2

Monetary policy and other issues

Overview

2.1 The outlook for the Australian economy is positive. The economy continues to perform well by comparison with other advanced countries. The near to medium term prospects for elements of the global economy remain uncertain, but Australia enjoys such strong growth that the Board of the Reserve Bank of Australia decided at its November 2010 meeting to lift the cash rate by 25 basis points. This left the overall setting of monetary policy a little tighter than average, but the Board judged this to be appropriate for the period ahead, in which growth in GDP is expected at a little more than 3 per cent.

2.2 For its part, the RBA remains committed to the same framework for monetary policy that it has followed for the past two decades, keeping the growth of demand sustainable, so as to achieve an average inflation rate of between 2 and 3 per cent.

2.3 At the time of the hearing, Australian consumer price inflation was about 2½ per cent in underlying terms and about 2¾ per cent in headline terms. The RBA expects that inflation will remain consistent with the target, though further ahead the medium-term risks on inflation probably lie in the direction of it being too high, rather than too low.

2.4 As a result of Australia's strong economic growth, the remaining gap between actual and potential output is small. The November 2010 hearing of the committee was set against optimistic forecasts for Australia's future growth and stability, though an important element of the wider context at the time was public controversy over the decision of the major banks to raise their lending rates above the RBA cash rate. The banks received significant public criticism for their unwillingness to absorb the increase in the cash rate out of their profits. There were also claims that there was insufficient competition in the domestic banking sector.

2.5 The most significant driver of Australia's economic growth has been the terms of trade. These now exceed the six-decade highs of several years ago. According to the Governor of the Reserve Bank, Mr Glenn Stevens, the terms of trade are near an all-time high. These are being driven up by the demand for Australian raw materials, which has in turn generated a major surge in business investment in the minerals sector.

2.6 The demand for Australian resources comes from Asia, which has experienced steady growth. Much of this demand comes directly from China and, to a lesser extent, India. Rapid urbanisation has ensured strong ongoing demand for steel. While the RBA forecasts assume a gradual decline in both iron ore and coal prices over the medium term due to an increase in supply, prices are nonetheless expected to remain high. GDP in both China and India is expected to continue to grow at a rate of 10 per cent per annum. The RBA is satisfied that Asian growth has returned to a sustainable pace, now that a number of countries (including China) have gradually withdrawn the monetary and fiscal stimulus that they had been applying.

2.7 By contrast, countries at the centre of the financial events of 2007 and 2008 have so far experienced subdued recoveries. The G7 countries are expected to grow at a rate of about 2½ per cent, following a contraction of 3½ per cent in 2009. This will leave a considerable margin of spare capacity, particularly of unemployed labour. In addition, global financial markets have continued to improve, but were increasingly focussed on the rise in sovereign debt in a number of countries. The sustainability of this debt remains an issue for markets and policymakers.

2.8 Overall, global GDP growth is likely to be around 4¾ per cent, which is above the trend established in the previous decade. The RBA expects that within a year from now there should be some moderation in the rate of global growth.

Forecasts for the economy

2.9 The RBA remains optimistic about Australia's economic prospects: its central forecast is for economic grow of 3½ per cent from the December quarter 2010, reaching 4 per cent by the end of 2011. The RBA stated:

> The outlook is positive, supported by the expected strong growth in investment in the resources sector, the income boost flowing from the elevated level of commodity prices and ongoing solid population growth, albeit at a reduced pace relative to the high rate of around a year ago.[1]

2.10 The RBA reported a recent shift from public to private demand and noted that while stimulus spending contributed to GDP growth over 2009-10, there will be a subtraction from GDP growth in the period ahead as this effect gradually fades.[2]

2.11 The RBA's key output and inflation forecasts are available in numerical form in Table 2.1 and graphically in Figure 2.1. Key drivers for the strong rate of growth in GDP include: a pick-up in private demand, itself largely driven by business investment (especially investment in mining), robust growth in income and a strong labour market.[3]

Table 2.1 RBA Output and Inflation Forecasts (a)

	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013
GDP	3.3	3½	3½	3¾	3¾	4	4
Non-farm GDP	3.3	3¼	3¼	3¾	3¾	4	4
CPI	3.1	2¾	2¾	2¾	2¾	3	3
Underlying inflation	2¾	2½	2½	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$1.00, TWI at 74, and WTI crude oil price at US$87 per barrel and Tapis crude oil price at US$90 per barrel. Sources: ABS; RBA

