reproduced at Appendix B. It states:

> …the Governor will continue to be available to report twice a year to the House of Representatives Standing Committee on Economics, and to other Parliamentary committees as appropriate.
>
> The Treasurer expresses support for the continuation of these arrangements, which reflect international best practice and enhance the public's confidence in the independence and integrity of the monetary policy process.[1]

1.3 A second procedural mechanism for achieving this accountability is set out in the Standing Orders of the House of Representatives, which provide for the referral of annual reports within a committee's area of portfolio responsibility for any inquiry the committee may wish to make.

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1 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016.

Scope and conduct of the review

1.4 The first public hearing of the committee with the RBA during the 46th Parliament was held in Canberra on 9 August 2019.

1.5 The proceedings of the hearing were webcast over the internet, through the Parliament's website, allowing interested parties to listen to the proceedings as they occurred. The transcript of the hearing is available on the committee's website.[2]

1.6 Before the hearing, the committee received a private briefing from Ms Besa Deda, Group Chief Economist at St George. This briefing provided valuable background information for the committee and perspectives on issues for discussion at the public hearing. The committee appreciates Ms Deda's cooperation and assistance.

1.7 The committee also appreciates the provision of additional briefing material from the Parliamentary Library Research Service.

1.8 The public hearings with the RBA continue to bring issues of monetary policy into the public arena, and have assisted in providing a public face to parliamentary committees and the RBA. These hearings are also an important means whereby financial markets can be better informed on the current thinking of the RBA.

1.9 This report focuses on matters raised at the public hearing, and also draws on issues raised in the RBA's August 2019 *Statement on Monetary Policy*. The *Statement on Monetary Policy* may be viewed through the RBA's website.[3]

Further evidence sought

1.10 Following the hearing the committee sought further clarification in writing from the RBA on a range of topics including:

- what 'unconventional' measures the RBA would consider adopting to boost the economy
- modelling of the potential effects of quantitative easing on the Australian economy
- modelling on whether Australia's ageing population and falling rates of home ownership are having an impact on monetary policy

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2 House of Representatives Standing Committee on Economics, *Past Public Hearings and Transcripts*, 9 August 2019, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBAReview2018/Public_Hearings>, accessed 13 August 2019.

3 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019.

- evidence showing that rate cuts boost cash flow, after the effect on Australians with savings is taken into account, and
- what impact increasing superannuation to 12 per cent would have on workers' disposable income.

1.11 The RBA's responses to questions in writing are available on the inquiry website.[4]

4 House of Representatives Standing Committee on Economics, *Review of the RBA Annual Report 2019,*<https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBAReview2018/Documents>, accessed 21 November 2019.

2

Monetary policy and other issues

Overview

2.1 Since the RBA appeared before the committee during the previous Parliament in February 2019, the RBA has eased monetary policy by 50 basis points to 1.00 per cent, following the RBA's decisions to cut the cash rate in June and July. At its meeting on 6 August 2019, the RBA decided to leave the cash rate unchanged at 1.00 per cent.

2.2 Commenting on the decision to keep rates on hold, the RBA Governor said 'the outlook for the global economy remains reasonable.'[1] However, he noted 'the increased uncertainty generated by the trade and technology disputes is affecting investment and means that the risks to the global economy remain tilted to the downside.'[2]

2.3 The Governor reported that Australia's economic growth over the first half of this year has 'been lower than earlier expected' but is anticipated 'to strengthen gradually from here.'[3] He said 'the central scenario is for the Australian economy to grow by around 2½ per cent over 2019 and 2¾ per cent over 2020.'[4]

2.4 This outlook, the Governor said, 'is being supported by the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, signs of

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1 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

2 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

3 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

4 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

stabilisation in some housing markets and a brighter outlook for the resources sector.' [5]

2.5 The RBA's August Statement reported that inflation remains low and that 'measures of underlying inflation have now been below 2 per cent for around three years.'[6] The RBA forecasts that an increase in inflation will now 'take place over a more extended period than previously envisaged'.[7] The RBA commented:

> Together, the recent data on wages, prices, output and unemployment suggest that there was more spare capacity in the economy than had previously been recognised. They also suggest that, like a number of other countries, Australia can sustain lower rates of unemployment and underemployment without running inflation risks.[8]

2.6 The committee questioned the Governor on the effectiveness of the RBA's monetary policy stance, in particular the justification for maintaining a low interest rate environment for the foreseeable future. The committee also scrutinised the Governor on the RBA's record in achieving its inflation target.

2.7 Options for stimulating growth were discussed, including the RBA's preparedness to use unconventional monetary policy if global interest rates headed towards zero. The committee also questioned the Governor on the transparency of the RBA board's decision-making process and communications strategy.

The cash rate and monetary policy

2.8 On 6 August 2019, the RBA Board decided to leave the cash rate unchanged at 1.00 per cent, following its decisions to lower the cash rate in June and July. Commenting on the decision in his opening statement, the Governor said the RBA 'judged that, after having moved twice in quick

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5 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

6 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 3.

7 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 4.

8 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 4.

succession, it was appropriate to wait and assess developments both internationally and domestically.'[9]

2.9 When the committee last met with the RBA in February, the Governor indicated the probabilities of a cash rate increase and a cash rate decrease were broadly balanced.[10] The Governor commented 'following that hearing, the situation continued to evolve, and the board reduced the cash rate twice—at its June and July meetings—to a new low of one per cent.'[11]

2.10 The Governor said the RBA lowered the cash rate because of an 'accumulation of evidence that the economy could be on a better path than the one we looked to be on'.[12] He commented:

> The incoming data on wages, prices, GDP and unemployment all suggested that the Australian economy was some distance from running up against capacity constraints. It also suggested that the day at which inflation was comfortably back within the two to three per cent range was not getting any closer. Faced with this evidence, the board decided that it was appropriate to lower the cash rate, after having kept it unchanged for around 2½ years. It judged that a lower cash rate would boost jobs and help make more assured progress towards the inflation target.[13]

2.11 The Governor also remarked it is 'reasonable to expect an extended period of low interest rates in Australia'.[14] He explained:

> While we might wish it were otherwise, it is difficult to escape the fact that, if global interest rates are low, they are going to be low here in Australia too. When the global appetite to save is elevated relative to the appetite to invest—as it is right now—interest rates in all countries are affected. Our floating exchange rate does give us the ability to set our own interest rates from a cyclical perspective, but it does not insulate us from long-lasting shifts in global interest rates driven by saving/investment decisions right around the world, and that's the reality we face.[15]

2.12 The Governor was asked if monetary policy became less effective when interest rates are persistently low. In response, the Governor said that 'it is

9 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

10 Dr Philip Lowe, RBA Governor, *Transcript*, 22 February 2019, <https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/RBAAnnualReport2018/Public_Hearings>, accessed 20 August 2019, p. 3.

