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Monetary policy and other issues

Overview

2.1 In early 2011 Australia experienced a series of natural disasters, the Queensland floods, Cyclone Yasi and serious storms off the coast of Western Australia which disrupted iron ore exports. At the time the Reserve Bank of Australia (RBA) expected that as a result of these events, economic activity during the March quarter would be weaker than previously expected, and that a recovery would set in by the middle of the year.[1] It was also thought that the rebuilding effort would provide a mild stimulus to demand from the second half of the year, especially in Queensland. The bank also expected a large effect on the price of food, due to crop losses. The bank's position was that the effects of these would all be temporary and that there were no immediate implications for monetary policy.[2]

2.2 These expectations have been largely vindicated, though there have been further developments that complicated matters. As predicted, GDP was weak in the March quarter, due to a fall in coal and iron production that exceeded a modest rise in output throughout the rest of the economy. The output of iron ore has rebound, while the economic disruption to Queensland in general has abated. [3]

2.3 However, the business of draining the coal pits has taken longer than initially expected. As a result, Queensland has so far only recovered about two-thirds of its coal output. A complete recovery is not expected until

1 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

2 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

3 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.

next year. The delay in returning to coal production levels prior to the natural disasters has been large enough to exert a material effect on forecasts for GDP. [4]

2.4 In addition, unexpected developments in the global economy such as the Japanese earthquake had a significant effect on global manufacturing production and sales, including in Australia's motor vehicle sector. This pressure on economic activity was augmented by the increase in energy prices in the first half of 2011, as well as by uncertainty over public debt in a range of major countries and the ensuing turmoil in equity markets.[5]

2.5 The global picture can be summed up simply enough: equity prices in most markets around the world are anything from 15 to 25 per cent below their recent highs, yields on long-term US securities and core European ones are at a historically low level. The price of gold and currencies perceived to be safe has soared.[6]

2.6 The effect on Australia has been to lower equity prices, but other Australian markets have travelled well. Funding costs have declined, which has resulted in lower costs of fixed rate mortgages. Major banks are now being offered substantial US dollar funding from offshore markets, while their reliance on such sources is falling due to a large increase in deposit funding at home and slower growth in balance sheets.[7]

2.7 The exchange rate has fallen since its peak in mid 2011, but it remains at historically high levels. Prices for selected commodities have fallen a bit, but not slumped. Prices for major Australian commodities remain quite high.[8]

2.8 The Chinese economy continues to grow. Inflation rates across Asia have risen in the past six months. The critical question for Asian countries is whether enough has been done to contain the inflation pressure, which does look to have spread beyond initial rises in food and energy prices.[9]

2.9 Australia's terms of trade remain very high. Investment in the resources sector is very strong. RBA liaison work suggests that, beyond the benefits being experienced by equipment hire, engineering, surveying and consulting firms, a range of businesses (i.e. suppliers of modular housing,

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4 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 1.
5 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
6 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
7 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
8 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
9 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

lab services and training of semiskilled, trade and other workers) share the stimulus that is flowing through the minerals sector.[10]

2.10 Nonetheless, the terms of trade and resultant high Australian dollar coincide with a popular mood of uncertainty and anxiety which is in turn fuelling changes in household behaviour. The Governor stated:

> ... we have seen a significant change in household behaviour. There was a lengthy period in which households saved progressively less out of current income, increased their leverage and enjoyed a sense of rising prosperity from the increase in asset values. That was most likely a one-time, if rather drawn out, adjustment to a number of important factors. It is understandable that it occurred. It should be equally understandable that it was not going to continue like that indefinitely. The new normal, so-called, which is actually the old normal, is where households save a non-trivial fraction of current income and keep their debt levels or their growth in debt levels more in line with growth of income.[11]

2.11 The Governor advised the committee that Australia appeared to be adapting to this situation quite fast and that, given the recent financial turmoil, it would not be surprising if Australians retained a degree of caution for some time. The Governor's assessment of Australia's present condition was optimistic and he concluded his introductory testimony by stating that:

> In summary, there is a heightened degree of uncertainty at present...There are major challenges to the global economy and there are significant forces at work in the Australian economy. But, at this point in time, our terms of trade are very high while our unemployment rate remains low. Inflation bears careful watching, but I think we can keep it under control. Our banks are strong, our currency is sound and our sovereign credit position is in the international top tier. Consumer caution, while certainly making life hard for retailers, is building resilience in household balance sheets. And corporate balance sheets remain in quite good shape. If we are entering another period of weaker international conditions, then I think that is a pretty good starting point from which to do so.[12]

10 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

11 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.

