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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

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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