11 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 2.

12 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

13 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

14 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

15 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 3.

certainly true that, in the current environment—at least in my view—monetary policy is less effective than it used to be.'[16] He commented:

> Once upon a time, when we lowered interest rates people were very quick to run off to the bank to borrow more to spend. We saw that in the level of debt relative to people's income; it grew a lot. So that was part of the transmission through which monetary policy used to work. In today's environment people don't run off to the bank to borrow more when interest rates fall; they are more likely to pay back their mortgage more quickly. So that dynamic is different. The other dynamic that is different is that, as interest rates get lower and lower, it is harder for the banks to pass it through fully to the mortgage rates because their deposit rates start to bunch up around zero, and they can't reduce those anymore. [17]

2.13 However, the Governor noted that monetary policy works through two main channels, the exchange rate channel and the cash rate channel, and said that the evidence suggests both channels 'are as effective.'[18]

2.14 The Governor said he was confident that if interest rates were one percentage point higher, the exchange rate would be higher and that would 'be hurting our agricultural sector, our miners, our tourism sector, the education sector and the advanced manufacturing sector that we are building.'[19]

2.15 The committee was interested in the effects of low interest rates on the depreciation of the Australian dollar, in particular whether a weaker currency was supporting Australian businesses. The RBA said that the lower Australian dollar was benefiting high end manufacturing, specifically drug and pharmaceutical companies, which have seen 'very strong growth in exports over the past couple of years'.[20]

2.16 The Governor was asked to explain the likely conditions that would lead the RBA to consider increasing interest rates. He responded:

> …our current thinking is that we probably need to get down to an unemployment rate of 4½ per cent to have wage growth consistent with the inflation target. That's the world in which we'll be raising rates. We will not be considering raising rates until we're

16 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 7.
17 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 7.
18 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 7.
19 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 7.
20 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 9 August 2019, p. 29.

comfortable that inflation's going to be within the target range and we're close to full employment.[21]

Forecasts

2.17 In its August Statement, the RBA forecasts Australia's GDP growth to reach about 2½ per cent over 2019 (see Table 1). It is expected to pick up gradually to 2¾ per cent over 2020, and around 3 per cent over 2021, which is a little higher than previously forecast.[22]

Table 1 Output Growth and Inflation Forecasts (per cent)(a)

	Year-ended					
	June 2019	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021
GDP growth	1¾	2½	2¾	2¾	3	3
Unemployment rate (b)	5.2	5¼	5¼	5¼	5	5
CPI inflation	1.6	1¾	1¾	1¾	2	2
Underlying inflation	1.6	1½	1¾	1¾	2	2
	Year-average					
	2018/19	2019	2019/20	2020	2020/21	2021
GDP growth	2¼	2	2½	2¾	3	3

Source Reserve Bank of Australia, Statement on Monetary Policy, August 2019, Table 5.1, p. 60.
(a) Technical assumptions include TWI at 59, A$ at US$0.68 and Brent crude oil price at US$58 per barrel; (b) Average rate in the quarter.

2.18 The committee asked the Governor what factors are working to support future growth in the Australian economy. The Governor noted 'the Australian dollar now is the lowest it's been since the financial crisis. That helps education, tourism, manufacturing, agriculture and resources.'[23] He identified a range of other positive factors, including the recent interest rate cuts, signs of a turnaround in the resources sector in Western Australia, stronger iron ore prices and some stabilisation of the housing market.[24]

21 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 8.
22 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.
23 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.
24 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

2.19 The Governor was asked how its most recent forecasts in the August Statement differed from previous forecasts, particularly if there were any downgrades. The RBA said that its 'wages growth profile has definitely been pushed out' and that, consequently, 'the inflation forecast has been lowered a bit, and the unemployment forecast is effectively starting from a higher point, although it has a very similar shape.'[25] The RBA added that 'consumption growth has been downgraded across the whole profile. GDP growth has been downgraded in the near term, for 2019, but it's been upgraded for 2021.'[26]

Adequacy of the inflation target

2.20 The committee scrutinised the Governor on the RBA's ability to meet its inflation target, as set out in the *Seventh Statement on the Conduct of Monetary Policy* (the Statement). In the Statement, the Governor and the then Treasurer, the Hon Scott Morrison MP, agreed 'that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time.'[27] The Statement also noted that 'the 2 to 3 per cent medium-term goal provides a clearly identifiable performance benchmark over time.'[28]

2.21 The committee asked the Governor if the RBA had failed to meet its inflation target in recent years. He responded, 'I wouldn't agree with the proposition that we've failed', and explained:

> We're facing some difficult challenges. Perhaps I can start off with the role of the inflation target, which I really see providing the north star for what we're doing. We're trying, over time, to get back to an inflation rate of two to three per cent. We want to deliver for the Australian community an average rate of inflation of two to three per cent. It's desirable and unavoidable that inflation will move around that medium-term range, and it's been below it for quite a while now. We're trying to get it back there, but we've faced difficult circumstances.[29]

25 Dr Luci Ellis, RBA Assistant Governor, Economic, *Transcript*, 9 August 2019, p. 28.

26 Dr Luci Ellis, RBA Assistant Governor, Economic, *Transcript*, 9 August 2019, p. 28.

27 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016, p. 3.

28 Reserve Bank of Australia (RBA), *Seventh Statement on the Conduct of Monetary Policy*, 19 September 2016, p. 3.

29 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 8.

2.22 Given these circumstances, the committee asked if it was a mistake for the RBA to have waited until June to cut interest rates. The Governor replied 'I think it's too early to tell whether we would have gotten better outcomes if we'd cut interest rates earlier. We have to let this whole cycle play out.'[30] He provided the following context for the RBA's decision not to cut interest rates in 2018:

> In the first half of last year, things looked like they were on track. Unemployment was coming down quickly, inflation had lifted, wage growth was picking up and we were growing at one per cent a quarter. In that environment, we thought it was reasonable that the economy would continue on that track, and we decided not to cut interest rates.
>
> During the second half of the year, things did slow. Globally they slowed, consumption was weaker, the economy was hit by some supply disruptions in the resources sector and we had this big increase in labour supply. Progressively, as that data came in, we made a revision to our outlook and we adjusted interest rates in response to that. But through most of last year, things looked pretty good. They were clearly moving in the right direction. It's turned out since then that they've slowed a bit.[31]

2.23 The Governor was asked if the RBA's inflation target of 2 to 3 per cent was effective. The Governor noted that in the 1980s Australia had 'high and variable inflation' that came down in the 1990s. He remarked 'since 1990, inflation has averaged 2.4 per cent. I accept it's a bit lower than that at the moment, but inflation expectations are very well anchored.'[32] The Governor added 'having a flexible inflation target centred around an average inflation rate of two point something has served Australia incredibly well.'[33]

Effects of low interest rates on consumer confidence and the income of depositors

2.24 The Governor was asked if the RBA would accept responsibility for any shift in consumer confidence as a consequence of lowering interest rates. He said he 'wouldn't accept the proposition the cuts in interest rates have

30 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 8.