12 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 3.

Forecasts for the economy

Forecasts for the global economy

2.12 The global economy continues to expand, though the rate of growth has begun to slow. This slow-down reflects supply-chain difficulties resultant from the Japanese earthquake. The International Monetary Fund's (IMF) central forecast for 2011 and 2012 is for above-average growth across the world economy. The IMF also expects growth in Australia's principal trading partners will be well above average.[13] Growth in China remains high, while growth in the rest of Asia (with the exception of Japan) remains substantial. This growth has sustained high prices for commodities, which in turn has had a distinctly inflationary effect.

2.13 The global economy faces risks from sovereign debt problems in the United States and Europe. In the US, net government debt is at its highest level since 1955.[14] The RBA noted that 'notwithstanding the recent agreement to reduce government spending in conjunction with raising the debt ceiling, public debt in the United States is forecast to continue to rise as a share of GDP for some time yet.'[15]

2.14 Conditions vary greatly across Europe.[16] In northern Europe, Germany's output now exceeds pre-crisis levels. Output has recovered in France and the Netherlands, while growth in the United Kingdom is expected to pick up. Elsewhere, things are not as good: in Italy and Spain the recovery is less advanced than in the leading economies, while activity is depressed in Greece, Ireland and Portugal.[17] While the EU has provided financial assistance to countries in need, further structural reform will be needed.

2.15 Though there has been some fluctuation, global commodity prices remain high by historic standards. The IMF All Primary Commodities has increased by around 25 per cent since mid 2010. This has been possible because of demand from Asia. Global food prices have fallen recently, but remain higher than they were at their peak in 2008. This is fuelled by rising demand in developing countries, not least by changes in consumer references towards higher protein foods.[18] The price of Australian wool is

13 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 7.

14 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

15 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

16 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 13.

17 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 3.

18 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

now 75 per cent higher than a year ago which is caused by high demand from China and the Australian sheep flock being around its lowest level since early last century.[19]

Forecasts for the Australian economy

2.16 The RBA advised the committee that it expects that the year-ended CPI inflation rate will probably remain well above three per cent in the September quarter. From then on, it will decline, as the combined effect of Cyclone Yasi and the Queensland floods on food prices weakens.

Table 1 RBA Output growth and inflation forecasts, year-ended (a)

	Dec 2010	*June 2011*	*Dec 2011*	*June 2012*	*Dec 2012*	*June 2013*	*Dec 2013*
GDP	2.7	1¼	3¼	4½	3¾	3¾	3¾
Non-farm GDP	2.2	1	3¼	4½	3¾	3¾	3¾
CPI	2.7	3.6	3½	2½	3½	3¾	3¼
Underlying inflation	2¼	2¾	3¼	3	3¼	3¼	3¼
CPI inflation excl carbon price	2.7	3.6	3½	2½	3	3	3¼
Underlying inflation excl carbon price)	2¼	2¾	3¼	3	3	3	3¼

(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, August 2011, p.73.*

Table 2 RBA Output growth and inflation forecasts, year-average (a)

	2010	*2010/11*	*2011*	*2011/12*	*2012*	*2012/13*	*2013*
GDP growth	2.7	1¾	2	4	4½	3¾	3¾

(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, August 2011, p.73.*

2.17 Growth for 2011 has been revised downwards since the May *Statement*. This is the consequence of weaker recovery in coal production and a fall in consumer spending. The medium-term outlook is characterised by the role of resources-sector investment and growth in resource exports.