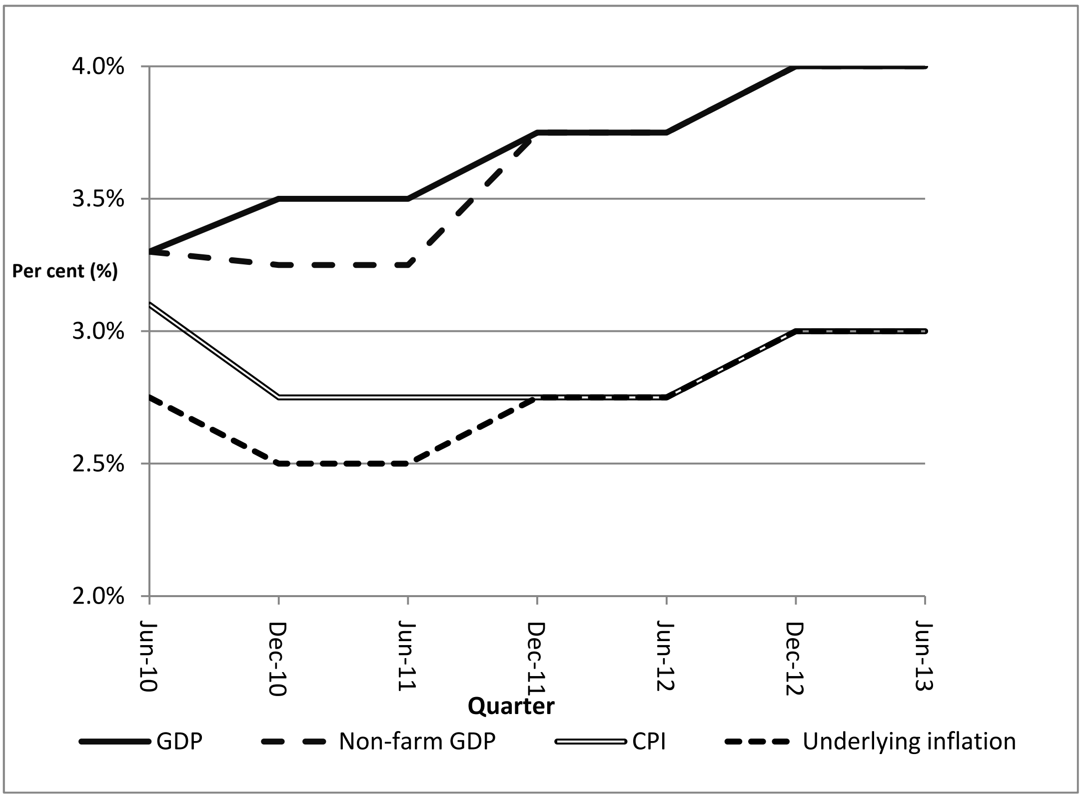
Source *Reserve Bank of Australia, Statement on Monetary Policy, 4 November 2010, p. 62.*

1 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

2 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

3 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, pp. 62-63.

Figure 2.1: RBA Output and Inflation Forecasts (per cent, by quarter)



Source Reserve Bank of Australia, Statement on Monetary Policy, 4 November 2010, p. 62.

2.12 The central forecasts rest on the technical assumption that the exchange rate remains at its current level and that changes in the cash rate are consistent with market expectations.[4]

Inflation targeting and monetary policy

2.13 The decision of the RBA Board to raise interest rates in November 2010 sparked public debate. The committee was interested in finding out what had prompted the Board's decision, given that inflation had appeared to be under greater control in November than it had in October. The Governor explained by stating that while the most recent inflation data was indeed 'a touch lower' than many had previously forecast, this was due to falling food prices, which he did not see continuing. Moreover,

4 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 62.

there were indications from the producer price data that indicated 'a pick-up in pressure' on inflation.[5]

2.14 The Governor further developed his views on inflationary pressures by referring to the international situation. In his view, the US was not falling into another recession at this time, Europe continued to 'ebb and flow', while China was growing at a rate of 10 per cent for this year. To compound matters, Australia's terms of trade were having an increasing impact on the domestic economy. This impact was considerable, making it 'a once or twice in 100 years event'.[6]

2.15 The committee referred to the consensus amongst economists that the cash rate would probably reach around 5½ per cent in 2011 and asked if this view was consistent with the RBA's central case. The Governor noted that:

> What we will find is that the consensus can shift around a bit. It is only a few months ago that some market pricing suggested that the cash rate might actually fall before the end of this year, which, of course, it did not.[7]

2.16 Further to this statement, Dr Debelle added that market pricing currently has the cash rate rising to 5 per cent by the middle of next year, with a minor rise beyond that.[8]

2.17 The committee explored the RBA's 2 to 3 per cent inflation target and the level of variation within that range. The Governor advised that half the time inflation has been above or below that range, but insisted that it is not possible to fine-tune inflation so closely that it is never outside that band.[9] The RBA aims to keep activity within the ideal range, but to do so without crushing the real economy in the process. In his opinion, it would be a mistake to set a higher target for inflation, merely because of the difficulty in meeting the low one and 'that would get us higher interest rates in the long run'.[10]

2.18 During the hearing the committee noted the increase in utility prices. The Governor explained that the current rise in electricity prices, for example, was an effect of developing new capacity after a period of

5 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, pp. 4-5.
6 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 6.
7 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 22.
8 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 22.
9 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 32.
10 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 33.

underinvestment. This can either be paid for by users or by taxpayers. The Governor also observed of this that 'analytically, it is best thought of as a one-time rise in prices, but it filters out over several years so we observe it as a higher rate of inflation in these parts of the CPI for a time.'[11]

The 'neutral' or 'normal cash rate

2.19 At previous hearings the committee has examined the RBA about the policy cash rate and, in particular, what the neutral level is. Interest rates are generally referred to as 'neutral' if they are not having an expansionary or contractionary effect on the economy. At the February 2007 hearing, Mr Stevens indicated that the then policy cash rate of 6¼ per cent was 'mildly on the restrictive side of neutral.'[12]

2.20 At the current hearing, Mr Stevens noted that the policy cash rate of 4¾ per cent is slightly above normal. The neutral level is lower in November 2010 compared to February 2007 because market rates are higher and the RBA takes market rates into consideration when setting the policy cash rate. The Governor stated:

> What we are saying today is that, because the margin in the cash rates and the rates people actually borrow at has risen, we calibrate what we think of as normal, at least while that widening remains in place. I would have said that the 4.5 cash rate, which is clearly well below what was normal before, is for all intents and purposes normal in the world we are in now where the margins have widened because it delivered a mortgage rate or a business loan rate that was pretty much the average of the past 15 years. As of the last decision, we have moved above that a bit now. I think we would have to say that, particularly given the increase in loan rates is a bit higher than what we did, monetary policy settings are a bit above normal now.[13]

11 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 35.

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

13 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 19.

The multi-speed economy

2.21 There are sectors of the economy which are experiencing varying degrees of growth. The committee discussed the adequacy of other economic policy mechanisms, besides monetary policy, for dealing with a multi-speed economy. The Governor acknowledged that the RBA can set the overnight price of money. He also stated that while banks used to be subject to a greater degree of direction thirty or forty years ago, 'those direct controls were pretty ineffective'.[14] The Governor believed that other policy mechanisms, such as fiscal policy, are better suited to addressing distributional problems across disparate regions and that 'we best manage them not by trying to resist the forces for but rather by helping change happen more smoothly and helping the people who bear the cost through it'.[15]

Capacity constraints

2.22 Earlier this year Dr Lowe outlined in a speech that the main task for Australia is to expand the supply side of the economy, so that demand can grow solidly without causing inflation to rise.[16] During the hearing the committee asked Dr Lowe to elaborate on the key supply side deficiencies that the RBA is concerned about.

2.23 Dr Lowe advised that his point had been that living standards are usually determined by productivity. Over the last decade the growth in living standards has largely come from increases in the terms of trade. Dr Lowe explained 'we cannot expect the terms of trade to keep rising and we will inevitably go back to a period where growth in our living standards is going to be determined by productivity growth, or, to put it another way, expansion of the supply side'.[17]

2.24 In the subsequent discussion about the supply-side of the economy, the committee noted that the government was investing $27 billion taxpayer capital and $10 billion taxpayer debt in the National Broadband Network

14 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 31

15 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 32.

16 Dr P Lowe, *Some Challenges For The Future*, Urban Development Institute of Australia National Congress (UDIA), Sydney, 10 March 2010; accessed on 4 February 2011 at http://www.rba.gov.au/speeches/index.html.