31 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 8.

32 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 30.

33 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 30.

damaged and hurt consumer confidence right across the country'.[34] The Governor accepted that the decision to lower rates 'has upset some people in the community', noting that 'other people see it as a positive sign because it's contributing to the turnaround in the housing market, and I think that helps people feel a bit better.'[35]

2.25 The committee asked what research the RBA was doing into the impact of low interest rates on depositors, and if that had a bearing on its interest rate decisions. The Governor said 'we continue to look at the distribution of income earned from interest and interest payments across the population through the various data sources that we have access to', adding 'we have a strong continuing focus on that.'[36]

2.26 The RBA said its research showed that 'the share of people who have debt and who have a positive effect on their cash flows when interest rates fall more than outweighs the effect on consumption from the people whose incomes have been reduced somewhat.'[37] The RBA explained:

> There are certainly people for whom interest income is a significant fraction of their income, but in the older age group category the bulk of income comes from pensions, superannuation fund income, dividends and, increasingly, increased participation in the labour market.[38]

2.27 The Governor added that he receives frequent letters from Australians with concerns about the loss of interest income, stating 'at the very human or individual level, I have a great deal of sympathy for the people who write to me.'[39] The Governor commented 'it's a very significant issue for many people, and we discuss this at the Reserve Bank Board. On balance, though, our responsibility is to the national interest.' [40]

Unconventional monetary policy options

2.28 The Governor was asked what forms of unconventional monetary policy might be considered if interest rates looked to be heading towards zero. He replied 'it's possible that we end up at the zero lower bound. I think it's

34 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

35 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

36 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

37 Dr Luci Ellis, RBA Assistant Governor, Economic, *Transcript*, 9 August 2019, p. 5.

38 Dr Luci Ellis, RBA Assistant Governor, Economic, *Transcript*, 9 August 2019, p. 5.

39 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 6.

40 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 6.

unlikely, but it is possible. We are prepared to do unconventional things if the circumstances warranted it.’[41]

2.29 The Governor said ‘as part of our preparation or understanding of the issues, we've studied overseas experience in a great deal of detail’.[42] He explained:

> When we look overseas, we see some central banks have very low interest rates and some countries have negative interest rates. In Switzerland right now the interest rate is minus three-quarters of a per cent, in the euro area it's minus 40 basis points and in Japan it's minus 10. So some central banks have gone negative. That's one possibility. Another thing that central banks have done is give very explicit forward guidance that they're not going to move interest rates until some time has passed or until some certain conditions are met…
>
> We've also seen some central banks support credit creation in their economies. There's a particular case in Europe where banks didn't want to lend. The European Central Bank has provided funding to the banks that is cheaper than the market rate, on the condition that they lend…We've seen some central banks expand their balance sheets very greatly by buying government securities in the effort to try and get the risk-free yield curve down. We've seen other central banks buy other assets, mortgage backed securities and corporate bonds. The Bank of Japan has bought equities. All are expanding their balance sheet. The other thing we've seen in just a couple of cases is foreign exchange intervention. Switzerland is the best example of that. Their currency was under strong upward pressure and they put a cap on it.[43]

2.30 The Governor noted ‘I'm not thinking that any or all of those would be appropriate in Australia’, and remarked ‘the effectiveness of these measures depends upon the specific circumstances the country's in and the nature of its financial markets.’[44] The Governor added:

> How we would apply those lessons to Australia would really depend upon the particular circumstances that we're in. I think the focus would be on trying to reduce the risk-free interest rate. We could reduce the cash rate down to a very low level, and it's possible, if the circumstances warrant it, that we could take action

41 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 10.
42 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 10.
43 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 10.
44 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 11.

> to lower the risk-free rates further out along the term spectrum. I think some of the other things wouldn't be appropriate, but we're certainly examining experience overseas and trying to work out how that would apply in Australia in specific circumstances. Again, it's unlikely. I want to repeat that. We're not doing this because we think it's likely; we're doing it because it's prudent in the global circumstances we face.[45]

2.31 The committee questioned the Governor on what conditions would likely cause the RBA to reduce interest rates to zero. He said that one scenario was if the other central banks 'all cut interest rates, and they keep cutting…then we would need to think about what we would do in that scenario. We would probably need to move lower.'[46]

2.32 The Governor said a second scenario 'would be if growth in the Australian economy fell considerably short of our central scenario.' [47] He commented:

> Lower interest rates, in that scenario, would be an option, as I hope fiscal measures would be as well, from both the state and the federal governments—and a package of structural reform as well. So, if the economy isn't doing very well and the unemployment rate's rising, we'll all need to look at how to support jobs growth, and lower interest rates, and, in extremis, unconventional policy measures would need to be on the table.[48]

2.33 The committee asked if quantitative easing (QE) was one of the options that could be considered. The Governor responded:

> If we're talking about QE as being the central bank purchasing government securities—which I think in the Australian context is the most likely form it would take—in principle, we could do that at any level of interest rate and principal.[49]

2.34 The Governor added 'I think it's reasonable to expect that we wouldn't do it [QE] at the current level of interest rate, or even a bit below the current level of interest rate. We'd need to be very close to zero to do that.' [50]

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45 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 11.

46 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 25.

47 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 25.

48 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 25.

49 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 26.

50 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 26.