2.18 The RBA noted that longer term forecasting needed to engage with the underlying issues that drive economic growth, in particular productivity. The bank advises that:

19 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

> From a longer-term perspective, an important influence on both costs and GDP growth is the rate of improvement in productivity. Since around the mid 2000s, the growth in output has been accounted for by growth in factors of production. The slower productivity growth has been offset by the rise in the terms of trade, so that it has not led to a slowdown in the growth of real incomes in Australia. With the terms of trade expected to decline somewhat over the next few years as additional global commodity supply comes on line, a return to faster rates of productivity growth is likely to be required if living standards are to continue to rise at the average rate of the past two decades.[20]

Budget/fiscal stimulus

2.19 The committee was interested in whether there was an effective balance between fiscal and monetary policy. In particular, the Governor was asked on how critical a federal budget surplus is and its impact on monetary settings.[21]

2.20 The Governor responded by explaining that monetary policy was made in response to developments, which may work to one or other result, but essentially it is the government's responsibility to set fiscal policy. The RBA does not pre-empt the success or failure of budget measures, but responds to evidence of what effect they have had on economic activity.

2.21 Pressed further on his views as to what would be the best fiscal settings to ensure that there is not undue upward pressure on demand, the Governor insisted that this was not a straightforward question, as an answer would involve a range of considerations, including the exchange rate.[22] The Governor stated:

> I think the key issues on the fiscal side are making sure we keep sound public finances over the medium term. You have to go back to balance and surplus, obviously, to do that. That has to be done...There were discretionary measures at the height of the crisis. In a crisis of that nature, that is fine. I think, though, that, absent crisis conditions, essentially devoting the fiscal side to issues of good structure of taxation, efficiency et cetera and sound

20 RBA, *Statement of Monetary Policy*, 4 August 2011, p. 15.

21 *Transcript*, 26 August 2011, p. 7.

22 *Transcript*, 26 August 2011, p. 7.

public finances in the long run, which has been the approach historically, is a good approach in normal times.[23]

Banking sector/savings/debt

2.22 In his opening remarks to the committee, the Governor noted 'that we have seen a significant change in household behaviour', namely a sustained rise in the rate of household savings.[24] He characterised this as a reversion to an old norm, whereby households save a greater than nominal proportion of their income and restrain the growth of debt. This observation was relevant to questions that had been raised by the committee at previous hearings, namely the issue of what might constitute a normal rate of savings. The committee again pursued this matter, asking the Governor what a normal savings rate would be. The Governor stated:

> It is hard to be doctrinaire about the optimal rate being X in theory. We should also take care with building very strong hypotheses on the saving rate per se, because it is inevitably not a very well measured aggregate—it is the residual... With that caveat in mind, I think what was not normal was for a saving rate to be zero in gross terms or negative in net terms. That is very unusual, historically. As to where it is now: I am not sure whether this is optimal, but it seems much more like saving performance that we would have observed through much of the post-war period. So in that sense it is more normal than what we were seeing.[25]

2.23 Picking up on a remark by the Governor that 'the rise in the rate of household savings is the biggest adjustment of its kind in the history of the quarterly national accounts', the committee asked the Governor to identify the positives and negatives inherent in this situation.[26] The Governor replied:

> The bad side is if you are a retailer coming off that 15-year period of gearing up, with falling savings and higher spending...[the good side is that] at some point people reach a stage where they are feeling, 'I don't really want more debt; maybe I really ought to be

23 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 7.
24 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 2.
25 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.
26 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.

> thinking about some saving out of current income for the future.' ...that is going to leave household finances in a stronger position. That is good because someday, if there is a downturn, you do not want households to be excessively exposed in terms of their leverage when there is an adverse shock to income...we are [also] having a very substantial investment pick-up in the economy in aggregate... we have an investment boom; it is actually not a bad thing to have some saving to help fund that. We do not have to fund it all ourselves; we can use the savings of foreigners—that is perfectly sensible.[27]

2.24 The committee was interested in identifying the causes behind the increased caution of Australian household consumers. The Governor referred to a recent speech that he had delivered to the Anika Foundation which had dealt with a number of the committee's concerns in a historical context.[28] He went on to explain that Australia had gone through a long period in which growth of spending exceeded growth of income every year on average by about a percentage point. Savings fell, leverage increased, housing prices rose, wealth rose – all because of the combined effects of financial liberalisation, an increased willingness of Australian banks to lend to households which were undergeared by international standards, a big decline in nominal interest rates and a fall in inflation from an average of eight percent to an average of two or three. This was compounded by international economic stability which provided low inflation, positive supply-side surprises and so on. In the Governor's words:

> That is a perfect environment for people to think it is sensible to have more debt: 'I can afford it, the bank wants to give it to me and so on.' There is nothing especially wrong with that, but when income and consumption do this sooner or later they are going to go back to parallel, which is roughly what they have done...[29]

2.25 The committee was interested in establishing what Australia needed to do to support further the stability of the financial system. Asked directly by the committee what policy issues need to be addressed, the Governor advised that a great deal of work has already been done internationally to address financial sector stability. The foundation for such stability is more

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27 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 4.

28 Mr Glenn Stevens, *The Cautious Consumer*, an address to the Anika Foundation Luncheon, Sydney, 26 July, 2011. This is available electronically at: http://www.rba.gov.au/speeches/2011/sp-gov-260711.html

29 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 10.

and better quality capital; the problem had been that large global banks had been very highly leveraged and undercapitalised. The Basel 3 initiatives, which Australia will implement, will address this matter. There is a also a range of work on increasing the strength of financial infrastructure to process the clearance of derivatives and related financial instruments. Work is already underway on this under the auspices of the Council of Financial Regulators. The central issue is whether we ought to mandate central clearing of certain instruments onshore or allow them to be established offshore.

2.26 The Governor elaborated further, explaining 'that the fundamentals ultimately matter most' and these included good prudential supervision, which we have through APRA and ASIC.[30] Summing up the situation of the Australian financial sector in a positive note, the Governor stated:

> [Australian] banks are pretty well capitalised. The consumer balance sheets...are coming into better shape too...while we do not want to say that nothing would bother us, I think that perhaps we have a stronger position than we had a few years back.[31]

Carbon

2.27 The committee was interested in the implications of the carbon pricing mechanism for monetary policy and requested that the Governor explain the possible implications for monetary policy. The Governor explained that the RBA perceived the carbon price as 'a public policy intervention...to achieve a particular outcome', similar to the GST, which raised the price level.[32] The RBA believe that such interventions are not the same thing as regular inflation and that it was not appropriate to tighten monetary policy in response to such things.

2.28 The Governor elaborated further by stating that, 'the key thing will be to make sure that there are not ongoing significantly higher inflation rates resulting from that'.[33] So long as there were not, monetary policy would not have to change. He also stated that 'it is to be hoped that that is the outcome here'.[34]

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30 Mr Glenn Stevens, Governor of the RBA, *Transcript,* 26 August 2011, p. 12.

31 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 12.

32 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

33 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

34 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

2.29 Pressed further by the committee, which referred to claims in the public arena made by third parties about the reputed views of the RBA on the likely impact of the proposed carbon price on the rate of inflation, the Governor dismissed the matter in its entirety:

> What we [the RBA] do not do is get into political debates over particular policies. What we do is keep focused on articulating our expectations and also monitoring actual measures of inflation expectations...Ultimately people will see what the effect is and then it will be clear. It is only another year or so.[35]

Productivity

2.30 The issue of productivity was examined in a variety of different contexts. The committee sought the RBA's opinion on why productivity growth has slowed since the mid 2000s. The Governor answered that productivity growth in Australia had indeed slowed, just as it appears to have done in a number of countries and that the problem was evident in the bulk of Australian industries. He stated that the impetus for productivity gains weakened during good times and that:

> ...the period of maximum focus on productivity-enhancing measures and reforms was really in the period when the banana republic issues were being debated. There was not any alternative; we felt we had to do it and we did do it...the thing we have rarely done is to try to work on improving productivity materially when the terms of trade are high, but if we could do that it would be a fabulous way to take advantage of the opportunities we have.[36]

2.31 The committee was also interested in the Governor's views about the possible relationship between the trimming of productivity growth and variations in the non-accelerating inflation rate of unemployment (NAIRU). The Governor replied that:

> In terms of demand versus supply inflation if you take as your starting point that there has been a material slowdown in productivity—if that is so—that is really saying in a way that the economy's capacity to supply the demand that we want to have is not what it used to be...What businesspeople say to me... is not so much that wages are excessive and indeed at this point in time the

35 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

36 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 19.