17 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 25.

and asked the Governor if there is a risk if the government funds capital projects that the private sector has rejected and what hurdles should such projects face. The Governor stated that 'I do not want to get into the NBN in any detail...[as] it is an area outside our core area of expertise'.[18] He went on to note that there probably are some projects that the private sector will not fund that ought to be done, but whether this is one of them would be another question. The Governor also stated that there ought to be proper cost-benefit analyses of all proposed projects.[19]

Labour market flexibility

2.25 The committee noted that the RBA had previously commented on labour market flexibility and sought the Governor's views about this, being concerned that decreased flexibility might have an inflationary impact.[20] The Governor responded by stating that the fact that unemployment had peaked below 6 per cent was unequivocally good news, but that it was very hard to tell what effect regulatory changes to the labour market might have.[21] The Governor stated:

> As to the regulatory changes, it is an important question to what extent these changes may have flexibility. It is very hard for me to tell. Many people that we encounter from a business background are quite concerned. It is not uncommon, of course, that when there has been a change for there to be uncertainty about how the new system will work. In some respects, I guess, one would have to say it is as much in the implementation and administration of it as in what the legal provisions themselves say.[22]

2.26 The committee asked the Governor about any knowledge that he might have about evidence or data concerning a possible connection between the legislative changes between 2004 and 2008 and enhanced productivity. In response to this, the Governor stated that:

> I think it would be hard to sustain an argument that a particular set of previous arrangements had led to a leap in productivity, based on the aggregate data. I would not want to have to make

18 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 26.

19 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.

20 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.

21 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.

22 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 12.

> that argument because the data are not that strong. The people who would defend those arrangements would not defend it on that set of figures, I guess.[23]

2.27 The Governor did not wish to make any judgement about the latest legislative changes on workplace relations, stating that he could not give any kind of precise date to look for evidence of the impact of legislation on productivity, but proposed instead that the key test would be 'whether we can go through a period of labour market tightness like we had three years ago and not see a materially more adverse outcome overall for the economy than we had then'.[24]

Fiscal stimulus

2.28 Following the committee mentioning that the fiscal stimulus was being withdrawn at a rate of about 1 per cent of GDP over the next financial year, the committee asked the Governor how confident he was that the economy would be able to offer employment for people who had been employed as a result of that stimulus. The Governor responded by stating that we simply cannot be certain about the so-called handover from public to private spending, but that various factors (including an increase in household income and increase in the terms of trade) suggested that we 'are getting...the handover from temporary public stimulus to the private'.[25] Dr Lowe confirmed that there has been a substantial increase in business investment.[26]

2.29 The committee was keen to explore the interplay between fiscal and monetary policy, in particular the impact of the structural budget deficit and the stimulus spending on interest and exchange rates. The Governor explained that this was an issue that had been covered many times before and went on to state:

> There are various shocks hitting the economy that affect demand. Some of them are offshore; some are domestic. There is monetary policy and, of course, there is fiscal policy which has an impact on final demand in the economy. As a matter of logic, it has to be true—doesn't it—that if there is a major change in the fiscal

23 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 14.
24 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 14.
25 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 19.
26 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 20.

> approach that has an impact on demand, and we are not talking trivial numbers but significant impacts, that has to affect, compared with the alternative, the outlook and therefore it has to affect the way we take our decisions.[27]

2.30 When pressed on what would have happened with the cash rate had there been less fiscal stimulus, the Governor stated that it would have been lower, but qualified that observation by noting that it would not necessarily follow that this 'would...be a better mix of policies'.[28]

2.31 During the hearing the committee mentioned a claim made by Chris Richardson of Access Economics, namely that a cut in the budget deficit of $13 billion would reduce interest rates by 1 per cent. The Governor responded to this by stating that significant fiscal tightening would indeed lead to an easing of monetary policy and a lower exchange rate.[29]

2.32 Following this, the committee raised the Non-Accelerating Inflation Rate of Unemployment (NAIRU) in connection with the Governor's opening statement that the economy was pretty close to full potential output. The Governor stated that, 'I do not want to make a prediction about the NAIRU if I can avoid it, because it is an analytical construct that is useful as a device but there is no statistic you can look up to see what it is; you can only observe it from experience.'[30] He also explained that the unemployment rate had been fairly stable at around 4 percent for a while, was now around 5 per cent, with a pick-up in wage growth that was no faster than was to be expected. We were close to potential output because 'we should not expect from here to be able to grow the economy very quickly over an extended period without getting into trouble'.[31]