United States-China trade dispute

2.35 The August Statement reported that 'global growth remains reasonable' although trade has 'declined noticeably in the context of continuing trade and technology disputes' between the United States and China.[51] The Governor described these disputes as posing 'a significant risk to the global economy.'[52] He commented:

> Not only are they disrupting trade flows, but they are also generating considerable uncertainty for many businesses around the world. Worryingly, this uncertainty is leading to investment plans being postponed or reconsidered. It's also now generating volatility in financial markets and has increased the prospects of monetary easing in many economies. This means that we have a lot riding on these disputes being resolved soon.[53]

2.36 The committee asked the Governor what the consequences would be if the trade disputes continued. The Governor responded '…the lesson from history is incredibly clear: no country has made itself wealthy and prosperous through protectionism.'[54] He added 'building walls actually make you worse off.'[55]

2.37 The Governor noted 'one potential offset, at least in the short run, is that the Chinese may decide to stimulate their domestic economy again.'[56] He explained:

> When they stimulate the domestic economy, they demand more resources from Australia and prices go up, and so we may get some benefit from that. And there may also be some opportunities in agriculture. China might decide to buy some agriculture products from us rather than the US, but they're very much short-run things.[57]

2.38 When asked if a global downturn would affect advanced manufacturing more than commodity exports, the Governor responded:

> What we're seeing at the moment are the supply chains being disrupted, and that affects manufacturers, obviously. We're also

51 Reserve Bank of Australia (RBA), Statement by Philip Lowe, Governor: Monetary Policy Decision, Media Release No. 2019-20, 6 August 2019.

52 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 2.

53 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 2.

54 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

55 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

56 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

57 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

> seeing firms want to invest less, and a lot of international trade is in capital goods, so trading capital goods is softening. So you're right: those things are weak, and we may get some benefit in commodity prices, particularly if there is a stimulus in China.[58]

2.39 However, the Governor added 'we shouldn't take that much comfort that we're better than the person next door when the whole neighbourhood is not doing so well, which is the prospect we face.'[59]

2.40 The committee asked if external forces shaped RBA monetary policy more than the rate decisions of other central banks, such as the Federal Reserve of the United States. In particular, the committee asked whether Australia had become a 'rate taker'. The Governor said 'no, I wouldn't put it like that',[60] and provided both a cyclical and structural perspective in response. From a cyclical perspective, the Governor noted Australia has 'a floating exchange rate that allows us to set the interest rate relative for the domestic considerations on output, employment and inflation'.[61]

2.41 The Governor also explained the global factors shaping monetary policy from a structural perspective, noting 'I think it is really important we understand this'[62]:

> At the moment, right around the world, there is an elevated desire to save and a depressed desire to invest. You see a lot of global savings because of demographic factors. There are a lot of savings in Asia. Many people borrowed too much in previous times and now they're having to repair their balance sheets, so they want to save a bit more. There is a lot of desire to save, and, right at the moment, not many firms want to invest. The reality we face is that, if a lot of people want to save and not many people want to use those savings to build new capital, savers are going to get low returns. The way the financial system works is that the central banks are the ones who set the interest rates, but we're really responding to this deep structural shift in the balance between savings and investment right around the world and there's not very much we can do about that. We can move our interest rates around this new structurally lower level, but we can't escape the fact that global interest rates are low.[63]

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58 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

59 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 12.

60 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 4.

61 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 4.

62 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 4.

63 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 4.

2.42 When asked if the current, global enthusiasm to save was brought about by economic conditions or demographic shifts, the Governor responded:

> We have a lot of people who are ageing during the prime saving years of their lives, so they are saving a lot. We are seeing a lot of saving in Asia. The saving rates in China are particularly high. The social safety net is not very strong, so people save a lot there. We have seen governments and individuals borrow a lot in previous decades, and a time comes when you actually have to save a bit to pay back the borrowings of the past. I think that time is upon us in many countries. Also, people feel a bit nervous at the moment so they're saving more. Their income growth has slowed and they're not sure about what the future holds; that makes us all want to save a bit more. It is a global story, not just an Australian story.[64]

2.43 The Governor further noted that investment intentions have weakened in the last six months, stating that 'is very clearly linked to what's going on with the trade and technology disputes between the US and China.'[65] He commented:

> Investment is weakening, saving is high and it's not surprising that interest rates are coming down lower. The way to get out of this is to create an environment where firms want to invest again and people feel confident about spending. Central banks are really responding to these deep structural forces in the global economy, and we are no different to other central banks in that respect.[66]

The labour market

2.44 The RBA's August Statement reported that 'employment growth has been strong. The response of labour supply has been even stronger, taking the participation rate to a record level.'[67] The RBA noted, however, that 'despite the strong employment growth, the unemployment rate has increased to 5.2 per cent, where it has remained for three months.'[68]

64 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

65 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

66 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 5.

67 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

68 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

2.45 The committee noted the RBA had revised down its estimate of the non-accelerating inflation rate of unemployment (NAIRU) to 4.5 per cent,[69] the rate of unemployment below which wages growth starts to pick up, and asked if this suggests interest rates should have been cut sooner. The Governor replied 'whether we should have adjusted it earlier or not, I think only time will tell.'[70] He also observed that both employment growth and workforce participation had increased recently:

> For the last three years, employment growth has averaged 2.5 per cent a year and the working age population is growing at 1.6 or 1.7 per cent. The economy has generated a huge number of extra jobs, and the employment-to-population ratio has never been higher in Australia than it is right now. One of the things that's happened, and that we're dealing with, is that the extra demand for labour has been there and the job creation has been there. A lot more people have joined the labour force. We did not predict that.[71]

2.46 The Governor said 'the evidence is pretty clear that, because of labour supply flexibility, employment growth can be even stronger than we had thought.'[72] He added:

> Lower interest rates are helping that. We have responded. We can debate whether we should have responded earlier or not, but, given the circumstances and the information we faced, we thought we made the right decision at the time.[73]

2.47 The Governor was asked to explain why there has been an increase in labour supply flexibility and how it is affecting labour markets. He remarked 'the increase in labour force participation has taken us by surprise' and commented:

> I think there are a series of things going on. One is that older people's health is actually quite a lot better than it used to be, and so that's allowing people to stay in the workforce longer. That's a positive development. Another change we've seen is that hours of work are becoming more flexible. Part-time employment is much more available. Flexible working hours are much more common. That's allowing people to transition into retirement in a different way and stay in the labour force. Another thing that may be at work is that people are carrying debt into their 60s in a way that

69 Dr Luci Ellis, RBA Assistant Governor, Economic, 'Watching the Invisibles', *The 2019 Freebairn Lecture in Public Policy*, University of Melbourne, 12 June 2019.

70 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 8.

71 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 9.

72 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 9.

73 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 9.