> aggregate data on wage growth which is probably fourish, a touch under maybe, is on a par with what we have seen over the years. What people say to me, I cannot verify it obviously, from their individual businesses is that they find it harder to negotiate flexibility. That is something that is said. If that is true that I think is a matter for concern.[37]

2.32 The committee, however, scrutinised the Governor over whether it was sensible to rely on anecdotal evidence in making conclusions about workplace flexibility. It was noted that the Australian workforce has demonstrated considerable flexibility over the last decade and that Australians work more hours in than just about any other OECD country. The Governor responded by saying that he had simply reported back on what he had been told and that: 'I would be the first to say that I do not have a rigorous study which can quantify whether that is material or not'.[38]

Terms of trade/two speed economy

2.33 The committee explored the terms of trade issue, seeking the RBA's advice on the benefits that the favourable terms of trade is bringing to Australians. In particular, the committee sought the RBA's advice on the benefits the mining boom has for other sectors of the economy. The Governor stated:

> National income is higher...about half of that higher terms of trade revenue stays in Australia one way or another, be it through employment or profits that go into people's equity holdings, super funds, revenues to government and so on.[39]

2.34 Dr Lowe expanded on this, explaining that the RBA has researched this issue over the past decade.[40] This research has found that for every dollar of extra revenue Australia receives from the resources sector about 10c is spent on domestic labour, 25c on buying domestic services and imports into the resources sector, somewhere between 15c and 20c goes to the state via royalties or taxation and somewhere between 5c and 10c goes to the domestic holders of the shares of the mining company. Added together,

37 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 8.

38 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 18.

39 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 5.

40 Dr Philip Lowe, Assistant Governor, Economic Group, RBA, *Transcript*, 26 August 2011, p. 5.

somewhere between 50c and 60c of every extra dollar of income that comes into the country is retained by Australians in one form or another.

2.35 The issue of the two-speed economy and regional growth was examined. In particular, the Governor was asked about the impact of monetary policy on regional economies and on industries such as manufacturing?'[41] The Governor explained that:

> ...issues of structural adjustment...are difficult. Some parts of the economy will shrink while others grow....I do not think monetary policy can stop that occurring...We do not have an instrument that can prevent these shifts in the structure of the economy from occurring. I am sorry but I think that is just the reality.[42]

2.36 The committee was also interested in the implications of the two-speed economy for managing inflation. The committee posed the question that if inflation was being driven by that 25 per cent of the economy experiencing a 15 or 16 per cent rate of growth (the resources sector), while the rest of the economy is growing at one per cent, what would be the best tool to curb inflation? [43]

2.37 The Governor dismissed quantitative easing as a solution because this was an easing of policy which would be expected to increase inflation. The Governor went on to explain that were we to look at the 100,000 prices that are in the CPI, mining is not pushing up most of them directly. Instead, there is evidence that accounts for inflation in other sectors, such as utilities. Consequently, the Governor declared that he did not 'accept that all the inflation is in fact coming just out of mining' and that 'were it not for the high exchange rate, I think we would have more of this'.[44]The RBA explained that 'the underlying inflation pressures in the economy are really coming from this combination of relatively weak productivity growth and around average wage growth'.[45] This inflationary pressure has been offset by decline in prices for manufactured goods, many of which are now lower than they were a decade ago.

2.38 The committee was interested in exploring if there was a connection between the mining boom and the increasing gap between rich and poor that has been evident for several decades past. The committee referred to a paper delivered at a recent RBA conference that showed that wage growth

41 *Transcript*, 26 August 2011, p. 17.

42 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 17.

43 *Transcript*, 26 August 2011, p. 8

44 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 8.