Bank profits and bank competition

2.33 As previously noted, the banking sector's profits had inspired some controversy in the weeks leading up to the hearing. The committee was interested in drawing out any connection between the profits of the banking sector and their rates. During the hearing the committee referred to a chart showing the growth in profits of the Commonwealth Bank over

27 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 10.
28 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.
29 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 9.
30 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.
31 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 11.

the last ten years and asked 'how is someone, who has a mortgage with the Commonwealth Bank or one of these big banks, expected to feel when they see figures like the profits that banks continue to make and justification that banks need to raise their margins?' The Governor stated that:

> ...if we prepared a chart like the one you did there in absolute dollars for the profits of a whole bunch of large listed Australian companies, they would look very like that chart...if my choice is between banks with good profits and banks with no profits then I choose the former every time from an overall macroeconomic point of view...we need to be careful not to forget the size of the capital that is invested in these institutions, because you have to compare the two...[32]

2.34 The Governor elaborated on bank profits by pointing out that businesses need to ensure that the price of their products covers their costs, including the cost of equity. The Governor stated:

> ...but over time I think the thing that, maybe, has not had much focus is that the overall bank margins that we see today are a little higher than they were a couple of years ago but, compared to 10 or 15 years ago, are much lower, particularly in the mortgage base. That is a result of competition and efficiency gains, and most of those gains actually are still in place today, compared with, say, the year 2000 or the year 1995. It is quite different to then. We are arguing about a small backtrack a little way back up that curve but, when you look at that story in broad historical perspective, the overall net interest margins have been fluctuating between 2¼ and 2½ for about four or five years. There is not a lot of change.[33]

2.35 The Governor insisted that if the underlying question is whether mortgage holders are paying seriously higher rates than they should be, the answer is no, 'because we have pretty much offset the change in the margins by doing different things in the cash rate from what we would have done had the margins not shifted'.[34]

2.36 The Governor went on to point out that increases in lending rates were an effect of increased competition for funds by banks. The major Australian banks have increased their holdings of domestic deposits, in order to

32 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 8.

33 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 8.

34 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, pp. 8-9.

reduce their holdings from wholesale funding sources. The Governor stated that:

> It is pretty obvious why that happens and I think it is prudent of them to do it. What we have seen in the past several years is that those wholesale funding sources, which for some years up to the middle of 2007 were very available, very inexpensive and, apparently, quite reliable and quite stable, changed dramatically after the problems began in 2007 and especially after the Lehman failure in September 2008. I think every banker in the world and every supervisor concluded that it was a more unstable and risky source of funding than had previously been assumed and that banks, therefore, needed to change their funding mix more in the direction of things that could be expected to be stable. Our banks have done that. I cannot say that I regard that as something to regret. I think it is probably prudent. What that has meant is that there has been much more intense competition to raise funds by financial institutions in that space than there had been before.[35]

2.37 The committee also expressed an interest in the significance of the market share of the major banks, noting that while in 2007 the leading four banks accounted for roughly 68 per cent of household lending, by 2010 this had risen to 80 per cent. Dr Debelle advised the committee that for the last six months, the major banks' share of lending has been falling.[36]

2.38 The committee was concerned that the costs of loans were higher for small business than for households (concerns expressed in terms of possible 'price-gouging'). The Governor noted that lending to small business entailed higher risks than lending on the average home.[37]

Bank guarantee and moral hazard

2.39 The committee explored the $850 billion worth of guarantees that taxpayers provided to private banks, in order to examine the issue of moral hazard. The Governor advised that the Australian Government had made available a guarantee for wholesale funding and that while there had been some risk in doing this it was very well paid to take that risk and

35 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 7.

36 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 16.