> they once didn't. When the debt is still there, people feel like they've got to stay in the labour force longer. All these factors—the structural improvement in people's health, higher debt, more employment opportunities—are seeing participation rise. We're seeing the same factors affecting women's participation.[74]

2.48 The Governor added 'I think it's a good news story that a higher share of the adult population have a job today than ever before in Australian history.'[75]

2.49 The Governor was asked about recent trends in the underemployment rate in Australia. He said 'the underemployment rate, if you count it in terms of the number of extra hours that people want to work, is around three per cent, and that's been fairly steady for a number of years now.'[76] He remarked that underemployment would be expected to decline 'if the labour market's sufficiently strong to get the unemployment rate down to 4½ per cent'.[77]

2.50 The Governor said that it was important to keep the underemployment rate in perspective, noting that 'back in the 1960s, I think only 10 per cent of the workforce worked part-time.'[78] Now, 'roughly a third of the labour force work part-time. So there has been a very big increase.'[79] The Governor commented:

> The vast bulk of part-time workers are actually happy with the hours they work; it is only around 20 or 25 per cent of people working part-time who say they want more hours than they have, and, on average, those people want two days extra.[80]

2.51 The Governor was asked to explain the consequences of slow growth in household incomes and its impact on household spending. He noted that 'employment growth has actually been strong—2½ per cent on average over the last three years, which, given the growth of the population, is very strong—so the issue isn't a lack of employment growth.'[81]

2.52 Going forward, the Governor said options to ensure that employment growth remains strong included monetary policy stimulus, 'fiscal options' and 'creating an environment where businesses want to expand and hire

74 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 15.
75 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 15.
76 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 16.
77 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 16.
78 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 16.
79 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 16.
80 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 16.
81 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.

people.'[82] He remarked 'that's the menu, and it's up to society, through the parliament, to choose from that menu.'[83]

2.53 When asked about the importance of investment in skills development and training, the Governor said 'I think this needs to be a priority not just to give people jobs right now but to build the productive capacity for the future'.[84] The Governor commented:

> I hear a lot of stories at the moment that firms are struggling to find workers with the necessary skills, and I think in the past decade there has been underinvestment in skills development by businesses, and maybe the VET system hasn't been working as well as it could have been as well.[85]

Public sector wage caps

2.54 The Governor remarked that stronger wage growth would help the RBA meet its inflation target, and said that 'caps on wages growth in public sectors right across the country are another factor contributing to subdued wage outcomes.'[86] He explained:

> Most public sectors have wage caps to 2½—some have 1½; I think in Western Australia it's probably even lower—and I can understand why governments are doing that, because it's important that we have budget discipline, and wages account for around 70 per cent of most state governments' budgets, so I can understand why the state governments want to do this. On the other hand, the wage caps in the public sector are cementing low wage norms across the country, because the norm is now two to 2½ per cent, and partly that's coming from the decisions that are taken by the state governments. So I'm hopeful that at some point the budget positions will improve sufficiently that state governments, or even the federal government, will be able to lift their wage caps.[87]

2.55 The Governor was asked how much wages would need to increase to bring inflation back into the RBA's target range. He replied 'over time, I

82 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.
83 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.
84 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 13.
85 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 13.
86 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 2.
87 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

hope the whole system, including the public sector, could see wages rising at three point something.'[88] He commented:

> We are in a situation now where wage norms have drifted down to two to 2½ per cent. At the Reserve Bank we talk a lot about inflation expectations lowering as a result of low inflation. But what is really important is the wage norms in the country. Most people are accepting wage increases of two to 2½ per cent. And the public sector wage norm I think is to some degree influencing private sector outcomes as well—because, after all, a third of the workforce work directly or indirectly for the public sector. So I think it is an issue but, on the other side of the ledger here, it is important that state governments manage their budgets prudently. I have spoken to a number of state treasurers. They say, 'We'd like to do more here but we've got a tough budget situation.' So there is a balancing act to be completed here. But I hope that, over time, that balance could shift in a way that would allow wage increases, right across the Australian community, of three point something.[89]

2.56 When asked if he considered the low growth in public sector wages to be a drag on consumer spending and wage growth more generally, the Governor responded 'it's part of the story.'[90] He explained:

> The public sector, directly and indirectly, employs roughly one-third of the labour force, and they're saying wage increases across the public sector may be averaging two per cent. That has as indirect effect on the private sector, because there's competition for workers and it reinforces the wage-norming economy at two-point something. I know that treasuries have to balance the considerations about the benefit they'd get from stronger aggregate wage growth against needing to deliver responsible, balanced budgets. Again, that's a trade-off that our society is making through its governments, and the trade-off that they're making is to entrench low wage norms in our country. Whether it's the right trade-off, I'm not going to comment on that.[91]

2.57 The Governor added:

> But if they made a different trade-off and wages in the public sector were rising at three per cent, then over time I think we'd see stronger aggregate demand growth in the economy. I don't think it

88 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 17.

89 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 17.

90 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.

91 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.

> would have much of a negative effect on employment; in fact, arguably it could be positive.[92]

Household sector

2.58 The RBA reported in its August Statement that the outlook for consumption 'continues to be the main uncertainty facing the domestic economy, especially in the context of ongoing high levels of household debt.'[93] The RBA said that 'this is likely to have continued into the June quarter', noting that 'household incomes will receive a boost in the second half of 2019 from the low- and middle-income tax offset.'[94]

2.59 The RBA said that 'a more positive signal for future consumption is that established housing markets appear to have stabilised.'[95] It explained:

> Prices in Sydney and Melbourne have stopped falling and, although prices are still falling in some other markets, the pace of decline has eased. The rate of sales turnover also appears to have troughed and auction clearance rates have risen. Rental vacancies remain low in most cities, except in Sydney, where the vacancy rate has increased as new apartments continue to be added to the rental stock.[96]

2.60 When asked if the election result had an effect on investment decisions, the Governor said 'I don't see any short-run impact on investment from the election—other than perhaps in residential property, where there was uncertainty about what the future tax arrangements would be.'[97]

2.61 The committee was interested in whether lower interest rates would push up house prices. The Governor commented 'it's certainly possible, because one of the ways that monetary policy works is by pushing up asset prices.'[98] He explained:

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92 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.

93 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

94 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

95 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

96 Reserve Bank of Australia, *Statement on Monetary Policy*, August 2019, <https://www.rba.gov.au/publications/smp/2019/aug/>, accessed 13 August 2019, p. 1.

97 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 7.

98 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 26.