45 Dr Philip Lowe, Assistant Governor, Economic Group, RBA, *Transcript*, 26 August 2011, p. 8.

over the last decade for the top quintile of wage earners had been twice as fast as for the bottom. In view of this, the Governor was asked whether the RBA targets the average dollar in Australia or the average person.[46]

2.39 The Governor explained that the RBA sought to contain the growth in the CPI to between two and three per cent per annum. In essence, the RBA was attempting to 'preserve the purchasing power of money, and not particularly the purchasing power of the money of the richest or the poorest but the total'.[47] Following further questions about the RBA's mandate concerning growth and full employment and the relative importance of the average person as compared to the average dollar, the Governor stated categorically that:

> My answer to the full employment question would be: I think the bank has fulfilled that side of its mandate, recognising of course that a sustainable unemployment rate ultimately is a function of industrial relations matters, not monetary policy.[48]

Payments system

2.40 The committee sought an update on developments with the payments system.[49] In particular, the committee sought advice on possible concerns about an erosion of competition between the four-party and three-party schemes since the last round of regulation. The Governor replied that it would be premature to provide too much detail on this matter as there is a review occurring.[50] The Governor noted, however, that the Payments System Board was aware of the comparison, and that the four-party schemes make the point that the three-party ones are not subject to the same degree of regulation.

2.41 The Governor also advised that he thought it best if such questions were addressed as part of wider discussion that not only covered interchange

46 *Transcript*, 26 August 2011, pp. 8-9. The paper in question is Jeff Borland's, 'The Australian labour market in the 2000s: The quiet decade', which was presented at the RBA's conference *The Australian Economy in the 2000s*, 15-16 August 2011; the paper is available at http://www.rba.gov.au/publications/confs/2011/borland.pdf.

47 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

48 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 9.

49 For an accessible introduction to the Australian payments system, see the RBA's web page on this, which is available at: http://www.rba.gov.au/payments-system/about.html.

50 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

regulation, but also surcharging, which is currently being reviewed by the RBA. The RBA will develop a considered opinion in due course.[51]

2.42 When asked directly if, with the benefit of hindsight, it might have been a mistake to have regulated only part of the market, the Governor replied that he would not draw that conclusion. He noted that there are no interchange fees in the three party schemes, 'so if you are regulating interchange fees there is not one to regulate there.'[52]

2.43 Dr Lowe explained that the relative price of using credit or debit cards has changed, so that consumers are no longer charged when we use a debit card, whereas some consumers had been charged. Consumers are becoming more cautious, in that people now prefer debit over credit, while many of the rewards that consumers used to get from using credit cards have diminished and the cost they pay for using debit cards has disappeared. The purpose of the reforms was to use price signals to get people to make choices based on underlying costs, rather than distortions arising from the interchange system. Summing the effect of the reforms, Dr Lowe noted that 'broadly speaking, that has worked.'[53]

2.44 The committee pursued the issue of how best to manage the payments systems, asking the Governor which option he thought best, more or less regulation? The Governor answered by stating that for less regulation, we would first require evidence that competition within the system has increased, because the payment system board's mandate is efficiency, but also competition. If we could find clear evidence that we have competition between card schemes and between competing payment mechanisms or both, that is the minimum precondition needed for less intrusive regulation. So far, it is not clear that we do see enough competition. In conclusion, the Governor stated that: 'I think if we took our hands off the interchange now the interchange fees would just go back up and we would be back to the situation...that we were trying to move away from.'[54]

51 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

52 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 21.

53 Dr Philip Lowe, Assistant Governor, Economics Group, RBA, *Transcript*, 26 August 2010, p. 21.

54 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 22.

Governance

RBA executive remuneration

2.45 The committee noted that the Governor and others had made statements about the importance of pay being strongly related to productivity, which in turn had led to public comment on the salaries of Reserve Bank officials.[55] The committee sought the Governor's views on Reserve Bank salaries and the relativities between RBA salaries and other central banks. The Governor stated:

> I am not sure I can help much there. I do not set my own pay. The board set it. They had quite a lengthy process of reviewing it after the system had been in place for many years. They took their decision, and I take what I am given, like anyone else in the country. I am not able to give you the whys and wherefores of whether that was an appropriate decision. I did not take it. I had no involvement in it. [56]