37 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 17.

is currently earning about $1 billion a year in fees.[38] In addition, the stock of guaranteed liabilities is now closed. The Governor stated while that while these had reached around $170 billion or $180 billion, they are now falling; and the guarantee on deposits of over $1 million finishes at the end of October 2011.[39]

2.40 As for the question of moral hazard, the Governor stated that the intervention by the Australian authorities was 'pretty mild' by global standards. These interventions were necessary because 'the system faced a catastrophe in the absence of these measures'.[40] He advised that the outstanding issue is whether or not such guarantees should be issued in future. His view is that the government should aim to be in a position to say to banks, 'no, we are not going to give a guarantee and the system can cope with that.'[41]

2.41 When asked as to whether these guarantees formed a contingent liability for the Commonwealth, the Governor warned that this is a difficult matter to discuss publicly. He did not believe that any government would ever allow the system to collapse and noted that 'a bank failure...is not like the failure of any other business...which is why we have regulation that is much more intrusive on a bank than it is on your average industrial company'.[42] It is, therefore, probably impossible to eradicate the risk of moral hazard.

2.42 Continuing with its interest in government support for the banking sector, the committee expressed concerns that, since the RBA was the lender of last resort to institutions in difficulty, it might end up supporting insolvent firms. The Governor explained that there were essential differences between responding to a liquidity crunch by loaning money at high rates to a sound bank and supporting an insolvent one. While the former was appropriate, the latter was not. If there was a case to be made for rescuing an insolvent bank, that decision would have to be made by the government of the day.[43]

2.43 The committee raised the possibility of a trade-off between competition in the banking sector and system stability. In his response to this issue, the Governor explained to the committee that while banking competition is good to a point, it may yet lead to problems, such as when lending

38 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
39 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
40 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
41 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 23.
42 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 24.
43 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 25.

standards fall to such an extent that the sector 'ends up lending money to people who really should not get it'.[44]

2.44 During the hearing the committee asked the Governor to elaborate on his views about competition and efficiency, especially in connection with the long-run drop in the net interest margin from 2000 to 2004 referred to in the statement on monetary policy.[45] The Governor answered by pointing out that the trend actually dates from 1990 or so, when non-bank competitors entered the mortgage market. The banks responded by containing their costs and improving their efficiency. As the efficiency of the financial system improved, credit became more available and prices fell.

2.45 The committee also asked about the role that the government's $16 billion injection into the residential mortgage-backed securities market is having on that market and whether it is helping those lenders recover. The Governor noted that the demand for mortgage backed securities suffered as a result of developments in America. Many of the sources of demand for such products have disappeared. The Australian Office of Financial Management (AOFM) purchases helped prop up demand. Dr Debelle supported this, stating that 'the AOFM has bought about one-quarter of the mortgage backed securities that have been issued over the past year or so'.[46]

Exchange rates and external trade

2.46 The link between the higher exchange rate and the suppression of inflation was examined during the hearing. The Governor explained that a higher exchange rate lowers the import prices for tradeable goods. The producers of export goods or services are price takers in global markets, so the domestic price goes down as the exchange rate goes up.[47] The purchasing power of importers goes up, enabling them to either enjoy higher margins or pass on price gains to customers. A transfer of income takes place via the exchange rate, which helps with holding down inflation. It also transfers some domestic demand off-shore, but makes it harder for many exporters.

44 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 28.

45 Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p. 42.

46 Dr G Debelle, Assistant Governor, Financial Markets, *Transcript*, 26 November 2010, p. 30.

47 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 36.

2.47 This does not have a large, negative, effect on the mining industry, because the price of iron ore has gone from $25 to $125 a tonne. However, exporters of education services suffer, because their foreign currency price has not gone up, so they must lower the Australian dollar price they charge in order to compete. As Ken Henry noted, it is almost a three-speed economy—there is the mining sector, the traded part of the economy that is not mining but is affected by the exchange rate, and the rest.

United States, China and the global economy

2.48 The ongoing crisis in European financial markets formed a critical feature of the context in which the hearing was held. In his opening remarks the Governor noted that there had been an increase in sovereign debt in a number of advanced countries and that the sustainability of this debt remains an issue for markets and policymakers alike. During the hearing the committee expressed its concern about the volatility and uncertainty in Europe and asked what possible consequence Australia might face. The Governor advised that the real question was not the fate of small countries like Ireland, but what would happen if the larger ones got into similar trouble. The Governor stated:

> ...for several years we will see periodic flare-ups of anxiety in Europe...What that means is that, for us, we balance the possibility that things could go pear-shaped in Europe— they may or may not; we will not know for sure for quite some time. I think in the US things are probably going to be okay, but they are not that strong. Of course, then we have Asia, and as every year it goes by it is clearer and clearer that the centre of gravity in the world economy is shifting there and we are very plugged into that, so we have to manage that. It is a complicated picture.[48]