> I think low interest rates do have a significant effect on housing prices. We saw this particularly in the early 1990s and up to the early 2000s when with lower interest rates we became a low-inflation country, and financial liberalisation meant people could borrow a lot more and that got capitalised into housing prices. So, that's very clear. The recent lowering of interest rates, I think, has pushed up house prices a bit as well.[99]

2.62 The Governor noted that supply and demand dynamics in the residential housing market and restrictions on the supply of credit have also affected the dynamic between interest rates and house prices.[100] He commented:

> At the moment, I'm not worried that we'll see a borrowing binge because of lower interest rates but we do need to keep an eye on that. If the economy does pick up, people are feeling good again, wage growth starts picking up and there are lower interest rates, they may decide now is the time to borrow again, particularly if housing prices are rising because the supply side's responding slowly. So, we need to keep an eye on it but today I'm not particularly worried about it.[101]

Options for stimulating growth

2.63 In his opening statement, the Governor remarked that the recent tax cuts were one of the factors supporting a strengthened growth outlook for the Australian economy.[102]

2.64 The Governor was asked what other options were available to the Government to stimulate the economy, if the need should arise. He identified building infrastructure and boosting productivity as priority areas and noted that fiscal stimulus could be considered 'if we find ourselves in the position where aggregate demand in the economy is very weak, we're not making progress on our unemployment and interest rates are very, very low.'[103]

2.65 The Governor identified a range of other options for reform including land taxes, tax incentives for innovation and entrepreneurship, competition

99 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 27.
100 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 27.
101 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 27.
102 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 2.
103 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

policy, skills and education, and the use of data by government to drive better delivery of services.[104]

Tax cuts

2.66 The Governor was questioned on the impacts of the recent tax cuts for low and middle income earning Australians. He said 'we estimate that they will boost household disposable income by roughly 0.6 or 0.7 per cent of income, and that is a sizable boost.'[105] The Governor commented:

> …one of the reasons that household income growth was so slow last year was that taxes paid by households rose by 10 per cent. Gross income by households was up 3.5 or four per cent, and tax paid was up 10 per cent. Last year, working Australians paid a lot more tax to the government and that restrained household income. I don't expect that to be repeated this year, and they are getting the tax refunds paid right now. I'm expecting that this will boost spending. I hope to see it in coming months.[106]

2.67 The committee asked how much of the tax cuts the RBA expects would be spent, thereby boosting consumption. The Governor replied 'our estimate is, based on the payments during the GFC and international work, that people will spend around half of the money. They will use the other half to build up their savings or pay back their debt.'[107]

Infrastructure

2.68 The Governor said that building infrastructure was one option for fiscal stimulus, and remarked 'what I find attractive about that is that it helps demand now but it creates future supply capacity in the economy.'[108] While noting that infrastructure investment needs to be carefully sequenced, the Governor said 'I still see potential to do more of that over time and help support demand growth in the economy, increase productive capacity and make people's lives better, and we can do it at very low interest rates.'[109]

2.69 The Governor was asked if it would be prudent to run a Budget deficit to support greater infrastructure spending. He replied:

104 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

105 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 13.

106 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 13.

107 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 13.

108 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

109 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.

> I don't see the trade-off in those terms, because there are ways that you can fund infrastructure that don't require drawing on the recurrent budget. It's important that the recurrent budget is in good shape, because having a strong recurrent budget allows you options if things turn bad. We saw that in the financial crisis. Having run disciplined fiscal policy, the country had options that it wouldn't otherwise have had. It's important that we keep disciplined fiscal policy. We can do that and still support further asset accumulation, either by the public sector or the private sector, through infrastructure.[110]

2.70 The Governor added:

> Spending has increased a lot over recent years, particularly in New South Wales and Victoria. The federal government has a plan to spend $100 billion over the next 10 years on supporting various infrastructure projects, and the state governments are spending a lot more. We're actually spending a lot on infrastructure at the moment. The debate is: how do we keep that high level of spending and what are the opportunities, perhaps, to do a bit more, particularly if we need more aggregate demand growth?[111]

2.71 The Governor was asked what kinds of infrastructure investment would support future growth in the Australian economy. He said that there were currently a number of public transport 'megaprojects' in Sydney and Melbourne, but noted that these types of projects ran up against capacity constraints:

> I think in the large capital cities at the moment there's probably limited scope to do another big megaproject. People tell me there are capacity constraints and the prices are rising, so we do have to be careful there. It's really a job for the state governments to plan to make sure that there's a strong pipeline of projects so that, as one winds down, they can do another one and, wherever they can, perhaps do a bit more, particularly if the economy were to weaken.[112]

2.72 The Governor remarked that 'there is scope to do more across the country, particularly in regional areas—maintenance of rail, road and bridges and some expansion of regional infrastructure—because people tell us at the regional level there is still spare capacity.'[113] He added:

110 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 17.

111 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 17.

112 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 21.

113 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 21.

> …right across the country there is the capacity to do more infrastructure spending that would make people's lives better and improve the quality of people's existence, so I encourage governments to look at the possibility of a series of smaller projects.[114]

2.73 When asked if there was scope to bring forward infrastructure spending to stimulate the economy, the Governor responded:

> If things turn out not to be so okay, then these issues would become pressing. If the global economy were to weaken, if these trade tensions were to get worse and if the Australian economy were to underperform our central scenario, then I think these would be serious issues, because then we wouldn't be doing okay, and in that situation we should be looking to all arms of public policy to help.[115]

2.74 The Governor was asked whether infrastructure spending could be improved or better targeted. The Governor said that 'there is certainly good and bad infrastructure, and it is possible to waste a lot of money in this area. But it is also possible to build great assets that the country needs for its future growth.'[116] He commented:

> The task that the political class has is to balance those things and make sure that the governance around project selection, cost management and risk sharing between the public and private sector are all in the public interest.[117]

Productivity

2.75 The committee was interested in the RBA's view on what structural reforms would support future growth in the Australian economy. While noting 'I'm always reticent to be giving the government advice', the Governor said that lifting productivity was a key issue:

> If you go back over the last 30 years, in the early nineties to the mid-2000s productivity growth in Australia averaged 2¼ per cent a year. That was the basis of a big pick-up in our collective living standards. Since 2005 productivity growth has averaged about 1¼ per cent, so a full percentage point less. And just recently there's

114 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 21.
115 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 21.
116 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 22.
117 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 22.

> been very little labour productivity growth at all. I think this is a serious issue for us to confront.[118]

2.76 The Governor said that low productivity growth was entrenching low wages growth:

> What I'm increasingly concerned about is the low productivity growth, and the prospects for that to continue, because if productivity growth is low, it means real wage growth is low, the budget is going to come under greater pressures, the value of people's assets won't rise at the rate they expect and people's incomes won't rise.[119]

2.77 When asked what policy levers were available to boost productivity, the Governor referred to his earlier testimony about the need to invest in quality infrastructure and areas for potential reform including land taxes, tax incentives for innovation and entrepreneurship, competition policy, skills and education, and the use of data to drive better service delivery.[120]

2.78 He noted 'there's no shortage of good ideas out there—things that I think would make a material difference to the growth prospects of the country.'[121] He added 'it's up to the political class to work out which of those it can support.'[122]

Fiscal stimulus

2.79 The Governor was asked to describe a successful fiscal stimulus package. He responded 'if you go back to the global financial crisis, the fact that Australia ran disciplined fiscal policy for many years allowed us to have one of the biggest fiscal stimuluses around the world.'[123] The Governor explained:

> For various reasons, Australia got through the global financial crisis with the unemployment rate going close to six per cent and growth returning pretty soon afterwards. The fiscal stimulus was part of the answer there. We were only able to do that because of the good history we had. We saw some countries which had run poor fiscal policy in the past actually have to tighten fiscal policy

118 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.
119 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 20.
120 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 14.
121 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 20.
122 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 20.
123 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 19.