Securency and Note Printing Australia

2.46 At the previous public hearing on 11 February 2011, the RBA was scrutinised on bribery allegations surrounding Securency and Note Printing Australia. At that hearing, the Governor confirmed that the first time the RBA became aware of bribery allegations in relation to the agents of Securency was around May 2009. At the most recent August public hearing, the RBA reconfirmed this advice.[57]

2.47 As part of the current hearing, the committee scrutinised the RBA in detail on the timeline and the actions that were taken by the RBA Board and the Boards of Securency and Note Printing.[58] In particular, it was noted that allegations about Note Printing were made in May 2007. The RBA confirmed that the Board of Note Printing received a paper about the need for stronger policies for agents. The RBA stated:

> So, as a result of that meeting in May [2007], the board of NPA said that there were issues about bad business practices in relation

55 *Transcript*, 26 August 2011, p. 10.
56 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 10.
57 Mr Glenn Stevens, Governor of the RBA, *Transcript*, 26 August 2011, p. 12.
58 *Transcript*, 26 August 2011, p. 10.

> to the agents and things like that, so they took some fairly hard decisions. They said, 'Look we want to stop the use of agents.'[59]

2.48 In addition, the RBA advised that the NPA board commissioned an audit into the use of agents. The audit found that the NPA board 'should undertake an investigation to make sure that no Australia laws had been breached.'[60] The NPA board commissioned Freehills to investigate whether any laws had been broken. The RBA reported that 'the investigation concluded that there was no evidence of any Australian laws being broken, and the NPA board at that point drew a line under it.'[61] The committee scrutinised the RBA on this citing an *Age* newspaper article that the audit report contained prima facie evidence of illegal conduct by an agent of a subsidiary. The RBA repeated its advice that an independent legal firm found 'that there was no evidence of any breach of Australian law.'[62]

2.49 The committee sought advice on what measures were taken in relation to agents used by Securency. The RBA advised that an audit in 2007 was done of Securency's use of agents which 'came back as a very sound audit with very few findings.'[63] However, the RBA reported that KPMG undertook 'a very forensic audit' of Securency after allegations were raised in 2009. During this period, Securency also stopped using agents. The RBA stated:

> It was around late 2009. At that point the KPMG audit investigation was still continuing, but they brought to the attention of the Securency board some information which they felt showed that the management had not been honest with the board and had been withholding information from the board. At that point the board of Securency terminated or suspended the management and suspended the use of agents.[64]

2.50 The RBA was asked if KPMG were given the RBA audit and the Freehills report, to which the RBA replied 'yes.'[65] However, after the hearing the RBA sought to clarify this advice and, in a submission dated 29 August 2011, stated:

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59 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
60 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
61 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 13.
62 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 15.
63 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 14.
64 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 16.
65 Mr Ric Battellino, Deputy Governor of the RBA, *Transcript*, 26 August 2011, p. 15.

> The specifics of the information given to KPMG are as follows: They were given access to all documents of Securency, including the two audit reports undertaken by the RBA's internal audit department. They were also briefed that the recommendations of the NPA audit was that the company should cease the use of agents and were given access to the team that undertook that audit (which was also the team that undertook the Securency audits). KPMG were told of the Freehills report and briefed on its conclusions but, as this was not a document of Securency, they were not given a copy of it.[66]

2.51 The RBA advised that the police have been provided with the audit reports and the Freehills report and 'these are matters before the courts.'

2.52 The committee will have an opportunity to seek an update from the RBA at the next hearing which will be scheduled in February 2012.

66 Reserve Bank of Australia, *Submission 1*, p. 1.

Conclusion

2.53 During a time of widespread uncertainty in global markets and recurrent anxiety about significant portions of the financial sector in many of the most advanced countries, Australia continues to enjoy the fruits of years of sound economic governance, not least of which is its monetary policy and very well regulated banking sector.

2.54 The recovery from Cyclone Yasi and the devastating Queensland floods has begun, albeit at a marginally slower pace thanks to external shocks (such as the Japanese earthquake) and domestic developments (the slower than expected drainage of Queensland coal mines)

2.55 Monetary policy remains on track to meet the goals of its long-standing policy of maintaining inflation within the 2 to 3 per cent band over the medium-term.

Julie Owens MP
Chair
2 November 2011