2.49 The committee was interested to learn about the implications of steel production in key global markets for Australia's terms of trade. The Governor explained that the rate of growth in some key markets (in particular those with steel-intensive built environments) is critical. Over the past decade and a half 300 million people in China have moved from rural areas to apartments in the cities and these apartments required steel, which in turn required iron ore. Thus, Chinese demand for steel keeps the global price of iron ore high. Dr Lowe added that India is just starting to urbanise on a comparable scale, but over the next 20 years we might

48 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 22.

reasonably expect 100 million or 200 million people in India to move from rural areas into city apartments. Demand for steel underpins our favourable terms of trade and is fundamental to our medium term prospects.[49]

2.50 During the hearing the committee examined developments in bank regulation under way within the G20. The Governor reported that: banks would have to hold more capital (in particular higher quality capital and more equity capital); there will be an average leverage ratio in addition to the Basel risk weighted capital standards; there will be liquidity standards designed to prompt more careful and more active management of capital, especially liquidity capital. It will be 2019 before these are all fully phased in.[50]

2.51 The Governor assured the committee that he did not anticipate any great difficulty for Australian banks in meeting the standards. The Governor stated:

> I do not think our banks will have very much trouble accumulating the additional capital they will need. They are quite close to the new requirements already in most cases. I might say that APRA has had a fairly conservative way of approaching these things all along. Our banks have tended to complain over the years that, if only APRA would measure capital the way the British do, we would all look better. But what is happening is that the way others are thinking about this is shifting closer to where APRA has been all along.[51]

2.52 According to the Governor, the principal issue for Australia is that the new standards require banks to hold more government securities, as a high-quality liquidity buffer, but there is not enough Australian government debt to do this.[52] Dismissing press reports that Australia would seek an exemption from the Basel standard, the Governor said:

> There will not be an exemption. Our system will meet the standard, but it will meet it in a different way to the average country in recognition of the fact that there just is not enough government debt in existence to meet it the normal way... I think

49 Dr P Lowe, Assistant Governor, Economics, *Transcript*, 26 November 2010, p. 31.

50 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

51 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

52 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.

> we will be able to come to a way of meeting the standard in a fashion that makes sense for Australia.[53]

2.53 The committee wanted to know how Australia's macroeconomic position compared to that of other developed countries. The Governor responded by stating that in respect to comparable countries, Australia had a modest downturn, that the fall in GDP here was relatively low and we returned back to growth more quickly. He also noted that it had been our smallest recession since World War 2, that unemployment rate peaked below 6 per cent and that while our public debt is higher than it was, it is low by the standards of developed countries.[54]

2.54 Asked directly if Australia had too much government debt, the Governor stated that: 'I have never felt in recent years that the size of the public debt that we have outstanding is a material problem for the country'.[55]

Household savings

2.55 The committee asked the Governor to elaborate on the increase in household savings referred to in the statement on monetary policy, in particular finding out if the trend is sustainable and what the consequences of this trend are likely to be. In his response the Governor replied that there has been a noticeable rise in the saving rate. The bank assumes that this trend will continue. The Governor hypothesised that 'there has been a kind of sea change in people's attitudes that we would expect to persist for a while'.[56] While this may be difficult for retailers, it increases competitive pressures on pricing, which assists with keeping inflation low.

ATM fees

2.56 During the hearing the committee sought advice on ATM interchange fees. The Governor advised that the bank had initiated some reforms. These included the abolition of interchange fees, disclosure of the fee at

53 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 18.
54 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.
55 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 27.
56 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 36.

the time that the fee is incurred and ensuring that the person who owns the ATM sets the fee.

2.57 The results have been that nobody pays a fee for using their own bank's ATM; almost everybody has access to a network that will give them a fee-free withdrawal; there has been a marked increase in the proportion of transactions done at own-bank and a corresponding fall in transactions at 'foreign' machines; the aggregate savings in fees resulting from all of this is about $120 million a year across the community, and an apparent increase in the number of ATMs available.[57]

Conclusions

2.58 Australia continues to enjoy economic conditions that would be a welcome relief to almost all other industrialised nations. Inflation remains within the targeted range and unemployment remains relatively low in historic terms, while the terms of trade has enhanced the global purchasing power of Australian households.

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Chair
9 February 2011

57 Mr G Stevens, Governor of the RBA, *Transcript*, 26 November 2010, p. 21.