> in the middle of the global financial crisis. We didn't. So it can work.[124]

2.80 When asked if an increase in transfer payments or tax cuts to low, middle or high income households would be more effective in stimulating the economy, the Governor responded:

> In the short run I think you get more stimulus from giving money to people who have a high propensity to spend that money, and that's obviously lower-income people. In the short run I think the answer to that is pretty clear. In the longer run it's more complicated because we've got to think about the incentives for work and innovation and reward. So it may be that, in the longer run, having lower tax rates on people who earn high income, either through entrepreneurship or other reasons, actually stimulates more growth in the economy so everyone can be better off. In the long run, there's not a simple answer.[125]

2.81 The Governor was questioned on the effectiveness of monetary policy in stimulating the economy, and whether implementing fiscal stimulus would help Australia withstand future shocks. The Governor responded:

> It's hard to answer that, because you've really got to think about the specific scenarios. If the global economy has a very bad downturn, I'd expect our exchange rate to depreciate. That's the great stabiliser, so that would be a first-order thing that would help. We could ease monetary policy further, including some of the unconventional things we talked about before. In that environment, I would expect and hope for some fiscal support as well, but I'm not going to lay out what the specific circumstances are or what that support would look like. But, if the economy is not doing well and the global economy is not doing well, we need all arms of public policy to support the Australian economy. But that's not a call for the government to do more now.[126]

Climate change

2.82 The Governor was asked to provide an update on the work it is doing to model the potential impacts of climate change. The RBA noted that it is a

124 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 20.

125 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 20.

126 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 28.

member of a global central banking group, the Network for Greening the Financial System (NGFS), and commented:

> One of the things we are working directly on, along with colleagues at the Bank of England and a few other central banks—this is not directly related to what you just said but is where we're devoting our resources at the moment—is thinking about various stress scenarios and stress testing that we think both investors and financial institutions should wish to consider in their reporting on this, which most of them are now doing.[127]

2.83 The committee asked what work the RBA was doing in relation to agriculture and the impacts of the ongoing drought. The RBA noted that it is working with the National Farmers Federation and others on this issue and remarked:

> An interesting thing about Australian agriculture is that one area where we have seen a lot of productivity growth and technological progress over the last couple of hundred years really is in adapting to the changing climate. I think our agricultural sector is one of the more advanced in its adaptation to that.[128]

2.84 When asked if that meant the issue of climate challenge was less pressing, the RBA commented:

> …no, not at all. The outlook isn't fantastic on this front, but you've also got to think about how things adapt to that. That's the challenge for us: you look at the direct impact but then you've also got to think about how the different parts of the economy are going to respond as the situation changes.[129]

Corporate governance

2.85 The committee questioned the Governor about the transparency of the RBA board's decisions in comparison to other central banks, in particular why it does not publish the voting record of board members. The Governor rejected the idea the RBA was not transparent and outlined how it communicated its decisions:

> I would reject that strongly. We release minutes after every meeting. We release the results of a meeting straight afterwards, an hour and a half afterwards. It's true we don't have voting

127 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 9 August 2019, p. 18.
128 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 9 August 2019, p. 18.
129 Dr Guy Debelle, RBA Deputy Governor, *Transcript*, 9 August 2019, p. 18.

> records; the decisions are taken by consensus as the board has decided that's the way it wants to operate. I give more public speeches than most central bank governors. I always take questions from the media at least once a month, sometimes twice a month, so I'm giving public speeches and taking questions from the media. I feel like the public understand what we're doing, why we're doing it and where we're coming from. We put a huge amount of material in the public domain. You can open up any newspaper in the country on any day and you'll find multiple stories about what we've said or what I've said, so I don't accept the idea that we're not transparent at all. We go to great efforts to have people understand what we're doing, why we're doing it and what trade-offs we're making.[130]

2.86 When asked whether the RBA was considering publishing the full transcripts of its board meetings, the Governor replied '…we're not considering that. The minutes of the meeting are pretty comprehensive.'[131]

2.87 The committee was interested in the composition of the RBA Board, in particular the familiarity of board members with relevant economic concepts and theories. The Governor said 'they [the RBA Board] may not fully understand how to interpret econometric equations and stochastic equilibrium models, but there is a high level of understanding.'[132] He commented:

> From my perspective, much of the time we're dealing with decision-making under uncertainty. The world is inherently uncertain, as we've talked about today, and the job that we have is more than just a technical job; it's how to make the best decisions under uncertainty. What I've noticed over time is that people from business and other backgrounds typically have very good skills at making decisions under uncertainty. The frame of reference they bring is sometimes different from the technical perspective, and a board, which is what the Reserve Bank board has, which marries those things together works very effectively. I do not have any concerns at all about the competency of my board. I think they bring great perspective and they're very good at making decisions under uncertainty and considering trade-offs, because that's what we have to do.[133]

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130 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 11.

131 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 23.

132 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 24.

133 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 24.

2.88 The committee asked whether appointing someone from outside of Australia to lead the RBA would alter how the RBA went about its work. The Governor replied 'none, I don't think' and commented:

> It would be a matter for the government whether they wanted to appoint the next governor as a non-Australian. I'm sure if they did that he or she would manage the bank as he or she saw fit. I can't speculate on what changes the next governor might make, and I don't think the nationality is particularly important from that perspective.[134]

Conclusion

2.89 Australia's economy has experienced a period of slow growth, with low growth in household incomes weighing on consumer spending. However, there are signs the economy has reached a turning point and that a combination of the recent tax cuts, the low level of interest rates, ongoing spending on infrastructure, the stabilisation in some housing markets and a more positive outlook for the resources sector will support growth over the coming years.

2.90 While noting the RBA has struggled to meet its inflation target in recent years, the inflation target framework has anchored inflation between 2 and 3 percent since 1990. The committee will continue to monitor the RBA's effectiveness in meeting its inflation target over time and will scrutinise the RBA for its performance against this benchmark.

2.91 The committee notes that the prevalence of downside risks in the global economy means that it is prudent for the RBA to consider all options for monetary policy if a serious downturn were to occur, including unconventional measures.

2.92 The committee is aware that many Australians, particularly those relying on interest-bearing deposits for their income, have been negatively affected by persistently low interest rates and further reductions in the cash rate in June and July this year. While the committee recognises that low interest rates may encourage people to borrow and invest, it also understands that low rates reduce interest income for others. The committee will continue to hold the RBA to account for the effects of its rate decisions on both borrowers and depositors.

134 Dr Philip Lowe, RBA Governor, *Transcript*, 9 August 2019, p. 25.

Mr Tim Wilson MP
Chair
10 December 2019

A

Appendix A — Hearing, briefing and witnesses

Public hearing

Friday, 9 August 2019 – Canberra

Reserve Bank of Australia

Dr Philip Lowe, Governor
Dr Guy Debelle, Deputy Governor
Dr Luci Ellis, Assistant Governor, Economic
Ms Michele Bullock, Assistant Governor, Financial System

Private briefing

Friday, 9 August 2019 – Canberra

Ms Besa Deda, Chief Economist, St George

B

Appendix B — *Seventh statement on the conduct of monetary policy*

The Treasurer and the Governor of the Reserve Bank

19 September 2016

The Statement on the Conduct of Monetary Policy (the Statement) has recorded the common understanding of the Governor, as Chair of the Reserve Bank Board, and the Government on key aspects of Australia's monetary and central banking policy framework since 1996.

The Statement seeks to foster a sound understanding of the nature of the relationship between the Reserve Bank and the Government, the objectives of monetary policy, the mechanisms for ensuring transparency and accountability in the way policy is conducted, and the independence of the Reserve Bank.

The centrepiece of the Statement is the inflation targeting framework, which has formed the basis of Australia's monetary policy framework since the early 1990s.

The Statement has also been updated over time to reflect enhanced transparency of the Reserve Bank's policy decisions and to record the Bank's longstanding responsibility for financial system stability.

Building on this foundation, the current Statement reiterates the core understandings that allow the Bank to best discharge its duty to direct monetary policy and protect financial system stability for the betterment of the people of Australia.

Relationship between the Reserve Bank and the Government

The Reserve Bank Governor, its Board and its employees have a duty to serve the people of Australia to the best of their ability. In the carrying out of their statutory obligations, through public discourse and in domestic and international forums, representatives of the Bank will continue to serve the best interests of the people of Australia with honesty and integrity.

The Governor and the members of the Reserve Bank Board are appointed by the Government of the day, but are afforded substantial independence under the Reserve Bank Act 1959 (the Act) to conduct the monetary and banking policies of the Bank, so as to best achieve the objectives of the Bank as set out in the Act.

The Government recognises and will continue to respect the Reserve Bank's independence, as provided by the Act.

The Government also recognises the importance of the Reserve Bank having a strong balance sheet and the Treasurer will pay due regard to that when deciding each year on the distribution of the Reserve Bank's earnings under the Act.

New appointments to the Reserve Bank Board will be made by the Treasurer from a register of eminent candidates of the highest integrity maintained by the Secretary to the Treasury and the Governor. This procedure ensures only the best qualified candidates are appointed to the Reserve Bank Board.

Objectives of Monetary Policy

The goals of monetary policy are set out in the Act, which requires the Reserve Bank Board to conduct monetary policy in a way that, in the Reserve Bank Board's opinion, will best contribute to:

- a the stability of the currency of Australia
- b the maintenance of full employment in Australia, and
- c the economic prosperity and welfare of the people of Australia.

These objectives allow the Reserve Bank Board to focus on price (currency) stability, which is a crucial precondition for long-term economic growth and employment, while taking account of the implications of monetary policy for activity and levels of employment in the short term.

Both the Reserve Bank and the Government agree on the importance of low and stable inflation. Effective management of inflation to provide greater certainty and to guide expectations assists businesses and households in making sound investment decisions. Low and stable inflation underpins the creation of jobs, protects the savings of Australians and preserves the value of the currency.

Both the Reserve Bank and the Government agree that a flexible medium-term inflation target is the appropriate framework for achieving medium-term price stability. They agree that an appropriate goal is to keep consumer price inflation between 2 and 3 per cent, on average, over time. This formulation allows for the natural short-run variation in inflation over the economic cycle and the medium-term focus provides the flexibility for the Reserve Bank to set its policy so as best to achieve its broad objectives, including financial stability. The 2-3 per cent medium-term goal provides a clearly identifiable performance benchmark over time.

The Governor expresses his continuing commitment to the inflation objective, consistent with his duties under the Act. For its part the Government endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving medium-term price stability.

Consistent with its responsibilities for economic policy as a whole, the Government reserves the right to comment on monetary policy from time to time.

Transparency and Accountability

Transparency in the Reserve Bank's views on economic developments and their implications for policy are crucial to shaping inflation expectations.

The Reserve Bank takes a number of steps to ensure the conduct of monetary policy is transparent. These steps include statements announcing and explaining each monetary policy decision, the release of minutes providing background to the Board's policy deliberations, and commentary and analysis on the economic outlook provided through public addresses and regular publications such as its quarterly Statement on Monetary Policy and Bulletin. The Reserve Bank will continue to promote public understanding in this way.

In addition, the Governor will continue to be available to report twice a year to the House of Representatives Standing Committee on Economics, and to other Parliamentary committees as appropriate.

The Treasurer expresses support for the continuation of these arrangements, which reflect international best practice and enhance the public's confidence in the independence and integrity of the monetary policy process.

Relationship between the Reserve Bank and the Government

Financial stability, which is critical to a stable macroeconomic environment, is a longstanding responsibility of the Reserve Bank and its Board. The Reserve Bank promotes the stability of the Australian financial system through managing and providing liquidity to the system, and chairing the Council of Financial Regulators (comprising the Reserve Bank, Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury).

The Payments System Board has explicit regulatory authority for payments system stability. In fulfilling these obligations, the Reserve Bank will continue to publish its analysis of financial stability matters through its half-yearly Financial Stability Review.

In addition, the Governor and the Reserve Bank will continue to participate, where appropriate, in the development of financial system policy, including any substantial Government reviews, or international reviews, of the financial system itself.

The Reserve Bank's mandate to uphold financial stability does not equate to a guarantee of solvency for financial institutions, and the Bank does not see its balance sheet as being available to support insolvent institutions. However, the Reserve Bank's central position in the financial system, and its position as the ultimate provider of liquidity to the system, gives it a key role in financial crisis management. In fulfilling this role, the Reserve Bank will continue to coordinate closely with the Government and with the other Council agencies.

The Treasurer and the Governor express their support for these longstanding arrangements continuing.